FEDERAL TAX REGULATIONS

1989

Volume 2

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FEDERAL

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THESE VOLUMES

The 1989 Federal Tax Regulations comprise the thirty-sixth in the annual series. The series preserves in permanent form, the regulations promulgated by the Treasury Department that interpret statutory provisions relating to income, estate, gift, and employment taxes, that illustrate methods of compliance, and that govern practice before the Internal Revenue Service. The regulations are codified in Code of Federal Regulations, Title 26—Internal Revenue, or Title 31—Money and Finance, and the Internal Revenue Code references are identical to 26 U.S.C.A. sections.

These volumes contain regulations adopted through December 31, 1988. Changes through October 31, 1988 are incorporated in the principal text. Later changes are covered in the "Last Minute Regulations" at the end of Volume 4.

New Material

These volumes contain regulations adopted or amended in 1988 covering amendments, additions and repeals made by the Tax Reform Act of 1986 (Pub.L. 99–514, Oct. 22, 1986, 100 Stat. 2085) and subsequent legislation to the United States Code. The Tax Reform Act of 1986 was enacted by the 99th Congress, Second Session, to revise the tax laws of the United States and represents the most comprehensive revision of those laws in over thirty years.

Keeping Regulations to Date

Changes made during 1989 in the regulations appearing in these volumes will appear in U.S. CODE CONGRESSIONAL AND ADMINISTRATIVE NEWS pamphlets. A cumulative Table of Sections Affected appears in each U.S. CODE CONGRESSIONAL AND ADMINISTRATIVE NEWS pamphlet.

THE PUBLISHER

February, 1989

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TABLE OF CONTENTS

Volume 1

TITLE 26—INTERNAL REVENUE, 1986
CODE OF FEDERAL REGULATIONS

Chapter 1—Internal Revenue Service, Department of the Treasury
Subchapter A—Income Tax

Volume 1—Continued

Volume 2

Volume 2—Continued

TABLE OF CONTENTS

Volume 3

Volume 3—Continued

Part 1. Income Tax; Taxable Years Beginning after December 31, 1953—Continued

Volume 4

Volume 4—Continued

Subchapter B—Estate and Gift Taxes

Subchapter C—Employment Taxes

Volume 4—Continued

Part 31. Employment Taxes and Collection of Income Tax At Source—Continued

Subchapter F—Procedure and Administration

Part 301. Procedure and Administration

Volume 4—Continued

Volume 4—Continued

Subchapter H—Internal Revenue Practice

Volume 4—Continued

Part 601. Statement of Procedural Rules—Continued

TREASURY DEPARTMENT REGULATIONS
CODE OF FEDERAL REGULATIONS

TITLE 31—MONEY AND FINANCE

Part 10. Practice Before the Internal Revenue Service

FEDERAL TAX REGULATIONS 1989

IN FORCE JANUARY 1, 1989

(See also the Last Minute Federal Tax Regulations at the end of Volume 4 for changes through December 31, 1988.)

INCOME TAX REGULATIONS

CODE OF FEDERAL REGULATIONS

TITLE 26—INTERNAL REVENUE, 1986

Chapter 1—Internal Revenue Service
Department of the Treasury

SUBCHAPTER A—INCOME TAX

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

For complete Analysis see Volume 1, page 1

Text of sections 1.401 to 1.860
appears in this volume

§ 1.381(a)–1 General rule relating to carryovers in certain corporate acquisitions.

(a) Allowance of carryovers. Section 381 provides that a corporation which acquires the assets of another corporation in certain liquidations and reorganizations shall succeed to, and take into account, as of the close of the date of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation. These items shall be taken into account by the acquiring corporation subject to the conditions and limitations specified in sections 381, 382(b), and 383 and the regulations thereunder.

(b) Determination of transactions and items to which section 381 applies—(1) Qualified transactions. Except to the extent provided in section 381(c)(20), relating to the carryover of unused pension trust deductions in certain liquidations, the items described in section 381(c) are required by section 381 to be carried over to the acquiring corporation (as defined in subparagraph (2) of this paragraph) only in the following liquidations and reorganizations:

(i) The complete liquidation of a subsidiary corporation upon which no gain or loss is recognized in accordance with the provisions of section 332, but only if the basis of the assets distributed to the acquiring corporation is not required by section 334(b)(2) to be the adjusted basis of the stock with respect to which the distribution is made;

(ii) A statutory merger or consolidation qualifying under section 368(a)(1)(A) to which section 361 applies;

(iii) A reorganization qualifying under section 368(a)(1)(C);

(iv) A reorganization qualifying under section 368(a)(1)(D) if the requirements of section 354(b)(1)(A) and (B) are satisfied; and

(v) A mere change in identity, form, or place of organization qualifying under section 368(a)(1)(F).

(2) Acquiring corporation defined. (i) Only a single corporation may be an acquiring corporation for purposes of section 381 and the regulations thereunder. The corporation which acquires the assets of its subsidiary corporation in a complete liquidation to which section 381(a)(1) applies is the acquiring corporation for purposes of section 381. Generally, in a transaction to which section 381(a)(2) applies, the acquiring corporation is that corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation. If, in a transaction qualifying under section 381(a)(2), no one corporation ultimately acquires all of the assets transferred by the transferor corporation, that corporation which directly acquires the assets so transferred shall be the acquiring corporation for purposes of section 381 and the regulations thereunder, even though such corporation ultimately retains none of the assets so transferred. Whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all the facts and circumstances.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). Y Corporation, a wholly-owned subsidiary of X Corporation, directly acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Y Corporation is the acquiring corporation for purposes of section 381.

Example (2). X Corporation acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred all the assets so acquired to Y Corporation, its wholly-owned subsidiary (see section 368(a)(2)(C)). Y Corporation is the acquiring corporation for purposes of section 381.

Example (3). X Corporation acquired all the assets of Z Corporation solely in exchange for the voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred one-half of the assets so acquired to Y Corporation, its wholly-owned subsidiary, and retained the other half of such assets. X Corporation is the acquiring corporation for purposes of section 381.

Example (4). X Corporation acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred one-half of the assets so acquired to Y Corporation, its wholly-owned subsidiary, and the other half of such assets to M Corporation, another wholly-owned subsidiary of X

Corporation. X Corporation is the acquiring corporation for purposes of section 381.

(3) **Transactions and items not covered by section 381.** (i) Section 381 does not apply to partial liquidations, divisive reorganizations, or other transactions not described in subparagraph (1) of this paragraph. Moreover, section 381 does not apply to the carryover of an item or tax attribute not specified in subsection (c) thereof. In a case where section 381 does not apply to a transaction, item, or tax attribute by reason of either of the preceding sentences, no inference is to be drawn from the provisions of section 381 as to whether any item or tax attribute shall be taken into account by the successor corporation.

(ii) If, pursuant to the provisions of subparagraph (2) of this paragraph, a corporation is considered to be the acquiring corporation even though a part of the acquired assets is transferred to one or more corporations controlled by the acquiring corporation, or all the acquired assets are transferred to two or more corporations controlled by the acquiring corporation, then the carryover of any item described in section 381(c) to such controlled corporation or corporations shall be determined without regard to section 381. Thus, for example, if a parent corporation is the acquiring corporation for purposes of section 381 notwithstanding the fact that, pursuant to the plan of reorganization, it transferred to its wholly-owned subsidiary property acquired from the transferor corporation which the transferor corporation had elected to inventory under the last-in first-out method, then the question whether the subsidiary corporation shall continue to use the same method of inventorying with respect to that property shall be determined without regard to section 381.

(c) **Foreign corporations.** A foreign corporation may be a distributor, transferor, or acquiring corporation for purposes of section 381. Thus, for example, the net operating loss carryovers of a foreign corporation, determined under the provisions of section 172 and subchapter N (section 861 and following), chapter 1 of the Code, may be carried over to a domestic acquiring corporation if the domestic corporation acquires the assets of the foreign corporation in a liquidation or reorganization described in section 381(a) and the requirements of § 1.367-1, if applicable, have been complied with.

(d) **Internal Revenue Code of 1939.** Any reference in the regulations under section 381 to any provision of the Internal Revenue Code of 1954 shall, where appropriate, be deemed also to refer to the corresponding provision of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7343, 40 FR 1698, Jan. 9, 1975]

§ 1.381(b)-1 Operating rules applicable to carryovers in certain corporate acquisitions.

(a) **Closing of taxable year—(1) In general.** Except in the case of a reorganization qualifying under section 368(a)(1)(F), the taxable year of the distributor or transferor corporation shall end with the close of the date of distribution or transfer.

(2) **Reorganizations under section 368(a)(1)(F).** In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

(b) **Date of distribution or transfer.** (1) The date of distribution or transfer shall be that day on which are distributed or transferred all those properties of the distributor or transferor corporation which are to be distributed or transferred pursuant to a liquidation or reorganization described in paragraph (b)(1) of § 1.381(a)-1. If the distribution or transfer of all such properties is not made on one day, then, except as provided in subparagraph (2) of this paragraph, the date of distribution or transfer shall be that day on which the distribution or transfer of all such properties is completed.

(2) If the distributor or transferor and acquiring corporations file the statements described in subparagraph (3) of this paragraph, the date of distribution or transfer shall be that day as of which (i) substantially all of the properties to be distributed or transferred have been distributed or transferred, and (ii) the distributor or transferor corporation has ceased all operations (other than liquidating

activities). Such day also shall be the date of distribution or transfer if the completion of the distribution or transfer is unreasonably postponed beyond the date as of which substantially all the properties to be distributed or transferred have been distributed or transferred and the distributor or transferor corporation has ceased all operations other than liquidating activities. A corporation shall be considered to have distributed or transferred substantially all of its properties to be distributed or transferred even though it retains money or other property in a reasonable amount to pay outstanding debts or preserve the corporation's legal existence. A corporation shall be considered to have ceased all operations, other than liquidating activities, when it ceases to be a going concern and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance of its money or other properties to its shareholders.

(3) The statements referred to in subparagraph (2) of this paragraph shall specify the day considered to be the date of distribution or transfer and shall specify, as of such date (i) the nature and amount of the total assets which were distributed or transferred and the dates so distributed or transferred, (ii) the nature and amount of the assets not distributed or transferred and the purpose for which they were retained, and (iii) the date on which the distributor or transferor corporation ceased all operations other than liquidating activities. Such statements shall be attached to the timely filed income tax return of the distributor or transferor corporation for its taxable year ending with such date of distribution or transfer and to the timely filed income tax return of the acquiring corporation for its first taxable year ending after such date, except that, with respect to any income tax return filed before October 11, 1960, any such statement shall be filed before October 11, 1960, with the district director with whom such return is filed.

(4) If—

(i) The last day of the acquiring corporation's taxable year is a Saturday, Sunday, or legal holiday, and

(ii) The day specified in subparagraph (1) or (2) of this paragraph as the date of distribution or transfer is the last business day before such Saturday, Sunday, or holiday,

then the last day of the acquiring corporation's taxable year shall be the date of distribution or transfer for purposes of section 381(b) and this section. For purposes of this subparagraph, the term "business day" means a day which is not a Saturday, Sunday, or legal holiday, and also means a Saturday, Sunday, or legal holiday if the date of distribution or transfer determined under subparagraph (1) or (2) of this paragraph is such Saturday, Sunday, or holiday.

(c) Return of distributor or transferor corporation. The distributor or transferor corporation shall file an income tax return for the taxable year ending with the date of distribution or transfer described in paragraph (b) of this section. If the distributor or transferor corporation remains in existence after such date of distribution or transfer, it shall file an income tax return for the taxable year beginning on the day following the date of distribution or transfer and ending with the date on which the distributor or transferor corporation's taxable year would have ended if there had been no distribution or transfer.

(d) Carryback of net operating losses. For provisions relating to the carryback of net operating losses of the acquiring corporation, see paragraph (b) of § 1.381(c)(1)–1.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960]

§ 1.381(c)(1)–1 Net operating loss carryovers in certain corporate acquisitions.

(a) Carryover requirement. (1) Section 381(c)(1) requires the acquiring corporation to succeed to, and take into account, the net operating loss carryovers of the distributor or transferor corporation. To determine the amount of these carryovers as of the close of the date of distribution or transfer, and to integrate them with any carryovers and carrybacks of the acquiring corporation for purposes of determining the taxable income of the acquiring corporation for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of section 172 in accordance with the conditions and limitations of section 381(c)(1) and this section. See also section 382(b) and the regulations thereunder.

(2) The net operating loss carryovers and carrybacks of the acquiring corporation determined as of the close of the date of distribution or transfer shall be computed without reference to any net operating loss of a distributor or transferor corporation. The net operating loss carryovers of a distributor or transferor corporation as of the close of the date of distribution or transfer shall be determined without reference to any net operating loss of the acquiring corporation.

(3) For purposes of the tax imposed under section 56, the acquiring corporation succeeding to and taking into account any net operating loss carryovers of the distributor or transferor corporation shall also succeed to and take into account along with such net operating loss carryforward any deferred tax liability under section 56(b) and the regulations thereunder attributable to such net operating loss carryover.

(b) **Carryback of net operating losses.** A net operating loss of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall not be carried back in computing the taxable income of a distributor or transferor corporation. However, a net operating loss of the acquiring corporation for any such taxable year shall be carried back in accordance with section 172(b) in computing the taxable income of the acquiring corporation for a taxable year ending on or before the date of distribution or transfer. If a distributor or transferor corporation remains in existence after the date of distribution or transfer, a net operating loss sustained by it for any taxable year beginning after such date shall be carried back in accordance with section 172(b) in computing the taxable income of such corporation for a taxable year ending on or before that date, but may not be carried back or over in computing the taxable income of the acquiring corporation. This paragraph may be illustrated by the following examples:

Example (1). On December 31, 1954, X Corporation merged into Y Corporation in a statutory merger to which section 361 applies, and the charter of Y Corporation continued after the merger. Y Corporation sustained a net operating loss for the calendar year 1955. Y Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation but shall be carried back in computing the taxable income of Y Corporation.

Example (2). On December 31, 1954, X Corporation and Y Corporation transferred all their assets to Z Corporation in a statutory consolidation to which section 361 applies. Z Corporation sustained a net operating loss for the calendar year 1955. Z Corporation's net operating loss for 1955 may not be carried back in computing the taxable income of X Corporation or Y Corporation.

Example (3). On December 31, 1954, X Corporation ceased all operations (other than liquidating activities) and transferred substantially all its properties to Y Corporation in a reorganization qualifying under section 368(a)(1)(C). Such properties comprised all of X Corporation's properties which were to be transferred pursuant to the reorganization. In the process of liquidating its assets and winding up its affairs, X Corporation sustained a net operating loss for its taxable year beginning on January 1, 1955. This net operating loss of X Corporation shall be carried back in computing the taxable income of that corporation but may not be carried back or over in computing the taxable income of Y Corporation.

(c) **First taxable year to which carryovers apply.** (1) The net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall first be carried to the first taxable year of the acquiring corporation ending after that date. This rule applies irrespective of whether the date of distribution or transfer is on the last day, or any other day, of the acquiring corporation's taxable year. Thus, such net operating loss carryovers shall first be used by the acquiring corporation with respect to the computation of its net operating loss deduction under section 172(a), and its taxable income determined under the provisions of section 172(b)(2), for such first taxable year. However, see paragraph (f) of this section.

(2) The net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall be carried to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation. Thus, if a parent corporation owning 80 percent of all classes of stock of its subsidiary corporation were to acquire its share of the assets of the subsidiary corporation upon a complete liquidation described in paragraph (b)(1)(i) of § 1.381(a)–1, then, subject to the conditions and limitations of this section, 100 percent of the net operating loss carryovers available to the subsidiary corporation as of the close of the date of distribution would be carried over to the parent corporation.

(d) **Limitation on net operating loss deduction for first taxable year ending after date of distribution or transfer.** (1) That part of the acquiring corporation's net operating loss deduction, determined in accordance with sections 172(a) and 381(c)(1), for its first taxable year ending after the date of distribution or transfer which is attributable to the net operating loss carryovers of the distributor or transferor corporation, is limited by section 381(c)(1)(B) and this paragraph to an amount equal to the acquiring corporation's postacquisition part year taxable income. Such postacquisition part year taxable income is the amount which bears the same ratio to the acquiring corporation's taxable income for the first taxable year ending after the date of distribution or transfer (determined under section 63 without regard to any net operating loss deduction but taking into account other items to which the acquiring corporation succeeds under section 381) as the number of days in such first taxable year which follow the date of distribution or transfer bears to the total number of days in such taxable

year. Thus, if the date of distribution or transfer is the last day of the acquiring corporation's taxable year, the net operating loss carryovers of the distributor or transferor are allowed in full in computing under section 172(a) the net operating loss deduction of the acquiring corporation for its first taxable year ending after that date. In such instance, the number of days in the first taxable year which follow the date of distribution or transfer is the total number of days in such taxable year.

(2) The limitation provided by section 381(c)(1)(B) applies solely for the purpose of computing the net operating loss deduction of the acquiring corporation under section 172(a) for the acquiring corporation's first taxable year ending after the date of distribution or transfer. The limitation does not apply for purposes of determining the portion of any net operating loss (whether of the distributor, transferor, or acquiring corporation) which may be carried to any taxable year of the acquiring corporation following its first taxable year ending after the date of distribution or transfer since such determination is made pursuant to section 172(b) and section 381(c)(1)(C). See paragraphs (e) and (f) of this section.

(3) The limitation provided by section 381(c)(1)(B) shall be applied to the aggregate of the allowable net operating loss carryovers of the distributor or transferor corporation without reference to the taxable years in which the net operating losses were sustained by such corporation. If the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, then the limitation provided by section 381(c)(1)(B) shall be applied to the aggregate of the net operating loss carryovers from all of such distributor or transferor corporations.

(4) If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more different dates of distribution or transfer within one taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(1)(B) to the aggregate of such carryovers shall be governed by the rules prescribed in paragraph (b) of § 1.381(c)(1)–2.

(5) Illustrations. The application of this paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation and Y Corporation were organized on January 1, 1956, and make their returns on the calendar year basis. On December 16, 1957, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and taxable income (computed without the net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1956	($35,000)	($5,000)
Ending 12–16–57	(30,000)	xxx
1957	xxx	36,500

(ii) The aggregate of the net operating loss carryovers of X Corporation carried under section 381(c)(1)(A) to Y Corporation's taxable year ending December 31, 1957, is $65,000; but pursuant to section 381(c)(1)(B), only $1,500 of such aggregate amount ($\$36{,}500 \times {}^{15}\!/_{365}$) may be used in computing the net operating loss deduction of Y Corporation for such taxable year under section 172(a). This limitation applies even though Y Corporation's own net operating loss carryover to such year is only $5,000, with the result that Y Corporation has taxable income under section 63 of $30,000 for its taxable year ending December 31, 1957, that is, $36,500 less the sum of $5,000 and $1,500.

(iii) For rules determining the portion of any given loss of X Corporation or Y Corporation which may be carried to a taxable year of Y Corporation following its taxable year ending December 31, 1957, see sections 172(b)(2) and 381(c)(1)(C) and paragraph (f) of this section.

Example (2). (i) X Corporation was organized on January 1, 1954, and Y Corporation was organized on January 1, 1956. Each corporation makes its return on the basis of the calendar year. On December 31, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($5,000)	xxx
1955	(15,000)	xxx
1956	(10,000)	$20,000
1957	xxx	40,000

(ii) The aggregate of the net operating loss carryovers of X Corporation carried under section 381(c)(1)(A) to Y Corporation's taxable year 1957 is $30,000, and the full amount of such carryovers is allowed in such taxable year to Y Corporation as a deduction under section 172(a), since such amount does not exceed the limitation ($40,000 × 365/365) for such taxable year under section 381(c)(1)(B).

Example (3). (i) X Corporation, Y Corporation, and Z Corporation were organized on January 1, 1954, and each corporation makes its return on the basis of the calendar year. On September 30, 1956, X Corporation and Y Corporation transferred all their assets to Z Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the three corporations are as follows, the

assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (transferor)	Z Corporation (acquirer)
1954	($5,000)	($3,000)	($40,000)
1955	(4,000)	(2,000)	10,000
Ending 9–30–56	(1,000)	(9,000)	xxx
1956	xxx	xxx	73,200

(ii) The aggregate of the net operating loss carryovers of X Corporation and Y Corporation carried under section 381(c)(1)(A) to Z Corporation's taxable year 1956 is $24,000; but, pursuant to section 381(c)(1)(B), only $18,400 of such aggregate amount ($73,200 × 92/366) may be used in computing the net operating loss deduction of Z Corporation for such taxable year under section 172(a). For this purpose, Z Corporation may not use the total of the aggregate carryovers ($10,000) from X Corporation plus the aggregate carryovers ($14,000) from Y Corporation, even though each such aggregate of carryovers is separately less than the limitation ($18,400) applicable under section 381(c)(1)(B) and this section.

(iii) For rules determining the portion of any given loss of X Corporation, Y Corporation, or Z Corporation which may be carried to a taxable year of Z Corporation following its taxable year ending December 31, 1956, see sections 172(b)(2) and 381(c)(1)(C) and paragraph (f) of this section.

(e) Computation of carryovers and carrybacks; general rule—(1) Sequence for applying losses and computation of taxable income. The portion of any net operating loss which is carried back or carried over to any taxable year is the excess, if any, of the amount of the loss over the sum of the taxable income for each of the prior taxable years to which the loss may be carried under sections 172(b)(1) and 381. In determining the taxable income for each such prior taxable year for this purpose, the various net operating loss carryovers and carrybacks to such prior taxable year are considered to be applied in reduction of the taxable income in the order of the taxable years in which the net operating losses are sustained, beginning with the loss for the earliest taxable year. The application of this rule to the taxable income of the acquiring corporation for any taxable year ending after the date of distribution or transfer involves the use of carryovers of the distributor or transfer corporation, and of carryovers and carrybacks of the acquiring corporation. In such instance, the sequence for the use of loss years remains the same, and the requirement is to begin with the net operating loss of the earliest taxable year, whether or not it is a loss of the distributor, transferor, or acquiring corporation. The taxable income of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall be determined in the manner prescribed by section 172(b)(2), except that, if the date of distribution or transfer is on a day other than the last day of a taxable year of the acquiring corporation, the taxable income of such corporation for the taxable year which includes such date shall be computed in the special manner prescribed by section 381(c)(1)(C) and paragraph (f) of this section.

(2) Loss year of transferor or distributor considered prior taxable year. Section 381(c)(1)(C) provides that, for the purpose of determining the net operating loss carryovers under section 172(b)(2), a net operating loss for a loss year of a distributor or transferor corporation which ends on or before the last day of a loss year of the acquiring corporation shall be considered to be a net operating loss for a year prior to such loss year of the acquiring corporation. In a case where the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, the loss years of the distributor or transferor corporations shall be taken into account in the order in which such loss years terminate; if any one of the loss years of a distributor or transferor corporation ends on the same day as the loss year of another distributor or transferor corporation, either loss year may be taken into account before the other.

(3) Years to which losses may be carried. The taxable years to which a net operating loss shall be carried back or carried over are prescribed by section 172(b)(1). Since the taxable year of the distributor or transferor corporation ends with the close of the date of distribution or transfer, such taxable year and the first taxable year of the acquiring corporation which ends after that date shall be considered two separate taxable years to which a net operating loss of the distributor or transferor corporation for any taxable year ending before that date may be carried over. This rule applies even though the taxable year of the distributor or transferor corporation which ends on the date of distribution or transfer is a period of less than twelve months. However, for the purpose of determining under section 172(b)(1) the taxable years to which a net operating loss of the acquiring corporation is carried over or carried back, the first taxable year of the acquiring corporation which ends after the date of distribution or transfer shall be treated as only one taxable year even though such taxable year is considered under section 381(c)(1)(C) and paragraph (f)(2) of this section as two taxable years. The application of this subparagraph may be illustrated by the following example:

Example. X Corporation was organized on January 1, 1954, and thereafter it sustained net operating losses in its calendar

years 1954, 1955, and 1956. On June 30, 1957, X Corporation transferred all its assets to Y Corporation, which was organized on January 1, 1955, in a statutory merger to which section 361 applies. In its taxable year ending June 30, 1957, X Corporation sustained a net operating loss. Y Corporation sustained net operating losses in its calendar years 1955, 1956, and 1958, but had taxable income for the year 1957. The years to which these losses of X Corporation and Y Corporation shall be carried, and the sequence in which carried, are as follows:

Loss year	
X 1954	X 1955, X 1956, X 6/30/57, Y 1957, Y 1958.
X 1955	X 1954, X 1956, X 6/30/57, Y 1957, Y 1958, Y 1959.
Y 1955	Y 1956, Y 1957, Y 1958, Y 1959, Y 1960.
X 1956	X 1954, X 1955, X 6/30/57, Y 1957, Y 1958, Y 1959, Y 1960.
Y 1956	Y 1955, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
X 6–30–57	X 1955, X 1956, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
Y 1958	Y 1955, Y 1956, Y 1957, Y 1959, Y 1960, Y 1961, Y 1962, Y 1963.

(4) Computation of carryovers in a case where the date of distribution or transfer occurs on last day of acquiring corporation's taxable year. The computation of the net operating loss carryovers from the distributor or transferor corporation and from the acquiring corporation in a case where the date of distribution or transfer occurs on the last day of a taxable year of the acquiring corporation may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1955, and each corporation makes its return on the basis of the calendar year. On December 31, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1955	($2,000)	($11,000)
1956	(3,000)	10,000
1957	xxx	(15,000)

The sequence in which the losses of X Corporation and Y Corporation are applied, and the computation of the carryovers to Y Corporation's calendar year 1958, may be illustrated as follows:

(i) X Corporation's 1955 loss. The carryover to 1958 is $2,000, computed as follows:

Net operating loss		$2,000
Less:		
X's 1956 taxable income	0	
Y's 1957 taxable income	0	
		0
Carryover		2,000

(ii) Y Corporation's 1955 loss. The carryover to 1958 is $1,000, computed as follows:

Net operating loss		$11,000
Less:		
Y's 1956 taxable income	$10,000	
Y's 1957 taxable income	0	
		10,000
Carryover		1,000

(iii) X Corporation's 1956 loss. The carryover to 1958 is $3,000, computed as follows:

Net operating loss		$3,000
Less:		
X's 1955 taxable income	0	
Y's 1957 taxable income	0	
		0
Carryover		3,000

(iv) Y Corporation's 1957 loss. The carryover to 1958 is $15,000, computed as follows:

Net operating loss			$15,000
Less:			
Y's 1955 taxable income		0	
Y's 1956 taxable income before net operating loss deduction	$10.000		
Minus Y's 1956 net operating loss deduction (i.e., Y's 1955 carryover)	11,000	0	
		0	
Carryover			15,000

(v) Summary of carryovers to 1958. The aggregate of the net operating loss carryovers to 1958 is $21,000, computed as follows:

X's 1955 loss	$2,000
Y's 1955 loss	1,000
X's 1956 loss	3,000
Y's 1957 loss	15,000
Total	21,000

(f) Computation of carryovers and carrybacks when date of distribution or transfer is not on last day of acquiring corporation's taxable year—(1) General rule. Pursuant to the provisions of section 381(c)(1)(C), the taxable income of the acquiring corporation for its taxable year which is a prior taxable year for purposes of section 172(b)(2) and paragraph (e) of this section shall be determined in the manner prescribed in this paragraph, if the date of distribution or transfer occurs within, but not on the last day of, such taxable year.

(2) Taxable year considered as two taxable years. Such taxable year of the acquiring corporation shall be considered as though it were two taxable years, but only for the limited purpose of applying section 172(b)(2). The first of such two

taxable years shall be referred to in this section as the preacquisition part year; the second, as the postacquisition part year. For purposes of section 172(b)(2), a net operating loss of the acquiring corporation shall be carried to the preacquisition part year and then to the postacquisition part year, whereas a net operating loss of a distributor or transferor corporation shall be carried to the postacquisition part year and then to the acquiring corporation's subsequent taxable years. In determining under section 172(b)(2) and this paragraph the portion of any net operating loss of a distributor or transferor corporation which is carried to any taxable year of the acquiring corporation ending after the postacquisition part year, the taxable income (as determined under this paragraph) of the postacquisition part year shall be taken into account but the taxable income of the preacquisition part year (as so determined) shall not be taken into account. Though considered as two separate taxable years for purposes of section 172(b)(2), the preacquisition part year and the postacquisition part year are treated as one taxable year in determining the years to which a net operating loss is carried under section 172(b)(1). See paragraph (e)(3) of this section.

(3) **Preacquisition part year.** The preacquisition part year shall begin with the beginning of such taxable year of the acquiring corporation and shall end with the close of the date of distribution or transfer.

(4) **Postacquisition part year.** The postacquisition part year shall begin with the day following the date of distribution or transfer and shall end with the close of such taxable year of the acquiring corporation.

(5) **Division of taxable income.** The taxable income for such taxable year (computed with the modifications specified in section 172(b)(2)(A) but without any net operating loss deduction) of the acquiring corporation shall be divided between the preacquisition part year and the postacquisition part year in proportion to the number of days in each. Thus, if in a statutory merger to which section 361 applies Y Corporation acquires the assets of X Corporation on June 30, 1960, and Y Corporation has taxable income (computed in the manner so prescribed) of $36,600 for its calendar year 1960, then the preacquisition part year taxable income would be $18,200 ($36,600 × 182/366) and the postacquisition part year taxable income would be $18,400 ($36,600 × 184/366).

(6) **Net operating loss deduction.** After obtaining the taxable income of the preacquisition part year and of the postacquisition part year in the manner described in subparagraph (5) of this paragraph, it is necessary to compute the net operating loss deduction for each such part year. This deduction shall be determined in the manner prescribed by section 172(b)(2)(B) but subject to the provisions of this subparagraph. The net operating loss deduction for the preacquisition part year shall, for purposes of section 172(b)(2) only, be determined in the same manner as that prescribed by section 172(b)(2)(B) but shall be computed without taking into account any net operating loss of the distributor or transferor corporation. Therefore, only net operating loss carryovers and carrybacks of the acquiring corporation to the preacquisition part year shall be taken into account in computing the net operating loss deduction for such part year. The net operating loss deduction for the postacquisition part year shall, for purposes of section 172(b)(2) only, be determined in the same manner as that prescribed by section 172(b)(2)(B) and shall be computed by taking into account all the net operating loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer, as well as the net operating loss carryovers and carrybacks of the acquiring corporation to the postacquisition part year. The sequence in which the net operating losses of the two corporations shall be applied for purposes of this subparagraph shall be determined in the manner prescribed in paragraph (e) of this section.

(7) **Limitation on taxable income.** In no case shall the taxable income of the preacquisition part year or the postacquisition part year, as computed under this paragraph, be considered to be less than zero.

(8) **Cross reference.** If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributors or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the determination of the taxable income of the acquiring corporation for such year pursuant to section 381(c)(1)(C) shall be governed by the rules prescribed in paragraph (c) of § 1.381(c)(1)–2.

(9) **Illustration.** The application of this paragraph may be illustrated by the following example:

Example—(i) Facts. X Corporation was organized on January 1, 1955, and Y Corporation was organized on January 1, 1954. Each corporation makes its return on the basis of the calendar year. On June 30, 1956, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income (computed without any net operating loss deduction) of

the two corporations are as follows, the assumption being made that none of the modifications specified in section 172(b)(2)(A) apply to any taxable year:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	xxx	($5,000)
1955	($65,000)	(20,000)
Ending June 30, 1956	1,000	xxx
1956	xxx	36,600

(ii) **Y Corporation's 1954 loss.** The carryover to 1957 is $0, computed as follows:

Net operating loss		$5,000
Less:		
Y's 1955 taxable income		0
Carryover to Y's preacquisition part year		5,000
Less:		
Y's preacquisition part year taxable income computed under subparagraph (5) of this paragraph ($36,600 × 182/366)	$18,200	
Minus Y's net operating loss deduction for preacquisition part year	xxx	18,200
Carryover to Y's postacquisition part year and also to Y 1957		0

(iii) **X Corporation's 1955 loss.** The carryover to 1957 is $45,600, computed as follows:

Net operating loss		$65,000
Less:		
X's 6/30/56 year taxable income		1,000
Carryover to Y's postacquisition part year		64,000
Less:		
Y's postacquisition part year taxable income computed under subparagraph (5) of this paragraph ($36,-600×184/366)	$18,400	
Minus Y's net operating loss deduction for postacquisition part year (i.e., Y's 1954 carryover of $0 to such part year)		$18,400
Carryover to Y 1957		45,600

(iv) **Y Corporation's 1955 loss.** The carryover to 1957 is $6,800, computed as follows:

Net operating loss		$20,000
Less:		
Y's 1954 taxable income		0
Carryover to Y's preacquisition part year		20,000
Less:		
Y's preacquisition part year taxable income computed under subparagraph (5) of this paragraph	$18,200	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1954 carryover to such part year)	5,000	
		13,200
Carryover to Y's postacquisition part year		6,800
Less:		
Y's postacquisition part year taxable income computed under subparagraph (5) of this paragraph	$18,400	
Minus Y's net operating loss deduction for postacquisition part year (i.e. Y's 1954 carryover of $0, and X's 1955 carryover of $64,000, to such part year)	64,000	
		0
Carryover to Y 1957		6,800

(v) **Summary of carryovers to 1957.** The aggregate of the net operating loss carryovers to 1957 is $52,400, determined as follows:

Y's 1954 loss	0
X's 1955 loss	$45,600
Y's 1955 loss	6,800
Total	52,400

(g) **Successive acquiring corporations.** An acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of sections 172 and 381, the net operating loss carryovers available to the first acquiring corporation under sections 172 and 381.

(h) **Illustration.** The application of this section may be further illustrated by the following example:

Example—(1) Facts. X Corporation was organized on January 1, 1954, and Y Corporation was organized on January 1, 1955. Each corporation makes its return on the basis of the calendar year. On August 31, 1957, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. The net operating losses and the taxable income of the two corporations for the taxable years involved are set forth in the tabulation below. The taxable income so shown is computed without the modifications required by section 172(b)(2)(A) and without the benefit of any net operating loss deduction. In its calendar year 1957, Y Corporation had a deduction of $365 which is disallowed by section 172(b)(2)(A).

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($7,000)	xxx
1955	(10,000)	($10,000)
1956	(25,000)	(15,000)
Ending 8-31-57	1,000	xxx
1957	xxx	54,750
1958	xxx	(5,000)
1959	xxx	50,000

(2) **Computation of carryovers and carrybacks.** The sequence in which the losses of X Corporation and Y Corporation are applied and the computation of the carryovers to Y Corporation's calendar year 1959 may be illustrated as follows:

(i) **X Corporation's 1954 loss.** The carryover to 1958, which is the last year to which this loss may be carried, is $0, computed as follows:

Net operating loss		$7,000
Less:		
X's 1955 taxable income	0	
X's 1956 taxable income	0	
		0
Carryover to X's 8/31/57-year		7,000
Less:		
X's 8/31/57-year taxable income		1,000
Carryover to Y's postacquisition part year		6,000
Less:		
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section (($54,750 + $365) × 122/365)	$18,422	
Minus Y's net operating loss deduction for postacquisition part year	xxx	
		18,422
Carryover to Y 1958		0

(ii) **X Corporation's 1955 loss.** The carryover to 1959 is $0, computed as follows:

Net operating loss		$10,000
Less:		
X's 1954 taxable income	0	
X's 1956 taxable income	0	
		0
Carryover to X's 8/31/57-year		10,000
Less:		
X's 8/31/57-year taxable income before net operating loss deduction	$1,000	
Minus X's net operating loss deduction for 8/31/57-year (i.e., X's 1954 carryover)	7,000	
		0
Carryover to Y's postacquisition part year		10,000
Less:		
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section	$18,422	
Minus Y's net operating loss deduction for postacquisition part year (i.e., X's 1954 carryover to such part year)	6,000	
		12,422
Carryover to Y 1958 and Y 1959		0

(iii) **Y Corporation's 1955 loss.** The carryover to 1959 is $0, computed as follows:

Net operating loss		$10,000
Less:		
Y's 1956 taxable income		0
Carryover to Y's preacquisition part year		10,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section (($54,750 + $365) × 243/365)	$36,693	
Minus Y's net operating loss deduction for preacquisition part year	xxx	
		36,693
Carryover to Y's postacquisition part year, to Y 1958, and to Y 1959		0

(iv) **X Corporation's 1956 loss.** The carryover to 1959 is $22,578, computed as follows:

Net operating loss			$25,000
Less:			
X's 1954 taxable income		0	
X's 1955 taxable income		0	
X's 8/31/57-year taxable income before net operating loss deduction	$1,000		
Minus X's net operating loss deduction for 8/31/57-year (i.e., X's 1954 carryover of $7,000 and X's 1955 carryover of $10,000)	$17,000	0	0
Carryover to Y's postacquisition part year			$25,000
Less:			
Y's postacquisition part year taxable income computed under paragraph (f)(5) of this section		$18,422	
Minus Y's net operating loss deduction for postacquisition part year (i.e., X's 1954 carryover of $6,000, X's 1955 carryover of $10,000 and Y's 1955 carryover of $0, to such part year)		16,000	
			2,422
Carryover to Y 1958			22,578
Less:			
Y's 1958 taxable income			0
Carryover to Y 1959			22,578

(v) **Y Corporation's 1956 loss.** The carryover to 1959 is $0, computed as follows:

Net operating loss		$15,000
Less:		
Y's 1955 taxable income		0
Carryover to Y's preacquisition part year		15,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section	$36,693	
Minus Y's net operating loss deduction for preacquisition part		

year (i.e., Y's 1955 carryover to such part year)	10,000	
		26,693
Carryover to Y's postacquisition part year, to Y 1958, and to Y 1959		0

(vi) Y Corporation's 1958 loss. The carryover to 1959 is $0, computed as follows:

Net operating loss		$5,000
Less:		
Y's 1955 taxable income [1]	0	
Y's 1956 taxable income	0	
		0
Carryback to Y's preacquisition part year		$5,000
Less:		
Y's preacquisition part year taxable income computed under paragraph (f)(5) of this section	$36,693	
Minus Y's net operating loss deduction for preacquisition part year (i.e., Y's 1955 carryover of $10,000, and Y's 1956 carryover of $15,000, to such part year)	25,000	
		11,693
Carryback to Y's postacquisition part year and carryover to Y 1959		0

[1] Three-year carryback in case of loss years ending after December 31, 1957.

(vii) Summary of carryovers to 1959. The aggregate of the net operating loss carryovers to 1959 is $22,578, computed as follows:

X's 1955 loss	0
Y's 1955 loss	0
X's 1956 loss	$22,578
Y's 1956 loss	0
Y's 1958 loss	0
Total	22,578

(3) **Net operating loss deduction for 1957.** (i) The net operating loss deduction available to Y Corporation under section 172(a) for the calendar year 1957, determined in accordance with paragraph (d) of this section, is $48,300, computed as follows:

Aggregate of the net operating loss carryovers available to the transferor corporation as of the close of August 31, 1957, but limited by paragraph (d) of this section to $18,300 (Y's 1957 taxable income of $54,750, computed without any net operating loss deduction, multiplied by 122/365)		
Carryover of X's 1954 loss	$6,000	
Carryover of X's 1955 loss	10,000	
Carryover of X's 1956 loss	25,000	
	$41,000	
Aggregate of carryovers, limited as above		$18,300
Carryover of Y's 1955 loss		10,000
Carryover of Y's 1956 loss		15,000
Carryback of Y's 1958 loss		5,000
Net operating loss deduction		48,800

(ii) The taxable income under section 63 for 1957 is $6,450, computed as follows:

Taxable income determined without any net operating loss deduction	$54,750
Less:	
Net operating loss deduction for 1957, as determined under subdivision (i) of this subparagraph	$48,300
Taxable income under section 63	6,450

(4) **Net operating loss deduction for 1959.** The taxable income under section 63 for 1959 is $27,422, computed as follows:

Taxable income determined without any net operating loss deduction	$50,000
Less:	
Net operating loss deduction for 1959 (i.e., the aggregate carryovers determined under subparagraph (2)(vii) of this paragraph)	22,578
Taxable income under section 63	27,422

(5) **Years to which losses may be carried.** The taxable years to which the losses of X Corporation and Y Corporation may be carried, and the sequence in which carried, are as follows:

Loss year	Carried to
X 1954	X 1955, X 1956, X 8/31/57, Y 1957, Y 1958.
X 1955	X 1954, X 1956, X 8/31/57, Y 1957, Y 1958, Y 1959.
Y 1955	Y 1956, Y 1957, Y 1958, Y 1959, Y 1960.
X 1956	X 1954, X 1955, X 8/31/57, Y 1957, Y 1958, Y 1959, Y 1960.
Y 1956	Y 1955, Y 1957, Y 1958, Y 1959, Y 1960, Y 1961.
Y 1958	Y 1955, Y 1956, Y 1957, Y 1959, Y 1960, Y 1961, Y 1962, Y 1963.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40493, Sept. 12, 1978]

§ 1.381(c)(1)–2 Net operating loss carryovers; two or more dates of distribution or transfer in the taxable year.

(a) **In general.** If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer within one taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(1)(B) to the aggregate of the net operating loss carryovers to that taxable year from all of the distributor or transferor corporations shall be determined by applying the rules prescribed in paragraph (b) of this section, and the taxable income of the acquiring corporation for that taxable year under sections 381(c)(1)(C) and 172(b)(2) shall be determined by applying the rules prescribed in paragraph (c) of this section. For purposes of this section, the term "postacquisition income" means postacquisition part year taxable income deter-

mined under paragraph (d)(1) of § 1.381(c)(1)–1 by treating the first date of distribution or transfer as though it were the only date of distribution or transfer during the taxable year of the acquiring corporation.

(b) Determination of limitation under section 381(c)(1)(B)—(1) In general. If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date of distribution or transfer equals or exceeds the postacquisition income, then the limitation under section 381(c)(1)(B) shall be an amount equal to such postacquisition income. If the amount of the net operating loss carryovers acquired on the first date of distribution or transfer is less than such postacquisition income, then the limitation under section 381(c)(1)(B) shall be determined as provided in subparagraphs (2) through (5) of this paragraph.

(2) Allocation of postacquisition income among partial postacquisition years. That part of the taxable year of the acquiring corporation beginning on the day following the first date of distribution or transfer and ending with the close of the taxable year of the acquiring corporation shall be divided into the same number of partial postacquisition years as the number of dates of distribution or transfer on which the acquiring corporation succeeds to net operating loss carryovers during its taxable year. The first partial postacquisition year shall begin with the day following the first date of distribution or transfer and shall end with the close of the second date of distribution or transfer. The second and succeeding partial postacquisition years shall begin with the day following the close of the preceding such partial year and shall end with the close of the succeeding date of distribution or transfer, or, if there is no such succeeding date, then with the close of the taxable year of the acquiring corporation. The postacquisition income of the acquiring corporation shall be allocated among the partial postacquisition years in proportion to the number of days in each such partial year.

(3) Two dates of distribution or transfer. If the acquiring corporation succeeds to the net operating loss carryovers of two distributor or transferor corporations on two dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date equals or exceeds the income for the first partial postacquisition year, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income. If the income for the first partial postacquisition year exceeds the net operating loss carryovers acquired on the first date of distribution or transfer, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income reduced by the amount of such excess. The application of this subparagraph may be illustrated by the following example:

Example. (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquires the assets of Y and Z Corporations in statutory mergers to each of which section 361 applies, the dates of transfer being January 1 and December 1, respectively. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carryovers	Income for partial years	Reduction
Y........	$ 1,000	$33,400 ($36,500 × 334/365)	$32,400
Z........	50,000	3,000 ($36,500 × 30/365)	0
	51,000	36,400	32,400

(ii) The limitation provided by section 381(c)(1)(B) equals the postacquisition income of $36,400 reduced by $32,400, the excess of the income for the first partial year ($33,400) over the net operating loss carryovers acquired on the first date of transfer ($1,000). Accordingly, the limitation is $4,000 ($36,400 minus $32,400). Therefore, although X Corporation acquired carryovers aggregating $51,000 during 1955, it can utilize only $4,000 of such carryovers in computing its net operating loss deduction for 1955.

(4) Three dates of distribution or transfer. If the acquiring corporation succeeds to the net operating loss carryovers of three distributor or transferor corporations on three dates of distribution or transfer during the same taxable year of the acquiring corporation, and if the amount of the net operating loss carryovers acquired on the first date equals or exceeds the income for the first and second partial postacquisition years, the limitation provided by section 381(c)(1)(B) shall be the amount of the postacquisition income. If the amount of the carryovers acquired on the first date equals or exceeds the income for the first partial postacquisition year but does not equal or exceed the income for the first and second partial postacquisition years, the limitation shall be the amount of the postacquisition income reduced by the excess of the income for the first and second partial postacquisition years over the amount of carryovers acquired on the first and second dates of distribution or transfer. If the income for the first partial postacquisition year exceeds the carryovers acquired on the first date, the limitation shall be the postacquisition income reduced by the sum of

the amount of such excess plus the amount, if any, by which the income for the second partial postacquisition year exceeds the carryovers acquired on the second date. This subparagraph may be illustrated by the following examples:

Example (1). (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquires the assets of M, N, and Z Corporations in statutory mergers to each of which section 361 applies, the dates of transfer being January 1, January 31, and December 1, respectively. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carry overs	Income for partial years	Reduction
M	$ 4,000	$ 3,000 ($36,500 × 30/365)	$23,400
N	6,000	30,400 ($36,500 × 304/365)	
Z........	50,000	3,000 ($36,500 × 30/365)	0
	60,000	36,400	23,400

(ii) Since the carryovers of $4,000 acquired on the first date of transfer exceed the income for the first partial year ($3,000), the limitation provided by section 381(c)(1)(B) is the amount of the postacquisition income ($36,400) reduced by the excess of the income for the first and second partial years ($33,400) over the carryovers acquired on the first and second dates of transfer ($10,000). Therefore, the limitation is $13,000 ($36,400 less $23,400).

Example (2). (i) Assume the same facts as in example (1) except that the amount of the net operating loss carryovers acquired from M Corporation is $1,000. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carry overs	Income for partial years	Reduction
M	$ 1,000	$ 3,000 ($36,500 × 30/365)	$ 2,000
N	6,000	30,400 ($36,500 × 304/365)	24,400
Z........	50,000	3,000 ($36,500 × 30/365)	0
	57,000	36,400	26,400

(ii) Since the income for the first partial year ($3,000) exceeds the $1,000 of carryovers acquired on the first date by $2,000, the limitation provided by section 381(c)(1)(B) is the postacquisition income of $36,400 reduced by such excess and also reduced by the excess of the income for the second partial year ($30,400) over the carryovers acquired on the second date of transfer ($6,000). Therefore, the limitation is $10,000 ($36,400 less the sum of $2,000 and $24,400).

Example (3). (i) Assume the same facts as in example (2) except that the carryovers acquired from N Corporation are $75,000. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carry overs	Income for partial years	Reduction
M	$ 1,000	$ 3,000 ($36,500 × 30/365)	$2,000
N	75,000	30,400 ($36,500 × 304/365)	0
Z........	50,000	3,000 ($36,500 × 30/365)	0
	126,000	36,400	2,000

(ii) Since the income for the first partial year ($3,000) exceeds the $1,000 of carryovers acquired on the first date by $2,000, the limitation provided by section 381(c)(1)(B) is the postacquisition income of $36,400 reduced by $2,000, or $34,400. No further reduction is made since the income for the second partial year ($30,400) does not exceed the carryovers of $75,000 acquired on the second date of transfer.

(5) Four or more dates of distribution or transfer. If the acquiring corporation succeeds to the net operating loss carryovers of four or more distributor or transferor corporations on four or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the limitation provided by section 381(c)(1)(B) shall be determined consistently with the methods prescribed in subparagraphs (3) and (4) of this paragraph. The application of this subparagraph may be illustrated by the following example:

Example. (i) X Corporation has taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1955. During 1955, X Corporation acquired the assets of M, N, O, Y, and Z Corporations in statutory mergers to each of which section 361 applied, the dates of transfer being, respectively, January 1, January 31, March 3, April 2, and December 1. The net operating loss carryovers of each transferor corporation and the income for each partial postacquisition year are:

Corp.	Carry overs	Income for partial years	Reduction
M	$ 1,000	$ 3,000 ($36,500 × 30/365)	$2,000
N	4,000	3,100 ($36,500 × 31/365)	
O........	1,000	3,000 ($36,500 × 30/365)	1,100
Y........	10,000	24,300 ($36,500 × 243/365)	14,300
Z........	20,000	3,000 ($36,500 × 30/365)	0
	36,000	36,400	17,400

(ii) The limitation provided by section 381(c)(1)(B) equals the postacquisition income of $36,400 reduced by the sum of (a) the $2,000 excess of the income for the first partial year ($3,000) over the carryovers acquired from M Corporation ($1,000), (b) the $1,100 excess of the income for the second and third partial years ($6,100) over the carryovers acquired from N and O Corporations ($5,000), and (c) the $14,300 excess of the income for the fourth partial year ($24,300) over the carryovers acquired from Y Corporation ($10,000). Accordingly, the limitation is $19,000 ($36,400 minus $17,400). Therefore, although X Corporation acquired carryovers aggregating $36,000 during 1955, it can utilize only $19,000 of such carryovers in computing its net operating loss deduction for 1955.

(c) Determination of taxable income of acquiring corporation under section 381(c)(1)(C)—(1) In general. If the acquiring corporation succeeds to the net operating loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer within one taxable year of the acquiring corporation, then pursuant to section 381(c)(1)(C) the taxable income of the acquiring corporation for its taxable year which is a prior taxable year for purposes of section 172(b)(2) and paragraph (e) of § 1.381(c)(1)-1 shall be determined as provided in this paragraph.

(2) **Division of taxable income.** The taxable income of the acquiring corporation (computed with the modifications specified in section 172(b)(2)(A) but without any net operating loss deduction) shall be allocated proportionately on a daily basis among a preacquisition part year (determined under paragraph (f)(3) of § 1.381(c)(1)-1 by treating the first date of distribution or transfer as though it were the only date of distribution or transfer during the taxable year of the acquiring corporation) and two or more partial postacquisition years (determined as provided in paragraph (b)(2) of this section). The preacquisition part year and each partial postacquisition year shall be considered a separate taxable year, but only for the limited purpose of applying sections 172(b)(2) and 381(c)(1)(C).

(3) **Net operating loss deduction.** The net operating loss deduction of the preacquisition part year and the partial postacquisition years shall be determined consistently with the manner described in paragraph (f)(6) of § 1.381(c)(1)-1 but by taking into account, in the case of any partial postacquisition year, only the net operating loss carryovers and carrybacks of the acquiring corporation and those net operating loss carryovers from a distributor or transferor corporation which become available to the acquiring corporation as of the close of those dates of distribution or transfer which occur before the beginning of that specific partial postacquisition year. The sequence in which the net operating losses of the distributor or transferor and acquiring corporations shall be applied for this purpose shall be determined in the manner described in paragraph (e) of § 1.381(c)(1)-1. Subject to the preceding sentence, the net operating loss carryovers to any specific partial postacquisition year, whether from a distributor, transferor, or acquiring corporation, shall be taken into account in the order of the taxable years in which the net operating losses arose, beginning with the loss for the earliest taxable year.

(4) **Illustration.** The application of this paragraph may be illustrated by the following example:

Example—(i) Facts. X Corporation, which was organized on January 1, 1957, sustained a net operating loss of $20,000 for its calendar year 1957 and had taxable income (computed without any net operating loss deduction) of $36,500 for its calendar year 1958. During 1958, X Corporation acquired the assets of Y and Z Corporations in statutory mergers to each of which section 361 applied, the dates of transfer being June 30 and September 30, respectively. None of the modifications specified in section 172(b)(2)(A) apply to any of the corporations for any taxable year. The taxable income (computed without any net operating loss deduction) and net operating losses of Y and Z Corporations (which were organized on January 1, 1957, and January 1, 1954, respectively) are set forth below:

Taxable year	Acquiring corporation X	Transferor corporation Y	Transferor corporation Z
1954	xxx	xxx	($30,000)
1955	xxx	xxx	1,000
1956	xxx	xxx	1,000
1957	($20,000)	($25,000)	1,000
Ending 6-30-58	xxx	1,000	xxx
Ending 9-30-58	xxx	xxx	1,000
1958	36,500	xxx	xxx

The sequence in which the losses of the acquiring corporation and the transferor corporations are applied and the computation of the carryovers to X Corporation's calendar year 1959 are illustrated in the following subdivisions of this example.

(ii) Computation of taxable income. X Corporation's taxable income, determined in the manner described in subparagraph (2) of this paragraph, for the preacquisition part year and for the partial postacquisition years is as follows:

Year	Taxable income	Computation
Preacquisition part year	$18,100	$36,500 × 181/365
Partial No. 1	9,200	36,500 × 92/365
Partial No. 2	9,200	36,500 × 92/365

(iii) Z Corporation's 1954 loss. The carryover to 1959 is $0, computed as follows:

Net operating loss	$30,000
Less:	
Z's 1955, 1956, 1957, and 9/30/58-3 year income	4,000
Net operating loss carryover to Partial No. 2 year	26,000
Less:	
Partial No. 2 year taxable income	9,200
	16,800

The balance of $16,800 is not carried over to 1959 since X Corporation's taxable year 1958 is the last of the five years to which Z's 1954 loss may be carried under section 172(b)(1).

(iv) Y Corporation's 1957 loss. The carryover to 1959 is $14,800, computed as follows:

Net operating loss		$25,000
Less:		
Y's 6/30/58-year income		1,000
Net operating loss carryover to Partial No. 1 year		24,000
Less:		
Partial No. 1 year taxable income		9,200
Carryover to Partial No. 2 year		14,800
Less:		
X's Partial No. 2 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 2 year (i.e., Z's 1954 carryover of $26,000 to such partial year)	26,000	
		0
Carryover to 1959		14,800

(v) *X Corporation's 1957 loss.* The carryover to 1959 is $1,900, computed as follows:

Net operating loss		$20,000
Less:		
X's preacquisition part year taxable income		18,100
Carryover to Partial No. 1 year		1,900
Less:		
Partial No. 1 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 1 year (i.e., Y's 1957 carryover of $24,000 to such partial year)	24,000	
		0
Carryover to Partial No. 2 year		1,900
Less:		
Partial No. 2 year taxable income	$9,200	
Minus X's net operating loss deduction for Partial No. 2 year (i.e., Z's 1954 carryover of $26,000, and Y's 1957 carryover of $14,800, to such partial year)	40,800	
		0
Carryover to 1959		$1,900

(vi) *Summary of carryovers to 1959.* The aggregate of the net operating loss carryovers to 1959 is $16,700, computed as follows:

Z's 1954 loss	xxx
Y's 1957 loss	$14,800
X's 1957 loss	91,900
Total	16,700

[T.D. 6500, 25 FR 11607, Nov. 26, 1960]

§ 1.381(c)(2)–1 Earnings and profits.

(a) *In general.* (1) Section 381(c)(2) requires the acquiring corporation in a transaction to which section 381(a) applies to succeed to, and take into account, the earnings and profits, or deficit in earnings and profits, of the distributor or transferor corporation as of the close of the date of distribution or transfer. In determining the amount of such earnings and profits, or deficit, to be carried over, and the manner in which they are to be used by the acquiring corporation after such date, the provisions of section 381(c)(2) and this section shall apply. For purposes of section 381(c)(2) and this section, if the distributor or transferor corporation accumulates earnings and profits, or incurs a deficit in earnings and profits, after the date of distribution or transfer and before the completion of the reorganization or liquidation, such earnings and profits, or deficit, shall be deemed to have been accumulated or incurred as of the close of the date of distribution or transfer.

(2) If the distributor or transferor corporation has accumulated earnings and profits as of the close of the date of distribution or transfer, such earnings and profits shall (except as hereinafter provided in this section) be deemed to be received by, and to become a part of the accumulated earnings and profits of, the acquiring corporation as of such time. Similarly, if the distributor or transferor corporation has a deficit in accumulated earnings and profits as of the close of the date of distribution or transfer, such deficit shall (except as hereinafter provided in this section) be deemed to be incurred by the acquiring corporation as of such time. In no event, however, shall the accumulated earnings and profits, or deficit, of the distribution or transferor corporation be taken into account in determining earnings and profits of the acquiring corporation for the taxable year during which occurs the date of distribution or transfer.

(3) Any part of the accumulated earnings and profits, or deficit in accumulated earnings and profits, of the distributor or transferor corporation which consists of earnings and profits, or deficits, accumulated before March 1, 1913, shall be deemed to become earnings and profits, or deficits, of the acquiring corporation accumulated before March 1, 1913, and any part of the accumulated earnings and profits of the distributor or transferor corporation which consists of increase in value of property accrued before March 1, 1913, shall be deemed to become earnings and profits of the acquiring corporation consisting of increase in value of property accrued before March 1, 1913.

(4) If the acquiring corporation and each distributor or transferor corporation has accumulated earnings and profits as of the close of the date of distribution or transfer, or if each of such corporations has a deficit in accumulated earnings and profits as of such time, then the accumulated earnings and profits (or deficit) of each such corporation shall be consolidated as of the close of the date of distribution or transfer in the accumulated earnings and profits account of the acquiring corporation. See subparagraph (6) of this paragraph for determination of the accumulated earnings and profits (or deficit) of the acquiring corporation as of the close of the date of distribution or transfer.

(5) If (i) one or more corporations a party to a distribution or transfer has accumulated earnings and profits as of the close of the date of distribution or transfer, and (ii) one or more of such corporations has a deficit in accumulated earnings and profits as of such time, the total of any such deficits shall be used only to offset earnings and profits accumulated, or deemed to have been accu-

mulated under subparagraph (6) of this paragraph, by the acquiring corporation after the date of distribution or transfer. In such instance, the acquiring corporation will be considered as maintaining two separate earnings and profits accounts after the date of distribution or transfer. The first such account shall contain the total of the accumulated earnings and profits as of the close of the date of distribution or transfer of each corporation which has accumulated earnings and profits as of such time, and the second such account shall contain the total of the deficits in accumulated earnings and profits of each corporation which has a deficit as of such time. The total deficit in the second account may not be used to reduce the accumulated earnings and profits in the first account (although such earnings and profits may be offset by deficits incurred, or deemed to have been incurred, after the date of distribution or transfer) but shall be used only to offset earnings and profits accumulated, or deemed to have been accumulated under subparagraph (6) of this paragraph, by the acquiring corporation after the date of distribution or transfer.

(6) In any case in which it is necessary to compute the accumulated earnings and profits, or the deficit in accumulated earnings and profits, of the acquiring corporation as of the close of the date of distribution or transfer and such date is a day other than the last day of a taxable year of the acquiring corporation—

(i) If the acquiring corporation has earnings and profits for its taxable year during which occurs the date of distribution or transfer, such earnings and profits (a) shall be deemed to have accumulated as of the close of such date in an amount which bears the same ratio to the undistributed earnings and profits of such corporation for such year as the number of days in the taxable year preceding the date following the date of distribution or transfer bears to the total number of days in the taxable year, and (b) shall be deemed to have accumulated after the date of distribution or transfer in an amount which bears the same ratio to the undistributed earnings and profits of such corporation for such year as the number of days in the taxable year following such date bears to the total number of days in such taxable year. For purposes of the preceding sentence, the undistributed earnings and profits of the acquiring corporation for such taxable year shall be the earnings and profits for such taxable year reduced by any distributions made therefrom during such taxable year.

(ii) If the acquiring corporation has an operating deficit for its taxable year during which occurs the date of distribution or transfer, then, unless the actual accumulated earnings and profits, or deficit, as of such date can be shown, such operating deficit shall be deemed to have accumulated in a manner similar to that described in subdivision (i) of this subparagraph.

(7) This paragraph may be illustrated by the following examples, in which it is assumed that none of the accumulated earnings and profits, or deficits, consist of earnings and profits or deficits accumulated, or increase in value of property accrued, before March 1, 1913.

Example (1). (i) M and N Corporations make their returns on the basis of the calendar year. On June 30, 1959, M Corporation transfers all its assets to N Corporation in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	M Corporation (transferor)	N Corporation (acquirer)
Accumulated earnings and profits at close of calendar year 1958	$100,000	$150,000
Earnings and profits of taxable year ending June 30, 1959	15,000	....
Earnings and profits of calendar year 1959	....	36,500
Distributions during calendar year 1959	0	0

(ii) As of the close of June 30, 1959, N acquires from M accumulated earnings and profits of $115,000. Since M and N each has accumulated earnings and profits as of the close of the date of transfer, M's accumulated earnings and profits are added to N's accumulated earnings and profits as of such time. However, no part of M's accumulated earnings and profits is taken into account in determining N's earnings and profits for the calendar year 1959. Therefore, N's earnings and profits for the calendar year 1959 are $36,500.

Example (2). (i) X and Y Corporations make their returns on the basis of the calendar year. On June 30, 1959, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (acquirer)
Accumulated earnings and profits at close of calendar year 1958	$20,000	$100,000
Deficit in earnings and profits for taxable year ending June 30, 1959	80,000	....
Earnings and profits of calendar year 1959	....	36,500
Distributions during calendar year 1959	0	0

(ii) As of the close of June 30, 1959, Y acquires from X a deficit in accumulated earnings and profits in the amount of $60,000. This deficit may be used only to reduce those earnings and profits of Y which are accumulated, or deemed to

have accumulated, after June 30, 1959. Accordingly, as of December 31, 1959, the accumulated earnings and profits of Y amount to $118,100; at such time Y also has a separate deficit in accumulated earnings and profits in the amount of $41,600. These amounts are determined as follows:

Accumulated earnings and profits of Y as of the close of 1958	$100,000
Add:	
Portion of undistributed earnings and profits of Y for 1959 deemed to have accumulated as of close of June 30, 1959 ($36,500 × 181/365)	18,100
Accumulated earnings and profits of Y as of close of June 30, 1959, and also as of Dec. 31, 1959	118,100
Portion of undistributed earnings and profits of Y for 1959 deemed to have accumulated after June 30, 1959 ($36,500 × 184/365)	18,400
Less:	
Deficit in accumulated earnings and profits acquired by Y from X Corporation as of close of June 30, 1959	60,000
Separate deficit in accumulated earnings and profits of Y as of Dec. 31, 1959	41,600

Example (3). Assume the same facts as in example (2), except that on September 15, 1959, Y Corporation makes a cash distribution of $96,500. The entire distribution is a dividend: $36,500 from earnings and profits for the taxable year 1959 and $60,000 from earnings and profits accumulated as of December 31, 1958. Accordingly, as of December 31, 1959, Y has accumulated earnings and profits of $40,000, and also has a separate deficit in accumulated earnings and profits of $60,000. These amounts are determined as follows:

Earnings and profits of Y for calendar year 1959	$36,500
Accumulated earnings and profits of Y as of close of 1958	100,000
Total	136,500
Less:	
Distributions during 1959	96,500
Accumulated earnings and profits of Y as of Dec. 31, 1959	40,000
Deficit in accumulated earnings and profits acquired from X as of close of June 30, 1959	60,000
Less:	
Portion of Y's undistributed earnings and profits for 1959 deemed to have accumulated after June 30, 1959	0
Separate deficit in accumulated earnings and profits of Y as of Dec. 31, 1959	60,000

Example (4). (i) M and N Corporations make their returns on the basis of the calendar year. On June 30, 1959, M Corporation transfers all its assets to N Corporation in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	M Corporation (transferor)	N Corporation (acquirer)
Accumulated earnings and profits at close of calendar year 1958	$100,000	$50,000
Earnings and profits for taxable year ending June 30, 1959	10,000	....
Deficit in earnings and profits for calendar year 1959	....	146,000
Distributions during calendar year 1959	0	0

(ii) Assuming that N has not shown its actual accumulated earnings and profits, or deficit, as of the close of June 30, 1959, N has a deficit in accumulated earnings and profits at such time which amounts to $22,400, determined as follows:

Accumulated earnings and profits of N as of close of 1958	$50,000
Less:	
Portion of deficit in earnings and profits of N for 1959 deemed to have accumulated as of close of June 30, 1959 ($146,000 × 181/365)	72,400
Deficit in accumulated earnings and profits of N as of close of June 30, 1959, and also as of Dec. 31, 1959	22,400

As of the close of June 30, 1959, N acquires from M accumulated earnings and profits in the amount of $110,000, no part of which may be offset by N's own deficit of $22,400; however, such earnings and profits may be offset by deficits incurred, or deemed incurred, by N after June 30, 1959. Thus, as of December 31, 1959, N has the above-mentioned deficit of $22,400; at such time N also has accumulated earnings and profits in the amount of $36,400, determined as follows:

Accumulated earnings and profits acquired from M as of close of June 30, 1959	$110,000
Less:	
Portion of deficit in earnings and profits of N for 1959 deemed to have accumulated after June 30, 1959 ($146,000 × 184/365)	73,600
Accumulated earnings and profits of N as of Dec. 31, 1959	36,400

Example (5). Assume the same facts as in example (4), except that on September 9, 1959, N Corporation makes a cash distribution of $100,000. The amount of $82,000 is a dividend from accumulated earnings and profits, computed as follows:

Accumulated earnings and profits acquired from M as of close of June 30, 1959	$110,000
Less:	
Deficit in earnings and profits of N for 1959 deemed to have accumulated from June 30 through Sept. 8, 1959 ($146,000 × 70/365)	28,000
Accumulated earnings and profits as of close of Sept. 8, 1959	82,000

As of December 31, 1959, N Corporation has a deficit in accumulated earnings and profits of $68,000, computed as follows:

Deficit in accumulated earnings and profits of N as of close of June 30, 1959	$22,400
Add:	
Portion of N's deficit in earnings and profits for 1959 deemed to have accumulated after Sept. 8, 1959 ($146,000 × 114/365)	45,600
Deficit in accumulated earnings and profits of N as of Dec. 31, 1959	68,000

Example (6). (i) X, Y, and Z Corporations make their returns on the basis of the calendar year. On June 30, 1959, X

Corporation and Y Corporation transfer all their assets to Z Corporation in a statutory merger to which section 361 applies. The books of the three corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (transferor)	Z Corporation (acquirer)
Accumulated earnings and profits (or deficit) at close of calendar year 1958	$35,000	($25,000)	($20,000)
Earnings and profits (or deficit) for taxable year ended June 30, 1959	5,000	(5,000)	....
Earnings and profits for calendar year 1959	....	....	36,500
Distributions during 1959	0	0	0

(ii) As of the close of June 30, 1959, Z acquires from Y a deficit in accumulated earnings and profits of $30,000. As of such time, Z's own deficit in accumulated earnings and profits amounts to $1,900, determined as follows:

Deficit in accumulated earnings and profits of Z as of close of 1958	$20,000
Less:	
Portion of undistributed earnings and profits of Z for 1959 deemed to have accumulated as of close of June 30, 1959 ($36,500 × 181/365)	18,100
Deficit in accumulated earnings and profits as of close of June 30, 1959	1,900

The total deficit of $31,900 may be used only to offset earnings and profits of Z accumulated, or deemed to have accumulated, after June 30, 1959; such deficit may not be used to reduce the accumulated earnings and profits of $40,000 acquired from X as of the close of June 30, 1959. Thus, as of December 31, 1959, the accumulated earnings and profits of Z amount to $40,000; at such time Z Corporation also has a separate deficit in accumulated earnings and profits in the amount of $13,500, determined as follows:

Deficit in accumulated earnings and profits as of close of June 30, 1959	$31,900
Less:	
Portion of undistributed earnings and profits of Z for 1959 deemed to have accumulated after June 30, 1959 ($36,500 × 184/365)	18,400
Separate deficit in accumulated earnings and profits as of Dec. 31, 1959	13,500

Example (7). X and Y Corporations make their returns on the basis of the calendar year. On December 31, 1954, X transfers all its assets to Y in a statutory merger to which section 361 applies. The books of the two corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (acquirer)
Accumulated earnings and profits (or deficit) at close of calendar year 1954	($50,000)	$210,000
Earnings and profits (or deficit) for calendar year:		
1955	....	5,000
1956	....	(20,000)
1957	....	70,000
1958	....	60,000
1959	....	55,000
Cash distributions on:		
Sept. 1, 1957	....	80,000
Sept. 1, 1958	....	40,000
Sept. 1, 1959	....	30,000

The balances in the accumulated earnings and profits account and the separate deficit account of Y Corporation at the close of the taxable year involved are as follows:

Year	Deficit acquired from X Corporation	Accumulated earnings and profits of Y Corporation
1954	$50,000	$210,000
1955	45,000	210,000
1956	45,000	190,000
1957	45,000	180,000
1958	25,000	180,000
1959	None	180,000

(b) **Successive acquisitions.** (1) If, as of the date of distribution or transfer, either the acquiring corporation, or the distributor or transferor corporation, or both, is considered under paragraph (a) of this section to be maintaining separate earnings and profits accounts as the result of a prior transaction or transactions to which section 381(a) applied, the accumulated earnings and profits, or deficit in accumulated earnings and profits, of each such corporation shall be combined with the appropriate earnings and profits account of the other such corporation. For example, if, as of the date of transfer, the acquiring corporation and the transferor corporation are each maintaining separate accounts, one containing accumulated earnings and profits and the other containing a deficit in accumulated earnings and profits, the amounts in the two accumulated earnings and profits accounts shall be combined into one account, and the amounts in the two deficit accounts shall be combined into a second account, and the amount in one combined account may not be used to offset the amount in the other combined account.

(2) This paragraph may be illustrated by the following examples, in which it is assumed that none of the accumulated earnings and profits, or deficits, consist of earnings and profits or deficits

accumulated, or increase in value of property accrued, before March 1, 1913.

Example (1). (i) X, Y, and Z Corporations make their returns on the basis of the calendar year. On June 30, 1958, X Corporation transfers all its assets to Z Corporation in a statutory merger to which section 361 applies, and on August 31, 1958, Y Corporation transfers all its assets to Z Corporation in another statutory merger to which section 361 applies. The books of the three corporations reveal the following information:

Description	X Corporation (transferor)	Y Corporation (transferor)	Z Corporation (acquirer)
Accumulated earnings and profits (deficit) at close of calendar year 1957	($40,000)	$10,000	$60,000
Deficit in earnings and profits for taxable year ending June 30, 1958....	(5,000)	....	....
Earnings and profits for taxable year ending Aug. 31, 1958	....	2,000	....
Earnings and profits of calendar year 1958	....	....	36,500
Distributions during calendar year 1958	0	0	0

(ii) As of the close of June 30, 1958, Z acquires from X a deficit in accumulated earnings and profits in the amount of $45,000, which deficit may be used only to reduce those earnings and profits of Z which are accumulated, or deemed to have been accumulated, after June 30, 1958. As of the close of August 31, 1958, Z acquires from Y earnings and profits of $12,000, no portion of which may be reduced by the deficit acquired by Z from X. Accordingly, as of December 31, 1958, Z has accumulated earnings and profits of $90,100, and also has a separate deficit in accumulated earnings and profits of $26,600. These amounts are determined as follows:

Accumulated earnings and profits of Z as of Dec. 31, 1957	$60,000
Add:	
Portion of undistributed earnings and profits of Z for 1958 deemed to have accumulated as of close of June 30, 1958 ($36,500 × 181/365)	18,100
Accumulated earnings and profits of Z as of June 30, 1958	78,100
Add:	
Accumulated earnings and profits acquired by Z from Y as of close of Aug. 31, 1958	12,000
Accumulated earnings and profits of Z as of close of Aug. 31, 1958, and also as of Dec. 31, 1958	90,100
Deficit in accumulated earnings and profits acquired by Z from X as of close of June 30, 1958..................................	45,000
Less:	
Portion of undistributed earnings and profits of Z for 1958 deemed to have accumulated from June 30 through Aug. 31, 1958 ($36,500 × 62/365)..................	6,200
Separate deficit in accumulated earnings and profits of Z as of Aug. 31, 1958	38,800
Less:	
Portion of undistributed earnings and profits of Z for 1958 deemed to have accumulated after Aug. 31, 1958 ($36,500 × 122/365)...........................	12,200
Separate deficit in accumulated earnings and profits of Z as of Dec. 31, 1958	26,600

Example (2). (i) Assume the same facts as in example (1), plus the additional fact that on June 30, 1959, Z Corporation transfers all its assets to M Corporation (which makes its return on the basis of the calendar year) in a statutory merger to which section 361 applies, and that as of such time M Corporation is considered to be maintaining separate earnings and profits accounts as the result of a previous transaction to which section 381(a) applied. The books of the two corporations reveal the following information:

Description	Z Corporation (transferor)	M Corporation (acquirer)
Accumulated earnings and profits as of Dec. 31, 1958..........	$90,100	$50,000
Separate deficit in accumulated earnings and profits as of Dec. 31, 1958	26,600	30,000
Earnings and profits for taxable year ending June 30, 1959	5,000	....
Earnings and profits of calendar year 1959	....	36,500
Distributions during 1959	0	0

(ii) As of June 30, 1959, M acquires from Z accumulated earnings and profits of $90,100, which amount is combined with M's own accumulated earnings and profits of $50,000; M also acquires from Z a deficit in accumulated earnings and profits of $21,600 ($26,600 minus $5,000), which amount is combined with M's own deficit of $11,900. The total deficit of $33,500 may be used only to reduce earnings and profits of M which are accumulated, or deemed to have accumulated, after June 30, 1959. Accordingly, as of December 31, 1959, M has accumulated earnings and profits of $140,100, and also has a separate deficit in accumulated earnings and profits in the amount of $15,100. These amounts are determined as follows:

Deficit of M as of Dec. 31, 1958	$30,000
Less:	
Portion of M's undistributed earnings and profits for 1959 deemed to have accumulated as of close of June 30, 1959 ($36,500 × 181/365)	18,100
Deficit of M as of June 30, 1959........	11,900
Plus:	
Deficit of Z as of June 30, 1959	21,600
Combined deficit of M as of close of June 30, 1959	33,500
Less:	
Portion of M's undistributed earnings and profits for 1959 deemed to have accumulated after June 30, 1959 ($36,500 × 184/365)	18,400
Separate deficit of M as of Dec. 31, 1959	15,100
Accumulated earnings and profits of M as of Dec. 31, 1958, and also as of June 30, 1959	50,000

Accumulated earnings and profits of Z as of Dec. 31, 1958, and also as of June 30, 1959	90,100
Combined accumulated earnings and profits of M as of close of June 30, 1959, and also as of Dec. 31, 1959	140,100

(c) Distribution of earnings and profits pursuant to reorganization or liquidation. (1) If, in a reorganization to which section 381(a)(2) applies, the transferor corporation pursuant to the plan of reorganization distributes to its stockholders property consisting not only of property permitted by section 354 to be received without recognition of gain, but also of other property or money, then the accumulated earnings and profits of the transferor corporation as of the close of the date of transfer shall be computed by taking into account the amount of earnings and profits properly applicable to the distribution, regardless of whether such distribution occurs before or after the close of the date of transfer.

(2) If, in a distribution to which section 381(a)(1) (relating to certain liquidations of subsidiaries) applies, the acquiring corporation receives less than 100 percent of the assets distributed by the distributor corporation, then the accumulated earnings and profits of the distributor corporation as of the close of the date of distribution shall be computed by taking into account the amount of earnings and profits properly applicable to the distributions to minority stockholders, regardless of whether such distributions occur before or after the close of the date of distribution.

(d) Treatment of earnings and profits where assets are transferred to a corporation controlled by the acquiring corporation. If, pursuant to the provisions of paragraph (b)(2) of § 1.381(a)–1, a corporation is considered to be the acquiring corporation even though a part of the acquired assets is transferred to one or more corporations controlled by the acquiring corporation, or all the acquired assets are transferred to two or more corporations controlled by the acquiring corporation, then whether any portion of the earnings and profits received by the acquiring corporation under section 381(c)(2) is allocable to such controlled corporation or corporations shall be determined without regard to section 381. See paragraph (a) of § 1.312–11.

[T.D. 6586, 26 FR 12550, Dec. 28, 1961, as amended by T.D. 6692, 28 FR 12817, Dec. 3, 1963]

§ 1.381(c)(3)–1 Capital loss carryovers.

(a) Carryover requirement. (1) Section 381(c)(3) requires the acquiring corporation in a transaction to which section 381(a) applies to succeed to, and take into account, the capital loss carryovers of the distributor or transferor corporation. To determine the amount of these carryovers as of the close of the date of distribution or transfer, and to integrate them with the capital loss carryovers of the acquiring corporation for purposes of determining the taxable income of the acquiring corporation for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of section 1212 in accordance with the conditions and limitations of section 381(c)(3) and this section.

(2) The capital loss carryovers of the acquiring corporation as of the close of the date of distribution or transfer shall be determined without reference to any capital gains or capital losses of the distributor or transferor corporation. The capital loss carryovers of a distributor or transferor corporation as of the close of the date of distribution or transfer shall be determined without reference to any capital gains or capital losses of the acquiring corporation.

(3) This section contains rules applicable to capital loss carryovers determined without reference to the amendment of section 1212(a) made by section 7 of the Act of September 2, 1964 (Public Law 88–571, 78 Stat. 860) in respect of foreign expropriation capital losses. If the distributor, transferor, or acquiring corporation sustains a net capital loss in a taxable year ending after December 31, 1958, any portion of which is attributable to a foreign expropriation capital loss, such portion shall be carried over to each of the ten succeeding taxable years consistently with the rules prescribed in this section and paragraph (a)(2) of § 1.1212–1.

(b) First taxable year to which carryovers apply. (1) The capital loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall first be carried to the first taxable year of the acquiring corporation ending after that date. This rule applies irrespective of whether the date of distribution or transfer is on the last day, or any other day, of the acquiring corporation's taxable year.

(2) The capital loss carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall be carried to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

(c) Limitation on capital loss carryovers for first taxable year ending after date of distribution or transfer. **(1)** Any capital loss carryover of a distributor or transferor corporation which is available to the acquiring corporation as of the close of the date of distribution or transfer shall be a short-term capital loss of the acquiring corporation in each of the taxable years to which the net capital loss giving rise to such carryover may be carried to the extent provided in section 1212 and this section. However, in the first taxable year of the acquiring corporation ending after the date of distribution or transfer, the total capital loss carryovers of the distributor or transferor corporation which may be treated in that year as short-term capital losses of the acquiring corporation is limited by section 381(c)(3)(B) to an amount which bears the same ratio to the acquiring corporation's capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such first taxable year (determined without regard to any capital loss carryovers) as the number of days in such first taxable year which follow the date of distribution or transfer bears to the total number of days in such taxable year. Thus, if the date of distribution or transfer is the last day of the acquiring corporation's taxable year, there is no limitation under section 381(c)(3)(B) on the amount of such carryovers which may be treated as short-term capital losses of the acquiring corporation for its first taxable year ending after that date.

(2) The limitation provided by section 381(c)(3)(B) shall be applied to the aggregate of the capital loss carryovers of the distributor or transferor corporation without reference to the taxable years in which the net capital losses giving rise to the carryovers were sustained. If the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, then the limitation provided by section 381(c)(3)(B) shall be applied to the aggregate of the capital loss carryovers from all of such distributor or transferor corporations.

(3) If the acquiring corporation succeeds to the capital loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the limitation to be applied under section 381(c)(3)(B) to the aggregate of such carryovers shall be determined consistently with the rules prescribed in paragraph (b) of § 1.381(c)(1)–2.

(4) The application of this paragraph may be illustrated by the following example:

Example. (i) X and Y Corporations are organized on January 1, 1954, and make their returns on the basis of the calendar year. On July 4, 1957, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The net capital losses and the net capital gains (capital gain net income for taxable years beginning after December 31, 1976), (computed without regard to any capital loss carryovers) of the two corporations are as follows:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1954	($5,000)	0
1955	(10,000)	$5,000
1956	(25,000)	(7,000)
Ending 7–4–57	(8,000)	....
1957	....	36,500

(ii) The capital loss carryovers of X Corporation which are available to Y Corporation as of the close of July 4, 1957, amount to $48,000 in the aggregate; but only $18,000 ($36,500 × 180/365) of such amount may be treated as short-term capital losses of Y Corporation for 1957.

(d) Computation of carryovers; general rule—(1) Sequence for applying losses and determination of capital gain net income. Section 1212 provides that a net capital loss sustained in any taxable year (hereinafter referred to as the "loss year") shall be carried over to each of the five succeeding taxable years and treated in each of such succeeding years as a short-term capital loss to the extent not allowed as a deduction against any capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of any taxable years intervening between the loss year and the taxable year to which such loss is carried. For this purpose, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of any intervening taxable year is determined without regard to the net capital loss for the loss year or for any taxable year thereafter, and the various capital loss carryovers from taxable years preceding the loss year to any such intervening taxable year are considered to be applied in reduction of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such year in the order of the taxable years in which the losses were sustained, beginning with the loss for the earliest preceding taxable year. The application of these rules to the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for any taxable year ending after the date of distribution or transfer involves the use of carryovers of the distributor or transferor corporation and of the acquiring corporation. In determining the order in which the capital loss carry-

overs of the distributor or transferor and acquiring corporations from taxable years ending on or before the date of distribution or transfer are considered to be applied in reduction of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for any intervening taxable year ending after such date, the following rules shall apply:

(i) Each taxable year of the distributor or transferor and acquiring corporations which, with respect to the first taxable year of the acquiring corporation ending after the date of distribution or transfer, constitutes a first preceding taxable year, shall be treated as if each such year ended on the same day, whether or not such taxable years actually end on the same day. In like manner, each taxable year of the distributor or transferor and acquiring corporations which, with respect to such first taxable year of the acquiring corporation ending after the date of distribution or transfer, constitutes a second preceding taxable year, shall be treated as if each such year ended on the same day (whether or not such taxable years actually end on the same day), and a similar rule shall be applied with respect to those taxable years of the distributor or transferor and acquiring corporations which constitute third, fourth, and fifth preceding taxable years;

(ii) If in the same preceding taxable year both the distributor or transferor and acquiring corporations incurred a net capital loss which is a carryover to an intervening taxable year of the acquiring corporation ending after the date of distribution or transfer, then in applying such losses in reduction of the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such an intervening year, either such loss may be taken into account before the other; and

(iii) The rules of subdivisions (i) and (ii) of this subparagraph shall apply regardless of the number of distributor or transferor corporations the assets of which are acquired by the acquiring corporation on the same date of distribution or transfer.

(2) **Cross reference.** If the date of distribution or transfer is a day other than the last day of a taxable year of the acquiring corporation, then in determining the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for its first taxable year ending after the date of distribution or transfer, section 1212 and this paragraph shall be applied in the special manner set forth in paragraph (e) of this section.

(3) **Years to which losses may be carried.** The taxable years to which a net capital loss shall be carried are prescribed by section 1212. Since the taxable year of a distributor or transferor corporation ends with the close of the date of distribution or transfer, such taxable year and the first taxable year of the acquiring corporation which ends after that date are considered two separate taxable years to which a net capital loss of the distributor or transferor corporation for any taxable year ending before that date shall be carried. This rule applies even though the taxable year of the distributor or transferor corporation which ends on the date of distribution or transfer is a period of less than twelve months. However, the distribution or transfer has no effect in determining under section 1212 the taxable years to which a net capital loss of the acquiring corporation is carried. For this purpose, the first taxable year of the acquiring corporation which ends after the date of distribution or transfer constitutes only one taxable year even though such taxable year is considered under paragraph (e) of this section as two taxable years for certain purposes. The application of this subparagraph may be illustrated by the following example:

Example. R and S Corporations are organized on January 1, 1954, and both corporations make their returns on the basis of the calendar year. R Corporation has net capital losses for its years 1954, 1955, and 1957, and S Corporation has net capital losses for its years 1954 and 1956. On June 30, 1958, R Corporation transfers all its assets to S Corporation in a statutory merger to which section 361 applies. The taxable years to which these losses of R and S Corporations may be carried are as follows:

Loss year	Carried to
R1954	R1955, R1956, R1957, R6/30/58, S1958.
S1954	S1955, S1956, S1957, S1958, S1959.
R1955	R1956, R1957, R6/30/58, S1958, S1959.
S1956	S1957, S1958, S1959, S1960, S1961.
R1957	R6/30/58, S1958, S1959, S1960, S1961.

(4) **Computation of carryovers in case where date of distribution or transfer occurs on last day of acquiring corporation's taxable year.** The computation of the capital loss carryovers from the distributor or transferor corporation and from the acquiring corporation in a case where the date of distribution or transfer occurs on the last day of a taxable year of the acquiring corporation may be illustrated by the following example:

Example. X and Y Corporations are organized on January 1, 1955, and make their returns on the basis of the calendar year. On December 31, 1956, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The net capital losses and the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to any capital loss carryovers) of the two corporations are as follows:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1955	($20,000)	($2,000)
1956	(10,000)	(8,000)
1957		$25,000
1958		10,000

The sequence in which the net capital losses of X and Y Corporations are applied, and the computation of the capital loss carryovers to Y Corporation's taxable year 1959, may be illustrated as follows. (For purposes of this example, the carryover from a preceding taxable year of the transferor corporation will be applied before the carryover from the same preceding taxable year of the acquiring corporation):

(i) X Corporation's 1955 loss. The carryover to 1959 is $0, computed as follows:

Net capital loss		$20,000
Less: Y's 1957 net capital gain (computed without regard to any capital loss carryovers)		25,000
Carryover to Y 1958 and Y 1959		0

(ii) Y Corporation's 1955 loss. The carryover to 1959 is $0, computed as follows:

Net capital loss		$2,000
Less:		
Y's 1957 net capital gain (computed without regard to any capital loss carryovers)	$25,000	
Minus capital loss carryovers to Y 1957 (i.e., carryover of $20,000 from X 1955)	20,000	
		5,000
Carryover to Y 1958 and Y 1959		0

(iii) X Corporation's 1956 loss. The carryover to 1959 is $0, computed as follows:

Net capital loss		$10,000
Less:		
Y's 1957 net capital gain (computed without regard to any capital loss carryovers)	$25,000	
Minus capital loss carryovers to Y 1957 (i.e., carryovers of $20,000 from X 1955 and $2,000 from Y 1955)	22,000	
		3,000
Carryover to Y 1958		7,000
Less:		
Y's 1958 net capital gain (computed without regard to any capital loss carryovers)	$10,000	
Minus capital loss carryovers to Y 1958	0	
		10,000
Carryover to Y 1959		0

(iv) Y Corporation's 1956 loss. The carryover to 1959 is $5,000, computed as follows:

Net capital loss		$8,000
Less:		
Y's 1957 net capital gain (computed without regard to any capital loss carryovers)	$25,000	
Minus capital loss carryovers to Y 1957 (i.e., carryovers of $20,000 from X 1955, $2,000 from Y 1955, and $10,000 from X 1956)	32,000	
		0
Carryover to Y 1958		8,000
Less:		
Y's 1958 net capital gain (computed without regard to any capital loss carryovers)	$10,000	
Minus capital loss carryovers to Y 1958 (i.e., carryover of $7,000 from X 1956)	7,000	
		3,000
Carryover to Y 1959		5,000

(e) **Computation of carryovers when date of distribution or transfer is not on last day of acquiring corporation's taxable year—(1) General rule.** If, in determining under paragraph (d) of this section the portion of a net capital loss for any taxable year which is carried over to a succeeding taxable year, an intervening taxable year is a taxable year of the acquiring corporation which includes, but does not end on, the date of distribution or transfer, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of such intervening year shall be determined by applying section 1212 in the special manner provided by this paragraph.

(2) **Taxable year considered as two taxable years.** Such intervening taxable year of the acquiring corporation shall be considered as though it were two taxable years, but only for the limited purpose of computing capital loss carryovers to subsequent taxable years. The first of such two taxable years shall be referred to in this paragraph as the preacquisition part year; the second, as the postacquisition part year. Though considered as two separate taxable years for purposes of this paragraph, the preacquisition part year and the postacquisition part year are treated as one taxable year in determining the years to which a net capital loss is carried under section 1212. See paragraph (d)(3) of this section.

(3) **Preacquisition part year.** The preacquisition part year shall begin with the beginning of such taxable year of the acquiring corporation and shall end with the close of the date of distribution or transfer.

(4) **Postacquisition part year.** The postacquisition part year shall begin with the day following the date of distribution or transfer and shall end with the close of such taxable year of the acquiring corporation.

(5) **Division of capital gain net income.** The capital gain net income (net capital gain for taxable years beginning before January 1, 1977) for such intervening taxable year (computed without regard to any capital loss carryovers) of the acquiring corporation shall be divided between the preacquisition part year and the postacquisition part year in proportion to the number of days in each. Thus, if in a statutory merger to which section 361 applies Y Corporation acquires the assets of X Corporation on June 30, 1956, and Y Corporation has net capital gain (computed in the manner so prescribed) of $36,600 for its calendar year 1956, then the preacquisition part year capital gain net income (net capital gain for taxable years beginning before January 1, 1977) would be $18,200 ($36,600 × 182/366) and the postacquisition part year capital gain net income (net capital gain for taxable years beginning before January 1, 1977) would be $18,400 ($36,600 × 184/366).

(6) **Application of capital loss carryovers.** After obtaining the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the preacquisition part year and postacquisition part year in the manner described in subparagraph (5) of this paragraph, it is necessary to determine the capital loss carryovers which are taken into account with respect to each such part year. The carryovers to be taken into account and the sequence in which such carryovers are applied, shall be determined in accordance with paragraph (d)(1) of this section but subject to the provisions of this subparagraph. With respect to the preacquisition part year, no capital loss carryovers of the distributor or transferor corporation shall be taken into account; that is, only capital loss carryovers of the acquiring corporation shall be taken into account. With respect to the postacquisition part year, capital loss carryovers of both the distributor or transferor corporation and the acquiring corporation shall be taken into account.

(7) **Cross reference.** If an intervening taxable year is a taxable year of the acquiring corporation during which the acquiring corporation succeeds to the capital loss carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer, the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) of the acquiring corporation for such intervening taxable year shall be determined consistently with the rules prescribed in paragraph (c) of § 1.381(c)(1)-2, except that the sequence in which the capital loss carryovers of the distributor or transferor and acquiring corporations shall be applied shall be determined under paragraph (d)(1) of this section.

(8) **Illustration.** The application of this paragraph may be illustrated as follows:

Example. X Corporation is organized on April 1, 1959, and makes its return on the basis of the fiscal year ending March 31. Y Corporation is organized on January 1, 1959, and makes its return on the basis of the calendar year. On June 30, 1961, X Corporation transfers all its assets to Y Corporation in a statutory merger to which section 361 applies. The net capital losses and the net capital gains (capital gain net income for taxable years beginning after December 31, 1976) (computed without regard to any capital loss carryovers) of the two corporations are as follows:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
1959		($24,000)
Ending 3-31-60	($19,000)	
1960		(6,000)
Ending 3-31-61	(5,000)	
Ending 6-30-61	0	
1961		36,500
1962		12,000

The following table shows those taxable years of the transferor and acquiring corporations which, with respect to Y Corporation's calendar year 1961, are first, second, and third preceding taxable years:

Taxable year	X Corporation (transferor)	Y Corporation (acquirer)
First preceding year	Ending June 30, 1961	1960
Second preceding year	Ending March 31, 1961	1959
Third preceding year	Ending March 31, 1960	

The sequence in which the net capital losses of X and Y Corporations are applied, and the computation of the capital loss carryovers to Y Corporation's calendar year 1963, may be illustrated as follows. (For purposes of this example, the carryover from a preceding taxable year of the acquiring corporation will be applied before the carryover from the same preceding taxable year of the transferor corporation):

(i) **X Corporation's 3/31/60 loss.** The carryover to 1963 is $0, computed as follows:

Net capital loss	$19,000
Less: Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph ($36,500 × 184/365)	18,400
Carryover to Y 1962	600
Less: Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	12,000
Carryover to Y 1963	0

(ii) **Y Corporation's 1959 loss.** The carryover to 1963 is $0, computed as follows:

Net capital loss	$24,000

Less: Y's preacquisition part year net capital gain computed under subparagraph (5) of this paragraph ($36,500 × 181/365)		18,100
Carryover to Y's postacquisition part year		5,900
Less:		
Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,400	
Minus capital loss carryovers to postacquisition part year (i.e., carryover of $19,000 from X 3/31/60)	19,000	0
Carryover to Y 1962		5,900
Less:		
Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	$12,000	....
Minus capital loss carryovers to Y 1962 (i.e., carryover of $600 from X 3/31/60)	600	11,400
Carryover to Y 1963		0

(iii) X Corporation's 3/31/61 loss. The carryover to 1963 is $0, computed as follows:

Net capital loss		$5,000
Less:		
Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,400	
Minus capital loss carryovers to postacquisition part year (i.e., carryovers of $19,000 from X 3/31/60 and $5,900 from Y 1959)	24,900	
		0
Carryover to Y 1962		5,000
Less:		
Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	$12,000	
Minus capital loss carryovers to Y 1962 (i.e., carryovers of $600 from X 3/31/60 and $5,900 from Y 1959)	6,500	
		5,500
Carryover to Y 1963		0

(iv) Y Corporation's 1960 loss. The carryover to 1963 is $5,500, computed as follows:

Net capital loss		$6,000
Less:		
Y's preacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,100	
Minus capital loss carryovers to preacquisition part year (i.e., carryover of $24,000 from Y 1959)	24,000	
		0
Carryover to Y's postacquisition part year		6,000
Less:		
Y's postacquisition part year net capital gain computed under subparagraph (5) of this paragraph	$18,400	
Minus capital loss carryovers to postacquisition part year (i.e., carryovers of $19,000 from X 3/31/60, $5,900 from Y 1959, and $5,000 from X 3/31/61)	29,900	0
		0
Carryover to Y 1962		6,000
Less:		
Y's 1962 net capital gain (computed without regard to any capital loss carryovers)	$12,000	
Minus capital loss carryovers to Y 1962 (i.e., carryovers of $600 from X 3/31/60, $5,900 from Y 1959, and $5,000 from X 3/31/61)	11,500	
		$500
Carryover to Y 1963		5,500

(f) Successive acquiring corporations. An acquiring corporation which, in a transaction to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of sections 1212 and 381, the capital loss carryovers available to the first acquiring corporation under sections 1212 and 381.

[T.D. 6552, 26 FR 1985, March 8, 1961, as amended by T.D. 6867, 30 FR 15094, Dec. 12, 1965; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.381(c)(4)–1 Method of accounting.

(a) **Carryover requirement—(1) General rule.** (i) Section 381(c)(4) provides that, in a transaction to which section 381(a) applies, an acquiring corporation shall use the same method of accounting used by the distributor or transferor corporation on the date of distribution or transfer unless different methods of accounting were used on that date by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods of accounting were used, the acquiring corporation shall use the method or combination of methods of accounting adopted pursuant to this section.

(ii) The acquiring corporation shall take into its accounts the dollar balances of those accounts of the distributor or transferor corporation representing items of income or deduction which, because of its method of accounting, were not required or permitted to be included or deducted by the distributor or transferor corporation in computing

taxable income for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall similarly take into its accounts the dollar balances of those accounts of the distributor or transferor corporation which represents reserves in respect of which the distributor or transferor corporation has taken a deduction for taxable years ending on or before the date of distribution or transfer. The acquiring corporation shall also take into its accounts the dollar balance of that account of the distributor or transferor corporation which represents a suspense account established by the distributor or transferor corporation under section 166(f)(4) in taxable years ending on or before the date of distribution or transfer. Items of income and deduction shall have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation or corporations if no distribution or transfer had occurred. This section shall have no application to items of income or deduction, or dollar balances, to the extent they are attributable to assets or liabilities not distributed or transferred, and shall have no application to items the tax treatment of which is specifically provided for in other paragraphs of section 381(c). In the case of an obligation of the distributor or transferor corporation which is assumed by the acquiring corporation and which gives rise to a liability (within the meaning of paragraph (a)(4) of § 1.381(c)(16)–1) after the date of distribution or transfer, the deductibility of such an item is determined under this section if it is not deductible under section 381(c)(16) and the regulations thereunder. The amount of the adjustments necessary to reflect a change in accounting method pursuant to this section, the manner in which they are to be taken into account, and the tax attributable thereto shall be determined and computed under section 481 and the regulations thereunder, subject to the rules provided in paragraphs (c) and (d) of this section. Where such change is a change from the accrual to the installment method by a dealer in personal property, section 453(c) and the regulations thereunder apply.

(2) Rules of application. For purposes of section 381(c)(4) and this section, the term "method of accounting" shall have the same meaning as that provided under section 446 and the regulations thereunder. This section shall not be construed as preventing the exercise of any election which may be made by the acquiring corporation without consent of the Commissioner, or preventing the application of section 269 or 482, or the regulations thereunder. For provisions defining the date of distribution or transfer, see paragraph (b) of § 1.381(b)–1. See other paragraphs of section 381(c) and the regulations thereunder for other rules regarding the treatment of the carryover of certain items specifically enumerated therein.

(b) Conditions for continuation of methods of accounting—(1) No differences in methods of accounting. If all the parties to a section 381(a) transaction used the same method of accounting on the date of distribution or transfer, the acquiring corporation shall continue to use such method of accounting, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a different method of accounting. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation and Y Corporation use the accrual method as their overall method of accounting. Both corporations have established a reserve for bad debts under section 166(c). Pursuant to elections made by each corporation, they are amortizing trademark and trade name expenditures over a 60-month period under section 177, expensing intangible drilling and development costs under section 263(c), and accruing real property taxes ratably under section 461(c). It is assumed that there are no other items to which paragraph (a) of this section might apply. Y Corporation acquires all of the assets of X Corporation in a transaction to which section 381(a) applies. On and after the date of distribution or transfer Y Corporation must continue, without further election, to use the same overall method of accounting and the same accounting treatment of the specified items, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change the methods of accounting. Thus, Y Corporation shall carry over the balance in X Corporation's reserve for bad debts account, shall continue to amortize and deduct over the remaining portion of the 60-month period the unamortized portion of the trademark and trade name expenditures carried over from X Corporation, and shall continue the same treatment of intangible drilling and development costs and of real property taxes.

Example (2). M Corporation and N Corporation use the cash receipts and disbursements method of accounting. N Corporation acquires all of the assets and assumes all the obligations of M Corporation in a transaction to which section 381(a) applies. M Corporation, immediately prior to the transaction, is entitled to receive $10,000 for unbilled services performed, and has billed but not received payment for services performed in an amount of $20,000. It has received but not paid invoices amounting to $18,000, and has received services in the amount of $5,000 for which no invoices have been received. Since M Corporation and N Corporation are both on the cash receipts and disbursements method, N Corporation must continue to use that method, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change its method of accounting. Accordingly, N Corporation must include in income when received the unrealized receivables of M Corporation and may deduct the payment of those obligations of M Corporation which would have been deductible by such corporation if paid by it. Thus, N Corporation shall treat as ordinary income the receipt by it of M Corporation's $30,000 of receivables, and may deduct

upon payment the amount of M Corporation's $23,000 of payables which would have been deductible by it.

Example (3). S Corporation and T Corporation are both publishers and use the accrual method as their overall method of accounting. Both corporations have elected under section 455 to defer prepaid subscription income to the taxable years during which the liability to furnish the newspaper, magazine, or other periodical exists. T Corporation, in a transaction to which section 381(a) applies, acquires all the assets of S Corporation and assumes the liability of such corporation to furnish or deliver the newspaper, magazine, or other periodical. On and after the date of the transfer, T Corporation must continue, without further election, to use the accrual method as its overall method of accounting and to defer prepaid subscription income under section 455, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change the method of accounting. T Corporation shall carry over the closing balance of S Corporation's prepaid subscription income account. The principles in this example would be equally applicable if both corporations had been deferring prepaid subscription income under a method permitted by subsection (e) of section 455.

(2) Separate businesses. If, after the date of distribution or transfer, the trades or businesses of the parties to a transaction described in section 381(a) are operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446–1, then the method of accounting employed by the parties to the transaction on the date of distribution or transfer with respect to each trade or business shall be used by the acquiring corporation, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a different method of accounting, or unless the Commissioner prescribes a different method of accounting under paragraph (b)(1) of § 1.446–1. However, if only a single method of accounting may be employed by a taxpayer with respect to a particular item regardless of the number of separate and distinct trades or businesses operated by such taxpayer, but different methods were employed by the several corporations on the date of distribution or transfer with respect to such item, then the acquiring corporation shall adopt the principal method of accounting determined under paragraph (c) of this section (see subparagraph (2)(iv) thereof) for such item, or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable. This subparagraph may be illustrated by the following examples:

Example (1). M Corporation is engaged in a personal service business and uses the cash receipts and disbursements method of accounting. N Corporation is engaged in a retail furniture business and uses the accrual method of accounting. N Corporation acquires the assets of M Corporation in a transaction to which section 381(a) applies. In accordance with paragraph (d) of § 1.446–1, N Corporation operates as a separate and distinct trade or business the personal service business formerly operated by M Corporation. Unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1 to change the method of accounting, N Corporation shall continue to use the cash receipts and disbursements method of accounting with respect to the personal service business formerly operated by M Corporation, and shall use the accrual method of accounting with respect to the retail furniture business.

Example (2). Assume the same facts as in example (1), except that M Corporation has elected under section 171 to amortize bond premium with respect to fully taxable bonds. N Corporation has not made the election to amortize bond premium with respect to such bonds owned by it. N Corporation may not continue separate accounting methods as to amortizable bond premium but must consistently apply only a single method of accounting with respect to such bond premium since the election to amortize bond premium applies to all fully taxable bonds held by the taxpayer. N Corporation shall use the principal method of accounting determined under paragraph (c) of this section for such bond premium, unless it is determined in accordance with paragraph (d) of this section that a different method of accounting is to be used. However, if such principal or different method of accounting is not to amortize bond premium N Corporation is not precluded from making a new election to the extent permitted by section 171.

(3) Integrated businesses. (i) If, after the date of distribution or transfer, any of the trades or business of the parties to a transaction in section 381(a) are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446–1, then, to the extent that the same methods of accounting were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or are required to be integrated in accordance with section 446(d) and the regulations thereunder, the acquiring corporation shall continue to employ such methods of accounting, unless the acquiring corporation has obtained the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a different method of accounting, or unless the Commissioner prescribes a different method of accounting under paragraph (b)(1) of § 1.446–1.

(ii) If, after the date of distribution or transfer, any of the trades or businesses of the parties to a transaction described in section 381(a) are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446–1, then, to the extent that different methods of accounting were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or required to be integrated in accordance with section 446(d) and the regulations thereunder, this paragraph shall not apply and the acquiring corporation shall adopt the principal method of accounting determined under paragraph (c) of this section or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable.

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). M Corporation and N Corporation both use the accrual method as an overall method of accounting. M Corporation has established a reserve for bad debts while N Corporation uses the specific charge-off method with respect to its bad debts. N Corporation acquires all of the assets of M Corporation in a transaction to which section 381(a) applies and integrates the business formerly operated by M Corporation into the business operated by N Corporation before the date of distribution or transfer. N Corporation shall continue to use the accrual method as its overall method of accounting, unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change its method of accounting. N Corporation shall use the principal method of accounting determined under paragraph (c) of this section with respect to bad debts, or the method of accounting determined in accordance with paragraph (d) of this section, whichever is applicable.

Example (2). X Corporation conducts two separate and distinct trades or businesses, a personal service business with respect to which the cash receipts and disbursements method of accounting is used and a manufacturing business with respect to which the accrual method of accounting is used. Y Corporation conducts a manufacturing business and uses the accrual method of accounting. Y Corporation acquires all of the assets of X Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, Y integrates the manufacturing business formerly operated by X Corporation into the manufacturing business operated by it and continues to operate as a separate and distinct trade or business the personal service business formerly operated by X Corporation. Unless consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446-1 to change the method of accounting, Y Corporation shall continue to use the accrual method of accounting with respect to the integrated manufacturing business and shall continue to use the cash receipts and disbursements method of accounting with respect to the personal service business.

(4) Rules of application. In any case where the method of accounting employed on the date of distribution or transfer is continued, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such method of accounting. Also, the acquiring corporation is bound by any election previously made by it or by any distributor or transferor corporation with respect to such method of accounting which is in effect on the date of distribution or transfer to the same extent as though the distribution or transfer had not occurred. If, on the date of distribution or transfer, any party to a section 381(a) transaction had no established method of accounting for any item, or came into existence as a result of the transaction, such party shall not be considered to be using a method of accounting for such item or having an overall method of accounting different from that used by the other parties to the transaction. Where under other sections of the Internal Revenue Code or regulations thereunder a taxpayer is permitted to elect a method of accounting on a project-by-project, job-by-job, or other similar basis (such as the election to charge taxes and carrying charges to capital account under § 1.266-1), that method elected with respect to each project or job shall be deemed to be an established method of accounting only for the project or job for which it is elected. Accordingly, unless two or more of the parties were working on the same project or job and were using different methods of accounting for such project or job before the date of distribution or transfer, the method of accounting previously elected for each project or job must be continued.

(c) Change of method of accounting without consent of Commissioner—(1) General rule. If the acquiring corporation may not continue to use, under the provisions of paragraph (b) of this section, the method of accounting used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, the acquiring corporation shall use the principal method of accounting of such corporation (as determined under subparagraph (2) of this paragraph), provided that (i) such method of accounting clearly reflects the income of the acquiring corporation, and (ii) the use of such method is not inconsistent with the provisions of any closing agreement entered into under section 7121 and the regulations thereunder. If the principal method of accounting does not meet these requirements, or if there is no principal method of accounting, see subdivision (i) of paragraph (d)(1) of this section. If the acquiring corporation wishes to use a method of accounting other than the principal method of accounting, see subdivision (ii) of paragraph (d)(1) of this section. Whenever this paragraph applies, the increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if on the date of distribution or transfer each of the several corporations whose method or methods of accounting are required to be changed in accordance with this section had initiated a change in accounting method. In addition, the acquiring corporation shall take into account the portion of such adjustments which is attributable to pre-1954 Code years to the extent not taken into account by any of the other corporations in accordance with the rules provided in section 481(b)(4) and this paragraph. If the principal method of accounting is adopted under this paragraph, it will be unnecessary for the acquiring corporation to renew any

election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting. Also, in such event, the acquiring corporation is bound by any election previously made by it or by any distributor or transferor corporation with respect to such principal method of accounting which is in effect on the date of distribution or transfer to the same extent as though the distribution or transfer had not occurred.

(2) Principal method of accounting. (i) The determination of the principal method of accounting shall be made with respect to each integrated trade or business operated by the acquiring corporation immediately after the date of distribution or transfer, except with respect to items for which only a single method of accounting may be used by any one taxpayer. See subdivision (iv) of this subparagraph. Such determination for an integrated trade or business shall be made by reference to the methods of accounting used immediately preceding the date of distribution or transfer by each of the component trades or businesses which now constitute the integrated trade or business of the acquiring corporation. The method of accounting for items other than those for which special methods of accounting are provided under chapter 1 of the Code and the regulations thereunder (see § 1.446-1(c)(1)(iii)) shall be governed by the principal overall method determined for such trade or business under subdivision (ii) of this subparagraph. The method of accounting for items for which special methods of accounting are provided under chapter 1 of the Code and the regulations thereunder shall be determined under subdivision (iii) of this subparagraph.

(ii) The principal overall method of accounting of an integrated trade or business is determined by making a comparison of—

(a) The total of the adjusted bases of the assets (determined under section 1011 and the regulations thereunder) immediately preceding the date of distribution or transfer, and

(b) The gross receipts for a representative period (ordinarily the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer)

of the component trades or businesses which are integrated or are required to be integrated. If more than one component trade or business used the same overall method, then such total assets and gross receipts of each of the component trades or businesses shall be aggregated and compared with the aggregate of such total assets and gross receipts of other component trades or businesses which used a different overall method. If this comparison shows that the one or more component trades or businesses (using a common overall method of accounting) having the greatest total of the adjusted bases of assets also has the greatest amount of gross receipts, then the overall method of accounting of such one or more component trades or businesses shall be the principal overall method of accounting. If this comparison shows that the one or more component trades or businesses (using a common overall method of accounting) having the greatest total of the adjusted bases of assets does not also have the greatest amount of gross receipts, then there is no principal overall method of accounting, and the acquiring corporation shall request the Commissioner to determine the appropriate overall method of accounting for such integrated trade or business in accordance with paragraph (d) of this section.

(iii) The principal method of accounting for an item for which a special method or methods of accounting are provided under chapter 1 of the Code and the regulations thereunder is determined by comparing the amounts of such item and related accounts for the component trades or businesses in accordance with the principles of subdivision (ii) of this subparagraph. Thus, for example, in the case of bad debts, trades or businesses which are components of the integrated trade or business and which had been using the reserve method of accounting will be compared with the other component trades or businesses which had been using the specific charge-off method of accounting. In such a case, the following factors would ordinarily be used in determining the principal method of accounting for bad debts: (a) Sales on account for the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer, (b) accounts receivable immediately before the date of distribution or transfer, and (c) the amount of debts which became worthless within the meaning of section 166(a) and the regulations thereunder during the most recent period of 12 consecutive calendar months ending on or prior to the date of distribution or transfer. If this comparison shows that the one or more component trades or businesses using the same method of accounting with respect to bad debts have the greater amounts of such sales, accounts receivable, and bad debts, then the method of accounting with respect to bad debts for such one or more component trades or businesses shall be the principal method of accounting. If such comparison shows that the one or more component trades or businesses using the same method of accounting with

respect to bad debts do not have the greater amounts of all of such items, then there is no principal method of accounting with respect to bad debts, and the acquiring corporation shall request the Commissioner to determine the appropriate method of accounting for bad debts for such integrated trade or business in accordance with paragraph (d) of this section.

(iv) If a single method of accounting must be employed by a taxpayer with respect to a particular item regardless of the number of separate and distinct trades or businesses operated by the taxpayer, the principal method of accounting for such item shall be determined by comparing the aggregate amount of the item and related accounts for all the parties to the transaction using a common method, with the aggregate amount of the item and related accounts for those parties to the transaction which use a different common method. The method of accounting of the party having the greatest aggregate amount of such item and related accounts shall be the principal method of accounting for such item.

(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). M Corporation, which commenced business in 1955, uses the cash receipts and disbursements method of accounting, while N Corporation uses the accrual method. On June 30, 1961, N Corporation acquires all of the assets of M Corporation in a transaction to which section 381(a) applies. N Corporation then integrates its own business with that of M Corporation. Immediately prior to the transfer the total of the adjusted bases of the assets of N Corporation was greater than that of M Corporation, and for the 12-month period ending on June 30, 1961, the gross receipts of N Corporation were greater than that of M Corporation. Under such circumstances, the accrual method of accounting is the principal overall method of accounting and N Corporation shall use such method for the integrated business, provided it clearly reflects income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting. Except as to items for which N Corporation had no established method of accounting and items for which a special method of accounting is provided under chapter 1 of the Code and the regulations thereunder, all adjustments necessary to place the accounts of M Corporation on the accrual method shall be made in accordance with section 481. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if M Corporation had initiated a change in method of accounting on June 30, 1961.

Example (2). Assume the same facts as in example (1) except that the gross receipts of M Corporation were greater than those of N Corporation for the 12-month period ending on June 30, 1961. N Corporation must, under such circumstances, request the Commissioner to determine the appropriate overall method of accounting, in accordance with the provisions of paragraph (d) of this section. The necessary adjustments to be made by the corporation whose method of accounting is changed shall be made in accordance with section 481 to place the integrated business on the method so adopted. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if the corporation whose method is changed had initiated a change in method of accounting on June 30, 1961.

Example (3). Assume the same facts as in example (1). Assume further that M Corporation's deduction for wages and salaries for the 12 calendar months ending on June 30, 1961, is larger than N Corporation's deduction for wages and salaries for such period. Since wages and salaries is not an item for which a special method of accounting is provided under chapter 1 of the Code or the regulations thereunder, the necessary adjustments shall be made in accordance with section 481 to place the wages and salary account of M Corporation on the accrual method of accounting, provided such accrual method clearly reflects income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting. Any increase or decrease in tax resulting from such adjustments shall be taken into account by N Corporation. Such adjustments and such increase or decrease in tax shall be determined and computed in the same manner as if M Corporation had initiated a change in method of accounting on June 30, 1961.

Example (4). Assume the same facts as in example (1). Assume further that M Corporation used the specific charge-off method with respect to bad debts, and that N Corporation has established a reserve for bad debts. M Corporation's sales on account and bad debts for the 12 calendar months ending June 30, 1961, were larger than those of N Corporation. Also M Corporation's accounts receivable immediately prior to June 30, 1961, were larger than those of N Corporation. Since the method of accounting for bad debts is a special method of accounting under section 166, M Corporation's method of accounting for bad debts is the principal method of accounting for such item. Assuming such method clearly reflects income, appropriate adjustments shall be made in accordance with section 481 to the accounts of N Corporation to place N Corporation on the specific charge-off method with respect to all of its bad debts, as if N Corporation had initiated a change in method of accounting on June 30, 1961, and N Corporation shall include the amount of its reserve for bad debts in gross income, unless consent of the Commissioner is obtained in accordance with paragraph (d) of this section to use a different method of accounting.

Example (5). Assume the same facts as in example (1) except that M Corporation commenced business in 1945. In addition assume that N Corporation is a calendar-year taxpayer and that of the total amount of the adjustments required by section 481 to place the accounts of M Corporation on the accrual method $40,000 is attributable to pre-1954 Code years as described in section 481(b)(4) and the regulations thereunder. Assume further that M Corporation does not elect, under section 481(b)(6), to take the $40,000 portion of the adjustments into account in the manner described in section 481(b)(1) or (2). In computing the increase in tax of M Corporation attributable to the $40,000 portion of the adjustment for the fiscal year ended June 30, 1961, only one-tenth, or $4,000, will be taken into account. The resulting increase in tax shall be taken into account by N Corporation. The remaining nine-tenths of the $40,000 portion of the adjustments, or $36,000, shall be taken into account by N Corporation in the amount of $4,000 in each of the calendar years 1962 through 1970.

(d) Change of method of accounting with consent of Commissioner—(1) General rule. (i) If the acquiring corporation may not continue to use,

under paragraph (b), the method of accounting used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, and may not under paragraph (c) use the principal method of accounting, or, if there is no principal method of accounting, then the Commissioner shall determine the appropriate method or combination of methods of accounting to be used.

(ii) If an acquiring corporation wishes to use a method or combination of methods of accounting other than the principal method of accounting which is required to be used by paragraph (c) of this section, it shall apply to the Commissioner for permission to use such other method or combination of methods of accounting. Permission to use such other method or combination of methods of accounting will not be granted unless the acquiring corporation and the Commissioner agree to the terms, conditions, and adjustments under which the change to such method or combination of methods will be effected.

(iii) The increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved shall be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax shall be determined and computed in the same manner as if, on the date of distribution or transfer, each of the several corporations that were not using the method or combination of methods of accounting adopted pursuant to subdivision (i) or (ii) of this subparagraph had initiated a change in accounting method.

(2) Time and manner of making application. Applications under subparagraph (1) of this paragraph for permission to use a method of accounting or requests for determination of the method of accounting to be used shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C., 20224, not later than 90 days after the date of distribution or transfer, except that in cases where the date of distribution or transfer occurs before August 5, 1964, such applications or requests shall be filed not later than November 3, 1964. The application shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in accounting methods used by the corporations concerned; the method or methods of accounting proposed to be used by the acquiring corporation; and the various amounts, if any, of items of income or deduction which will be duplicated or omitted in the computation of taxable income under such proposed method or methods. The Commissioner may also require such other information as may be necessary in order to determine the appropriate method or combination of methods of accounting to be used by the acquiring corporation.

(e) Special rules applicable to distributions or transfers before August 5, 1964—(1) Statute of limitations bars assessment or refund. If the date of distribution or transfer was before August 5, 1964, and if the assessment of any deficiency or the refund or credit of any overpayment for the taxable year of the acquiring corporation which includes the date of distribution or transfer or any subsequent taxable year is prevented by the operation of any law or rule of law, then this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of accounting in any taxable year of the acquiring corporation. However, the Commissioner or the acquiring corporation may change such method or methods of accounting under the provisions of section 446 and the regulations thereunder or, where applicable, any section of the Internal Revenue Code (other than section 381(c)(4)), or the regulations thereunder, in accordance with which such changes may be made without the consent of the Commissioner.

(2) Statute of limitations does not bar assessment and refund. Except as provided in subparagraph (1) of this paragraph—

(i) If the date of distribution or transfer was before August 5, 1964, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, (a) adopted or continued a method of accounting consistent with the rules of this section, (b) been granted permission by the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a method or combination of methods of accounting, or (c) adopted a method of accounting that under other sections of the Internal Revenue Code, or regulations thereunder, may be adopted without the consent of the Commissioner, then the method or methods of accounting adopted or continued in the manner described in (a), (b), and (c) shall not be changed, by reason of the rules contained in this section, by the Commissioner or the acquiring corporation for any taxable year ending after the date of distribution or transfer. However, the Commissioner or the acquiring corporation may change such methods of accounting for any such taxable year under the provisions of, and to the extent permitted by, section 446 and the regula-

tions thereunder or, where applicable, any section of the Internal Revenue Code (other than section 381(c)(4)), or regulations thereunder, in accordance with which such change may be made without the consent of the Commissioner.

(ii) If the date of distribution or transfer was before August 5, 1964, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, adopted or continued a method or methods of accounting other than in the manner described in (a), (b), and (c) of subdivision (i) of this subparagraph, then the acquiring corporation may—

(a) Continue to use the method or methods of accounting so adopted or continued if such method or methods clearly reflect income and if proper adjustments were made to reflect the adoption of such method or methods, or

(b) Adopt the method or methods of accounting prescribed by this section. Such method or methods of accounting shall be adopted by filing an amended return (which includes the proper adjustments required by this section) for the taxable year of the acquiring corporation which includes the date of distribution or transfer, and by filing amended returns for all subsequent taxable years of the acquiring corporation for which returns have previously been filed. Such amended return or returns shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in accounting methods used by the corporations concerned; the method or methods of accounting originally adopted by the acquiring corporation; the method or methods of accounting adopted on the amended return or returns; and the computation of the amount of the adjustments and the resulting increase or decrease in tax.

[T.D. 6750, 29 FR 11263, Aug. 5, 1964, as amended by T.D. 8071, 51 FR 2481, Jan. 17, 1986]

§ 1.381(c)(5)–1 Inventories.

(a) Carryover requirement—(1) General rule. Section 381(c)(5) provides that in a transaction to which section 381(a) applies and in which inventories are received by the acquiring corporation (as defined in § 1.381(a)–1(b)(2)) such inventories shall be taken by the acquiring corporation (in determining its income) on the same basis on which such inventories were taken by the distributor or transferor corporation on the date of distribution or transfer unless different inventory methods were used on that date by several distributor or transferor corporations or by a distributor or transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation shall use the method or combination of methods of taking inventories adopted pursuant to the provisions of this section.

(2) **Rules of application.** Reference in this section to a method or methods of taking inventories are to be construed as referring to both the method or methods of identifying the goods and the method or methods of valuing the goods. The method or methods of taking inventories shall be determined on the date of distribution or transfer, and any corporation, a party to a section 381(a) transaction whose taxable year does not end on such date shall be considered as using the method or methods of taking inventories that it would have employed had its taxable year ended on such date. The amount of the adjustments necessary to reflect the change in method of taking inventories pursuant to this section, the manner in which they are to be taken into account by the acquiring corporation, and the tax attributable thereto shall be determined and computed under section 481 and the regulations thereunder, subject to the rules provided in paragraphs (c) and (d) of this section. However, in the case of any party to a section 381(a) transaction which changes its method of taking inventories to the last-in, first-out method of identification, the adjustments required by section 472(d) shall be applicable. See paragraph (e) of this section. This section shall not be construed as preventing any party to a section 381(a) transaction from adopting an inventory method which, under the provisions of section 471 or 472, and the regulations thereunder, may be adopted without the consent of the Commissioner. For provisions defining the date of distribution or transfer, see paragraph (b) of § 1.381(b)–1.

(b) Conditions for continuation of methods of taking inventories—(1) No difference in method of taking inventories. (i) If all the parties to a section 381(a) transaction used the same method of taking inventories on the date of distribution or transfer, the acquiring corporation, whether or not immediately after the date of distribution or transfer it operates separate or integrated trades or businesses, shall continue to use such method of taking inventories, unless the acquiring corporation has, in accordance with paragraph (e) of § 1.446–1, obtained the consent of the Commissioner to use a different method of taking inventories. For purposes of this determination, a corporation shall be deemed to be using the last-in, first-out method of taking inventories with respect

to a particular type of goods on the date of the distribution or transfer, if such corporation elects, under the provisions of section 472, to adopt the last-in, first-out method with respect to such goods for its taxable year within which or with which the date of distribution or transfer occurs.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. O and P corporations are manufacturing companies which compute their entire inventories by the use of the last-in, first-out method of identification and the cost basis of valuation. In applying the last-in, first-out method both corporations use the dollar-value method, use the double-extension method, pool under the natural business unit method, and value annual inventory increases by reference to the actual cost of goods most recently purchased. P corporation acquires the assets of O corporation in a transaction to which section 381(a) applies. Under the provisions of this subparagraph, on and after the date of distribution or transfer P corporation must continue to use the last-in, first-out method of identification, the cost basis of valuation, and, in applying the last-in, first-out method, must continue to use the dollar-value method, use the double-extension method, pool under the natural business unit method, and value annual inventory increases by reference to the actual cost of goods most recently purchased, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking inventories.

(2) Separate businesses. (i) If, immediately after the date of distribution or transfer, any of the trades or businesses of the parties to a section 381(a) transaction are operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446–1, then the method or methods of taking inventories employed by such parties to the transaction on the date of distribution or transfer with respect to such trades or businesses shall be used by the acquiring corporation, unless the acquiring corporation has, in accordance with paragraph (e) of § 1.446–1, obtained the consent of the Commissioner to use a different method of taking inventories. This subparagraph shall not be construed as precluding the Commissioner under section 471 or 472, and the regulations thereunder, from requiring that the method of taking inventories used in a particular trade or business be used in another trade or business with respect to similar types of goods, if, in the opinion of the Commissioner, the use of such method of taking inventories is necessary for a clear reflection of income.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. R Corporation is engaged in the production of radios and television sets and S Corporation is engaged in the production of washers and driers. In computing their inventories both corporations use the cost basis of valuation. R Corporation uses the last-in, first-out method of identification, whereas S Corporation uses the first-in, first-out method. T Corporation acquires the assets of R Corporation and S Corporation in a transaction to which section 381(a) applies. T Corporation operates as a separate and distinct trade or business, within the meaning of paragraph (d) of § 1.446–1, each of the businesses formerly operated by R Corporation and S Corporation. Under the provisions of this subparagraph, T Corporation is required to continue to use the method of taking inventories previously used by R Corporation and S Corporation, respectively, with respect to each trade or business, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the methods of taking inventories, on and after the dates of transfer. However, the Commissioner may require T Corporation, in accordance with § 1.472–2, to use the last-in, first-out method with respect to that portion of the goods in the trades or businesses formerly operated by S Corporation and T Corporation which are similar to goods in the trade or business formerly operated by R Corporation, if, in his opinion, the use of the last-in, first-out method with respect to such similar goods is necessary for a clear reflection of income.

(3) Integrated businesses—(i) Same inventory method. If, immediately after the date of distribution or transfer, any of the trades or businesses of the parties to a section 381(a) transaction are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446–1, then, to the extent that the same methods of taking inventories for particular types of goods were employed on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or are required to be integrated in accordance with paragraph (d) of § 1.446–1, the acquiring corporation shall continue to employ such methods of taking inventories for such types of goods, unless, in accordance with paragraph (e) of § 1.446–1, the acquiring corporation has obtained the consent of the Commissioner to use a different method of taking inventories. This subdivision shall not be construed as precluding the Commissioner under section 471 or 472, and the regulations thereunder, from requiring that the method of taking inventories used with respect to particular types of goods in a particular trade or business operated by the acquiring corporation after the date of distribution or transfer be used with respect to similar types of goods in another trade or business operated by it after such date if, in the opinion of the Commissioner, the use of such method of taking inventories is necessary for a clear reflection of income.

(ii) Different inventory methods. If, immediately after the date of distribution or transfer, any of the trades or businesses of the parties to a section 381(a) transaction are not operated as separate and distinct trades or businesses within the meaning of paragraph (d) of § 1.446–1, then, to the extent that different methods of taking inventories for particular types of goods were employed

on the date of distribution or transfer by the parties to the transaction with respect to any trades or businesses which are integrated or required to be integrated in accordance with paragraph (d) of § 1.446–1, the acquiring corporation shall not be permitted to continue to use such different methods of taking inventories, and shall adopt the method of taking inventories described in paragraph (c) of this section for such types of goods unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

(iii) Examples. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). O and P corporations are manufacturing companies which compute their entire inventories by the use of the last-in, first-out method of identification and the cost basis of valuation. In applying the last-in, first-out method both corporations use the dollar-value method and the double-extension method. However, O corporation pools under the natural business unit method while P corporation pools under the multiple pool method. In addition, O corporation determines the cost of its annual inventory increase by reference to the actual cost of goods most recently purchased, whereas P corporation determines the cost of such increase by reference to the actual cost of the goods purchased during the taxable year in the order of acquisition. P corporation acquires the assets of O corporation in a transaction to which section 381(a) applies and integrates the business formerly operated by O corporation into the business which was operated by P corporation before the date of distribution or transfer. Under the provisions of subdivision (i) of this subparagraph (relating to the same inventory methods in an integrated trade or business), P corporation shall continue to use the last-in, first-out method of identification, the cost basis of valuation, and in applying the last-in, first-out method, shall continue to use the dollar-value method and the double-extension method, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking inventories. However, under the provisions of subdivision (ii) of this subparagraph (relating to different inventory methods in an integrated trade or business), P corporation shall use the method of taking inventories described in paragraph (c) of this section with respect to the method of pooling and the method of determining the cost of annual inventory increases, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

Example (2). Y and Z corporations are engaged in the manufacture of cereal products. Y corporation uses the first-in, first-out method of identification and the cost or market, whichever is lower, method of valuing its inventories, including oats. Z corporation uses the first-in, first-out method of identification and the cost or market, whichever is lower, method of valuing its inventories, except oats which are valued on the cost method. Y corporation acquires all of the assets of Z corporation in a transaction to which section 381(a) applies and integrates the business formerly operated by Z corporation into the business which was operated by Y corporation before the date of distribution or transfer. Under the provisions of subdivision (i) of this subparagraph (relating to the same inventory methods in an integrated trade or business), Y corporation must continue to use the first-in, first-out method with respect to all of its inventories and must continue to use the cost or market, whichever is lower, method of valuing all inventories except oats, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking inventories. In addition, under the provisions of subdivision (ii) of this subparagraph (relating to different inventory methods in an integrated trade or business), Y corporation shall use the method described in paragraph (c) of this section in valuing its inventory of oats, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of valuing its oats.

(4) Rules of application. (i) In any case where the method of taking inventories employed on the date of distribution or transfer is continued, it will be unnecessary for the acquiring corporation to renew any election previously made by it or by any distributor or transferor corporation with respect to such method of taking inventories, and the acquiring corporation is bound by any such elections. If, on the date of distribution or transfer, any party to a section 381(a) transaction had no inventories of a particular type of goods, or such party came into existence as a result of the transaction, such party shall not be considered to be using a method of taking inventories for the particular type of goods different from that used by the other parties to the transaction. If, on the date of distribution or transfer, any one of the parties to the transaction is using the cash receipts and disbursements method of accounting and is not required to take inventories, the determination as to whether such method of accounting is to be continued by the acquiring corporation shall be made in accordance with section 381(c)(4) and the regulations thereunder.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). M corporation is engaged in manufacturing and computes its inventories under the first-in, first-out method of identification and the cost or market, whichever is lower, method of valuation. N corporation is also engaged in manufacturing and computes its inventories under the first-in, first-out method of identification and the cost method of valuation. M corporation acquires the assets of N corporation in a transaction to which section 381(a) applies and M corporation integrates the business formerly operated by N corporation into the business which was operated by M corporation before the date of distribution or transfer. On the date of distribution or transfer, N corporation has inventories of sheet steel while M corporation has no inventories of this particular type of goods. In all other respects the inventories of the two corporations consist of similar types of goods. Under the provisions of this subparagraph, M corporation must use the first-in, first-out method of identification and the cost method of valuation of inventories of sheet steel, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of taking such inventories. For other goods in its inventories M corporation must use the first-in, first-out method of identification (as required by subparagraph (3)(i) of this paragraph), and with respect to the method of valuation, must use the method of taking inventories described

in paragraph (c) of this section, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

Example (2). W corporation is engaged in the business of raising cattle and uses the cash receipts and disbursements method of computing taxable income. Inventories, therefore, are not required. X corporation is also engaged in the business of raising cattle and uses the accrual method of computing taxable income under which it has elected to use the "farm-price method" of valuing inventories. The assets of W corporation are acquired by X corporation in a transaction to which section 381(a) applies and X corporation integrates the business formerly operated by W corporation into the business which was operated by X corporation before the date of distribution or transfer. Under the provisions of this subparagraph, whether X corporation is required to take inventories will depend upon which method of accounting is used by X corporation after the date of distribution or transfer, in accordance with the provisions of section 381(c)(4) and the regulations thereunder. Therefore, if X corporation uses the cash receipts and disbursements method, it will not be required to take inventories into account in computing its taxable income. However, if X corporation uses the accrual method, it must use the "farm-price method" of taking inventories, unless, in accordance with paragraph (d) of this section, consent of the Commissioner is obtained to use a different method of taking inventories.

(c) Change of method of taking inventories without consent of Commissioner—(1) General rule. If, under the provisions of paragraph (b) of this section, the acquiring corporation is not permitted to continue to use the method of taking inventories used by it or by the distributor or transferor corporation or corporations on the date of distribution or transfer, the acquiring corporation shall use the principal method of taking inventories for each particular type of goods of such corporations, as determined under subparagraph (2) of this paragraph: Provided, That:

(i) Such method clearly reflects the income of the acquiring corporation after the distribution or transfer as provided by sections 446(a) and 471 and the regulations thereunder, and

(ii) The use of such method is not inconsistent with the provisions of any closing agreement entered into under section 7121 and the regulations thereunder.

If the principal method does not satisfy the requirements of subdivisions (i) and (ii) of this subparagraph, or if the acquiring corporation wishes to use a method other than the principal method, see paragraph (d)(1) of this section. If the principal method of taking inventories is adopted under this paragraph, it will not be necessary for the acquiring corporation or corporations to renew any election previously made by it or by the distributor or transferor corporation with respect to such principal method of taking inventories, and the acquiring corporation is bound by any such election.

(2) Principal method of taking inventories. The determination of the principal method of taking inventories shall be made with respect to each particular type of goods of each integrated trade or business operated by the acquiring corporation immediately after the date of distribution or transfer. Such determination for each integrated trade or business shall be made by reference to the methods of taking inventories previously used in the component trades or businesses for such types of goods which constitute the subsequent integrated trade or business of the acquiring corporation. For purposes of this determination, a corporation shall be deemed to be using the last-in, first-out method of taking inventories with respect to a particular type of goods on the date of the distribution or transfer, if such corporation elects, under the provisions of section 472, to adopt the last-in, first-out method with respect to such goods for its taxable year within which or with which the date of distribution or transfer occurs. The fair market value of the particular types of goods of each group of component trades or businesses with respect to which one method of taking inventories common to all was employed shall be compared with the fair market value of comparable types of goods of other groups of component trades or businesses with respect to which another method of taking inventories common to all was employed. For purposes of the above comparison and to the extent that particular types of goods are included in inventory by grouping or pooling, then such group or pool shall be considered as a single unit. The total fair market value of such group or pool shall be the basis for comparison in determining the principal method of taking inventories. The method of taking inventories of the group of component trades or businesses having the largest fair market value of such inventories shall be the principal method of taking inventories. For purposes of this subparagraph, the fair market value of the inventories of a component trade or business shall be determined immediately after the date of distribution or transfer.

(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). (i) X, Y, and Z corporations are all engaged in the manufacture of sheet metal. In addition, Y and Z corporations are engaged in the manufacture of paper containers. X and Y corporations use the first-in, first-out method of identifying goods and the cost method of valuing all inventories, while Z corporation uses the first-in, first-out method of identifying goods and the cost or market, whichever is lower, method of valuing all inventories. X, Y, and Z corporations enter into a transaction to which section 381(a) applies, and the acquiring corporation integrates the sheet metal businesses formerly operated by X, Y, and Z corporations and also integrates the paper

container businesses formerly operated by Y and Z corporations. Each corporation has the same types of goods in the inventories of its sheet metal business and Y and Z corporations have the same types of goods in the inventories of their paper container businesses. Immediately after the date of distribution or transfer the fair market values of the respective inventories are as follows:

	X	Y	Z
Sheet metal	$10,000	$7,000	$15,000
Paper container....	....	6,000	7,000

(ii) Since X, Y, and Z corporations all used the first-in, first-out method of identifying their inventories as of the date of distribution or transfer, then, under the provisions of paragraph (b)(3)(i) of this section, the acquiring corporation shall continue to use the first-in, first-out method of identifying all goods unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of accounting.

(iii) Since the acquired corporations used different methods of valuing inventories in their sheet metal business and their paper container business, when the businesses were integrated the acquiring corporation must, under the provisions of this paragraph, determine which method of inventory valuation used by the acquired corporations on the date of distribution or transfer is the principal method of inventory valuation for each of such businesses.

(a) In determining which is the principal method of valuing inventories for the sheet metal business pursuant to subparagraph (2) of this paragraph, the total fair market value of the sheet metal inventories of X and Y corporations, $17,000 (*i.e.*, $10,000 + $7,000 = $17,000), is compared with the fair market value of the sheet metal inventory of Z corporation, $15,000. Since the total fair market value of the sheet metal inventories of X and Y corporations ($17,000) exceeds the fair market value of the sheet metal inventory of Z corporation ($15,000), the cost method of valuation used by X and Y corporations is the principal method of taking such inventories, and must be used by the acquiring corporation in valuing such inventories, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

(b) In determining which is the principal method of valuing inventories for the paper container business pursuant to subparagraph (2) of this paragraph, the fair market value of the paper container inventory of Y corporation ($6,000) is compared with the fair market value of the paper container inventory of Z corporation ($7,000). Since the fair market value of the paper container inventory of Z corporation ($7,000) exceeds the fair market value of the paper container inventory of Y corporation ($6,000), the cost or market, whichever is lower, method of valuation used by Z corporation is the principal method of taking such inventories, and must be used by the acquiring corporation in valuing such inventories, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

Example (2). (i) X, Y, and Z corporations are all engaged in the manufacture of electrical appliances. In addition, X and Z corporations are engaged in the manufacture of plastic containers. X corporation uses the first-in, first-out method of identifying goods and the cost method of valuing all inventories. Y and Z corporations use the last-in, first-out method of identifying goods and the cost method of valuing all inventories. In applying the last-in, first-out method, Y corporation uses the dollar value method, the double-extension method, and pools under the natural business unit method, while Z corporation uses the dollar value method, the double-extension method, and pools under the multiple pooling method for all inventories. X, Y, and Z corporations enter into a transaction to which section 381(a) applies, and the acquiring corporation integrates the electric appliance businesses formerly operated by X, Y, and Z corporations and also integrates the plastic container businesses formerly operated by X and Z corporations. Each corporation has the same types of goods in the inventories of its electric appliance business and X and Z corporations have the same types of goods in the inventories of their plastic container businesses. Immediately after the date of distribution or transfer, the fair market values of the respective inventories are as follows:

	X	Y	Z
Electric appliance ..	$13,000	$10,000	$5,000
Plastic container ...	7,000	....	6,000

(ii) Since X, Y, and Z corporations all used the cost method of valuing their inventories as of the date of distribution or transfer, then, under the provisions of paragraph (b)(3)(i) of this section, the acquiring corporation shall continue to use the cost method of valuing all goods unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of accounting.

(iii) Since the acquired corporations used different methods of identifying inventories in their electric appliance business and their plastic container business, when the businesses were integrated the acquiring corporation must, under the provisions of this paragraph, determine which method of inventory identification used by the acquired corporations on the date of distribution or transfer is the principal method of inventory identification for each of such businesses.

(a)(1) In determining which is the principal method of identifying inventories for the electric appliance business pursuant to subparagraph (2) of this paragraph, the fair market value of the electric appliance inventory of X corporation, $13,000, is compared with the total fair market value of the electric appliance inventories of Y and Z corporations, $15,000 (*i.e.*, $10,000 + $5,000 = $15,000). Since the total fair market value of the electric appliance inventories of Y and Z corporations ($15,000) exceeds the fair market value of the electric appliance inventory of X corporation ($13,000), the last-in, first-out method of identification is the principal method of taking the electric appliance inventories and must be used by the acquiring corporation, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

(2) Since Y and Z corporations used different pooling methods, in applying the last-in, first-out method, the acquiring corporation must, under the provisions of this paragraph, determine which pooling method as used by Y and Z corporations on the date of distribution or transfer is the principal method. In making such determination pursuant to subparagraph (2) of this paragraph, the fair market value of the electric appliance inventory of Y corporation ($10,000) is compared with the fair market value of the electric appliance inventory of Z corporation ($5,000). Since the fair market value of the electric appliance inventory of Y corporation ($10,000) exceeds the fair market value of the electric appliance inventory of Z corporation ($5,000), the natural business unit method is the principal method of pooling and must be used by the acquiring corporation in applying the last-in, first-out method with respect to the electric appliance business, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

In addition, under the provisions of paragraph (b)(3)(i) of this section, the acquiring corporation must use the dollar value method and the double-extension method for valuing goods in its electric appliance inventory since Y and Z corporations both used such methods in valuing their electric appliance invento-

ries as of the date of distribution or transfer, unless, in accordance with paragraph (e) of § 1.446–1, consent of the Commissioner is obtained to change the method of accounting.

(b) In determining which is the principal method of identifying inventories for the plastic container business pursuant to subparagraph (2) of this paragraph, the fair market value of the plastic container inventory of X corporation ($7,000) is compared with the fair market value of the plastic container inventory of Z corporation ($6,000). Since the fair market value of the plastic container inventory of X corporation. ($7,000) exceeds the fair market value of the plastic container inventory of Z corporation ($6,000) the first-in, first-out method of identification, as used by X corporation, is the principal method of taking the plastic container inventories and must be used by the acquiring corporation, if the conditions set forth in subparagraph (1) of this paragraph are satisfied.

(d) Change of method of taking inventories with consent of the Commissioner—(1) General rule—(i) Carryover and principal method not permitted. If the acquiring corporation is not permitted, under paragraph (b) of this section, to continue to use the method of taking inventories used by it or the distributor or transferor corporation or corporations on the date of distribution or transfer, and is not permitted, under paragraph (c) of this section, to use the principal method of taking inventories, then such acquiring corporation must request the Commissioner to determine the appropriate method of taking inventories.

(ii) Principal method required. If the acquiring corporation wishes to use a method of taking inventories other than the principal method of taking inventories which is required to be used under paragraph (c) of this section, it shall apply to the Commissioner for permission to use such other method of taking inventories. Permission to use such other method of taking inventories will not be granted unless the acquiring corporation and the Commissioner agree to the terms, conditions, and adjustments under which the change to such method will be effected.

(2) Time and manner of making application. Request for a determination of the method of taking inventories to be used under subparagraph (1)(i) of this paragraph or applications for permission to use a method of taking inventories under subparagraph (1)(ii) of this paragraph shall be filed with the Commissioner of Internal Revenue, Attention: T:I:C, Washington, D.C. 20224, not later than 90 days after the date of distribution or transfer, except that in cases where the date of distribution or transfer occurs before January 15, 1975, such applications or requests shall be filed not later than 90 days after such date. The application shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the differences in methods of taking inventories used by the corporations concerned; the method of taking inventories proposed to be used by the acquiring corporations; and the amount of adjustments necessary to prevent duplication or omission of items in the computation of taxable income under such proposed method. The Commissioner may also require such other information as may be necessary in order to determine the proper method of taking inventories to be used by the acquiring corporation.

(e) Treatment of layers of inventories by the acquiring corporation and rules for making adjustments—(1) In general. This paragraph provides rules for treating layers of inventories by the acquiring corporation and rules for making adjustments, once the acquiring corporation's method of taking inventories for its taxable year including the date of distribution or transfer has been determined in accordance with the rules set forth in paragraphs (a) through (d) of this section. Thus, for example, if the acquiring corporation uses the last-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, either because such corporation elects the last-in, first-out method of taking inventories under the provisions of section 472 for such year or because such method is otherwise determined to be the principal method of taking inventories under paragraph (c)(2) of this section, then such corporation shall integrate its layers of inventories and make the necessary adjustments in accordance with the rules under paragraph (e)(2) of this section.

(2) Acquiring corporation uses last-in, first-out method—(i) Dollar-value method—(a) Distributor or transferor corporation using last-in, first-out method. In any case where the acquiring corporation is required or permitted to use the dollar value method of pricing inventories on the last-in, first-out method for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which used the last-in, first-out method for its taxable year in which the distribution or transfer occurred shall be placed on the dollar value method pursuant to the rules contained in paragraph (f) of § 1.472–8, and then such inventories shall be integrated with the inventories of the acquiring corporation. If pools of each corporation are permitted or required to be combined, they shall be combined in accordance with the principles set forth in paragraph (g)(2) of § 1.472–8. For purposes of combining pools, all base-year inventories or layers of increment which occur in taxable years includ-

ing the same December 31 shall be combined. A base-year inventory or layer of increment occurring in any short taxable year not including a December 31 or in the final taxable year of a distributor or transferor corporation shall be merged with and considered a layer of increment of its immediately preceding taxable year.

(b) Distributor or transferor corporation not using last-in, first-out method. In any case where the acquiring corporation is required or permitted to use the last-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which did not use the last-in, first-out method for its taxable year in which the distribution or transfer occurred shall be treated by the acquiring corporation as having been acquired at their average unit cost in a single transaction on the date of distribution or transfer. Thus, where the acquiring corporation is required or permitted to use the dollar value method of pricing inventories, if an item of inventory is to be combined in an existing dollar value pool, such item shall be treated as if it were purchased at its average unit cost on the date of distribution or transfer with respect to such pool. On the other hand, if such item is not to be combined in an existing pool and the taxpayer otherwise uses LIFO with respect to such item, such item will be treated as if it were purchased at its average unit cost on the date of distribution or transfer with respect to a new pool (if any), with the base-year being the year of distribution or transfer. Adjustments resulting from a restoration to cost of any write-down to market value of such inventories of a distributor or transferor corporation shall be taken into account by such corporation in its final taxable year (where such year is closed by reason of section 381(b)). See section 472(d).

(ii) **Specific goods method**—(a) Distributor or transferor corporation using last-in, first-out method. In any case where the acquiring corporation is required or permitted to use the specific goods method of pricing inventories on the last-in, first-out method for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which used the last-in, first-out method for its taxable year in which the distribution or transfer occurred shall be treated by the acquiring corporation as having the acquisition dates and costs of the distributor or transferor corporation.

(b) Distributor or transferor not using last-in, first-out method. See paragraph (e)(1)(i)(b) of this section.

(3) **Acquiring corporation uses first-in, first-out method**—(i) **Distributor or transferor corporations not using first-in, first-out method.** In any case where the acquiring corporation is permitted or required to use the first-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which did not use the first-in, first-out method shall be treated by the acquiring corporation as having the same acquisition dates and costs which such inventory would have had if the distributor or transferor corporation had been using the first-in, first-out method for its taxable year in which the distribution or transfer occurred. However, if the acquiring corporation values its inventories at cost or market, whichever is lower, then the acquired inventories shall be treated as having been acquired at cost or market, whichever is lower.

(ii) **Distributor or transferor corporation using first-in, first-out method.** In any case where the acquiring corporation is required or permitted to use the first-in, first-out method of taking inventories for its taxable year including the date of distribution or transfer, the inventories of each distributor or transferor corporation which used such method for its taxable year in which the distribution or transfer occurred shall be treated by the acquiring corporation as having the same acquisition dates and costs as the distributor or transferor corporations. However, where the acquiring corporation values its inventories at cost or market, whichever is lower, then the acquiring corporation shall treat the acquired inventories as having been acquired at cost or market, whichever is lower.

(4) **Adjustments.** Except as provided in paragraph (e)(1) of this section with respect to any adjustments under section 472(d), the adjustments necessary to reflect the change from the method of taking inventories previously used by any of the corporations involved (including any adjustments required by section 481), shall be determined and computed in the same manner as if on the date of distribution or transfer, each of the several corporations that were not using the method of taking inventories used by the acquiring corporation for its taxable year including the date of distribution or transfer had initiated a change in the method of taking inventories. However, such adjustments (as an item of income or deduction, as the case may be) shall be taken into account solely by the acquiring corporation in computing its taxable income.

(f) Basis of inventories received. The basis of inventories received by the acquiring corporation from a distributor or transferor corporation shall be determined in accordance with section 334(b)(1) or 362(b), and the regulations thereunder. See also section 1013, and the regulations thereunder.

(g) Additional rules applicable to distributions or transfers before January 15, 1975—(1) Statute of limitations bars assessment or refund. If the date of distribution or transfer was before January 15, 1975, and if the assessment of any deficiency or the refund or credit of any overpayment for the taxable year of the acquiring corporation which includes the date of distribution or transfer or any subsequent taxable year is prevented by the operation of any law or rule of law, then this section does not authorize the Commissioner or the acquiring corporation to change any method or methods of computing inventories in any taxable year of the acquiring corporation. However, the Commissioner or the acquiring corporation may change such method or methods of computing inventories under the provisions of section 446, 471, or 472 and the regulations thereunder.

(2) Statute of limitations does not bar assessment and refund. Except as provided in subparagraph (1) of this paragraph—

(i) If the date of distribution or transfer was before January 15, 1975, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer:

(a) Adopted or continued a method or methods of taking inventories consistent with the rules of this section,

(b) Been granted permission by the Commissioner, in accordance with section 446, 471, or 472 and the regulations thereunder, to use a method or methods of taking inventories, or

(c) Adopted a method or methods of taking inventories that, under section 446, 471, or 472 and the regulations thereunder may be adopted without the consent of the Commissioner,

then the method or methods of taking inventories adopted or continued in the manner described in (a), (b), or (c) of this subdivision, shall not be changed, by reason of the rules contained in this section, by the Commissioner or by the acquiring corporation for any taxable year ending after the date of distribution or transfer. However, the Commissioner or the acquiring corporation may change such method or methods of taking inventories for any such taxable year under the provisions of, and to the extent permitted by, section 446, 471, or 472 and the regulations thereunder.

(ii) If the date of distribution or transfer was before January 15, 1975, and the acquiring corporation has, for the taxable year which includes the date of distribution or transfer, adopted or continued a method or methods of taking inventories other than in the manner described in (a), (b), or (c) of subdivision (i) of this subparagraph, then the acquiring corporation may—

(a) Continue to use the method or methods of taking inventories so adopted or continued if such method or methods clearly reflect income and if proper adjustments were made to reflect the adoption of such method or methods, or

(b) Adopt the method or methods of taking inventories prescribed by this section.

Such method or methods of taking inventories shall be adopted by filing an amended return (which includes the proper adjustments required by this section) for the taxable year of the acquiring corporation which includes the date of distribution or transfer, and by filing amended returns for all subsequent taxable years of the acquiring corporation for which returns have previously been filed. Such amended return or returns shall be accompanied by a copy of the statement described in paragraph (b)(3) of § 1.381(b)–1, and by a statement specifying the nature of the transaction which causes section 381 to apply; the difference in methods of taking inventories used by the corporation concerned; the method or methods of taking inventories originally adopted by the acquiring corporation; the method or methods of taking inventories adopted on the amended return or returns; and the computation of the amount of the adjustments and the resulting increase or decrease in tax.

(h) Effective date. This section is applicable with respect to taxable years beginning after January 15, 1975. However, if a taxpayer wishes to rely on the rules stated in this section for taxable years beginning before January 15, 1975 it may do so, subject to the provisions of paragraph (g) of this section.

[T.D. 7344, 40 FR 2684, 3289, Jan. 15, 1975]

§ 1.381(c)(6)–1 Depreciation method.

(a) Carryover requirement—(1) Distributions in taxable years ending before July 25, 1969. (i) Section 381(c)(6) provides that if, in a transaction in a taxable year which ends before July 25, 1969, to which section 381(a) applies, an acquiring cor-

poration acquires depreciable property from a distributor or transferor corporation which computes its allowance for the depreciation of the property under section 167(b)(2), (3), or (4), the acquiring corporation shall compute its depreciation allowance by the same method used by the distributor or transferor corporation with respect to such property. Thus, if the distributor or transferor corporation used the sum of the years-digits method under section 167(b)(3) with respect to an asset distributed or transferred to an acquiring corporation, the acquiring corporation will be required to use the sum of the years-digits method with respect to such asset acquired. The computation of the depreciation allowance with respect to the property acquired shall be made under the provisions of section 167 and the regulations thereunder.

(ii) The rules provided in section 381(c)(6) and subdivision (i) of this subparagraph will apply only with respect to that part or all of the basis of the property in the hands of the acquiring corporation immediately after the date of distribution or transfer as does not exceed the basis of the property in the hands of the distributor or transferor corporation on the date of the distribution or transfer. For this purpose, the basis of the property in the hands of the distributor or transferor corporation shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. For provisions defining the date of distribution or transfer see § 1.381(b)–1(b).

(2) Distributions in taxable years ending after July 24, 1969. (i) Section 381(c)(6) provides that if, in a transaction in a taxable year ending after July 24, 1969, to which section 381(a) applies, an acquiring corporation acquires depreciable property from a distributor or transferor corporation which computes its allowances for the depreciation of the property under subsection (b), (j), or (k) of section 167, the acquiring corporation shall compute its depreciation allowance by the same method used by the distributor or transferor corporation with respect to such property. Thus, if the distributor or transferor corporation used the straight line method under section 167(b)(1) with respect to an asset distributed or transferred to an acquiring corporation, the acquiring corporation will be required to use the straight line method with respect to such asset. Similarly, if the distributor or transferor corporation elected to compute depreciation under section 167(k) with respect to property attributable to rehabilitation expenditures, and such property is transferred to an acquiring corporation, the acquiring corporation will be required to compute depreciation under section 167(k) with respect to the property acquired. The computation of the depreciation allowance with respect to the property acquired shall be made under the provisions of section 167 and the regulations thereunder.

(ii) The rules provided in section 381(c)(6) and subdivision (i) of this subparagraph shall apply only with respect to that part or all of the basis of the property in the hands of the acquiring corporation immediately after the date of distribution or transfer as does not exceed the basis of the property in the hands of the distributor or transferor corporation on the date of the distribution or transfer. For this purpose, the basis of the property in the hands of the distributor or transferor corporation shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. For provisions defining the date of distribution or transfer see § 1.38(b)–1(b).

(b) Portion in excess of distributor or transferor corporation's basis—(1) General rule. With respect to that part of the basis of the depreciable property (other than certain section 1250 property described in subparagraph (2) of this paragraph) which in the hands of the acquiring corporation exceeds the adjusted basis to the distributor or transferor corporation, the acquiring corporation may use any reasonable method of computing depreciation, other than the methods provided in section 167(b)(2), (3), or (4). See paragraph (b) of § 1.167(b)–0 for methods which are acceptable under section 167(a) with respect to such property. See also sections 334(b)(1) and 362(b) for the determination of basis of property in the hands of the acquiring corporation in connection with a transaction to which section 381(a) applies.

(2) Section 1250 property. With respect to that part of the basis of section 1250 property acquired after July 24, 1969, which in the hands of the acquiring corporation exceeds the adjusted basis to the distributor or transferor corporation, the acquiring corporation shall be subject to the limitations contained in section 167(j)(4) (relating to used section 1250 property) or 167(j)(5) (relating to used residential rental property). Thus, for example, if section 1250 property which is not residential rental property is acquired in a section 381(a) transaction after July 24, 1969, the straight line method of depreciation (or other method allowable under section 167(j)(4)(B)) is the only acceptable method with respect to that portion of the basis of the property which, in the hands of the

acquiring corporation, exceeds the adjusted basis to the transferor or distributor corporation.

(c) Records required. Records shall be maintained in sufficient detail to identify any depreciable property to which this section applies, and to establish the basis thereof.

(d) Agreement under section 167(d). To the extent not inconsistent with paragraph (b) of this section, an acquiring corporation shall be treated as the distributor or transferor corporation in the case of an agreement between the distributor or transferor corporation and the district director under section 167(d) and § 1.167(d)–1 with respect to property to which section 381(c)(6) and this section apply. Thus, in the case where the basis of an asset in the hands of an acquiring corporation exceeds the basis of such asset in the hands of the distributor or the transferor corporation, such an agreement will not have the effect of permitting the acquiring corporation to compute its depreciation allowance with respect to such excess basis under the methods provided in section 167(b)(2), (3), or (4). However, the provisions of the agreement will continue to apply with respect to the useful life of the asset.

(e) Change of method of depreciation. Although the acquiring corporation is required to use the method of computing depreciation used by the distributor or transferor with respect to depreciable property to which this section applies, such acquiring corporation may use another method with respect to such property if consent of the Commissioner is obtained in accordance with paragraph (e) of § 1.446–1. Further, subject to the provisions of paragraph (b) of § 1.167(e)–1 the acquiring corporation may change from the declining balance method described in section 167(b)(2) to the straight line method without consent of the Commissioner.

(f) Successive transactions to which section 381(a) applies. The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, for example, if X Corporation, a transferor corporation, used the sum of the years-digits method under section 167(b)(3) with respect to an asset transferred to Y Corporation, an acquiring corporation, in a transaction to which section 381(a) applies, and subsequently Y Corporation, using the same method, transfers such asset to Z Corporation in a transaction to which section 381(a) also applies, then Z Corporation shall be required to use the sum of the years-digits method with respect to such asset.

(g) Illustration. The application of this section may be illustrated by the following example:

Example. M and N Corporations compute their taxable incomes on the basis of the calendar year. On December 31, 1959, M Corporation transfers all of its assets to N Corporation in a transaction to which section 381(a) applies. Included among these assets is an item of depreciable property which on that date has an adjusted basis (for determining gain) of $800,000 after M Corporation takes into account for 1959 its allowance for depreciation under section 167(b)(2). The basis attributable to the asset under section 362(b) is determined to be $900,000 in the hands of N Corporation. Under the provisions of section 381(c)(6) and paragraph (a) of this section, N Corporation is required to compute its allowance for the depreciation of the asset under section 167(b)(2) for 1960 and subsequent years but only in respect of $800,000 of its basis. N Corporation may use any reasonable method other than the methods provided in section 167(b)(2), (3), or (4) in computing its depreciation allowance of the remaining $100,-000.

[T.D. 6559, 26 FR 2983, April 7, 1961, as amended by T.D. 7166, 37 FR 5246, March 11, 1972; 37 FR 6400, March 29, 1972]

§ 1.381(c)(8)–1 Installment method.

(a) Carryover requirement. (1) Section 381(c)(8) provides that if, in a transaction to which section 381(a) applies, an acquiring corporation acquires installment obligations, the income from which the distributor or transferor corporation has elected under section 453 and the regulations thereunder to report on the installment method, then the acquiring corporation shall be treated as the distributor or transferor corporation would have been treated under section 453 had it not transferred the installment obligations. Thus, if the distributor or transferor corporation had properly elected to return income from the sale or other disposition of property giving rise to the obligations on the installment method, then the acquiring corporation shall be required to return the income from all such installment obligations in the same manner and to the same extent as the distributor or transferor corporation, unless consent of the Commissioner to use another method is obtained in accordance with paragraph (e) of § 1.446–1. Amounts received by the acquiring corporation on or after the date of distribution or transfer with respect to an installment sale made by the distributor or transferor corporation will not be taken into account in applying the limitation under section 453(b)(2) with respect to the amount of payments received in the year of sale or other disposition.

(2) Section 381(c)(8) and this section have no application to sales or other dispositions of property made by the acquiring corporation on or after the date of distribution or transfer. For provisions defining the date of distribution or transfer, see

§ 1.381(b)–1(b). See section 381(c)(4) and the regulations thereunder for rules relating to the proper method or combination of methods of accounting to be used by the acquiring corporation.

(b) Basis of obligations. The basis in the hands of an acquiring corporation of installment obligations described in section 381(c)(8) and paragraph (a) of this section shall be the same as in the hands of the distributor or transferor corporation.

(c) Repossession of property sold in prior years. If the acquiring corporation repossesses property, previously sold by the distributor or transferor corporation, by reason of default by the purchaser in payment of the acquired installment obligations, then the acquiring corporation shall be treated as though it were the vendor corporation for purposes of determining, under section 453 and the regulations thereunder, the gain, loss, income, or deduction with respect to the property repossessed.
[T.D. 6559, 26 FR 2983, April 7, 1961]

§ 1.381(c)(9)–1 Amortization of bond discount or premium.

(a) Carryover requirement. If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for the payment of bonds of a distributor or transferor corporation which were issued at a discount or premium, then under the provisions of section 381(c)(9) the acquiring corporation is to be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable, or includible, with respect to such discount or premium in computing taxable income. Thus, if subsequent to February 28, 1913, a distributor or transferor corporation issues bonds at a premium and the liability for them is assumed by the acquiring corporation in a transaction to which section 381(a) applies, then the net amount of the premium is income which should be prorated or amortized over the life of the bonds, including the period during which the acquiring corporation is liable upon the obligations assumed. On the other hand, if a distributor or transferor corporation issues bonds at a discount and the liability for them is assumed by the acquiring corporation in a transaction to which section 381(a) applies, then the net amount of the discount is deductible in computing taxable income but should be prorated or amortized over the life of the bonds, including the period during which the acquiring corporation is liable upon the obligations assumed.

(b) Expense incurred upon issuance of bonds. If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for bonds of a distributor or transferor corporation which were issued at a discount or premium, the acquiring corporation shall be treated as the distributor or transferor corporation after the date of distribution or transfer with respect to the expense incurred upon the issuance of such bonds.

(c) Purchase of bonds. If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for bonds of a distributor or transferor corporation which were issued at a discount or premium and if the acquiring corporation subsequently purchases such bonds, then the acquiring corporation shall be treated as the distributor or transferor corporation for the purpose of determining the amount of any income or deduction resulting from the purchase. See paragraph (c) of § 1.61–12. For rules relating to the exchange or substitution of bonds issued by the acquiring corporation for bonds of a distributor or transferor corporation, see paragraph (d) of this section.

(d) Exchange of new for old bonds. Notwithstanding any other provision of this section, if—

(1) In a transaction to which section 381(a) applies, bonds of the acquiring corporation are exchanged or substituted for bonds of a distributor or transferor corporation which were issued at a discount or premium, or

(2) Bonds of the acquiring corporation are exchanged or substituted for bonds of a distributor or transferor corporation which were issued at a discount or premium and in respect of which the acquiring corporation has assumed the liability in a transaction to which section 381(a) applies,

then, with respect to any unamortized discount, premium, or expense of issuance attributable to such bonds of the distributor or transferor corporation, the acquiring corporation shall be treated as the distributor or transferor corporation.

(e) Bonds of a distributor or transferor corporation. For purposes of applying section 381(c)(9), the term "bonds of a distributor or transferor corporation" includes not only bonds issued by the distributor or transferor corporation but also bonds for which the distributor or transferor corporation has assumed liability. Thus, if the distributor or transferor corporation has assumed liability for bonds in a transaction in which any unamortized discount or premium attributable to such bonds carried over to such corporation, then the acquiring corporation assuming liability for the

bonds shall be treated as the distributor or transferor corporation after the date of distribution or transfer for purposes of determining the amount of amortization allowable, or includible, with respect to such discount or premium. On the other hand, if the distributor or transferor corporation has assumed liability for bonds in a transaction in which any unamortized discount or premium attributable to such bonds did not carry over to such corporation, then there can be no carryover to the acquiring corporation under this section.

[T.D. 6532, 26 FR 405, Jan. 19, 1961]

§ 1.381(c)(10)–1 Deferred exploration and development expenditures.

(a) Carryover requirement. **(1)** If for any taxable year a distributor or transferor corporation has elected under section 615 or section 616 (or corresponding provisions of prior law) to defer and deduct on a ratable basis any exploration or development expenditures made in connection with any ore, mineral, mine, or other natural deposit transferred to the acquiring corporation in a transaction described in section 381(a), then under the provisions of section 381(c)(10) the acquiring corporation shall be entitled to deduct such expenditures on a ratable basis in the same manner, and to the same extent, as they would have been deductible by the distributor or transferor corporation in the absence of the distribution or transfer. For this purpose, the acquiring corporation shall be treated as though it were the distributor or transferor corporation. The principles set forth in paragraph (e) of § 1.615–3 and paragraph (f) of § 1.616–2 are applicable in computing the amount of the deduction allowable to the acquiring corporation in respect of expenditures deferred by a distributor or transferor corporation.

Example. X and Y Corporations are both organized on January 1, 1955, and both corporations compute their taxable income on the basis of the calendar year. During 1955, X Corporation purchases a mineral property which it begins to develop in 1956. During 1956, X Corporation incurs development expenditures of $500,000 in respect of such property which it elects to defer under section 616(b). On December 31, 1956, Y Corporation acquires all of the assets of X Corporation in a reorganization to which section 381(a) applies, no gain being recognized to X Corporation on the transfer. In 1957, Y Corporation sells 150,000 units of produced ore benefited by the development expenditures incurred and deferred by X Corporation, and the number of units remaining as of the end of 1957, plus the number of units sold during that year, is estimated to be 1,000,000. In addition to its deduction for depletion, Y Corporation is, in 1957, entitled to a deduction under sections 616(b) and 381(c)(10) of $75,000 of the development expenditures previously deferred by X Corporation, that is, $500,000 × 150,000/1,000,000.

(2) If a distributor or transferor corporation has elected under section 615 or section 616 (or corresponding provisions of prior law) to defer exploration or development expenditures in respect of a mine or other natural deposit which it subsequently disposes of except for a retained economic interest therein, such as the right to royalty income or in-ore payments, and such retained economic interest is transferred to the acquiring corporation in a transaction to which section 381(a) applies, then the acquiring corporation shall be entitled to deduct such deferred expenditures attributable to the economic interest retained on a ratable basis to the same extent they would have been deductible by the distributor or transferor corporation in the absence of the distribution or transfer. See paragraph (c) of § 1.615–3 and paragraph (c) of § 1.616–2.

(3) For purposes of this section, the terms "exploration expenditures" and "development expenditures" shall have the same meaning as that ascribed to them in the regulations under sections 615 and 616 of the Internal Revenue Code of 1954, or under sections 23(cc) and 23(ff) of the Internal Revenue Code of 1939, whichever applies. See, for example, paragraph (a) of § 1.615–1 and paragraph (a) of § 1.616–1.

(b) Effect and identification of election previously made. **(1)** The election made by a distributor or transferor corporation under the provisions of section 615 or section 616 (or corresponding provisions of prior law) to defer exploration or development expenditures in respect of any taxable year may not be revoked by the acquiring corporation for any reason whatsoever.

(2) When filing its return for the first taxable year for which it deducts exploration or development expenditures which were deferred under section 615 or section 616 (or corresponding provisions of prior law) by a distributor or transferor corporation, the acquiring corporation shall attach thereto a statement properly identifying the taxable year for which the election to defer was made by the distributor or transferor corporation, the name of the corporation which made the election, and the district director with whom the election was filed.

(3) It is unnecessary for an acquiring corporation to renew an election to defer exploration or development expenditures which was made by a distributor or transferor corporation.

(c) Successive transactions to which section 381(a) applies. If, by virtue of section 381(c)(10), the acquiring corporation is entitled to deduct exploration or development expenditures deferred

by a distributor or transferor corporation, then such acquiring corporation shall be deemed to have made the election to defer such expenditures for purposes of applying section 381(c)(10) to any subsequent transaction in which such acquiring corporation is a distributor or transferor corporation.

(d) Carryover of limitation requirements. (1) If a distributor or transferor corporation transfers any mineral property to the acquiring corporation in a transaction described in section 381(a) and the acquiring corporation pays or incurs exploration expenditures in a taxable year ending after the date of the distribution or transfer, then in applying the 4-year or $400,000 limitations described in section 615(c) and paragraphs (a) and (b) of § 1.615–4, whichever is applicable, the acquiring corporation shall be deemed to have been allowed any deduction which, for any taxable year ending on or before the date of distribution or transfer, was allowed to the distributor or transferor corporation under section 615(a), or under section 23(ff)(1) of the Internal Revenue Code of 1939, or to have made any election which, for any such preceding year, was made by the distributor or transferor corporation under section 615(b), or under section 23(ff)(2) of the Internal Revenue Code of 1939. Thus, in such instance, the acquiring corporation shall take into account the years in which the distributor or transferor corporation exercised the election to deduct or defer exploration expenditures and any amounts so deducted or deferred. For this purpose, it is immaterial whether the deduction has been allowed to, or the election has been made by, the distributor or transferor corporation with respect to the specific mineral property transferred by that corporation to the acquiring corporation.

(2) Generally, for purposes of applying the 4-year limitation described in paragraph (a) of § 1.615–4, if there are two or more distributor or transferor corporations that transfer any mineral property to the acquiring corporation, each taxable year of any such corporation ending on or before the date of distribution or transfer in which exploration expenditures were deducted or deferred shall be treated as a separate taxable year regardless of the fact that the taxable years of two or more such corporations normally end on the same date. However, if the date of distribution or transfer is the same with respect to more than one distributor or transferor corporation, then the taxable years of such corporations ending on the same date of distribution or transfer shall be considered as one taxable year for purposes of applying the 4-year limitation even though more than one such corporation deducted or deferred exploration expenditures for such taxable years.

(3) For purposes of applying the $400,000 limitation described in paragraph (b) of § 1.615–4, if there are two or more distributor or transferor corporations that transfer any mineral property to the acquiring corporation, any exploration expenditures which were deducted or treated as deferred expenses by such corporations for taxable years ending after December 31, 1950, shall be taken into account by the acquiring corporation.

(4) If a distributor or transferor corporation that transfers any mineral property to the acquiring corporation was required to take into account any taxable years or amounts of its transferor, as provided by paragraph (e) of § 1.615–4, for purposes of either the 4-year limitation described in paragraph (a) of § 1.615–4 or the $400,000 limitation described in paragraph (b) of § 1.615–4, then the acquiring corporation shall also take these taxable years and amounts into account in applying the same limitations.

(5) The provisions of this paragraph may be illustrated by the following examples:

Example (1). M and N Corporations were organized on January 1, 1956, and each corporation computes its taxable income on the basis of the calendar year. For each of its taxable years 1956 and 1957, M Corporation expended $60,000 for exploration expenditures and exercised the option to deduct such amounts under section 615(a). N Corporation made no exploration expenditures during its taxable years 1956 and 1957. On December 31, 1957, M Corporation transferred all of its assets to N Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. N Corporation made exploration expenditures of $100,000, $120,000, $110,000, and $100,000 for the years 1958, 1959, 1960, and 1961, respectively, which expenditures it desired to deduct under section 615(a) to the extent allowable. On the basis of these facts, N Corporation may deduct up to $100,000 for each of the years 1958 and 1959. No deduction or deferral is allowable for 1960 since the benefits of section 615(c) were previously availed of for 4 taxable years. However, N Corporation may deduct $80,000 for 1961 (the 4-year limitation not applying to such year) but, if such deduction is made, N Corporation will not be allowed any further deductions or deferrals since the $400,000 limitation of paragraph (b) of § 1.615–4 will have been reached.

Example (2). R and S Corporations were organized on January 1, 1955, and each corporation computes its income on the basis of the calendar year. For the 1955 taxable year neither corporation made any exploration expenditures under section 615(a). On June 30, 1956, R Corporation transferred all its assets to S Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. During its short taxable year ending June 30, 1956, R Corporation made exploration expenditures of $60,000 which it elected to deduct under section 615. For its taxable year ending December 31, 1956, S Corporation may deduct or defer exploration expenditures up to $100,000 since this is a separate election for purposes of utilizing section

615 and is not affected by the $60,000 previously deducted by R Corporation. Assuming S Corporation exercises an election under section 615 for its taxable year ending December 31, 1956, S Corporation may elect to apply the benefits of section 615 to exploration expenditures for two more taxable years. However, for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), S Corporation is entitled under section 615 to deduct or defer exploration expenditures made in such years to the extent that the combined deductions and deferrals by R and S Corporations in prior years did not exceed $400,000.

Example (3). O and P Corporations were organized on January 1, 1955, and each corporation computes its taxable income on the basis of the calendar year. For their taxable years 1955, 1956, and 1957, each corporation deducted exploration expenditures made in such years under section 615(a). On June 30, 1958, O Corporation transferred all its assets to P Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. If, during its short taxable year ending June 30, 1958, O Corporation made additional exploration expenditures, it may deduct or defer such expenditures (up to $100,000) under section 615 since O Corporation has utilized section 615 in only three previous taxable years. For its taxable years ending after June 30, 1958, and beginning before July 7, 1960, P Corporation may not deduct or defer exploration expenditures under section 615, since the benefits of that section were utilized by O and P Corporations for 4 taxable years. However, for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), P is entitled under section 615 to deduct or defer exploration expenditures made in such years to the extent that the combined deductions and deferrals by O and P Corporations in prior years do not exceed $400,000. See paragraph (b) of § 1.615–4.

Example (4). X, Y, and Z Corporations were organized on January 1, 1955, and each corporation computes its taxable income on the basis of the calendar year. For their taxable years ending December 31, 1955, X and Y Corporations each deferred $100,000 for exploration expenditures made in such taxable years under section 615(b). Z Corporation made no exploration expenditures during its taxable year ending December 31, 1955. On March 31, 1956, X and Y Corporations transferred all their assets to Z Corporation in a transaction to which section 381(a) applies, no gain being recognized to the transferor corporations on the transfer. X and Y Corporations each made exploration expenditures of $75,000 during their short taxable years ending March 31, 1956, which they deducted under section 615(a). For purposes of taxable years beginning before July 7, 1960, Z Corporation must take into account the taxable years in which X and Y Corporations deducted or deferred exploration expenditures. In so doing, each taxable year in which exploration expenditures were deducted or deferred must be taken into account except that the taxable years of X and Y Corporations ending on March 31, 1956, shall be considered as one taxable year. Therefore, Z Corporation may deduct or defer exploration expenditures in accordance with section 615 for any one taxable year ending after March 31, 1956, and beginning before July 7, 1960. However, for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), Z Corporation must take into account for purposes of the $400,000 limitation all of the $350,000 of exploration expenditures deducted or deferred by X, Y, and Z Corporations during taxable years ending after December 31, 1950. Therefore, Z Corporation, assuming it has not deducted or deferred any exploration expenditures, is entitled under section 615 to deduct or defer in taxable years beginning after July 6, 1960, up to $50,000 for exploration expenditures made in such years.

Example (5). For purposes of this example, assume that each taxpayer computes taxable income on the basis of the calendar year. Taxpayer A, an individual who has deducted exploration expenditures of $75,000 under section 23(ff) of the Internal Revenue Code of 1939 for each of his taxable years 1952 and 1953, transferred a mineral property to K Corporation on January 1, 1954, in a transaction in which the basis of the mineral property in the hands of K Corporation is determined under section 362(a). For its taxable year 1954 and pursuant to section 615(a), K Corporation deducted exploration expenditures of $100,000 which it made in such year. K Corporation had made no exploration expenditures in any preceding taxable year. On December 31, 1954, K Corporation transferred all its assets to L Corporation in a reorganization to which section 381(a) applies, no gain being recognized to the transferor corporation on the transfer. Assuming that L Corporation has not deducted or deferred exploration expenditures in any preceding taxable year, L Corporation may deduct or defer exploration expenditures (up to $100,000) in accordance with section 615 for any one taxable year ending after December 31, 1954, and beginning before July 7, 1960, in view of the 4-year limitation. However, if L Corporation does not deduct or defer exploration expenditures in that period, then for taxable years beginning after July 6, 1960 (the 4-year limitation not applying), L Corporation is entitled to deduct or defer up to $150,000 (but not to exceed $100,000 per year) for exploration expenditures made in such years. See paragraph (b) of § 1.615–4.

[T.D. 6552, 26 FR 1988, March 8, 1961, as amended by T.D. 6685, 28 FR 11406, Oct. 24, 1963]

§ 1.381(c)(11)–1 Contributions to pension plan, employees' annuity plans, and stock bonus and profit-sharing plans.

(a) Carryover requirement. Section 381(c)(11) provides that, for purposes of determining amounts deductible under section 404 for any taxable year, the acquiring corporation shall be considered after the date of distribution or transfer to be the distributor or transferor corporation in respect of any pension, annuity, stock bonus, or profit-sharing plan.

(b) Nature of carryover. **(1)** Primarily, section 381(c)(11) and this section apply to the amount of any unused deductions or excess contributions carryovers which, in the absence of the transaction causing section 381 to apply, would have been available to the distributor or transferor corporation under section 404. Thus, for example, this section applies to unused deductions under a profit-sharing or stock bonus trust which, in accordance with the second sentence of section 404(a)(3)(A) and § 1.404(a)–9, would have been available in succeeding taxable years to the transferor corporation if the transfer of assets to the acquiring corporation had not occurred.

(2) Section 381(c)(11) also permits or requires the acquiring corporation to be treated as though it were the distributor or transferor corporation for the purpose of satisfying any conditions which

would have been required of the distributor or transferor corporation in the absence of the distribution or transfer, so that it may be determined whether the distributor or transferor corporation, or the acquiring corporation, is entitled to take a deduction under section 404 in respect of a trust or plan established by the distributor or transferor corporation. Thus, for example, in a case when the taxable year of the transferor corporation ends on the date of transfer pursuant to section 381(b)(1), that corporation is entitled, pursuant to the provisions of section 404(a)(6) and paragraph (c) of § 1.404(a)–1, to a deduction in such taxable year for a payment to a qualified trust of that corporation made by the acquiring corporation after the close of such taxable year but within the time specified in section 404(a)(6). In further illustration, if the transferor corporation were to establish a qualified plan, and if the plan were maintained as a qualified plan by the acquiring corporation, then any contributions paid under the plan by the acquiring corporation (other than those which are deductible by the transferor corporation by reason of section 404(a)(6)) would be deductible under section 404 by the acquiring corporation even though the plan were exclusively for the benefit of former employees of the transferor corporation. Also, for example, if the transferor corporation were to adopt an annuity plan during its taxable year ending on the date of transfer, the acquiring corporation would be entitled, subject to the provisions of section 401(b) and § 1.401–5, to amend the plan so as to make it retroactively satisfy the requirements of section 401(a)(3), (4), (5), and (6) for the period beginning with the date on which the plan was put into effect.

(c) Taxable year of deduction. The first taxable year of the acquiring corporation in which any amount shall be allowed as a deduction to that corporation by reason of section 381(c)(11) and this section shall be its first taxable year ending after the date of distribution or transfer.

(d) Requirements for deductions. (1) In order for any amount paid by the acquiring corporation (other than amounts deductible under section 404(a)(5)) to be deductible by the acquiring corporation by reason of this section in respect of a trust or nontrusteed annuity plan which is established by a distributor or transferor corporation and maintained by the acquiring corporation, the contributions must be paid (or deemed to have been paid under section 404(a)(6)) by the acquiring corporation in a taxable year of that corporation which ends with or within a year of the trust for which it is exempt under section 501(a), or, in the case of a nontrusteed annuity plan, for which it meets the requirements of section 404(a)(2). See, however, section 404(a)(4) and § 1.404(a)–11 for rules relating to deductions for contributions to foreign-situs trusts. The trust or plan which is established by the distributor or transferor corporation and maintained by the acquiring corporation may separately satisfy the requirements of section 401(a) or section 404(a)(2) or may, together with other trusts or plans of the acquiring corporation, constitute a single plan which qualifies under section 401(a) or meets the requirements of section 404(a)(2).

(2) Excess contributions paid under a qualified trust or plan established by the transferor or distributor corporation may be carried over and, subject to the applicable limitations, deducted by the acquiring corporation in a taxable year ending after the date of distribution or transfer regardless of whether the trust is exempt, or the plan meets the requirements of section 404(a)(2), during such taxable year. There are, however, special rules for computing the limitations on the amount of excess contributions which are deductible in a taxable year ending after the trust or plan has terminated (see § 1.404(a)–7, paragraph (e) of § 1.404(a)–9, and paragraph (a) of § 1.404(a)–13). For this purpose, the pension, annuity, stock bonus, or profit-sharing plan of the distributor or transferor corporation under which the excess contributions were made shall be considered continued (and not terminated) by the acquiring corporation if, after the date of distribution or transfer, the acquiring corporation continues the plan as a separate and distinct plan of its own which continues to qualify under section 401(a), or to meet the requirements of section 404(a)(2), or consolidates or replaces that plan with a comparable plan. See subparagraph (4) of this paragraph for rules relating to what constitutes a "comparable" plan.

(3) In order for any amount paid by the acquiring corporation to be deductible by the acquiring corporation as an unused deduction carried over from a qualified profit-sharing or stock bonus trust established by a distributor or transferor corporation, the acquiring corporation must continue such trust established by the distributor or transferor corporation as a separate and distinct trust of its own which continues to qualify under section 401(a), or must consolidate or replace that trust with a comparable trust. In addition, the amount paid by the acquiring corporation will be deductible as an unused deduction carried over from the transferor or distributor corporation only if it is paid into the profit-sharing or stock bonus

trust established by the transferor or distributor corporation, or the comparable trust, in a taxable year of the acquiring corporation which ends with or within a year of such trust (or such comparable trust) for which it meets the requirements of section 401(a) and is exempt under section 501(a). See subparagraph (4) of this paragraph for rules relating to what constitutes a "comparable" trust.

(4) For purposes of subparagraphs (2) and (3) of this paragraph, a plan under which deductions are determined pursuant to paragraph (1) or (2) of section 404(a) shall be considered comparable to another plan under which deductions are determined pursuant to either of those paragraphs, and a plan under which deductions are determined pursuant to paragraph (3) of section 404(a) shall be considered comparable to another plan under which deductions are determined pursuant to such paragraph (3). Thus, a profit-sharing plan (which qualifies under section 401(a)) established by the transferor or distributor corporation shall, for purposes of subparagraphs (2) and (3) of this paragraph, be considered terminated if, after the date of distribution or transfer, the acquiring corporation transfers the funds accumulated under the profit-sharing plan into a pension plan covering the same employees. In such a case, excess contributions paid under the profit-sharing plan by the distributor or transferor corporation may be carried over and deducted by the acquiring corporation in a taxable year ending after the date of distribution or transfer subject to the limitations in section 404(a)(3)(A) computed in accordance with the rules in paragraph (e)(2) of § 1.404(a)–9 for computing limitations when a profit-sharing plan has terminated. On the other hand, unused deductions attributable to the profit sharing plan may not be carried over and used by the acquiring corporation as a basis for deducting amounts contributed by it to the pension plan.

(e) Effect of consolidation or replacement of plan on prior contributions. If a pension, annuity, stock bonus, or profit-sharing plan which was established by a distributor or transferor corporation is terminated after the date of distribution or transfer because of consolidation or replacement with a comparable plan of the acquiring corporation, then the contributions paid to or under its plan by the distributor or transferor corporation on or before the date of distribution or transfer shall not be disallowed under section 404 merely because of the termination of the plan which was established by that corporation, provided that the termination does not cause the plan to fail to qualify under section 401(a).

(f) Amounts deductible under section 404. Section 381(c)(11) and this section apply only to amounts which are otherwise deductible under section 404 and the regulations thereunder. See §§ 1.404(a)–1 through 1.404(d)–1. Thus, to be deductible by reason of this section, contributions paid by the acquiring corporation must be expenses which otherwise satisfy the conditions of section 162 (relating to trade or business expenses). No deduction shall be allowed by reason of section 381(c)(11) and this section for a contribution which is allowable under section 162 but is not allowable under section 404. Thus, the acquiring corporation shall not be allowed a deduction by reason of this section in respect of a plan established by a distributor or transferor corporation if the contribution would not otherwise be deductible under section 404 by reason of section 404(c) and § 1.404(c)–1. On the other hand, any unused deductions or excess contributions of a distributor or transferor corporation which are carried over from 1939 Code years shall be deductible by the acquiring corporation if the requirements of this section, section 404(d), and § 1.404(d)–1 are satisfied.

(g) Cost of past service credits. In computing the cost of past service credits under a plan with respect to employees of the distributor or transferor corporation, the acquiring corporation may include the cost of credits for periods during which the employees were in the service of the distributor or transferor corporation.

(h) Separate carryovers required. The excess contributions which are available to a distributor or transferor corporation under the provisions of section 404(a)(1)(D) and section 404(a)(3)(A) at the close of the date of distribution or transfer and are carried over to the acquiring corporation under this section shall be kept separate and distinct from each other and from any excess contributions which are available to the distributor or transferor corporation at that time under the provisions of section 404(a)(7) and are carried over to the acquiring corporation under this section. If there are excess contributions carried over to the acquiring corporation from more than one transferor or distributor corporation, the excess contributions of each transferor or distributor corporation shall be kept separate and distinct from those of the other transferor or distributor corporations and, with respect to each such transferor or distributor corporation, shall be kept separate and distinct as provided in the preceding sentence. See, however, paragraph (i) of this section for rules for applying the provisions of section 404(a)(3)(A) when the

acquiring corporation maintains two or more profit-sharing or stock bonus trusts, one or more of which was established by a distributor or transferor corporation. The requirements in this paragraph shall apply with respect to any excess contributions which are carried over to the acquiring corporation from a distributor or transferor corporation under the provisions of section 404(d) and this section.

(i) **Limitations applicable to profit-sharing or stock bonus trusts.** When contributions are paid by the acquiring corporation after the date of distribution or transfer to two or more profit-sharing or stock bonus trusts, and one or more of such trusts was established by a distributor or transferor corporation, such trusts shall be considered as a single trust in applying the provisions of section 404(a)(3)(A) under this section. Accordingly, in determining its secondary limitation, and its excess contributions carryover, under section 404(a)(3)(A) and § 1.404(a)–9 in any taxable year ending after the date of distribution or transfer, the acquiring corporation shall take into accounts its primary limitations, and the deductions allowed or allowable to it, for all prior years under the limitations provided in those sections, and also the primary limitations of, and deductions allowed or allowable to, the distributor or transferor corporation or corporations for all prior years under the limitations provided in those sections.

(j) **Successive carryovers.** The provisions of section 381(c)(11) and this section shall apply to an acquiring corporation which, in a distribution or transfer to which section 381(a) applies acquires the assets of a distributor or transferor corporation which has previously acquired the assets of another corporation in a transaction to which section 381(a) applies, even though, in computing an unused deductions or excess contributions carryover to the second acquiring corporation, it is necessary to take into account contributions paid by, and limitations applicable to, the first distributor or transferor corporation.

(k) **Information to be furnished by acquiring corporation.** The acquiring corporation shall furnish such information with respect to a plan established by a distributor or transferor corporation as will, consistently with the principles of section 404, establish that the provisions of such section and this section apply. For purposes of this section, the district director may require any other information that he considers necessary to determine deductions allowable under section 404 and this section or qualification under section 401. Any unused deductions or excess contributions carried over from a distributor or transferor corporation pursuant to this section shall be properly identified with the corporation which would have been permitted to use those deductions or contributions in the absence of the transaction causing section 381 to apply.

(*l*) **Illustration.** The application of this section may be illustrated by the following example:

Example. In 1955, X Corporation, which makes its return on the basis of the calendar year, paid $400,000 to completely fund past service credits under a qualified pension plan and deducted 10 percent ($40,000) of that cost in each of the taxable years 1955, 1956, and 1957. The pension plan established by X Corporation had an anniversary date of January 1. On December 31, 1957, on which date the undeducted part of the cost amounted to $280,000, X Corporation transferred all its assets to Y Corporation in a statutory merger to which section 361 applies. Y Corporation, which also makes its return on the basis of the calendar year, had a qualified pension plan and trust which also had an anniversary date of January 1. Since Y Corporation had many more employees than X Corporation on the date of transfer, it covered the former employees of X Corporation under its own plan. Y Corporation is entitled to deductions under section 404(a)(1)(D) and this section in 1958 and succeeding taxable years, in order of time, with respect to the undeducted balance of $280,000, to the extent of the difference between the amount paid and deductible by that corporation in each such taxable year and the maximum amount deductible by that corporation for such taxable year in accordance with the applicable limitations of section 404(a)(1). In computing the maximum amount deductible by Y Corporation for 1958 and 1959 under section 404(a)(1)(C), that corporation may include $40,000 for each year, the amount that X Corporation could have included for each of those years in computing the maximum amount that would have been deductible by X Corporation under section 404(a)(1)(C) if the merger had not occurred. Thus, assuming that Y Corporation's appropriate limitation so computed under section 404(a)(1)(C) is $1,000,000 (including the $40,000 carried over from X Corporation under this section) for each of those taxable years, and that Y Corporation contributed $925,000 to its trust in 1958 and $975,000 in 1959, then Y Corporation is entitled under section 404(a)(1)(D) and this section to deduct in 1958 $75,000, and in 1959 $25,000, of the amount ($280,000) carried over from X Corporation. The undeducted balance of such amount ($180,000) available to Y Corporation on December 31, 1959, would be deductible by that corporation in succeeding taxable years in accordance with section 404(a)(1)(D) and this section.

[T.D. 6556, 26 FR 2405, March 22, 1961, as amended by T.D. 7168, 37 FR 5024, March 9, 1972]

§ 1.381(c)(12)–1 Recovery of bad debts, prior taxes, or delinquency amounts.

(a) **Carryover requirement.** (1) If, as a result of a distribution or transfer to which section 381(a) applies, the acquiring corporation is entitled to the recovery of a bad debt, prior tax, or delinquency amount on account of which a deduction or credit was allowed to a distributor or transferor corporation for a prior taxable year, and such debt, tax, or amount is recovered by the acquiring corporation

after the date of distribution or transfer, then under the provisions of section 381(c)(12) the acquiring corporation is required to include in its gross income for the taxable year of recovery the same amount of income attributable to the recovery as the distributor or transferor corporation would have been required to include under section 111 and the regulations thereunder had the distribution or transfer not occurred.

(2) The rule prescribed by paragraph (a)(1) of this section and by section 381(c)(12) with respect to bad debts, prior taxes, and delinquency amounts applies equally with respect to the recovery by the acquiring corporation of all other losses, expenditures, and accruals made the basis of deductions from the gross income of a distributor or transferor corporation for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. An item which is not a "section 111 item" for purposes of the regulations under section 111 is not subject to the provisions of section 381(c)(12). The provisions of section 111(c) shall be applied with respect to a recovery by the acquiring corporation in the same manner as they would have been applied by the distributor or transferor corporation.

(b) Amount of recovery exclusion allowable for year of recovery. For the year of any recovery by the acquiring corporation, the amount of the recovery exclusion for the original taxable year shall be determined in accordance with paragraph (b) of § 1.111–1. For the purpose of this paragraph and section 381(c)(12), the recovery exclusion for any year with respect to section 111 items of the acquiring corporation shall be kept separate from the recovery exclusion for any year with respect to section 111 items of each distributor or transferor corporation. The recovery by the acquiring corporation of any section 111 item of such corporation after the date of the distribution or transfer shall be considered separately from recoveries by the acquiring corporation of any such item which was deducted or credited by a distributor or transferor corporation. Any recovery by the acquiring corporation of a section 111 item shall be excluded from the gross income of the acquiring corporation to the extent of the recovery exclusion (1) determined for the original year for which that item was deducted or credited by the specific corporation which claimed the deduction or credit and (2) reduced by the excludable recoveries (whether made by the acquiring corporation, or by the distributor or transferor corporation) in intervening years with respect to the recovery exclusion of such corporation for such original year. There shall be taken into account the effect of net operating loss carryovers and carrybacks or capital loss carryovers.

(c) Illustration of carryover of recovery exclusion—(1) Facts. (i) The application of section 381(c)(12) may be illustrated by the following example. M and N Corporations are both organized on January 1, 1957, and both corporations compute their taxable income on the basis of the calendar year. On December 31, 1959, M Corporation transfers all its assets to N Corporation in a reorganization to which section 381(a) applies.

(ii) The section 111 items of the two corporations for the following taxable years are as follows, identification of such items being made by an appropriate letter:

Taxable year of deduction or credit	M Corporation (transferor)	N Corporation (acquirer)
1957	$500(g)	$200(h)
1958	300(i)	400(j)
1959	600(k)	100(m)

(iii) The recovery exclusions in respect of such taxable years, computed in accordance with § 1.111–1(b)(2), are assumed to be as follows:

Taxable year	M Corporation (transferor)	N Corporation (acquirer)
1957	$400	$150
1958	200	300
1959	500	75

(iv) The recoveries of the above-mentioned section 111 items by the two corporations are as follows:

Taxable year of recovery	M Corporation (transferor)	N Corporation (acquirer)
1958	$25(g)	$50(h)
1959	50(g)	
	30(i)	20(h)
1960	......	15(j)
		350(g)
		225(i)
		550(k)
		100(h)
		350(j)
		85(m)

(2) M Corporation's 1958 recovery.

Total recovery of section 111 items for 1957	$25
Less: Recovery exclusion for 1957	400

Amount included in gross income of M Corporation for 1958 0

(3) M Corporation's 1959 recoveries.

(i) Total recovery of section 111 items for 1957 .... $50
Less: Recovery exclusion for 1957 .... $400
Minus excludable recovery 25
375
Amount included in gross income of M Corporation for 1959 0

(ii) Total recovery of section 111 items for 1958 30
Less: Recovery exclusion for 1958 200
Amount included in gross income of M Corporation for 1959 0

(4) N Corporation's 1958 recovery.

Total recovery of section 111 items for 1957 .... $50
Less: Recovery exclusion for 1957 150
Amount included in gross income of N Corporation for 1958 0

(5) N Corporation's 1959 recoveries.

(i) Total recovery of section 111 items for 1957 .... $20
Less: Recovery exclusion for 1957 .... $150
Minus excludable recovery in 1958 50
100
Amount included in gross income of N Corporation for 1959 0

(ii) Total recovery of section 111 items for 1958 15
Less: Recovery exclusion for 1958 300
Amount included in gross income of N Corporation for 1959 0

(6) N Corporation's 1960 recoveries.

(i) Total recovery of section 111 items of M Corporation for 1957 .... $350
Less: Recovery exclusion of M Corporation for 1957 .... $400
Minus: Excludable recovery in 1959 .... $50
Excludable recovery in 1958 25
75
325
Amount included in gross income of N Corporation for 1960 25

(ii) Total recovery of section 111 items of M Corporation for 1958 225
Less: Recovery exclusion of M Corporation for 1958 .... $200
Minus excludable recovery in 1959 30
170
Amount included in gross income of N Corporation for 1960 55

(iii) Total recovery of section 111 items of M Corporation for 1959 550
Less: Recovery exclusion of M Corporation for 1959 500
Amount included in gross income of N Corporation for 1960 50

(iv) Total recovery of section 111 items of N Corporation for 1957 100
Less: Recovery exclusion of N Corporation for 1957 .... $150
Minus: Excludable recovery in 1959 .... $20
Excludable recovery in 1958 50
70
80
Amount included in gross income of N Corporation for 1960 20

(v) Total recovery of section 111 items of N Corporation for 1958 .... $350
Less: Recovery exclusion of N Corporation for 1958 .... $300
Minus excludable recovery in 1959 15
285
Amount included in gross income of N Corporation for 1960 65

(vi) Total recovery of section 111 items of N Corporation for 1959 85
Less: Recovery exclusion of N Corporation for 1959 75
Amount included in gross income of N Corporation for 1960 10

(7) Summary of recoveries included in gross income of N Corporation for 1960.

(i) Recovery of M Corporation items for:
1957 .... $25
1958 55
1959 50
$130

(ii) Recovery of N Corporation items for:
1957 20
1958 65
1959 10
95

Total amount included in gross income 225

[T.D. 6559, 26 FR 2984, April 7, 1961]

§ 1.381(c)(13)–1 Involuntary conversions.

(a) **Carryover requirement—(1) General rule.** Section 381(c)(13) requires that after the date of distribution or transfer the acquiring corporation, in a transaction to which section 381(a) applies, shall be treated as the distributor or transferor corporation for purposes of applying section 1033, relating to involuntary conversions. This rule shall apply even though the property similar or related in service or use to the property converted, or the stock of a corporation owning such similar property, is purchased by the acquiring corporation after the date of distribution or transfer and is not received from the distributor or transferor corporation in the transaction to which section 381(a) applies. Accordingly, if any factor essen-

tial to the application of section 1033 occurs on or before the date of distribution or transfer and any other such factor also occurs after that date, then, in accordance with section 381(c)(13) and this section, the provisions of section 1033 shall apply to the acquiring corporation in the same manner that they would have applied to the distributor or transferor corporation in the absence of the distribution or transfer. For purposes of this section, the terms "involuntary conversion" and "disposition of the converted property" shall have the meaning ascribed to them by the regulations under section 1033.

(2) Application to other transactions. The provisions of this section shall apply to any transaction which, under provisions of the Internal Revenue Code of 1954, is treated as though it were an involuntary conversion within the meaning of section 1033. See, for example, section 1071, relating to gain from a sale or exchange to effectuate the policies of the Federal Communications Commission; and sections 1332(b)(3) and 1333(3), relating to war loss recoveries.

(b) Conversion into similar property. Section 1033(a)(1) provides that no gain shall be recognized if property is involuntarily converted only into property which is similar or related in service or use to the property so converted. If there is a disposition of property of a distributor or transferor corporation and, subsequent to the date of distribution or transfer, property similar or related in service or use to the property disposed of is received by the acquiring corporation as compensation for the property so disposed of, then no gain shall be recognized to the acquiring corporation, provided that no gain would have been recognized under section 1033(a)(1) if the similar property had been received directly by the distributor or transferor corporation.

Example. Property of S Corporation with an adjusted basis of $100 is condemned by the local government. Shortly after the property is so condemned, S Corporation liquidates and distributes its assets to P Corporation in a distribution to which section 381(a) applies. Subsequent to the date of distribution, P Corporation receives from the government (in settlement of the condemnation proceedings) property with a market value of $500 which is similar or related in service or use to the property so condemned. No gain is recognized to either corporation upon P Corporation's receipt of the similar property, and the property so received has a basis of $100 in the hands of P Corporation on the date of its acquisition.

(c) Conversion into money or dissimilar property when disposition occurs after December 31, 1950—(1) General rule. Section 1033(a)(3) and § 1.1033(a)–2 provide rules for involuntary conversions of property into money or dissimilar property where the disposition of the converted property occurs after December 31, 1950. In such a case, the gain on the conversion, if any, shall be recognized, at the election of the taxpayer, only to the extent that the amount realized on the conversion exceeds the cost of other property purchased by the taxpayer which is similar or related in service or use to the property so converted, or exceeds the cost of stock purchased by the taxpayer in the acquisition of control of a corporation owning such other property, provided (i) the taxpayer purchases such other property or stock for the purpose of replacing the property so converted and (ii) the purchase occurs during the period of time specified in section 1033(a)(3)(B). The provisions of this paragraph shall apply to involuntary conversions where the disposition of the property occurs after December 31, 1950, and where the election to have section 1033(a)(3) apply to the treatment of the gain upon the conversion is contingent upon activities of both the distributor or transferor corporation and the acquiring corporation. For purposes of section 381(c)(13), the period of time specified in section 1033(a)(3)(B) shall be determined by taking into account taxable years of, and extensions of time granted to, both the distributor or transferor corporation and the acquiring corporation.

(2) Replacement period. The period during which the purchase of similar property or stock must be made in order to prevent the recognition of gain on the involuntary conversion terminates 2 years (or, in the case of a disposition occurring before Dec. 31, 1969, 1 year) after the close of the first taxable year in which any part of the gain upon the conversion is realized, or at the close of such later date as may be designated pursuant to an application of the taxpayer. See paragraph (c)(3) of § 1.1033(a)–2. Therefore, if, in a case to which this subparagraph applies, the first taxable year in which gain is realized is the taxable year of the distributor or transferor corporation ending with the close of the date of distribution or transfer, the acquiring corporation will have a maximum of only 2 years (or, in the case of a disposition occurring before Dec. 31, 1969, 1 year) after that date in which to purchase the similar property or stock, unless an extension of time has been granted upon application by the distributor, transferor, or acquiring corporation within the time prescribed. See paragraph (a) of § 1.381(b)–1 as to the termination of the taxable year of the distributor or transferor corporation. See paragraph (c)(3) of § 1.1033(a)–2 as to applications to extend the period within which to replace the converted property. In addition to the information otherwise required under paragraph (c)(3) of

§ 1.1033(a)–2, the application shall contain sufficient detail in connection with the distribution or transfer to establish that section 381(c)(13) applies to the involuntary conversion involved.

(3) *Examples.* The application of this paragraph may be illustrated by the following examples:

Example (1). A and B Corporations compute their taxable income on the basis of the calendar year, and both corporations use the cash method of accounting. During 1970 property of A Corporation is destroyed by fire, and in January 1971, A Corporation receives $15,000 from an insurance company as compensation for its loss of property. The adjusted basis of the property on the date of destruction is $10,000; as a consequence, A Corporation realizes a gain of $5,000 on the involuntary conversion. On June 30, 1971, B Corporation acquires all of the assets of A Corporation in a reorganization to which section 381(a) applies. In accordance with paragraph (c)(2) of § 1.1033(a)–2, A Corporation reports in its return for the short taxable year ending June 30, 1971, all the details in connection with the involuntary conversion but does not include the realized gain in gross income, thereby electing to have the gain recognized only to the extent provided in section 1033(a)(3). On June 15, 1973, B Corporation purchases for $20,000 property which is similar or related in service or use to the property previously destroyed. In its return for 1973, B Corporation reports all of the details in connection with its replacement of the property, as required by paragraph (c)(2) of § 1.1033(a)–2. As a result of this replacement by B Corporation, none of the gain realized by A Corporation is recognized. The replacement property which is purchased by B Corporation has a basis to that corporation of $15,000 on the date of its purchase, that is, the cost of such property ($20,000) decreased by the amount of gain not recognized to A Corporation on the involuntary conversion ($5,000).

Example (2). Assume the same facts as in example (1), except that B Corporation does not purchase similar property on or before June 30, 1973, and does not apply on or before that date (in accordance with paragraph (c)(3) of § 1.1033(a)–2) for an extension of time in which to make a replacement. In such event, the gain realized by A Corporation is recognized to that corporation for its taxable year ending June 30, 1971. A Corporation's tax liability for such taxable year must be recomputed in accordance with paragraph (c)(2) of § 1.1033(a)–2 in order to reflect this additional income.

Example (3). Assume the same facts as in example (1), except that the property of A Corporation is destroyed in 1968, A Corporation receives the $15,000 from an insurance company in January 1969, B Corporation acquires all of the assets of A Corporation on June 30, 1969, and A Corporation's return is filed for the short taxable year ending June 30, 1969. B Corporation would have to purchase property which is similar or related in service or use to the property previously destroyed by June 30, 1970, in order to take advantage of the provisions of section 1033.

Example (4). M and N Corporations compute their taxable income on the basis of the calendar year, and both corporations use the cash method of accounting. During 1970, property of M Corporation is destroyed by fire. The adjusted basis of the property on the date of destruction is $10,000. The property is insured against loss by fire, but the insurance claim is not satisfied on or before June 30, 1971, the date on which N Corporation acquires all of the assets (including the insurance claim) of M Corporation in a reorganization to which section 381(a) applies. On September 1, 1972, N Corporation receives $15,000 from the insurance company as compensation for the fire loss suffered by M Corporation. Upon receipt of the insurance proceeds, N Corporation realizes a gain of $5,000 upon the involuntary conversion; however, in its return for 1972, N Corporation elects under the provisions of paragraph (c)(2) of § 1.1033(a)–2 to have the gain recognized only to the extent provided by section 1033(a)(3). On December 30, 1974, N Corporation purchases for $20,000 property which is similar or related in service or use to the property previously destroyed in the hands of M Corporation. As a result of this replacement by N Corporation, none of the gain realized by N Corporation in 1972 is recognized. The replacement property which is purchased by N Corporation has a basis to that corporation of $15,000 on the date of its purchase, that is, the cost of such property ($20,000) decreased by the amount of gain not recognized to N Corporation on the involuntary conversion ($5,000).

Example (5). R and S Corporations compute their taxable income on the basis of the calendar year, and both corporations use the cash method of accounting. During 1970 property of R Corporation is destroyed by fire. The adjusted basis of the property on the date of destruction is $10,000. In anticipation of taking the benefit of section 1033(a)(3), R Corporation purchases for $20,000 on June 1, 1971, property which is similar or related in service or use to the destroyed property. In its return for 1971, R Corporation reports all of the details in connection with the replacement of the property, as required by paragraph (c)(2) of § 1.1033(a)–2. The property destroyed in 1970 is insured against loss by fire, but the insurance claim is not satisfied on or before March 1, 1972, the date on which S Corporation acquires all of the assets (including the insurance claim) of R Corporation in a reorganization to which section 381(a) applies. On October 1, 1972, S Corporation receives $12,000 from the insurance company as compensation for the fire loss suffered by R Corporation. Upon receipt of the insurance proceeds, S Corporation realizes a gain of $2,000 upon the involuntary conversion; however, in its return for 1972, S Corporation elects under the provisions of paragraph (c)(2) of § 1.1033(a)–2 to have the gain recognized only to the extent provided by section 1033(a)(3). As a result of the replacement by R Corporation, none of the gain realized by S Corporation in 1972 is recognized. Assuming there are no adjustments for depreciation, the replacement property has a basis on October 1, 1972, of $18,000, that is, the cost of such property ($20,000) decreased by the amount of gain not recognized to S Corporation on the involuntary conversion ($2,000)

(d) *Conversion into money when disposition occurs before January 1, 1951.* Section 1033(a)(2) provides that, if property is disposed of in an involuntary conversion before January 1, 1951, and money is received as compensation for the conversion, no gain shall be recognized if such money is forthwith expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund. That section also provides that, if any part of the money is not so expended, the gain, if any, shall be recognized to the extent of the money which is not so expended. For example, if, pursuant to section 381(c)(13) and section 1033(a)(2), property of a distributor or transferor corporation is disposed of before January 1, 1951, in an invol-

untary conversion, and the proceeds from the conversion are received by the acquiring corporation so that the gain on the conversion is realized by that corporation, the acquiring corporation may avoid recognition of the gain if it complies with the provisions of section 1033(a)(2) for nonrecognition of gain. Thus, the acquiring corporation must forthwith expend the proceeds in the acquisition of similar property or stock, or in the establishment of a replacement fund, in order to avoid recognition of the gain, if the disposition occurred before January 1, 1951. See the provisions of §§ 1.1033(a)-3 and 1.1033(a)-4 relating to involuntary conversions and replacement funds when disposition of the converted property occurred before January 1, 1951.

(e) **Successive acquiring corporations.** An acquiring corporation which, in a transaction to which section 381(a) applies, acquires the assets of a corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall be treated as such other corporation for purposes of applying sections 381(c)(13) and 1033 (relating to involuntary conversions). Thus, for example, if any factor essential to the application of section 1033 occurs on or before the date of distribution or transfer in one transaction to which section 381(a) applies, and any other such factor occurs after the date of distribution or transfer in a subsequent transaction to which section 381(a) applies, then the acquiring corporation in such subsequent transaction shall be treated as the first distributor or transferor corporation subject to the rules and limitations of this section for purposes of sections 381(c)(13) and 1033.

[T.D. 6552, 26 FR 1989, March 8, 1961, as amended by T.D. 7075, 35 FR 17995, Nov. 24, 1970]

§ 1.381(c)(14)-1 Dividend carryover to personal holding company.

(a) **Carryover requirement.** Section 381(c)(14) provides that an acquiring corporation shall succeed to and take into account the dividend carryover (described in section 564) of a distributor or transferor corporation in computing its dividends paid deduction under section 561 for taxable years ending after the date of distribution or transfer for which the acquiring corporation is a personal holding company under section 542. To determine the amount of such dividend carryover and to integrate it with the dividend carryover of the acquiring corporation in computing the dividends paid deduction for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of section 564 and § 1.564-1 in accordance with this section.

(b) **Manner of computing dividend carryover—(1) Preceding taxable years.** If the acquiring corporation is a personal holding company under section 542 for its first taxable year ending after the date of distribution or transfer, the taxable year of the distributor or transferor corporation ending with such date is a first preceding taxable year for purposes of section 564, and the taxable year of the distributor or transferor corporation immediately preceding such first preceding year is a second preceding taxable year for purposes of section 564. If the acquiring corporation is a personal holding company for its second taxable year ending after the date of distribution or transfer, the taxable year of the distributor or transferor corporation ending with such date is a second preceding taxable year for purposes of section 564.

(2) **Determination of dividends paid deduction and taxable income.** The dividends paid deduction of any distributor or transferor corporation (determined under section 561 but without regard to any dividend carryover) and the taxable income of any such corporation (adjusted as provided in section 545(b)) for any taxable year ending on or before the date of distribution or transfer shall be determined without reference to any dividends paid deduction, or taxable income, of the acquiring corporation or any other distributor or transferor corporation; in like manner, the dividends paid deduction and the taxable income of the acquiring corporation for any such taxable year shall be determined without reference to any dividends paid deduction, or taxable income, of a distributor or transferor corporati[illegible]

(3) **Computation of dividend carryover.** (i) For the purpose of determining the dividend carryover to the first taxable year of the acquiring corporation ending after the date of distribution or transfer, the amount of the dividend carryover from the distributor or transferor corporation shall be determined under section 564 without reference to the dividends paid deduction or taxable income of the acquiring corporation or any other corporation. If two or more transactions to which section 381(a) applies have the same date of distribution or transfer, or if a particular taxable year of the acquiring corporation is the first taxable year ending after the dates of distribution or transfer of two or more such transactions occurring on different dates, the amount of the dividend carryover from each distributor or transferor corporation shall be determined separately as provided in the preceding sentence. Except as provided in subdi-

vision (iii) of this subparagraph, the aggregate of the dividend carryovers from each distributor or transferor corporation and the dividend carryover of the acquiring corporation (computed without regard to this section) shall constitute the dividend carryover under section 561(a)(3) of the acquiring corporation for its first taxable year ending after the date (or dates) of distribution or transfer.

(ii) For the purpose of determining the dividend carryover to the second taxable year of the acquiring corporation ending after the date (or dates) of distribution or transfer, the excess, if any, of the dividends paid deduction (determined under section 561 without regard to any dividend carryover) over the taxable income (adjusted as provided in section 545(b)) for the taxable year of each distributor or transferor corporation and the acquiring corporation referred to as a second preceding taxable year shall be determined separately without reference to the dividends paid deduction or taxable income of any other of such corporations. The excesses thus determined shall be aggregated, and such aggregate shall be—

(a) Increased by the excess of the dividends paid deduction (determined without regard to any dividend carryover) over the taxable income (adjusted as provided in section 545(b)), or

(b) Reduced by the excess of the taxable income (adjusted as provided in section 545(b)) over the dividends paid deduction (determined without regard to any dividend carryover),

for the first preceding taxable year of the acquiring corporation. Except as provided in subdivision (iii) of this subparagraph, the amount thus determined shall constitute the dividend carryover under section 561(a)(3) of the acquiring corporation for its second taxable year ending after the date (or dates) of distribution or transfer.

(iii) If a particular taxable year of the acquiring corporation is its first taxable year ending after the date (or dates) of distribution or transfer of one or more transactions to which section 381(a) applies, and if the same taxable year of the acquiring corporation is also its second taxable year ending after the date (or dates) of distribution or transfer of one or more other transactions to which section 381(a) applies, then, for the purpose of determining the dividend carryover to such taxable year of the acquiring corporation, the rules contained in both subdivisions (i) and (ii) of this subparagraph shall be applied. Insofar as such taxable year constitutes the first taxable year ending after the date (or dates) of distribution or transfer of any transaction, the amount of the dividend carryover from any distributor or transferor corporation involved in such transaction shall be determined separately as provided in subdivision (i) of this subparagraph. Insofar as such taxable year constitutes the second taxable year ending after the date (or dates) of distribution or transfer of any transaction, the amount of the dividend carryover from any distributor or transferor corporation involved in the transaction and the acquiring corporation shall be determined as provided in subdivision (ii) of this subparagraph. The aggregate of the dividend carryovers thus determined shall constitute the dividend carryover under section 561(a)(3) of the acquiring corporation for such taxable year. See example (4) in paragraph (c) of this section.

(c) **Illustrations.** The rules set forth in paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). (i) **Facts.** N Corporation acquired on June 30, 1960, all the assets of M Corporation in a reorganization to which section 381(a) applies. Both corporations compute taxable income on the basis of the calendar year. N Corporation is a personal holding company for its taxable years ending December 31, 1960, and December 31, 1961.

(ii) **Dividend carryover to N Corporation's taxable year ending December 31, 1960.** With respect to N Corporation's taxable year ending December 31, 1960, the taxable years referred to as first preceding taxable years and second preceding taxable years are—

(a) M Corporation's taxable years ending June 30, 1960, and December 31, 1959, respectively; and

(b) N Corporation's taxable years ending December 31, 1959, and December 31, 1958, respectively.

The dividend carryover to N Corporation's taxable year ending December 31, 1960, is $22,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	M Corporation		*N Corporation*	
Second preceding taxable year:				
Dividends paid deduction	$25,000		$12,000	
Taxable income	15,000		13,000	
Excess dividends paid deduction		$10,000		
First preceding taxable year:				
Dividends paid deduction	23,000		20,000	
Taxable income	21,000		10,000	
Excess dividends paid deduction		2,000		$10,000
Separate dividend carryovers		12,000		10,000

The aggregate dividend carryover of $22,000 is the sum of $12,000 (the separate dividend carryover from M Corporation) and $10,000 (the separate dividend carryover from N Corporation's own preceding taxable years).

(iii) Dividend carryover to N Corporation's taxable year ending December 31, 1961. With respect to N Corporation's taxable year ending December 31, 1961, the first preceding taxable year is N Corporation's taxable year ending December 31, 1960; and the taxable years referred to as second preceding taxable years are M Corporation's taxable year ending June 30, 1960, and N Corporation's taxable year ending December 31, 1959. The dividend carryover to N Corporation's taxable year ending December 31, 1961, is $17,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

Second preceding taxable year	M Corporation	N Corporation
Dividends paid deduction	$23,000	$20,000
Taxable income	21,000	10,000
Separate excess of dividends paid deduction over taxable income	2,000	10,000

The aggregate excess of dividends paid deduction over taxable income for the second preceding taxable year is $12,000, the sum of $2,000 (separate excess from N Corporation) and $10,000 (separate excess from N Corporation). Such aggregate excess is increased by the excess dividends paid deduction, or is reduced by the excess of taxable income, for the first preceding taxable year as follows:

Aggregate excess of dividends paid deduction for second preceding taxable year		$12,000
Dividends paid deduction of N Corporation for first preceding taxable year	$50,000	
Taxable income of N Corporation for first preceding taxable year	45,000	
		$5,000
Dividend carryover to N Corporation's taxable year ending December 31, 1961		17,000

Example (2). (i) Facts. X Corporation is organized on May 1, 1956, and computes its taxable income on the basis of the fiscal year ending April 30. Y Corporation and Z Corporation are both organized on January 1, 1955, and both compute their taxable income on the basis of the calendar year. On July 31, 1957, X Corporation and Y Corporation transfer all their assets to Z Corporation in a statutory merger to which section 381(a) applies. For its taxable years ending December 31, 1957, and December 31, 1958, Z Corporation is a personal holding company.

(ii) Dividend carryover to Z Corporation's taxable year ending December 31, 1957. With respect to Z Corporation's taxable year ending December 31, 1957, the taxable years referred to as first preceding taxable years and second preceding taxable years are—

(a) X Corporation's taxable years ending July 31, 1957, and April 30, 1957, respectively;

(b) Y Corporation's taxable years ending July 31, 1957, and December 31, 1956, respectively; and

(c) Z Corporation's taxable years ending December 31, 1956, and December 31, 1955, respectively.

The dividend carryover to Z Corporation's taxable year ending December 31, 1957, is $40,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	X Corporation		*Y Corporation*		*Z Corporation*	
Second preceding taxable year:						
Dividends paid deduction	$56,000		$19,000		$6,000	
Taxable income	24,000		17,000		5,000	
Excess		$32,000		$2,000		$1,000
First preceding taxable year:						
Dividends paid deduction	9,000		4,000		10,000	
Taxable income	7,000		8,000		5,000	
Excess		2,000		(4,000)		5,000
Separate dividend carryovers		34,000		0		6,000

The aggregate dividend carryover of $40,000 is the sum of $34,000 (the separate dividend carryover from X Corporation) and $6,000 (the separate dividend carryover from Z Corporation's own preceding taxable years).

(iii) Dividend carryover to Z Corporation's taxable year ending December 31, 1958. With respect to Z Corporation's taxable year ending December 31, 1958, the first preceding taxable year is Z Corporation's taxable year ending December 31, 1957; and the taxable years referred to as second preceding taxable years are X Corporation's taxable year ending July 31, 1957, Y Corporation's taxable year ending July 31, 1957, and Z Corporation's taxable year ending December 31, 1956. The dividend carryover to Z Corporation's taxable year ending December 31, 1958, is $1,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	X Corporation	*Y Corporation*	*Z Corporotion*
Second preceding taxable year:			
Dividends paid deduction	$9,000	$4,000	$10,000
Taxable income	7,000	8,000	5,000
Separate excess of dividends paid deduction over taxable income	2,000	0	5,000

The aggregate excess of dividends paid deduction over taxable income for the second preceding taxable year is $7,000, the sum of $2,000 (separate excess from X Corporation) and $5,000 (separate excess from Z Corporation). Such aggregate excess is increased by the excess dividends paid deduction, or is reduced by the excess of taxable income, for the first preceding taxable year as follows:

Aggregate excess of dividends paid deduction for second preceding taxable year		$7,000
Dividends paid deduction of Z Corporation for first preceding taxable year	$102,000	
Taxable income of Z Corporation for first preceding taxable year	108,000	(6,000)
Dividend carryover to Z Corporation's taxable year ending December 31, 1958		1,000

Example (3). Assume the facts stated in example (2), except that Y Corporation transferred all its assets to Z Corporation on May 31, 1957. Assume also that the facts for Y Corporation's taxable year ending May 31, 1957, are otherwise the same as those stated for its taxable year in example (2) ending July 31, 1957. In such case, the dividend carryovers to Z Corporation's taxable years ending on December 31, 1957, and December 31, 1958, are the same as in example (2) notwithstanding the fact that the transfers from X Corporation and Y Corporation occurred on the different dates.

Example (4). (i) **Facts.** T Corporation acquired on June 30, 1960, all the assets of U Corporation in a statutory merger to which section 381(a) applies, and in a like transaction acquired on June 30, 1961, all the assets of V Corporation. Such corporations all compute taxable income on the basis of the calendar year. T Corporation is a personal holding company for its taxable years 1960 and 1961.

(ii) Dividend carryover to T Corporation's taxable year 1960. With respect to T Corporation's taxable year ending December 31, 1960, the taxable years referred to as first preceding taxable years and second preceding taxable years are—

(a) U Corporation's taxable years ending June 30, 1960, and December 31, 1959, respectively; and

(b) T Corporation's taxable years ending December 31, 1959, and December 31, 1958, respectively.

The dividend carryover to T Corporation's taxable year ending December 31, 1960, is $7,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

	U Corporation		*T Corporatian*	
Second preceding taxable year:				
Dividends paid deduction	$16,000		$10,000	
Taxable income	12,000		13,000	
Excess		$4,000		0
First preceding taxable year:				
Dividends paid deduction	7,000		17,000	
Taxable income	5,000		16,000	
Excess		2,000		$1,000
Separate dividend carryovers		6,000		1,000

The aggregate dividend carryover of $7,000 is the sum of $6,000 (the separate dividend carryover from U Corporation) and $1,000 (the separate dividend carryover from T Corporation's own first preceding taxable year).

(iii) Dividend carryover to T Corporation's taxable year 1961. Inasmuch as T Corporation's taxable year 1961 is the second taxable year ending after the date of distribution or transfer from U Corporation, paragraph (b)(3)(ii) of this section governs the determination of the dividend carryover from taxable years of T Corporation and U Corporation. On the other hand, inasmuch as T Corporation's taxable year 1961 is the first taxable year ending after the date of distribution or transfer from V Corporation, paragraph (b)(3)(i) governs the determination of the dividend carryover from taxable years of V Corporation.

(a) Application of paragraph (b)(3)(ii) of this section. With respect to T Corporation's taxable year 1961, the first preceding taxable year is T Corporation's taxable year ending December 31, 1960; and the taxable years referred to as second preceding taxable year are T Corporation's taxable year ending December 31, 1959, and U Corporation's taxable year ending June 30, 1960. The dividend carryover from taxable years of T Corporation and U Corporation is $1,500 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

Second preceding taxable year	U Corporation	T Corporation
Dividends paid deduction	$7,000	$17,000
Taxable income	5,000	16,000
Separate excess of dividends paid deduction over taxable income	2,000	1,000

The aggregate excess of dividends paid deduction over taxable income for the second preceding taxable year is $3,000, the sum of $2,000 (separate excess from U Corporation) and $1,000 (separate excess from T Corporation). Such aggregate is increased by the excess dividends paid deduction, or is reduced by the excess of taxable income, for the first preceding taxable year as follows:

		T Corporation
Aggregate excess of dividends paid deduction for second preceding taxable year		$3,000
First preceding taxable year:		
Dividends paid deduction of T Corporation	$21,000	
Taxable income of T Corporation	22,500	
Excess taxable income		(1,500)
Separate dividend carryover (without regard to V Corporation)		1,500

(b) Application of paragraph (b)(3)(i) of this section. With respect to T Corporation's taxable year 1961, V Corporation's taxable year ending June 30, 1961, is a first preceding taxable year, and its taxable year ending December 31, 1960, is a second preceding taxable year. The separate dividend carryover from V Corporation is $8,000 computed as follows, assuming the dividends paid deduction before dividend carryovers, and the taxable income after section 545(b) adjustments, to be as stated in the computation:

Second preceding taxable year		V Corporation
Dividends paid deduction	$11,000	
Taxable income	6,000	
Excess		$5,000
First preceding taxable year:		
Dividends paid deduction	$9,000	
Taxable income	6,000	
Excess	3,000	
Separate dividend carryover from V Corporation		8,000

(c) Dividend carryover. The dividend carryover to T Corporation's taxable year 1961 is $9,500, the sum of $8,000 (the separate dividend carryover from V Corporation) and $1,500 (the aggregate dividend carryover from T Corporation and U Corporation).

(d) Successive carryovers. The provisions of this section shall apply for the purpose of determining a dividend carryover to an acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which has previously acquired the assets of another corporation in a transaction to which section 381(a) applies; even though, in computing the dividend carryover to such second acquiring corporation, it is necessary to take into account the deduction for dividends paid, and the adjusted taxable income, of the first distributor or transferor corporation.

(e) Acquiring corporation not receiving all the assets. The dividend carryover acquired from a distributor or transferor corporation by an acquiring corporation in a transaction to which section 381(a) applies is not reduced by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

(f) Dividends paid after the close of taxable year. A transaction to which section 381(a) applies does not prevent the application of section 563(b) to a dividend paid by a distributor or transferor corporation after the close of its taxable year ending with the date of distribution or transfer but on or before the 15th day of the third month following the close of such taxable year. However, dividends paid by the acquiring corporation may not be taken into account under section 563(b) for the purpose of determining the dividends paid deduction of the distributor or transferor corporation for its taxable year ending with the date of distribution or transfer.

[T.D. 6532, 26 FR 406, Jan. 19, 1961]

§ 1.381(c)(15)–1 Indebtedness of certain personal holding companies.

(a) Qualified indebtedness—(1) Carryover requirement. If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for any indebtedness which was qualified indebtedness (as defined in section 545(c) and § 1.545–3) in the hands of the distributor or transferor corporation immediately before the assumption of such indebtedness, then, under section 381(c)(15), in computing its undistributed personal holding company income for any taxable year beginning after December 31, 1963, and ending after the date of distribution or transfer, the acquiring corporation shall be considered the distributor or transferor corporation for purposes of computing the deduction under section 545(c) and § 1.545–3. Such deduction shall be allowed to the acquiring corporation in accordance with section 545(c) and § 1.545–3.

(2) Successive transactions to which section 381(a) applies. If in a transaction to which section 381(a) applies, an acquiring corporation assumes liability for qualified indebtedness, such acquiring corporation shall be deemed to have incurred such qualified indebtedness for the purpose of applying section 381(c)(15) to any subsequent transaction in which such acquiring corporation is the distributor or transferor corporation.

(b) Pre-1934 indebtedness—(1) Carryover requirement. If, in a transaction to which section 381(a) applies, the acquiring corporation assumes liability for any indebtedness incurred, or assumed, before January 1, 1934, by a distributor or transferor corporation, then under section 381(c)(15) the acquiring corporation shall be allowed, in computing its undistributed personal holding company income for any taxable year ending after the date of distribution or transfer, a deduction under section 545(b)(7) for amounts used or irrevocably set aside to pay or to retire such indebtedness. Such deduction shall be allowed to the acquiring corporation in accordance with section 545(b)(7) and paragraph (g) of § 1.545–2 as though the indebtedness had been incurred, or assumed, by the acquiring corporation before January 1, 1934.

(2) Successive transactions to which section 381(a) applies. If, in a transaction to which section 381(a) applies, an acquiring corporation as-

sumes liability for indebtedness described in subparagraph (1) of this paragraph, such acquiring corporation shall be deemed to have incurred the indebtedness before January 1, 1934, for the purpose of applying section 381(c)(15) to any subsequent transaction in which such acquiring corporation is the distributor or transferor corporation.

(c) **Special rule.** For purposes of this section, if, in a transaction otherwise described in this section, an acquiring corporation acquires real estate—(1) of which the distributor or transferor corporation is the legal or equitable owner immediately before the acquisition, and (2) which is subject to indebtedness that, with respect to the distributor or transferor corporation, is indebtedness described in this section immediately before the acquisition, then the acquiring corporation will be treated as having assumed such indebtedness, provided it shows to the satisfaction of the Commissioner that under all the facts and circumstances it bears the burden of discharging such indebtedness.

[T.D. 6532, 26 FR 406, Jan. 19, 1961, as amended by T.D. 6949, 33 FR 5524, April 9, 1968; 33 FR 6091, April 20, 1968]

§ 1.381(c)(16)-1 Obligations of distributor or transferor corporation.

(a) **Deduction allowed to acquiring corporation.** (1) If, in a transaction to which section 381(a) applies, the acquiring corporation assumes an obligation of a distributor or transferor corporation which gives rise to a liability after the date of distribution or transfer and if the distributor or transferor corporation would be entitled to deduct such liability in computing taxable income were it paid or accrued after that date by such corporation, then, under the provisions of section 381(c)(16) and this section, the acquiring corporation shall be entitled to deduct such liability as if it were the distributor or transferor corporation. However, in the case of a transaction to which section 381(a)(2) applies, section 381(c)(16) shall not apply to an obligation which is reflected in the amount of consideration, that is, the stock, securities, or other property, transferred by the acquiring corporation to a transferor corporation or its shareholders in exchange for the property of that transferor corporation. An obligation which is so reflected in the amount of consideration will be treated as an item or tax attribute not specified in section 381(c)(16). Such an obligation is subject to section 381(c)(4). See subparagraph (2) of this paragraph. Any deduction allowed under section 381(c)(16) to the acquiring corporation shall be taken by that corporation in the taxable year ending after the date of distribution or transfer in which the liability is paid or accrued by that corporation, as the case may be.

(2) In order to determine whether, in the case of obligations of a distributor or transferor corporation assumed by an acquiring corporation, section 381(c)(16) and this section, or section 381(c)(4) and the regulations thereunder, apply, the following rules shall govern:

(i) If the obligation gave rise to a liability before the date of distribution or transfer, see section 381(c)(4) and the regulations thereunder.

(ii) If the obligation gives rise to a liability after the date of distribution or transfer, and the obligation was not reflected in the amount of consideration transferred by the acquiring corporation to the distributor or transferor corporation or its shareholders in exchange for the property of the distributor or transferor corporation, then section 381(c)(16) and this section shall apply.

(iii) In the case of a transaction to which section 381(a)(1) applies, if the obligation gives rise to a liability after the date of a distribution, and the obligation was reflected in the amount of consideration transferred by the acquiring corporation to the distributor corporation or its shareholders in exchange for the property of the distributor corporation, then section 381(c)(16) and this section shall apply.

(iv) In the case of a transaction to which section 381(a)(2) applies, if the obligation gives rise to a liability after the date of a transfer, and the obligation was reflected in the amount of consideration transferred by the acquiring corporation to the transferor corporation or its shareholders in exchange for the property of the transferor corporation, then see section 381(c)(4) and the regulations thereunder.

(3) The rules of this section apply to obligations assumed by agreement of the parties as well as by operation of law.

(4) For purposes of this section, an obligation of a distributor or transferor corporation gives rise to a liability when the liability would be accruable by a taxpayer using the accrual method of accounting notwithstanding the fact that the distributor or transferor corporation is not using the accrual method of accounting. See paragraph (a)(2) of § 1.461-1.

(5) In the case of a transaction to which section 381(a)(2) applies, the determination as to whether

or not an obligation was reflected in the amount of consideration transferred by the acquiring corporation to the transferor corporation or its shareholders in exchange for the property of the transferor corporation shall be made on the basis of all the facts of each particular transfer. Where, on the date of distribution or transfer, the parties were aware of the existence of a specific obligation and reduced the amount of consideration to be transferred by the acquiring corporation by a specific amount because of the existence of such obligation, then such obligation shall be considered to have been reflected in the amount of consideration transferred. In the absence of such facts, it shall be presumed that the obligation was not reflected in the amount of consideration transferred.

(b) **Distribution or transfer occurring under the Internal Revenue Code of 1939.** Subject to the provisions of section 381(c)(16) and this section, a corporation which would have been an acquiring corporation (under the provisions of paragraph (b) of § 1.381(a)–1) in a transaction to which section 381(a) applies if the date of distribution or transfer had occurred on or after the effective date of the provisions of subchapter C, chapter 1 of the Internal Revenue Code of 1954, applicable to a liquidation or reorganization, as the case may be, shall be entitled to take a deduction for amounts paid or accrued in any taxable year beginning after December 31, 1953, in respect of any obligation which it has assumed from a corporation which would have been a distributor or transferor corporation in such transaction. However, this paragraph shall have no application to a situation described in paragraph (a)(2)(iv) of this section.

(c) **Examples.** The application of the foregoing rules may be illustrated by the following examples:

Example (1). X Corporation and Y Corporation compute their taxable income on the basis of the calendar year, and both corporations use an accrual method of accounting. On December 31, 1954, Y Corporation acquires the assets of X Corporation in a transfer to which section 381(a)(2) applies. By reason of State law, Y Corporation assumes responsibility for all of the obligations for which X Corporation is then, or may become, liable. The parties have no knowledge of any specific obligations of X Corporation which are not yet fixed and ascertainable, but it is agreed to reduce the amount of consideration that Y Corporation is to transfer in exchange for the assets of X Corporation by $5,000 to reflect any unforeseen contingent liabilities of X Corporation for which Y Corporation might subsequently become liable. After the date of the transfer, a claim for damages on account of the alleged negligence of an alleged agent of X Corporation is filed. After commencement of legal action by the claimant and in order to eliminate the possibility of injury to its business, Y Corporation settles the claim in 1955 by paying the claimant the amount of $3,000. Assuming that such sum would have been deductible under section 162 if paid by X Corporation, Y Corporation is entitled to deduct such sum in accordance with the provisions of section 381(c)(16) and this section in computing its taxable income for 1955, since the claim gave rise to a liability after the date of transfer, the parties were not aware of a specific obligation, and the specific obligation was not reflected in the consideration transferred by Y Corporation in exchange for the assets of X Corporation.

Example (2). Assume the same facts as in example (1), except that the claim for damages was filed prior to the transfer of X Corporation's assets to Y Corporation, but the parties considered the chances for recovery by the claimant so remote that no specific amount other than the $5,000 reduction in consideration for all contingent liabilities as a whole is reflected in the consideration transferred by Y Corporation in exchange for the assets of X Corporation. Assuming that such sum would have been deductible under section 162 if paid by X Corporation, the $3,000 paid by Y Corporation in 1955 is deductible in accordance with the provisions of section 381(c)(16) and this section in 1955.

Example (3). Assume the same facts as in example (1), except that the parties consider the chances of recovery by the claimant of sufficient probability that Y Corporation reduces the amount of consideration it transfers in exchange for the assets of X Corporation by $1,000 in addition to the $5,000 reduction for all other contingent liabilities. The $3,000 paid by Y Corporation in 1955 is not deductible under section 381(c)(16) and this section, since the specific obligation was reflected in the consideration transferred by Y Corporation in exchange for the assets of X Corporation. The deductibility of the payment is accordingly governed by the provisions of section 381(c)(4) and the regulations thereunder. Similarly, if in this case Y Corporation had transferred $10,000 less in consideration for the assets of X Corporation because of this particular claim, Y Corporation would not be entitled to any deduction for the $3,000 paid in 1955 under section 381(c)(16) and this section, and the deductibility of the payment would be governed by the provisions of section 381(c)(4) and the regulations thereunder. If the date of transfer of X Corporation's assets had occurred prior to the effective date of subchapter C, chapter 1 of the Internal Revenue Code of 1954, applicable to a reorganization, no deduction would be allowed to Y Corporation under that section.

[T.D. 6750, 29 FR 11267, Aug. 5, 1964]

§ 1.381(c)(17)–1 Deficiency dividend of personal holding company.

(a) **Carryover requirement.** If a determination (as defined in section 547(c)) establishes that a distributor or transferor corporation in a transaction to which section 381(a) applies is liable for personal holding company tax imposed by section 541 (or by a corresponding provision of prior income tax law) for any taxable year ending on or before the date of distribution or transfer, then in computing such tax the deduction described in section 547 shall be allowed pursuant to section 381(c)(17) to such corporation for the amount of deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation. Except as otherwise provided in this section, the provisions of section 547 and the regulations thereunder apply with respect to a deficiency dividend deduction allowable pursuant to section 381(c)(17).

(b) Deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation. A deficiency dividend paid by the acquiring corporation with respect to the distributor or transferor corporation is a distribution that would satisfy the definition of a deficiency dividend under section 547(d)(1) if paid by the distributor or transferor corporation to its own shareholders except that it shall be paid by the acquiring corporation to its own shareholders and shall be paid after the date of distribution or transfer and on, or within 90 days after, the date of the determination but before the acquiring corporation files claim under paragraph (c) of this section.

(c) Claim for deduction. A claim for a deduction under this section shall be made by the acquiring corporation on Form 976, and shall be filed within 120 days after the date of the determination. The form shall contain, or be accompanied by, the information required under paragraph (b)(2) of § 1.547–2 in sufficient detail to properly identify the facts with the distributor or transferor corporation and the acquiring corporation. The statement required with respect to the shareholders on the date of payment of the deficiency dividend shall relate to the shareholders of the acquiring corporation, and the required certified copy of the resolution authorizing the payment of the dividend shall be that of the board of directors, or other authority, of the acquiring corporation. Necessary changes may be made in Form 976 in order to carry out the provisions of this paragraph. The claim shall be filed with the district director for the internal revenue district in which the return of the distributor or transferor corporation to which such claim relates was filed.

(d) Effect on dividends paid deduction. A deficiency dividend paid by the acquiring corporation, which is allowable as a deduction to a distributor or transferor corporation pursuant to section 381(c)(17), shall not become a part of the dividends paid deduction of the acquiring corporation under section 561 for any taxable year.

(e) Successive transactions to which section 381(a) applies. The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, if X Corporation transfers its assets to Y Corporation in a transaction to which section 381(a) applies and if Y Corporation transfers its assets to Z Corporation in a subsequent transaction to which section 381(a) applies, then, subject to the provisions of this section, X Corporation may take a deficiency dividend deduction for the amount of deficiency dividends paid by Z Corporation with respect to X Corporation.

(f) Example. The provisions of this section may be illustrated by the following example:

Example. M Corporation, a personal holding company, computes its taxable income on the basis of the calendar year. On December 31, 1956, N Corporation acquires the assets of M Corporation in a transaction to which section 381(a) applies. On July 31, 1958, a determination (as defined in section 547(c)) establishes that M Corporation is liable for the taxable year 1955 for personal holding company tax in the amount of $35,500 based on undistributed personal holding company income of $42,000 for such taxable year. N Corporation complies with the provisions of this section and on September 30, 1958, distributes $42,000 to its shareholders as deficiency dividends with respect to M Corporation's taxable year 1955. The distribution of $42,000 by N Corporation is a taxable dividend under section 316(b)(2) regardless of whether N Corporation is a personal holding company for the taxable year 1958 or whether it had any current or accumulated earnings and profits. See example (3) in paragraph (e) of § 1.316–1. Because N Corporation has paid deficiency dividends of $42,000 in accordance with this section, M Corporation is entitled to a deficiency dividend deduction of $42,000 for the taxable year 1955 and is thus relieved of its liability for personal holding company tax of $35,500 for such taxable year. To prevent a duplication of deductions, the amount distributed by N Corporation in 1958 does not become a part of N Corporation's dividends paid deduction under section 561 for any taxable year.

[T.D. 6532, 26 FR 409, Jan. 19, 1961, as amended by T.D. 7604, 44 FR 18661, March 29, 1979; T.D. 7767, 45 FR 11264, Feb. 6, 1981]

§ 1.381(c)(18)–1 Depletion on extraction of ores or minerals from the waste or residue of prior mining.

(a) Carryover requirement. Section 381(c)(18) provides that the acquiring corporation in a transaction described in section 381(a) shall be considered as though it were the distributor or transferor corporation after the date of distribution or transfer for the purpose of determining the applicability of section 613(c)(3) (relating to extraction of ores or minerals from the ground). Thus, an acquiring corporation which has acquired the waste or residue of prior mining from a distributor or transferor corporation in a transaction described in section 381(a) shall be entitled, after the date of distribution or transfer, to an allowance for depletion under section 611 in respect of ores or minerals extracted from such waste or residue if the distributor or transferor corporation would have been entitled to such an allowance for depletion in the absence of the distribution or transfer. See paragraph (f) of § 1.613–4 to determine whether a distributor or transferor corporation is entitled to an allowance for depletion with respect to the waste or residue of prior mining.

(b) Application of section 614 to waste or residue of prior mining. If, in a transaction described in section 381(a), the acquiring corporation acquires waste or residue of prior mining from a distributor or transferor corporation, then the acquiring corporation shall be considered as though it were the distributor or transferor corporation for the purpose of applying section 614 and the regulations thereunder to the waste or residue so acquired. Thus, if the distributor or transferor corporation was required under paragraph (c) of § 1.614–1 to treat the waste or residue as part of the mineral deposit from which it was extracted and if the acquiring corporation acquires both the waste or residue and the mineral deposit from which it was extracted in a transaction described in section 381(a), then such waste or residue shall be treated as a part of such mineral deposit in the hands of the acquiring corporation. On the other hand, if the waste or residue was required to be treated as a separate mineral deposit in the hands of the distributor or transferor corporation, such waste or residue shall be treated as a separate mineral deposit in the hands of the acquiring corporation.

[T.D. 6552, 26 FR 1991, March 8, 1961, as amended by T.D. 7170, 37 FR 5373, March 15, 1972]

§ 1.381(c)(19)–1 Charitable contribution carryovers in certain acquisitions.

(a) Carryover requirement. Section 381(c)(19) provides that, in computing taxable income for its taxable years which begin after the date of distribution or transfer to which section 381(a) applies, the acquiring corporation shall take into account any charitable contributions made by a distributor or transferor corporation during the taxable year ending on the date of distribution or transfer, and in certain immediately preceding taxable years, which are in excess of the maximum amount deductible for those taxable years under section 170(b)(2) in the following manner:

(1) If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins before January 1, 1962, the acquiring corporation shall, in computing taxable income for its first 2 taxable years which begin after the date of such distribution or transfer, take into account the excess contributions made by the distributor or transferor corporation in the taxable year ending on the date of distribution or transfer and in the immediately preceding taxable year;

(2) If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins after December 31, 1961, the acquiring corporation shall, in computing taxable income for certain taxable years which begin after the date of distribution or transfer, take into account the excess contributions made by the distributor or transferor corporation in the taxable year ending on such date of distribution or transfer and in any of the four taxable years immediately preceding such taxable year but excluding any taxable year beginning before January 1, 1962 (see paragraph (c)(3) of this section). Notwithstanding the preceding sentence, if the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins after December 31, 1961, and before January 1, 1963, the acquiring corporation shall, in computing taxable income for its first taxable year which begins after the date of distribution or transfer, also take into account the excess contributions made by the distributor or transferor corporation in the taxable year immediately preceding the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer (see paragraph (c)(2) of this section).

To determine the amount of excess contributions made by a distributor or transferor corporation and to integrate them with contributions made by the acquiring corporation for the purpose of determining the charitable contributions deductible by the acquiring corporation for its taxable years beginning immediately after the date of distribution or transfer, it is necessary to apply the provisions of section 170(b)(2) and § 1.170–3 (or, if applicable, section 170(b)(2) and (d)(2) and § 1.170A–11) in accordance with the conditions and limitations of section 381(c)(19) and this section. For taxable years beginning before January 1, 1970, see section 170 for provisions of section 170(b)(2) as referred to in this section. For taxable years beginning after December 31, 1969, see section 170A for provisions of section 170(b)(2) or (d)(2) as referred to in this section. For special rules for applying section 170(d)(2) with respect to contributions paid, or treated as paid, in taxable years beginning before January 1, 1970, see paragraph (d) of § 1.170A–11.

(b) Manner of computing excess charitable contribution carryovers. (1) The amount of any charitable contribution made by a distributor or transferor corporation in any taxable year ending on or before the date of distribution or transfer, or made by the acquiring corporation in any taxable year before its taxable year beginning after the date of distribution or transfer, in excess of the amount allowable as a deduction to such corporation for

such taxable year under section 170(b)(2) shall be determined by taking into account the taxable income of, and the contributions made by, that corporation only.

(2) An acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of sections 170 and 381, the charitable contribution carryovers available to the first acquiring corporation under sections 170 and 381, including those derived by such first acquiring corporation from its distributor or transferor corporation.

(3) The excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer and in certain immediately preceding taxable years (see paragraph (c) of this section) which are not deductible by the distributor or transferor corporation because of the 5-percent limitation of section 170(b)(2) shall be available to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation. Thus, if a parent corporation owning 80 percent of all classes of stock of its subsidiary corporation were to acquire its share of the assets of the subsidiary corporation upon a complete liquidation described in paragraph (b)(1)(i) of § 1.381(a)–1, then, subject to the conditions and limitations of this section, 100 percent of the excess contributions made by the subsidiary corporation would be available to the acquiring corporation.

(c) Taxable years to which carryovers apply and amount deductible—(1) Taxable years beginning before January 1, 1962. If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins before January 1, 1962:

(i) The excess charitable contributions made by a distributor or transferor corporation in its taxable year immediately preceding that ending on the date of distribution or transfer, to the extent not deductible by it because of the limitations of section 170(b)(2) in its taxable year ending on that date, shall be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) in its first taxable year beginning after the date of distribution or transfer. Any portion of such excess which is not deductible under this section by the acquiring corporation in such first taxable year shall not be deducted by that corporation in any other taxable year.

(ii) The excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer shall first be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) and this section in its first taxable year beginning after that date and then, to the extent prescribed by section 170(b)(2) and this section, in its second taxable year beginning after that date. Any portion of such excess which is not deductible under this section by the acquiring corporation in such first and second taxable years shall not be deducted by that corporation in any other taxable year.

(2) Taxable years beginning in 1962. If the taxable year of the distributor or transferor corporation ending on the date of distribution or transfer begins after December 31, 1961, and before January 1, 1963:

(i) The excess charitable contributions made by a distributor or transferor corporation in its taxable year immediately preceding that ending on the date of distribution or transfer, to the extent not deductible by it because of the limitations of section 170(b)(2) in its taxable year ending on that date, shall be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) in its first taxable year beginning after the date of distribution or transfer. Any portion of such excess which is not deductible under this section by the acquiring corporation in such first year shall not be deducted by that corporation in any other taxable year.

(ii) The excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer and beginning after December 31, 1961, and before January 1, 1963, shall first be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) and this section in its first taxable year beginning after that date and then, to the extent prescribed by section 170(b)(2) and this section, in its second, third, fourth, and fifth taxable year, in order of time, beginning after that date. Any portion of such excess which is not deductible under this section by the acquiring corporation in such 5 taxable years shall not be deducted by that corporation in any other taxable year.

(3) Taxable years beginning after December 31, 1962. (i) If the taxable year of the distributor or

transferor corporation ending on the date of distribution or transfer begins after December 31, 1962, the excess charitable contributions made by a distributor or transferor corporation in its taxable year ending on the date of distribution or transfer and in each of its four immediately preceding taxable years (excluding any taxable year beginning before January 1, 1962), to the extent not deductible by it because of the limitations of section 170(b)(2) in its taxable year ending on the date of distribution or transfer or its prior taxable years, shall be deductible by the acquiring corporation to the extent prescribed by section 170(b)(2) (or, if applicable, section 170(d)(2)) and subdivision (ii) of this subparagraph, in its taxable years which begin after the date of distribution or transfer. However, any portion of the excess charitable contributions made by a distributor or transferor corporation in a particular taxable year, to which this subparagraph is applicable, which is not deductible under this section within the 5 taxable years immediately following the taxable year in which the contribution was paid by the distributor or transferor corporation shall not be deductible by the acquiring corporation in any other taxable year.

(ii) For purposes of determining the 5 taxable years in which the excess contributions may be deducted, all taxable years of the distributor or transferor corporation subsequent to the taxable year in which the excess contribution was made, including the taxable year ending on the date of distribution or transfer shall be treated as taxable years of the acquiring corporation.

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. X Corporation and Y Corporation both compute taxable income on the calendar year basis. X Corporation has excess charitable contributions for 1962 and 1964. On December 31, 1966, X Corporation distributes all its assets to Y Corporation in a complete liquidation to which section 381(a) applies. The excess 1962 charitable contributions of X Corporation (to the extent not deductible by X because of the limitations of section 170(b)(2) in its taxable years 1963 through 1966) may be deducted by Y Corporation only in 1967. Y Corporation's taxable year 1967 is the fifth taxable year succeeding the taxable year 1962 (the year in which the excess contributions were made), and the portion of such excess contributions which is not deductible in the 5 taxable years immediately succeeding 1962 (1963 through 1967) is not deductible by Y Corporation in any other taxable year. Any excess charitable contributions for 1964 to which Y Corporation may be entitled must be deducted by Y Corporation (if deductible at all) in 1967, 1968, and 1969 since such years are the third, fourth, and fifth taxable years succeeding the taxable year 1964 (the year in which the excess contributions were paid).

(4) General rules. No excess charitable contributions made by a distributor or transferor corporation shall be deductible by the acquiring corporation in its taxable year which includes the date of distribution or transfer. In addition, an excess charitable contribution made by a distributor or transferor corporation in a taxable year prior to the taxable year of the transfer is only deductible by the distributor or transferor corporation, subject to the limitations of section 170(b)(2) (or, if applicable, section 170(d)(2)), in its subsequent taxable years which begin on or before the date of distribution or transfer, and by the acquiring corporation in its taxable year or years beginning after the date of distribution or transfer.

(d) **Rules governing amounts deductible by acquiring corporations.** (1) In applying the provisions of section 170(b)(2) (or, if applicable, section 170(d)(2)) for the purpose of determining the amount of excess charitable contributions which are deductible by the acquiring corporation in its taxable years beginning after the date of distribution or transfer, all taxable years of the distributor or transferor and acquiring corporations which, with respect to a particular taxable year beginning after the date of distribution or transfer, constitute the same numbered preceding taxable year shall together be considered as a 1 taxable year even though the taxable years involved may not end on the same date. Thus, for example, all taxable years of the distributor or transferor and acquiring corporations which, with respect to the first taxable year of the acquiring corporation beginning after the date of distribution or transfer, constitutes the second preceding taxable year shall together be considered as 1 taxable year even though the taxable years involved may not end on the same date. Any excess charitable contributions carried over from preceding taxable years which are considered as 1 taxable year shall be taken into account by the acquiring corporation as one amount, without regard to the extent to which the contributions were made by a distributor or transferor corporation or the acquiring corporation.

(2) For purposes of this paragraph, each taxable year of the distributor or transferor corporation beginning on or before the date of distribution or transfer shall be treated as a preceding taxable year with reference to the acquiring corporation's taxable years beginning after such date. For example, the taxable year of a distributor or transferor corporation which ends on the date of distribution or transfer shall be considered a first preceding taxable year with reference to the acquiring corporation's first taxable year beginning after that date, a second preceding taxable year with reference to the acquiring corporation's second taxable

year beginning after that date, and so forth with respect to succeeding taxable years of the acquiring corporation. Also, for example, the taxable year of a distributor or transferor corporation which immediately precedes its taxable year ending on the date of distribution or transfer shall be considered a second preceding taxable year with reference to the acquiring corporation's first taxable year beginning after that date.

(e) **Illustration.** The application of this section may be illustrated by the following example:

Example. (i) X Corporation is organized on April 1, 1956, and computes its taxable income on the basis of the fiscal year ending March 31. Y Corporation is organized on July 1, 1955, and computes its taxable income on the basis of the fiscal year ending June 30. Z Corporation is organized on January 1, 1956, and computes its taxable income on the basis of the calendar year. On June 30, 1957, X Corporation distributes all its assets to Y Corporation in a complete liquidation to which section 381(a) applies. On November 30, 1957, Y Corporation transfers all its assets to Z Corporation in a statutory merger to which section 381(a) applies.

(ii) The 5-percent limitation (computed in the manner prescribed by section 170(b)(2)), the charitable contributions actually paid, and the excess contributions with respect to each such corporation during the taxable years involved are as follows:

Name of corporation	*X*	*X*	
Taxable year ending	*3–31–57*	*6–30–57*	
5-percent limitation	$20,000	$9,000	
Current contributions	32,000	15,000	
(Excess contributions)	(12,000)	(6,000)	
Name of corporation	*Y*	*Y*	*Y*
Taxable year ending	*6–30–56*	*6–30–57*	*11–30–57*
5-percent limitation	$15,000	$10,000	$18,000
Current contributions	29,000	0	17,000
(Excess contributions)	(14,000)		
Balance of 5-percent limitation		10,000	1,000
Name of corporation	*Z*	*Z*	*Z*
Taxable year ending	*12–31–56*	*12–31–57*	*12–31–58*
5-percent limitation	$10,000	$30,000	$58,000
Current contributions	40,000	28,000	92,000
(Excess contributions)	(30,000)		
Balance of 5-percent limitation		2,000	56,000

(iii) X Corporation was in existence for two taxable years, in each of which it made charitable contributions in excess of the maximum amount deductible for those years under section 170(b)(2). The excess contributions made in the year ending March 31, 1957, of $12,000, are deductible by X Corporation in its short taxable year ending June 30, 1957, and then by Y Corporation in its short taxable year ending November 30, 1957, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section. The excess contributions made by X Corporation in the year ending June 30, 1957, of $6,000, are deductible by Y Corporation in its short taxable year ending November 30, 1957, and then by Z Corporation in its taxable year 1958, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section.

(iv) Y Corporation was in existence for three taxable years. In the year ended June 30, 1956, its contributions in excess of the amount deductible for that year under section 170(b)(2) amounted to $14,000. Such excess is deductible by Y Corporation in its taxable year ending June 30, 1957, and, together with X Corporation's excess contributions of $18,000, in its short taxable year ending November 30, 1957, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section. Accordingly, since Y Corporation made no contributions in its taxable year ending June 30, 1957, its deduction for that year on account of excess contributions carried over is $10,000, an amount equal to the 5-percent limitation of section 170(b)(2). The deduction is attributable to excess contributions made by Y Corporation in the taxable year ended June 30, 1956; thus, the excess of those contributions over $10,000, namely, $4,000, is deductible by Y Corporation in its short taxable year ending November 30, 1957, in the manner and to the extent prescribed by section 170(b)(2) and this section. With respect to the short taxable year ending November 30, 1957, the excess contributions of the second preceding year are X Corporation's excess contributions of $12,000 made in the year ending March 31, 1957, and Y Corporation's excess contributions of $4,000 made in the year ending June 30, 1956, which were not deductible by Y Corporation in the taxable year ending June 30, 1957, because of the 5-percent limitation prescribed by section 170(b)(2), an aggregate of $16,000. Inasmuch as Y Corporation's limitation for the short taxable year ended November 30, 1957, exceeds the contributions made in that year by $1,000, the excess contributions of the second preceding taxable year are deductible in the taxable year ending November 30, 1957, to the extent of $1,000 and the remainder ($15,000) is not deductible by any corporation in any taxable year. The excess contributions of the first preceding taxable year, namely, X Corporation's excess contributions made in the short taxable year ending June 30, 1957, are deductible by Z Corporation in its taxable year 1958, in the manner and to the extent prescribed in section 170(b)(2) and this section.

(v) Z Corporation has been in existence for 3 taxable years. The contributions made in 1956 in excess of the amount deductible for that year under section 170(b)(2) amounted to $30,000. Such excess is deductible by Z Corporation in its taxable year 1957 and, together with X Corporation's excess contributions of $6,000 (derived through Y Corporation) made in the taxable year ending June 30, 1957, in the taxable year 1958, in each instance in the manner and to the extent prescribed by section 170(b)(2) and this section. Thus, $2,000 of the $30,000 excess contributions made in the year 1956 are deducted in 1957 and the remainder ($28,000), together with X Corporation's excess contributions of $6,000 made in the short taxable year ending June 30, 1957, are deducted in 1958 since the aggregate of such amounts plus the contributions actually made in that year does not exceed the 5-percent limitation prescribed by section 170(b)(2).

[T.D. 6552, 26 FR 1992, March 8, 1961, as amended by T.D. 6900, 31 FR 14642, Nov. 17, 1966; T.D. 7207, 37 FR 20795, Oct. 5, 1972]

§ 1.381(c)(21)–1 Pre-1954 adjustments resulting from change in method of accounting.

(a) **Carryover requirement.** Section 381(c)(21) provides that, in a transaction to which section

381(a) applies, an acquiring corporation shall take into account the net amount of any adjustments described in section 481(b)(4) (relating to adjustments arising from changes in accounting methods initiated by the taxpayer attributable to pre-1954 Code years) of the distributor or transferor corporation to the extent that such net amount of such adjustments has not been taken into account in any taxable year, including a short taxable year, by the distributor or transferor corporation. The acquiring corporation shall take into account in each taxable year beginning with the taxable year ending after the date of distribution or transfer the net amount of such adjustments in the same manner and at the same time as such net amount would have been taken into account by the distributor or transferor corporation. Thus, the amount of any such adjustment which the acquiring corporation shall take into account in each taxable year shall be the same amount that would have been taken into account in each taxable year by the distributor or transferor corporation.

(b) This section may be illustrated by the following example:

Example. On January 1, 1960, X Corporation, a calendar year taxpayer, voluntarily changed its method of accounting giving rise to a $50,000 adjustment under section 481(a), of which $20,000 is attributable to pre-1954 Code years. Under section 481(b)(4) the $20,000 adjustment is to be spread over 1960 and the following 9 years at the rate of $2,000 each year. On November 1, 1963, all the assets of X Corporation are acquired by Y Corporation in a transaction to which section 381(a) applies. Y Corporation reports its income on a fiscal year ending June 30. X and Y Corporations must take into account the $20,000 adjustment at the rate of $2,000 in each taxable year in the following time and manner:

X Corporation		
Calendar years 1960–62 ($2,000 × 3)	$6,000	
Short taxable year ending Nov. 1, 1963 ($2,000 × 1)	2,000	$8,000
Y Corporation		
Fiscal years ending:		
June 30, 1964 ($2,000 × 1)	2,000	
June 30, 1965–69 ($2,000 × 5)	10,000	12,000
		20,000

(c) Successive transactions to which section 381(a) applies. The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, if R Corporation, which was taking into account adjustments described in section 481(b)(4), distributes or transfers its assets to S Corporation in a transaction to which section 381(a) applies, and S Corporation was required to take into account any remaining portion of such adjustments under section 381(c)(21) and this section, and if subsequently S Corporation distributes or transfers its assets to T Corporation in a transaction to which section 381(a) applies, then T Corporation, under section 381(c)(21) and this section, shall take into account any remaining portion of such adjustments not previously taken into account by R and S Corporations.

(d) Acquiring corporation not receiving all the assets. The adjustments described in this section acquired from a distributor or transferor corporation by an acquiring corporation in a transaction to which section 381(a) applies is not reduced by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

[T.D. 6553, 26 FR 2171, March 15, 1961]

§ 1.381(c)(22)–1 Successor life insurance company.

(a) Carryover requirement. If in a taxable year beginning after December 31, 1957, a distributor or transferor corporation which is a life insurance company (as defined in section 801(a)) is acquired by a corporation which is a life insurance company (as defined in section 801(a)), in a transaction to which section 381(a) applies, section 381(c)(22) provides that the acquiring corporation shall take into account the appropriate items which the distributor or transferor corporation was required to take into account for purposes of part I, subchapter L, chapter 1 of the Code. Furthermore, except as otherwise provided by this section, the acquiring corporation shall take into account the items described in paragraphs (2) through (21), other than paragraphs (14), (15), and (17), of section 381(c) and the regulations thereunder. For example, the acquiring corporation shall take into account the reserves described in section 810(c) distributed or transferred to it as of the close of the date of distribution or transfer by the distributor or transferor corporation in accordance with the provisions of section 381(c)(4) and the regulations thereunder. For provisions defining the date of distribution or transfer, see paragraph (b) of § 1.381(b)–1.

(b) Items required to be taken into account by acquiring corporation. If a transaction meets the requirements of paragraph (a) of this section, the acquiring corporation shall, except as otherwise provided, take into account as of the close of the date of distribution or transfer the following items of the distributor or transferor corporation:

(1) The operations loss carryovers (as determined under section 812), subject to conditions and limitations consistent with the conditions and

limitations prescribed in section 381(c)(1) and the regulations thereunder. For example, a loss from operations for a loss year of a distributor or transferor corporation which ends on or before the last day of a loss year of the acquiring corporation shall be considered to be a loss from operations for a year prior to such loss year of the acquiring corporation. All references in section 381(c)(1) and the regulations thereunder to section 172 shall be construed as referring to the appropriate corresponding provisions of section 812. Thus, a reference to section 172(b) shall be construed as referring to section 812(b) and (d). In determining the span of years for which a loss from operations may be carried, the number of taxable years for which the distributor or transferor corporation was authorized to do business as an insurance company shall be taken into account. For purposes of this determination, the taxable year of the distributor or transferor corporation which ends on the date of distribution or transfer shall be taken into account even though such taxable year is a period of less than 12 months.

(2)(i) The investment yield and the beginning of the year asset balance for the distributor or transferor corporation's taxable year ending with the close of the date of distribution or transfer. Such items shall be integrated with the investment yield and beginning of the year asset balance of the acquiring corporation for its first taxable year ending after such date of distribution or transfer for purposes of determining the current earnings rate of the acquiring corporation for such taxable year. Furthermore, for purposes of determining the average earnings rate of the acquiring corporation, the investment yield and mean of the assets of the distributor or transferor corporation for its 4 taxable years immediately preceding its taxable year which closes with the date of distribution or transfer shall be integrated with the investment yield and mean of the assets of the acquiring corporation for such corresponding taxable years.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). X qualified as a life insurance company in 1949. Y qualified as a life insurance company in 1951. On June 30, 1961, at which time both X and Y were life insurance companies (as defined in section 801(a)), X transferred all its assets to Y in a statutory merger to which section 361 applies. For its taxable year ending on June 30, 1961, X had investment yield of $15 and assets at the beginning of such taxable year of $450. For purposes of determining its current earnings rate for its taxable year ending on December 31, 1961, Y had investment yield of $45 (including the $15 of investment yield of X), assets at the beginning of such taxable year of $1,250 (including the $450 of X's assets at the beginning of its taxable year 1961), and assets at the end of such taxable year of $1,750 (after the application of section 806(a)). Under the provisions of subdivision (i) of this subparagraph, the current earnings rate of Y for the taxable year 1961 would be 3 percent, determined by dividing the investment yield of Y, $45, by the mean of the assets of Y, $1,500 ($1,250+$1,750÷2). In order to determine its average earnings rate and adjusted reserves rate for the taxable year 1961, Y would make up the following schedule:

Taxable year	Investment yield			Mean of assets			Current earnings rate of Y
	Column 1—X	Column 2—Y	Column 3 (Col. 1 + Col. 2) integrated investment yield	Column 4—X	Column 5—Y	Column 6 (Col. 4 + Col. 5) integrated means of assets	Column 7 (Col. 3 ÷ Col. 6)
1960	$16	$26	$42	$400	$800	$1,200	3.5
1959	16	24	40	500	750	1,250	3.2
1958	17	22	39	650	650	1,300	3.0
1957	19	21	40	700	500	1,200	3.3

For the taxable year 1961, Y would have an average earnings rate of 3.2 percent, computed by taking into account the current earnings rates for the taxable year 1961 and each of the 4 taxable years immediately preceding such taxable year. The adjusted reserves rate for such taxable year would be 3 percent since the current earnings rate of 3 percent for 1961 is lower than the average earnings rate of 3.2 percent.

Example (2). The facts are the same as in example (1), except that the taxable year in issue is 1962, and the current earnings rate of Y for such taxable year was 3.8 percent. For the taxable year 1962, Y would have an average earnings rate of 3.3 percent, computed by taking into account only the current earnings rates for the taxable year 1962 and each of the 4 taxable years immediately preceding such taxable year. The adjusted reserves rate for such taxable year would be 3.3 percent since the average earnings rate of 3.3 percent is lower than the 1962 current earnings rate of 3.8 percent.

(3) To the extent there are any amounts accrued for discounts in the nature of interest which have not been included as interest paid under section 805(e)(3), the acquiring corporation shall be treated as the distributor or transferor corporation for purposes of including such amounts as interest paid.

(4) Any adjustment required by section 806(b) with respect to an item described in section 810(c) shall be made by the acquiring corporation in its

first taxable year which begins after the date of distribution or transfer.

(5) The amount of the deduction provided by section 809(d)(6), as limited by section 809(f), for all taxable years of the distributor or transferor corporation which end on and before the date of distribution or transfer (irrespective of whether or not the distributor or transferor corporation claimed this deduction for such taxable years) for the purpose of determining the limitation under section 809(d)(6).

(6)(i) To the extent there are any remaining net increases or net decreases in reserves required to be taken into account by the distributor or transferor corporation under section 810(d)(1), the acquiring corporation shall be treated as the distributor or transferor corporation as of its first taxable year which begins after the date of distribution or transfer.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. Assume that the amount of an item described in section 810(c) of X, a life insurance company, at the beginning of the taxable year 1959 is $100. Assume that at the end of the taxable year 1959, as a result of a change in the basis used in computing such item during the taxable year, the amount of the item (computed on the new basis) is $200 but computed on the old basis would have been $150. Since the amount of the item at the end of the taxable year computed on the new basis, $200, exceeds the amount of the item at the end of the taxable year computed on the old basis, $150, by $50, section 810(d)(1) provides that one-tenth of the amount of such excess, or $5, shall be taken into account by X as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1959. Assume further that on June 30, 1961, X transferred all its assets to Y, a life insurance company, in a statutory merger to which section 361 applies. Under the provisions of section 810(d)(1), X would include $5 as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for its taxable years 1960 and 1961. Thus, the remaining net increase to be taken into account by X under section 810(d)(1) is $40 (eight-tenths of $50). Accordingly, Y shall take into account $5 as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of its 8 taxable years beginning in 1962 ($\$5 \times 8 = \$40$).

(7)(i) The dollar balances in the shareholders surplus account, policyholders surplus account, and other accounts provided, however, that the acquiring corporation is a stock life insurance company. The dollar balance in the policyholders surplus account shall reflect the amount (if any) treated as a subtraction from such account by reason of the application of the limitation provided under section 815(d)(4) immediately prior to the close of the date of distribution or transfer. To the extent that any amount must be added to the shareholders surplus account as a result of the application of the limitation provided under section 815(d)(4), the acquiring corporation shall be treated as the distributor or transferor corporation as of its first taxable year which begins after the date of distribution or transfer.

(ii) If the acquiring corporation is a mutual life insurance company, the dollar balances in the shareholders surplus account, policyholders surplus account, and other accounts shall not be taken into account by such acquiring corporation and the distributor or transferor corporation shall be subject to the provisions of section 815(d)(2)(A) as of the close of the date of distribution or transfer.

(8) To the extent that any amount must be added to the shareholders surplus account as a result of an election made under section 815(d)(1) by the distributor or transferor corporation, the acquiring corporation shall be treated as the distributor or transferor corporation as of its first taxable year which begins after the date of distribution or transfer.

(9) The amount of the life insurance reserves at the end of 1958, but only for the purpose of applying the limitation provided under section 815(d)(4)(B).

(10) To the extent there are amounts subject to the provisions of section 817(d), the acquiring corporation shall be treated as the distributor or transferor corporation.

(11) To the extent there are any installments of tax imposed by section 818(e)(3)(A) remaining to be paid, the acquiring corporation shall be treated as the distributor or transferor corporation for the purpose of paying such installments.

(12) The capital loss carryovers, subject to conditions and limitations consistent with the conditions and limitations prescribed in section 381(c)(3) and the regulations thereunder, except that any net capital loss of the distributor or transferor corporation for a taxable year beginning before January 1, 1959, shall not be taken into account. See section 817(c).

[T.D. 6625, 27 FR 12541, Dec. 19, 1962]

§ 1.381(c)(23)–1 Investment credit carryovers in certain corporate acquisitions.

(a) Carryover requirement. **(1)** Section 381(c)(23) requires the acquiring corporation in a transaction to which section 381 applies to succeed

to and take into account under such regulations as may be prescribed by the Secretary or his delegate, the investment credit carryovers of the distributor or transferor corporation. To determine the amount of these carryovers as of the close of the date of distribution or transfer, and to integrate them with any carryovers and carrybacks of the acquiring corporation for purposes of determining the amount of credit allowed by section 38 to the acquiring corporation for taxable years ending after the date of distribution or transfer, it is necessary to apply the provisions of sections 46, 47, and 48 in accordance with the conditions and limitations of this section.

(2) The investment credit carryovers and carrybacks of the acquiring corporation determined as of the close of the date of distribution or transfer shall be computed without reference to any unused credit of a distributor or transferor corporation. The investment credit carryovers of a distributor or transferor corporation as of the close of the date of distribution or transfer shall be determined without reference to any unused credit of the acquiring corporation.

(b) Carryback of unused credits. An unused credit of the acquiring corporation for any taxable year ending after the date of distribution or transfer shall not be carried back in computing the credit allowed by section 38 to a distributor or transferor corporation. However, an unused credit of the acquiring corporation for any such taxable year shall be carried back in accordance with section 46(b)(1) in computing the credit allowed to the acquiring corporation for a taxable year ending on or before the date of distribution or transfer. If a distributor or transferor corporation remains in existence after the date of distribution or transfer, an unused credit sustained by it for any taxable year beginning after such date shall be carried back in accordance with section 46(b)(1) in computing the credit allowed by section 38 to such corporation for a taxable year ending on or before that date, but may not be carried back or over in computing the credit allowed by section 38 to the acquiring corporation.

(c) Computation of carryovers and carrybacks. (1) Subject to the modifications set forth in this paragraph, the provisions of § 1.46-2 shall apply in computing carryovers and carrybacks of unused credits to taxable years of the acquiring corporation.

(2)(i) The investment credit carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall first be carried to the first taxable year of the acquiring corporation ending after that date. This rule applies whether the date of distribution or transfer is on the last day, or any other day, of the acquiring corporation's taxable year.

(ii) The investment credit carryovers available to the distributor or transferor corporation as of the close of the date of distribution or transfer shall be carried to the acquiring corporation without diminution by reason of the fact that the acquiring corporation does not acquire 100 percent of the assets of the distributor or transferor corporation.

(3) An unused credit of a distributor or transferor corporation for a taxable year which ends on or before the last day of a taxable year of the acquiring corporation shall be considered to be an unused credit for a year prior to such taxable year of the acquiring corporation. If the acquiring corporation has acquired the assets of two or more distributor or transferor corporations on the same date of distribution or transfer, the unused credit years of the distributor or transferor corporations shall be taken into account in the order in which such years terminate. If any one of the unused credit years of a distributor or transferor corporation ends on the same day as the unused credit year of another distributor or transferor corporation, either unused credit year may be taken into account before the other.

(4) The extent to which an investment credit carryover of a distributor or transferor corporation or of an acquiring corporation from an unused credit year ending before January 1, 1971, may be taken into account by the acquiring corporation for a taxable year beginning after December 31, 1970, shall be determined without regard to the credit earned by the acquiring corporation for such year. Thus, in such a case, the amount of unused credit from such unused credit years which may be taken into account in a taxable year of the acquiring corporation beginning after December 31, 1970, shall be determined solely with reference to the limitation based on amount of tax for such taxable year (without reduction for the credit earned for such year).

(d) Computation of carryovers when date of distribution or transfer occurs on last day of acquiring corporation's taxable year. The computation of the investment credit carryovers from the distributor or transferor corporation and from the acquiring corporation in a case where the date of distribution or transfer occurs on the last day of a

taxable year of the acquiring corporation may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1971, and each corporation files its return on the calendar year basis. On December 31, 1972, X transfers all its assets to Y in a statutory merger to which section 361 applies. X's credit earned and its limitation based on amount of tax for its taxable years 1971 and 1972 are as follows:

X Corporation's taxable year	Credit earned	Limitation based on amount of tax
1971	$10,000	$5,000
1972	5,000	3,000

Y's credit earned and its limitation based on amount of tax for its taxable years 1971 through 1973 are as follows:

Y Corporation's	Credit earned	Limitation based on amount of tax
1971	$6,000	$5,000
1972	5,000	3,000
1973	3,000	10,000

The sequence for the allowance of unused credits of X Corporation and Y Corporation, and the computation of the carryovers to Y Corporation's calendar year 1974, may be illustrated as follows:

(1) X Corporation's 1971 unused credit. The carryover to Y 1974 is $0, computed as follows:

Unused credit	$5,000
Excess of X's 1972 limitation based on tax over credit earned	0
Carryover to Y's year 1973	5,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Carryover to Y's year 1974	0

(2) Y Corporation's 1971 unused credit. The carryover to Y 1974 is $0, computed as follows:

Unused credit	$1,000
Excess of Y's 1972 limitation based on tax over credit earned	0
Carryover to Y's year 1973	1,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Less: X's $5,000 carryover from 1971	5,000
	2,000
Carryover to Y's year 1974	0

(3) X Corporation's 1972 unused credit. The carryover to Y 1974 is $1,000, computed as follows:

Unused credit	$2,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Less: X's $5,000 carryover from 1971 and Y's $1,000 carryover from 1971	6,000
	1,000
Carryover to Y's year 1974	1,000

(4) Y Corporation's 1972 unused credit. The carryover to Y 1974 is $2,000, computed as follows:

Unused credit	$2,000
Excess of Y's 1973 limitation based on tax over credit earned	7,000
Less: X's $5,000 carryover from 1971, Y's $1,000 carryover from 1971 and X's $1,000 carryover from 1972	7,000
	0
Carryover to Y's year 1974	2,000

(5) The aggregate of the investment credit carryovers to Y's year 1974 is $3,000, computed as follows:

X's 1972 unused credit	$1,000
Y's 1972 unused credit	2,000
Total	3,000

(e) Computation of carryovers when date of distribution or transfer is not on last day of acquiring corporation's taxable year. (1) If the date of distribution or transfer occurs on any day other than the last day of a taxable year of the acquiring corporation, the amount which may be added to the amount allowable as a credit by section 38 for the first taxable year of the acquiring corporation ending after the date of distribution or transfer (hereinafter called the "year of acquisition") shall be determined in the following manner. The year of acquisition shall be considered as though it were 2 taxable years. The first of such 2 taxable years shall be referred to in this paragraph as the preacquisition part year and shall begin with the beginning of the year of acquisition and end with the close of the date of distribution or transfer. The second of such 2 taxable years shall be referred to in this paragraph as the postacquisition part year and shall begin with the day following the date of distribution or transfer and shall end with the close of the year of acquisition.

(2) The excess limitation for the year of acquisition (*i.e.*, the excess of the limitation based on the amount of tax for such year over the amount of credit earned for such year) shall be divided between the preacquisition part year and the postacquisition part year in proportion to the number of days in each. Thus, if in a statutory merger to which section 361 applies Y Corporation, a calendar year taxpayer, acquires the assets of X Corporation on June 30, 1975, and Y Corporation has an excess limitation of $36,500 for its calendar year 1975, then the excess limitation for the preacquisition part year would be $18,100 ($36,500 × 181/365) and the excess limitation for the postacquisition part year would be $18,400 ($36,500 × 184/365).

(3) An unused credit of the acquiring corporation shall be carried to and applied against the excess limitation for the preacquisition part year and then carried to and applied against the excess limitation for the postacquisition part year, whereas an unused credit of the distributor or transferor corporation shall not be carried to the preacquisition part year but shall only be carried to and applied against the excess limitation for the postacquisition part year. For special rule relating to carryovers from taxable years ending before January 1, 1971, to taxable years beginning after December 31, 1970, see subparagraph (6) of this paragraph.

(4) Though considered as two separate taxable years for purposes of this paragraph, the preacquisition part year and the postacquisition part year are treated as one taxable year in determining the years to which an unused credit is carried under section 46(b)(1).

(5) The preceding subparagraphs may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1971, and each corporation files its return on the calendar year basis. On May 1, 1972, X transfers all its assets to Y in a statutory merger to which section 361 applies. X's credit earned and its limitation based on amount of tax for its taxable years 1971 and ending May 1, 1972, are as follows:

X Corporation's taxable year	Credit earned	Limitation based on amount of tax
1971	$11,000	$5,000
Ending 5–1–72	3,000	6,000

Y's credit earned and its limitation based on amount of tax for its taxable years 1971 and 1972 are as follows:

Y Corporation's taxable year	Credit earned	Limitation based on amount of tax
1971	$7,000	$3,000
1972	3,000	9,000

The sequence for the allowance of unused credits of X Corporation and Y Corporation, and the computation of carryovers to Y Corporation's calendar year 1973, may be illustrated as follows:

(i) **X Corporation's 1971 unused credit.** The carryover to Y 1973 is $0, computed as follows:

Unused credit	$6,000
Excess of X's 5–1–72 limitation based on tax over credit earned	3,000
Carryover to Y's postacquisition part year 1972	3,000
Excess limitation for Y's postacquisition part year ($6,000 × 244/366)	4,000
Carryover to Y's year 1973	0

(ii) **Y Corporation's 1971 unused credit.** The carryover to Y 1973 is $1,000, computed as follows:

Unused credit	$4,000
Excess limitation for Y's preacquisition part year ($6,000 × 122/366)	2,000
Carryover to Y's postacquisition part year	2,000
Excess limitation for Y's postacquisition part year ($6,000 × 244/366)	4,000
Less: X's $3,000 carryover from 1971	3,000
	1,000
Carryover to Y's year 1973	1,000

(iii) The aggregate of the investment credit carryovers to Y's year 1973 is $1,000, computed as follows:

X's 1971 unused credit	0
Y's 1971 unused credit	$1,000
Total	1,000

(6) If the year of acquisition is a taxable year beginning after December 31, 1970, and if there is an unused credit of the distributor or transferor corporation or of the acquiring corporation arising in an unused credit year ending before January 1, 1971, which may be carried to such year of acquisition (see paragraph (c)(4) of this section), then in applying subparagraphs (1), (2), and (3) of this paragraph, in lieu of dividing the excess limitation for the year of acquisition between the preacquisition and postacquisition part years, only the limitation based on the amount of tax for such year (*i.e.*, without reduction for the credit earned) shall be divided between the preacquisition and postacquisition part years. If there is also an unused credit arising in an unused credit year ending after December 31, 1970, which may be carried to the year of acquisition, then for the purpose of determining the amount of such unused credit which may be taken into account for such year of acquisition, the credit earned for the year of acquisition shall first be applied against the limitation based on amount of tax for the preacquisition part year (reduced by any investment credit carryovers to such part year from unused credit years ending before January 1, 1971) and the excess, if any, shall then be applied against the limitation based on amount of tax for the postacquisition part year (also reduced by any investment credit carryovers to such part year from unused credit years ending before January 1, 1971).

(7) Subparagraph (6) of this paragraph may be illustrated by the following example:

Example. X Corporation and Y Corporation were organized on January 1, 1970, and each corporation files its return on the calendar year basis. On May 1, 1972, X transfers all its assets to Y in a statutory merger to which section 361 applies. X's credit earned and its limitation based on amount of tax for its taxable years 1970, 1971, and ending May 1, 1972, are as follows:

X Corporation's taxable year.........	Credit earned	Limitation based on amount of tax
1970..................	$300	....
1971..................	100	....
Ending 5–1–72	200	....

Y's credit earned and its limitation based on amount of tax for its taxable years 1970 through 1972 are as follows:

Y Corporation's taxable year..	Credit earned	Limitation based on amount of tax
1970..........................	$100	....
1971..........................	200	
1972..........................	300	$900

The sequence for the allowance of unused credits of X Corporation and Y Corporation, and the computation of carryovers to Y Corporation's calendar year 1973, may be illustrated as follows:

(i) **X Corporation's 1970 unused credit.** The carryover to Y 1973 is $0, computed as follows:

Unused credit	$300
X Corporation's 1971 limitation based on tax	0
X Corporation's 5–1–72 limitation based on tax	0
Carryover to Y's postacquisition part year 1972.................................	300
Limitation based on tax for Y's postacquisition part year 1972 ($900 × 244/366)	600
Carryover to Y's year 1973	0

(ii) **Y Corporation's 1970 unused credit.** The carryover to Y 1973 is $0, computed as follows:

Unused credit	$100
Y Corporation's 1971 limitation based on tax	0
Carryover to Y's preacquisition part year 1972	100
Limitation based on tax for Y's preacquisition part year 1972 ($900 × 122/366)	300
Carryover to Y's postacquisition part year 1972	0

(iii) **Y Corporation's credit earned for 1972.** The carryover to Y 1973 is $0, computed as follows:

Credit earned............................	$300
Limitation based on tax for preacquisition part year 1972 ($900 × 122/366)............	300
Less: Y's $100 carryover from 1970	100
	$200
Carryover to Y's postacquisition part year 1972	100
Limitation based on tax for postacquisition part year 1972 ($900 × 244/366)	600
Less: X's $300 carryover from 1970	$300
	300
Carryover to Y's year in 1973	0

(iv) **X Corporation's 1971 unused credit.** The carryover to Y 1973 is $0, computed as follows:

Unused credit	$100
Excess of X's 1972 limitation based on tax over credit earned	0
Carryover to Y's postacquisition part year 1972	100
Limitation based on tax for postacquisition part year 1972 ($900 × 244/366)	600
Less:	
X's $300 carryover from 1970.............	300
Y's 1972 credit earned for postacquisition part year	100
	400
	200
Carryover to Y's year 1973	0

(v) **Y Corporation's 1971 unused credit.** The carryover to Y 1973 is $100, computed as follows:

Unused credit	$200
Limitation based on tax for preacquisition part year 1972 ($900 × 122/366)............	300
Less:	
Y's $100 carryover from 1970.............	100
Y's 1972 credit earned for preacquisition part year 1972	200
	300
	0
Carryover to Y's postacquisition part year	200
Limitation based on tax for postacquisition part year 1972 ($900 × 244/366)	600
Less:	
X's $300 carryover from 1970.............	300
Y's 1972 credit earned for postacquisition part year 1972	100
X's $100 carryover from 1971.............	100
	500
	100
Carryover to Y's year 1973	100

(vi) **X Corporation's 5–1–72 unused credit.** The carryover to Y 1973 is $200, computed as follows:

Unused credit	$200
Limitation based on tax for postacquisition part year 1972 ($900 × 244/366)	600
Less:	
X's $300 carryover from 1970...........	300
Y's 1972 credit earned for postacquisition part year 1972.......................	100
X's $100 carryover from 1971, and Y's $100 carryover from 1971	200
	600
	0
Carryover to Y's year 1973	200

(vii) The aggregate of the investment credit carryovers to Y 1973 is $300, computed as follows:

Y's 1971 unused credit	$100
X's 1972 unused credit	200
Total	300

(8) If the year of acquisition is a taxable year to which the limitation provided in § 1.46–2(b)(2) (relating to 20-percent limitation on carryovers and carrybacks to certain taxable years) applies, then for purposes of applying such limitation the preacquisition part year and the postacquisition part year shall each be considered a fractional part of a year, but, if the date of distribution or transfer is not on the last day of a month, the entire month in which the date of distribution or transfer occurs shall be considered as included in the preacquisition part year and no portion thereof shall be considered as included in the postacquisition part year.

(9) If the acquiring corporation succeeds to the investment credit carryovers of two or more distributor or transferor corporations on two or more dates of distribution or transfer during the same taxable year of the acquiring corporation, the manner in which the unused credits of the distributor or transferor corporations shall be applied shall be determined consistently with the rules prescribed in paragraph (c) of § 1.381(c)(1)–2.

(f) Successive acquiring corporations. An acquiring corporation which, in a distribution or transfer to which section 381(a) applies, acquires the assets of a distributor or transferor corporation which previously acquired the assets of another corporation in a transaction to which section 381(a) applies, shall succeed to and take into account, subject to the conditions and limitations of § 1.46–2 and this section, the investment credit carryovers available to the first acquiring corporation under § 1.46–2 and this section.

(g) Recomputation of credit allowed by section 38 on certain property of acquiring corporation.— If section 38 property acquired by an acquiring corporation in a transaction to which section 381(a) applies is disposed of, or otherwise ceases to be section 38 property (or becomes public utility property) with respect to the acquiring corporation, before the close of the estimated useful life which was taken into account in computing the distributor or transferor corporation's qualified investment, see paragraph (e) of § 1.47–3.

(h) Electing small business corporation. An unused credit of a distributor or transferor corporation arising in an unused credit year for which such corporation is not an electing small business corporation (as defined in section 1371(b)) may not be carried over in a transaction to which section 381 applies to a taxable year of the acquiring corporation for which such corporation is an electing small business corporation and may not be added to the amount allowable as a credit under section 38 to the shareholders of the acquiring corporation for such taxable year. However, in such a case, a taxable year for which the acquiring corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

(i) [Reserved]

(j) Carryover of operating capacity for qualified intercity bus. For rules for determining an acquiring corporation's qualified investment for the energy credit for a qualified intercity bus, see § 1.48–9(q)(11).

[T.D. 7289, 38 FR 30554, Nov. 6, 1973; as amended by T.D. 7982, 49 FR 39544, Oct. 9, 1984; 49 FR 41246, Oct. 22, 1984]

§ 1.381(c)(24)–1 Work incentive program credit carryovers in certain corporate acquisitions.

The computation of carryovers and carrybacks of unused WIN credits in a transaction to which section 381 applies shall be made under the principles of § 1.381(c)(23)–1 (relating to the computation of carryovers and carrybacks of unused investment credits), except that the provisions of paragraph (c)(4) and paragraph (e)(6), (7), and (8) of such section shall not apply.

[T.D. 7289, 38 FR 30557, Nov. 6, 1973]

§ 1.381(c)(25)–1 Deficiency dividend of a qualified investment entity.

(a) Carryover requirement. If a distributor or transferor corporation in a transaction to which section 381(a) applies—

(1) Was a qualified investment entity (within the meaning of section 860(b)) for any taxable year ending on or before the date of distribution or transfer, and

(2) A determination (as defined in section 860(e)) establishes that the transferor or distributor corporation is liable for the tax imposed by section 11(a), 56(a), 852(b), 857(b)(1), 857(b)(3)(A), or 1201(a) for such taxable year, then in determining the liability for such tax the deduction described in section 860 shall be allowed pursuant to section 381(c)(25) to such corporation for the amount of deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation. Except as otherwise provided in this section, the provisions of section 860 and the regulations thereunder apply with

respect to a deficiency dividend deduction allowable pursuant to section 381(c)(25).

(b) Deficiency dividends paid by the acquiring corporation with respect to the distributor or transferor corporation. A deficiency dividend paid by the acquiring corporation with respect to the distributor or transferor corporation must be a distribution that would satisfy the definition of a deficiency dividend under section 860(f) if paid by the distributor or transferor corporation to its own shareholders. The distribution, however, shall be paid by the acquiring corporation to its own shareholders. The distribution also shall be paid after the date of distribution or transfer and on, or within 90 days after, the date of the determination but before the acquiring corporation files a claim under paragraph (c) of this section.

(c) Claim for deduction. A claim for deduction under this section shall be made by the acquiring corporation on Form 976 and shall be filed within 120 days after the date of the determination. The form shall contain, or be accompanied by, the information required under § 1.860–2(b)(2) in sufficient detail to properly identify the facts with respect to the distributor or transferor corporation and the acquiring corporation. The required certified copy of the resolution authorizing the payment of the dividend shall be that of the trustees, board of directors, or other authority, of the acquiring corporation. Necessary changes may be made in Form 976 in order to carry out the provisions of this paragraph. The claim shall be filed with the district director, or director of the internal revenue service center, with whom the return of the distributor or transferor corporation to which the claim relates was filed.

(d) Effect on dividends paid deduction. A deficiency dividend paid by the acquiring corporation that is allowable as a deduction to a distributor or transferor corporation pursuant to section 381(c)(25) shall not become a part of the dividends paid deduction of the acquiring corporation under section 561 for any taxable year.

(e) Successive transactions to which section 381(a) applies. The provisions of this section shall apply in the case of successive transactions to which section 381(a) applies. Thus, if X corporation transfers its assets to Y corporation in a transaction to which section 381(a) applies and if Y corporation transfers its assets to Z corporation in a subsequent transaction to which section 381(a) applies, then, subject to the provisions of this section, X corporation may take a deficiency dividend deduction for the amount of deficiency dividends paid by Z corporation with respect to X corporation.

[T.D. 7767, 46 FR 11264, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.381(c)(26)–1 Credit for employment of certain new employees.

(a) Carryovers and carrybacks. For taxable years beginning before January 1, 1984, the computation of carryovers and carrybacks of unused targeted jobs credit (new jobs credit in the case of wages paid before 1979) under section 44B (as in effect prior to enactment of the Tax Reform Act of 1984) in a transaction to which section 381(a) applies shall be made under the principles of § 1.381(c)(23)–1 (relating to the computation of carryovers and carrybacks of unused investment credit), except that the provisions of paragraph (c)(4) and paragraph (e)(6), (7) and (8) of such section shall not apply.

(b) Other items. See § 1.51–1(h) for a rule that applies to certain transfers of a trade or business in which a member of a targeted group is employed.

[T.D. 7921, 48 FR 52903, Nov. 23, 1983; T.D. 8062, 50 FR 46003, Nov. 6, 1985]

§ 1.381(d)–1 Operations loss carryovers of life insurance companies.

For the application of part V, subchapter C, chapter 1 of the Code to operations loss carryovers of life insurance companies, see section 812(f) and § 1.812–7 and section 381(c)(22) and § 1.381(c)(22)–1.

[T.D. 6625, 27 FR 12543, Dec. 19, 1962]

§ 1.382–1T Limitation on net operating loss carryforwards and certain built-in losses following ownership change (temporary).

In order to facilitate use of § 1.382–2T, this section lists the paragraphs, subparagraphs, and subdivisions contained in § 1.382–2T.

(a) Ownership change.

(1) In general.

(2) Events requiring a determination of whether an ownership change has occurred.

(i) Testing date.

(ii) Information statement required.

(iii) Records to be maintained by loss corporation.

(h) Constructive ownership of stock.

(1) In general.

(2) Attribution from corporations, partnerships, estates and trusts.

(i) In general.

(ii) Limitation on attribution from entities with respect to certain interests.

(iii) Limitation on attribution from certain entities.

(iv) Examples.

(3) Attribution to corporations, partnerships, estates and trusts.

(4) Option attribution.

(i) In general.

(ii) Examples.

(iii) Contingencies.

(iv) Series of options.

(v) Interests that are similar to options.

(vi) Actual exercise of options.

(A) In general.

(B) Actual exercise within 120 days of deemed exercise.

(vii) Effect of deemed exercise of options on the outstanding stock of the loss corporation.

(A) Right of obligation to issue stock.

(B) Right or obligation to acquire outstanding stock by the loss corporation.

(C) Effect on value of old loss corporation.

(viii) Options that lapse or are forfeited.

(ix) Option rule inapplicable if pre-change losses are de minimis.

(x) Options not subject to attribution

(A) Long-held options with respect to actively traded stock.

(B) Right to receive or obligation to issue a fixed dollar amount of value of stock upon maturity of certain debt.

(C) Right or obligation to redeem stock of the loss corporation.

(D) Options exercisable only upon death, disability or mental incompetency.

(E) Right to receive or obligation to issue stock as interest or dividends.

(F) Options outstanding following an ownership change.

(1) In general.

(2) Example.

(G) Right to acquire loss corporation stock pursuant to a default under loan agreement.

(H) Agreement to acquire or sell stock owned by certain shareholders upon retirement.

(xi) Certain transfers of options disregarded.

(xii) Exercise of an option that has not been treated as stock.

(5) Stock transferred under certain agreements.

(6) Family attribution.

(i) [Reserved]

(j) Aggregation and segregation rules.

(1) Aggregation of public shareholders and public owners into public groups.

(i) Public group.

(ii) Treatment of public group that is a 5-percent shareholder.

(iii) Presumption of no cross-ownership.

(iv) Identification of the public groups treated as 5-percent shareholders.

(A) Analysis of highest tier entities.

(B) Analysis of other higher tier entities and first tier entities.

(C) Aggregation of the public shareholders.

(v) Appropriate adjustments.

(vi) Examples.

(2) Segregation rules applicable to transactions involving the loss corporation.

(i) In general.

(ii) Direct public group.

(iii) Transactions to which segregation rules apply.

(A) In general.

(B) Certain equity structure shifts and transactions to which section 1032 applies.

(1) In general.

(2) Examples.

(C) Redemption-type transactions.

(1) In general.

(2) Examples.

(D) Acquisition of loss corporation stock as the result of the ownership of a right to acquire stock.

(1) In general.

(2) Example.

(E) Transactions identified in the Internal Revenue Bulletin.

(F) Issuance of rights to acquire loss corporation stock.

(1) In general.

(2) Example.

(iv) Combination of de minimis public groups.

(A) In general.

(B) Example.

(v) Multiple transactions.

(A) In general.

(B) Example.

(vi) Acquisitions made by either a 5-percent shareholder or the loss corporation following application of the segregation rules.

(3) Segregation rules applicable to transactions involving first tier entities or higher tier entities.

(i) Dispositions.

(ii) Example.

(iii) Other transactions affecting direct public groups of a first tier entity or higher tier entity.

(iv) Examples.

(v) Acquisitions made by a 5-percent shareholder, a higher tier entity, or a first tier entity following application of the segregation rules.

(k) Operating rules.

(1) Presumptions regarding stock ownership.

(i) Stock subject to regulation by the Securities and Exchange Commission.

(ii) Statements under penalties of perjury.

(2) Actual knowledge regarding stock ownership.

(3) Duty to inquire as to actual stock ownership in the loss corporation.

(4) Ownership interests structured to avoid the section 382 limitation.

(5) Example.

(6) First tier entity or higher tier entity that is a foreign corporation or entity. [Reserved.]

(*l*) Changes in percentage ownership which are attributable to fluctuations in value. [Reserved]

(m) Effective date.

(1) In general.

(2) Plan of reorganization.

(3) Earliest commencement of the testing period.

(4) Transitional rules.

(i) Rules provided in paragraph (j) of this section for testing dates before September 4, 1987.

(ii) Example.

(iii) Rules provided in paragraph (j) of this section for testing dates on or after September 4, 1987.

(iv) Rules provided in paragraphs (f)(18) (ii) and (iii) of this section.

(v) Rules provided in paragraph (a)(2)(ii) of this section.

(5) Bankruptcy proceedings.

(i) In general.

(ii) Example.

(6) Transactions of domestic building and loan associations.

(7) Transactions not subject to section 382.

(i) Application of old section 382.

(ii) Effect on testing period.

(iii) Termination of old section 382. [Reserved]

(8) Options issued or transferred before January 1, 1987.

(i) Options issued before May 6, 1986.

(ii) Options issued on or after May 6, 1986 and before September 18, 1986.

(iii) Options issued on or after September 18, 1986 and before January 1, 1987.

(9) Examples.

[T.D. 8149, 52 FR 29674, Aug. 11, 1987]

§ 1.382–2 Election of application of sections 382 and 383, as amended by the Tax Reform Act of 1976.

(a) In general. (1) An election may be made under this section to have sections 382(a) and 383 (as it relates to section 382(a)), as amended by the Tax Reform Act of 1976, apply with respect to transactions specified in section 382(a), as so amended, occurring—

(i) During the first taxable year beginning after June 30, 1978, of the loss corporation; and

(ii) Pursuant to a written binding contract or option entered into before September 27, 1978.

(2) An election may be made under this section to have sections 382(b) and 383 (as it relates to section 382(b)), as amended by the Tax Reform Act of 1976, apply with respect to any reorganization specified in section 382(b), as so amended, occurring—

(i) Pursuant to a plan adopted on or after January 1, 1978, and before the end of the first taxable year beginning after June 30, 1978, of either the acquired or the acquiring corporation, whichever ends later; and

(ii) Pursuant to a written binding contract or option entered into before September 27, 1978.

(b) Taxpayer making election. (1) The election described in paragraph (a)(1) of this section shall be made by the loss corporation.

(2) In the case of a reorganization described in section 368(a)(1)(B), the election described in paragraph (a)(2) of this section shall be made by the loss corporation. In the case of all other reorganizations specified in section 382(b), as amended, the election shall be made by the acquiring corporation, as defined in § 1.381(a)–1(b)(2).

(3) For rules in the case where the loss corporation becomes a member of an affiliated group of corporations which files a consolidated return, see paragraph (d) of this section.

(c) Time and manner of making. (1)(i) Except as provided in paragraph (c)(2) of this section, the taxpayer shall make the election described in paragraph (a) of this section by making a written statement on its income tax return for the taxable year in which the transaction(s) or reorganization occurs. For the election to be valid, this return must be filed no later than the time prescribed by law (including extensions) for filing the return (hereafter "timely filed"). If the taxpayer takes a net operating loss deduction on this return, the statement shall be made on the schedule showing the computation of this deduction. Otherwise, the statement shall be made on a separate sheet of paper physically attached to the return. The statement shall briefly describe the transaction(s) or reorganization involved, and indicate that the taxpayer elects to have section 382(a) or (b) and section 383, as amended by the Tax Reform Act of 1976, apply with respect to such transaction(s) or reorganization.

(ii) If the taxpayer's return for the taxable year in which the transaction(s) or reorganization occurs is timely filed on or before November 26, 1979, and the election described in paragraph (a) of this section is made with that return, the election will be valid regardless of whether the election is made in the manner provided in paragraph (c)(1)(i) of this section.

(2) If the taxpayer's return for the taxable year in which the transaction(s) or reorganization occurs was due before February 6, 1979, and the taxpayer made the election described in paragraph (a) of this section before February 6, 1979, the election is valid regardless of whether the election was made with the taxpayer's timely-filed return for that year.

(d) Consolidated returns. If the loss corporation becomes a member of an affiliated group of corporations which files a consolidated return for the taxable year in which the transaction(s) or reorganization occurs, the election described in paragraph (a) of this section may be made by the common parent. If this paragraph (d) applies, the election shall be made as provided in paragraph (c) of this section, treating the common parent as the taxpayer and the consolidated return for the taxable year in which the transaction(s) or reorganization occurs as the relevant income tax return.

(e) Effect of election. (1) Generally, a person who acquires more than one loss corporation during the period in which the effective dates of the amendments to sections 382 and 383, made by the Tax Reform Act of 1976, would be postponed by section 368(a) of the Revenue Act of 1978 may not choose to have the 1976 Act amendments apply with respect to some but not all of these acquisitions. Accordingly, if an election is made under paragraph (a) of this section, sections 382 and 383, as amended, shall apply with respect to all such

acquisitions made by that person during this period.

(2) For purposes of this paragraph, an acquisition means either of the following:

(i) An increase in ownership of the total fair market value of the outstanding stock of the loss corporation of 50 percentage points or more, during the period described in section 381(a), as amended, attributable to transactions described in that section. For purposes of this subdivision, "stock" means all shares except nonvoting stock which is limited and preferred as to dividends. In addition, as under section 382(a), a person's increase in stock ownership in the loss corporation shall be taken into account under this subdivision only to the extent the increase is reflected in that person's stock ownership on the last day of the corporation's taxable year.

(ii) A reorganization specified in section 382(b), as amended, in which the person, directly or indirectly, is the acquiring corporation.

[T.D. 7650, 44 FR 61593, Oct. 26, 1979]

§ 1.382–2T Definition of ownership change under section 382, as amended by the Tax Reform Act of 1986 (temporary).

(a) Ownership change—(1) In general. A corporation is a new loss corporation and thus subject to limitation under section 382 only if an ownership change has occurred with respect to such corporation. An ownership change occurs with respect to a corporation if it is a loss corporation on a testing date and, immediately after the close of the testing date, the percentage of stock of the corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points over the lowest percentage of stock of such corporation owned by such shareholders at any time during the testing period. See paragraph (a)(2)(i) of this section for the definition of testing date. See paragraph (d) of this section for the definition of testing period. See paragraphs (f) (1) and (3) of this section for the respective definition of loss corporation and new loss corporation. See paragraph (g) of this section for the definition of 5-percent shareholder.

(2) Events requiring a determination of whether an ownership change has occurred—(i) Testing date. Except as otherwise provided in this paragraph (a)(2)(i), a loss corporation is required to determine whether an ownership change has occurred immediately after any owner shift, any equity structure shift, or any transaction in which an option with respect to stock of the loss corporation is—

(A) Transferred to (or by) a 5-percent shareholder (or a person who would be 5-percent shareholder if the option were treated as exercised), or

(B) Issued by the loss corporation, a first tier entity, or a higher tier entity that owns five percent or more of the loss corporation (determined without regard to the application of paragraph (h)(2)(i)(A) of this section). Notwithstanding the preceding sentence, any transfer of stock of the loss corporation (or an option with respect to such stock) in any of the circumstances described in section 382(l)(3)(B), or any equity structure shift that is not also an owner shift, is not an event that requires the loss corporation to make a determination of whether an ownership change has occurred. For purposes of this section, each date on which a loss corporation is required to make a determination of whether an ownership change has occurred is referred to as a testing date, all computations of increases in percentage ownership are to be made as of the close of the testing date, and any transactions described in this paragraph (a)(2)(i) that occur on that date are treated as occurring simultaneously at the close of the testing date. See paragraphs (e) (1) and (2) of this section for the respective definitions of owner shift and equity structure shift. See paragraphs (f) (9) and (14) of this section for the respective definitions of first tier entity and higher tier entity.

(ii) Information statement required. A loss corporation must file a statement with its income tax return for each taxable year that it is a loss corporation. The statement must—

(A) Indicate whether any testing dates occurred during the taxable year;

(B) Identify each testing date, if any, on which an ownership change occurred;

(C) Identify the testing date, if any, that occurred during and closest to the end of each of the three month periods ending on March 31, June 30, September 30 and December 31 during the taxable year, regardless of whether an ownership change occurred on the testing date,

(D) Identify each 5-percent shareholder on each such testing date;

(E) State the percentage ownership of the stock of the loss corporation for each 5-percent shareholder as of each such testing date and the increase, if any, in such ownership during the testing period; and

(F) Disclose the extent to which the loss corporation relied upon the presumptions regarding stock ownership under paragraph (k)(i) of this section to determine whether an ownership change occurred on any identified testing date.

(iii) Records to be maintained by loss corporation. A loss corporation shall keep such records as are necessary to determine: (A) The identity of its 5-percent shareholders, (B) the percentage of its stock owned by each such 5-percent shareholder, and (C) whether the section 382 limitation is applicable. Such records shall be retained so long as they may be material in the administration of any internal revenue law.

(b) Nomenclature and assumptions. For purposes of the example in this section—

(1) L is a loss corporation, and, if there is more than one loss corporation, they are designated as L_1, L_2, L_3, etc.

(2) P is a corporation that is not a loss corporation, and, if there is more than one such corporation, they are designated as P_1, P_2, P_3, etc.

(3) HC is a corporation whose assets consist solely of the stock of other corporations.

(4) E is an entity other than a corporation (e.g., a partnership), and, if there is more than one such entity, they are designated as E_1, E_2, E_3, etc.

(5) Unless otherwise stated—

(i) A, B, C, D, AA, BB, CC, and DD are unrelated individuals who own interests in corporations or other entities only to the extent expressly stated,

(ii) All corporations have one class of stock outstanding and each share of stock has the same fair market value as each other share,

(iii) The capital structure of the loss corporation and its business do not change over time, and

(iv) The rules of paragraphs (k) (2) and (4) of this section are not applicable.

(6) Public L represents a group of unrelated individuals and entities that own direct (and not indirect) stock ownership interests in loss corporation L, each of whom owns less than five percent of the stock of the loss corporation, and, if there is more than one loss corporation, such groups are designated as Public L_1, Public L_2, Public L_3, etc.

(7) Public P represents a group of unrelated individuals and entities that own direct (and not indirect) stock ownership interests in corporation P, each of whom owns less than five percent of the stock of the corporation, and, if there is more than one corporation, such groups are designated as Public P_1, P_2, P_3, etc.

(8) Public E represents a group of unrelated individuals and entities that own direct (and not indirect) ownership interests in entity E, each of whom owns less than five percent of the entity, and, if there is more than one entity, such groups are designated as Public E_1, Public E_2, Public E_3, etc.

(c) Computing the amount of increases in percentage ownership—(1) In general. In order to determine whether an ownership change has occurred on a testing date, the loss corporation must identify each 5-percent shareholder whose percentage of stock ownership in the loss corporation immediately after the close of the testing date has increased, compared to such shareholder's lowest percentage of stock ownership in such corporation at any time during the testing period. The amount of the increase in the percentage of stock ownership in the loss corporation of each 5-percent shareholder must be computed separately by comparing the percentage ownership of each such 5-percent shareholder immediately after the close of the testing date to such shareholder's lowest percentage ownership at any time during the testing period. Each such increase in the percentage ownership of a 5-percent shareholder is then added together with any other such increases of other 5-percent shareholders to determine whether an ownership change has occurred. Because only those 5-percent shareholders whose percentages of stock ownership have increased are taken into account, a 5-percent shareholder is disregarded if his percentage of stock ownership, immediately after the close of the testing date, has decreased (or has remained the same), compared to his lowest percentage ownership interest on any previous date during the testing period.

(2) Example.

(i) A and B each own 40 percent of the outstanding L stock. The remaining 20 percent of the L stock is owned by 100 unrelated individuals, none of whom own as much as five percent of L stock ("Public L"). C negotiates with A and B to purchase all their stock in L.

(ii) The acquisitions from both A and B are completed on September 13, 1990. C's acquisition of 80 percent of L stock results in an ownership change because C's percentage ownership has increased by 80 percentage points as of the testing date, compared to his lowest percentage ownership in L at any time during the testing period (0 percent).

(3) Related and unrelated increases in percentage stock ownership. The determination whether an ownership change has occurred is made with-

out regard to whether the changes in stock ownership of the loss corporation (by one or more 5-percent shareholders) result from related or unrelated events.

(4) Example.

(i) L has outstanding 200 shares of common stock. A, B and C respectively own 100, 50 and 50 shares of the L stock. On January 2, 1988, A sells 60 shares of L stock to B. Thus, B's percentage ownership interest in L increases by 30 percentage points, from 50 shares to 110 shares. On January 1, 1989, A purchases C's entire interest in L. Thus, A's percentage ownership interest in L increases by 25 percentage points, compared to his lowest percentage ownership interest in L, from 40 shares immediately following the January 2, 1988 sale to B to 90 shares. Even though A's ownership interest in L as of January 1, 1989 has decreased, compared to his 50 percent ownership interest at the beginning of the testing period, A is a 5-percent shareholder who must be taken into account for purposes of the computation required under paragraph (c)(1) of this section because his interest in L on that testing date (45 percent) has increased, compared to his lowest percentage ownership interest in L at any time during the testing period (20 percent following the sale to B).

(ii) Accordingly, although A and B jointly have increased their aggregate total ownership interest in L between January 2, 1988 and January 1, 1989 by only 25 percentage points (i.e., the total ownership interest in L held by A and B at all times is not less than a 75 percent interest), the total of their separate increases in the percentage stock ownership of L, compared to their respective lowest percentage ownership interests at any time during the testing period, is 55 percentage points. Thus, an ownership change occurs as a result of A's acquisition of L stock on January 1, 1989.

(d) Testing period—(1) In general. Except as otherwise provided in paragraphs (d) and (m) of this section, the testing period for any testing date is the three-year period ending on the testing date. See paragraph (a)(2)(i) of this section for the definition of testing date.

(2) Effect of a prior ownership change. Following an ownership change, the testing period for determining whether a subsequent ownership change has occurred shall begin no earlier than the first day following the change date of the most recent ownership change. See paragraph (f)(19) of this section for the definition of change date.

(3) Commencement of the testing period—(i) In general. Except as otherwise provided in paragraph (d)(3)(ii) of this section, the testing period for any loss corporation shall not begin before the earlier of the first day of either—

(A) The first taxable year from which there is a loss or excess credit carryforward to the first taxable year ending after the testing date, or

(B) The taxable year in which the testing date occurs.

(ii) Exception for corporations with net unrealized built-in loss. Paragraph (d)(3)(i) of this section shall not apply if the corporation has a net unrealized built-in loss (determined after application of section 382(h)(3)(B)) on the testing date, unless the loss corporation establishes the taxable year in which the net unrealized built-in loss first accrued.

In that event, the testing period shall not begin before the earlier of—

(A) The first day of the taxable year in which the net unrealized built-in loss first accrued, or

(B) The day described in paragraph (d)(3)(i) of this section. See section 382(h) for the definition of net unrealized built-in loss.

(4) Disregarding testing dates. Any testing date that occurs before the beginning of the testing period shall be disregarded for purposes of this section.

(5) Example.

(i) A owns all 100 outstanding shares of L stock. A sells 40 shares to B on January 1, 1988. C purchases 20 shares of L stock from A on July 1, 1991. In determining if an ownership change occurs on the July 1, 1991 testing date, B's acquisition of L stock is disregarded because it occurred before the testing period that ends on such testing date. Thus, B's ownership interest in L does not increase during the testing period, and no ownership change results from C's acquisition.

(ii) The facts are the same as in (i), except that throughout the period during which B negotiated his stock purchase transaction with A, B knew that C intended to attempt to acquire a significant stock interest in L. Also, B and C have been partners in a number of significant business ventures. The result is the same as in (i).

(e) Owner shift and equity structure shift—(1) Owner shift.— (i) Defined. For purposes of this section, an owner shift is any change in the ownership of the stock of a loss corporation that affects the percentage of such stock owned by any 5-percent shareholder. See paragraph (g) of this section for the definition of a 5-percent shareholder. An owner shift includes, but is not limited to, the following transactions:

(A) A purchase of disposition of loss corporation stock by a 5-percent shareholder,

(B) A section 351 exchange that affects the percentage of stock owned by a 5-percent shareholder,

(C) A redemption or a recapitalization that affects the percentage of stock owned by a 5-percent shareholder,

(D) An issuance of loss corporation stock that affects the percentage of stock owned by a 5-percent shareholder, and

(E) An equity structure shift that affects the percentage of stock owned by a 5-percent shareholder.

(ii) Transactions between persons who are not 5-percent shareholders disregarded. Transfers of loss corporation stock between persons who are not 5-percent shareholders of such corporation (and between members of separate public groups resulting from the application of the segregation rules of paragraphs (j)(2) and (3)(iii) of this section) are not owner shifts and thus are not taken into account. See paragraph (h)(4)(xi) of this section for a similar rule applicable to transfers of options.

(iii) Examples.

Example (1). A has owned all 1000 shares of outstanding L stock for more than three years. On June 15, 1988, A sells 300 of his L shares to B. This transaction is an owner shift. No other 5-percent shareholder has increased his percentage ownership of L stock during the testing period. Thus, the owner shift resulting from B's acquisition does not result in an ownership change, because B has increased his stock ownership in L by only 30 percentage points.

Example (2). The facts are the same as in Example (1). In addition, on June 15, 1989, L issues 100 shares to each of C, D and AA. The stock issuance is an owner shift. The transaction, however, does not result in an ownership change, because B, C, D and AA (the 5-percent shareholders whose stock ownership has increased as of the testing date, compared to any other time during the testing period) have increased their percentage of stock ownership in L by a total of only 46.2 percentage points during the testing period (by 23.1 percentage points [300 shares/1300 shares] for B, and 7.7 percentage points [100 shares/1300 shares] for each of C, D and AA].

Example (3). All 1000 shares of L stock are owned by a group of 100 unrelated individuals, none of whom own as much as five percent of L stock ("Public L"). Several of the members of Public L sell their L stock, amounting to a 30 percent ownership interest in L, to B on June 15, 1988. The sale of stock to B is an owner shift. Between June 16, 1988 and June 15, 1989, each of the remaining individuals in Public L sells his stock to another person who is not a 5-percent shareholder. Under paragraph (e)(1)(ii) of this section, trading activity among the members of Public L is disregarded and does not result in an owner shift. On June 15, 1989, L issues 100 shares to each of C, D and AA. The only sale transactions by members of Public L that are taken into account in determining whether an ownership change occurs on June 15, 1989 are the sales to B on June 15, 1988. Because B, C, D and AA together have increased their percentage ownership of L stock as a result of B's purchase and the stock issuance by an amount not in excess of 50 percentage points during the testing period ending on June 15, 1988, an ownership change does not occur on that date.

Example (4). The facts are the same as in Example (2). In addition, on December 15, 1989, L redeems 200 of the L shares from A. The redemption is an owner shift that results in an ownership change, because B, C, D and AA are 5-percent shareholders whose percentage ownership of L increase by a total of 54.6 percentage points during the testing period (by 27.3 percentage points [300 shares/1100 shares] for B and 9.1 percentage points [100 shares/1100 shares] for each of C, D and AA).

Example (5). L is owned entirely by 10,000 unrelated shareholders, none of whom owns as much as five percent of the stock of L ("Public L"). Accordingly, Public L is L's only 5-percent shareholder. See paragraph (j)(1) of this section. There are one million shares of common stock outstanding. On December 1, 1988, L issues two million new shares of its common stock to members of the public, none of whom owned any L stock prior to the issuance. Following the public offering, no shareholder of L owns, directly or indirectly, five percent or more of L stock. Under paragraph (j)(2) of this section, however, all of the newly issued stock is treated as acquired by a 5-percent shareholder ("Public NL") that is unrelated to Public L. Therefore, the public offering constitutes an owner shift that results in an ownership change because Public NL's percentage of stock ownership in L increased by 66⅔ percentage po.nts (two million shares acquired in the public offering/three million shares outstanding following the offering) over its lowest percentage ownership during the testing period (0 percent prior to the offering).

Example (6). The facts are the same as in Example (5), except that L issues only 500,000 new shares of L stock on December 1, 1988, and Public NL's percentage ownership interest in L increases by only 33⅓ percentage points (500,000 shares acquired in the public offering/1.5 million shares outstanding following the offering). During the two years following December 2, 1988, 14 percent of the stock outstanding on that date is sold over a public stock exchange. On December 3, 1990, A purchases five percent of L stock (75,000 shares) over a public stock exchange. The purchase of five percent of L stock by A is an owner shift and is presumed to have been made proportionately from Public L and Public NL under paragraph (j)(1)(vi) of this section. Under paragraph (e)(1)(ii) of this section, transfers of L stock in transactions not involving A (i.e., in transactions among or between members of separate public groups resulting from the application of paragraphs (j)(2) and (3) of this section) are not taken into account, and do not constitute owner shifts. (Transfers between members of Public NL and Public L, which are treated as separate 5-percent shareholders solely by virtue of paragraph (j)(2) of this section, are disregarded even if L has actual knowledge of any such transfers.) A and Public NL, the only 5-percent shareholders whose interests in L have increased during the testing period, have increased there respective stock ownership by only 36⅔ percentage points—five percentage points for A [75,000 shares/1.5 million shares outstanding] and 31⅔ percentage points for Public NL [((500,000 shares issued in the public offering)—(5 percent × 500,000 shares presumed to have been acquired by A)) /1.5 million shares outstanding]. Accordingly, there is no ownership change with respect to L notwithstanding that, taking into account the public trading, a change of more than 50 percentage points in the ultimate beneficial ownership of L stock occurred during the three-year period ending on the December 3, 1990 testing date.

Example 7. The facts are the same as in Example 6, except that five percent of the L stock has always been owned by P which, in turn, has always been owned by Public P. On December 6, 1990, P sells all of its L stock over a public stock exchange. Although the trading of P stock among persons that are not 5-percent share-holders (without regard to the segregation rules of paragraph (j) of this section) are disregarded under paragraph (e)(1)(ii) of this section, the disposition of the L stock by P is not disregarded because the L stock is transferred in a transaction that is subject to paragraph (j)(3)(i) of this section.

(2) Equity structure shift—(i) Tax-free reorganizations. An equity structure shift is any reorganization within the meaning of section 368 with

respect to which the loss corporation is a party to the reorganization, except that such term does not include a reorganization described in—

(A) Section 368(a)(1) (D) or (G) unless the requirements of section 354(b)(1) are met, or

(B) Section 368(a)(1)(F).

(ii) Transactions designated under section 382(g)(3)(B) treated as equity structure shifts. [Reserved]

(iii) Overlap of owner shift and equity structure shift. Any equity structure shift that affects the percentage of loss corporation stock owned by a 5-percent shareholder also constitutes an owner shift. See paragraph (e)(i)(E) of this section

(iv) Examples.

Example (1). A owns all of the stock of L and B owns all of the stock of P. On October 13, 1988, L merges into P in a reorganization described in section 368a(1)(A). As a result of the merger, A and B own 25 and 75 percent, respectively, of the stock of P. The merger is an equity structure shift (and, because it affects the percentage of L stock owned by 5-percent shareholders, it also constitutes an owner shift). On the October 13, 1988 testing date, B is a 5-percent shareholder whose stock ownership in the loss corporation following the merger has increased by 75 percentage points over his lowest percentage of stock ownership in L at any time during the testing period (0 percent prior to the merger). Accordingly, an ownership change occurs as a result of the merger. P is thus a new loss corporation and L's pre-change losses are subject to limitation under section 382. See paragraph (f)(1)(iii) of this section requiring P to account separately for L's pre-change losses.

Example (2). (i) A owns 100 percent of L_1 stock and B owns 100 percent of L_2 stock. On January 1, 1988, L_1 merges into L_2 in a reorganization described in section 368(a)(1)(A). Immediately after the merger, A and B own 40 percent and 60 percent, respectively, of the L_2 stock. There is an equity structure shift (as well as an owner shift) with respect to both L_1 and L_2 on January 1, 1988.

(ii) Because the percentage of L_2 stock owned by B immediately after the merger (60 percent) increases by more than 50 percentage points over the lowest percentage of the stock of L_1 owned by B during the testing period (0 percent prior to the merger), there is an ownership change with respect to L_1 . L_2 is a new loss corporation and thus, under paragraph (f)(1))(iii) of this section, the pre-change losses of L_1 must be accounted for separately by L_2 from the losses of L_2 (immediately before the ownership change) and are subject to limitation under section 382.

(iii) L_2 is a new loss corporation because it is a successor corporation to L_1. There is no ownership change with respect to L_2, however, because A's stock ownership in L_2 increased by only 40 percentage points (to 40 percent) over the amount owned by A prior to the merger (0 percent). Therefore, the pre-change losses of L_2 are not limited under section 382 as a result of the merger, but must be separately accounted for under paragraph (f)(1)(iii) of this section.

Example (3). The result in Example (2) would be the same if L_1 had survived the merger (i.e., L_2 merged into L_1) with A and B owning 40 and 60 percent, respectively, of L_1 stock. L_1's pre-change losses would be accounted for separately and limited under section 382 and the pre-change losses of $_2$ would be accounted for separately under paragraph (f)(1)(iii) of this section, but would not be limited under section 382. See paragraph (f)(1)(ii) for the treatment of $_2$ following the transaction.

Example (4). The facts are the same as Example (2), except, instead of acquiring^1 in a merger,^{2} acquires all of the^1 stock from A on January 1, 1988, solely in exchange for stock representing a 40 percent interest in^2 , in a reorganization described in section 368(a)(1)(B). The acquisition of stock by^2 is an equity structure shift (as well as an owner shift) with respect to^1 that results in an ownership change with respect to^1 because the percentage of^1 stock owned by B immediately after the reorganization (60 percent, by virtue of B's ownership of^2, through the operation of the constructive ownership rules of paragraph (h) of this section) increases by more than 50 percentage points over the lowest percentage of^1 stock owned by B at any time during the testing period (0 percent prior to the reorganization). The acquisition also results in an equity structure shift and an owner shift with respect to^2, but^2 incurs no ownership change, because A's stock ownership in^2 increased by only 40 percentage points over the percentage of^2 stock owned by A prior to the reorganization (0 percent).

(f) Definitions. For purposes of this section—

(1) Loss corporation—(i) In general. The term "loss corporation" means a corporation entitled to use a net operating loss carryforward or having a net operating loss for the taxable year in which an owner shift, equity structure shift or other transaction described in paragraph (a)(2)(i) of this section occurs (determined for purposes of this paragraph (f)(1) without regard to whether the corporation is a loss corporation). The term loss corporation also includes any corporation with a net unrealized built-in loss (determined for purposes of this paragraph (f)(1) by treating the date on which such determination is made as the change date). See section 382(h)(3) for the definition of net unrealized built-in loss. Any predecessor or successor to a loss corporation described in this paragraph (f)(1) also is a loss corporation.

(ii) Distributor or transferor loss corporation in a transaction under section 381. Notwithstanding that a loss corporation ceases to exist under state law, if its net operating loss carryforwards (or other items described in section 381(c)) are succeeded to and taken into account by an acquiring corporation in a transaction described in section 381(a), such loss corporation shall be treated as continuing in existence until—

(A) Any pre-change losses (determined as if the date of such transaction were the change date) are fully absorbed or expire under section 172, and

(B) Any net unrealized built-in losses (determined as if the date of such transaction were the change date) may no longer be treated as pre-change losses.

Following a transaction described in the preceding sentence, the stock of the acquiring corporation shall be treated as the stock of the loss corporation for purposes of determining whether an ownership change occurs with respect to the pre-change losses and net unrealized built-in losses that may be treated as pre-change losses of the distributor or transferor corporation.

(iii) Separate accounting required for losses of an acquiring corporation and a distributor or transferor loss corporation. Pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) that are succeeded to and taken into account by an acquiring corporation in a transaction to which section 381(a) applies must be accounted for separately from losses of the acquiring corporation for purposes of applying this section. See Example (2) of paragraph (e)(2)(iv) of this section.

(2) Old loss corporation. The term "old loss corporation" means any corporation with respect to which there is an ownership change and that was a loss corporation immediately before the ownership change.

(3) New loss corporation. The term "new loss corporation" means a corporation with respect to which there is an ownership change if, immediately after such change, it is a loss corporation. A successor corporation to the corporation described in the preceding sentence also is a new loss corporation.

(4) Successor corporation. A successor corporation is a distributee or transferee corporation that succeeds to and takes into account items described in section 381(c) from a loss corporation as the result of an acquisition of assets described in section 381(a).

(5) Predecessor corporation. A predecessor corporation is a distributor or transferor corporation that distributes or transfers its assets to an acquiring corporation in a transaction described in section 381(a).

(6) Shift. As the context may require, a shift means an equity structure shift, an owner shift or both.

(7) Entity. An entity is any corporation, estate, trust, association, company, partnership, or similar organization.

(8) Direct ownership interest. A direct ownership interest means the interest a person owns in an entity, including a loss corporation, without regard to the constructive ownership rules of paragraph (h) of this section.

(9) First tier entity. A first tier entity is an entity that, at any time during the testing period, owns a five percent or more direct ownership interest in the loss corporation.

(10) 5-percent owner. A 5-percent owner is any individual that, at any time during the testing period, owns a five percent or more direct ownership interest in a first tier entity or a higher tier entity. See paragraph (g) of this section for rules to determine whether, as a result of the constructive ownership rules of paragraph (h) of this section, a 5-percent owner is a 5-percent shareholder.

(11) Public shareholder. A public shareholder is any individual, entity, or other person with a direct ownership interest in a loss corporation of less than five percent at all times during the testing period.

(12) Public owner. A public owner is any individual, entity, or other person that, at all times during the testing period, owns less than a five percent direct ownership interest in a first tier entity or any higher tier entity.

(13) Public group. A public group is a group of individuals, entities, or other persons each of whom owns, directly or constructively, less than five percent of the loss corporation. See paragraphs (g) and (j) of this section for the rules applicable to identify public groups and to determine whether a public group is a 5-percent shareholder.

(14) Higher tier entity. A higher tier entity is any entity that, at any time during the testing period, owns a five percent or more direct ownership interest in a first tier entity or in any higher tier entity.

(15) Indirect ownership interest. An indirect ownership is an interest a person owns in an entity determined solely as a result of the application of the constructive ownership rules of paragraph (h) of this section and without regard to any direct ownership interest (or other beneficial ownership interest) in the entity.

(16) Highest tier entity. A highest tier entity is a first tier entity or a higher tier entity that is not owned, in whole or in part, at any time during the testing period by a higher tier entity.

(17) Next lower tier entity. The next lower tier entity with respect to a first tier entity is the loss corporation. The next lower tier entity with respect to a higher tier entity is any first tier entity

or other higher tier entity in which the higher tier entity owns, at any time during the testing period, a five percent or more direct ownership interest.

(18) Stock—(i) In general. Except as provided in this paragraph (f)(18), the term "stock" means stock other than stock described in section 1504(a)(4). Notwithstanding the preceding sentence, stock that is not described in section 1504(a)(4) solely because it is entitled to vote as a result of dividend arrearages shall be treated as so described and thus shall not be considered stock. Stock described in section 1504(a)(4), however, is not excluded for purposes of determining the value of the loss corporation under section 382(e). The determination of the percentage of stock of any corporation owned by any person shall be made on the basis of the relative fair market value of the stock owned by such person to the total fair market value of the outstanding stock of the corporation.

(ii) Treating stock as not stock. Any ownership interest that otherwise would be treated as stock under paragraph (f)(18)(i) of this section shall not be treated as stock if—

(A) As of the time of its issuance or transfer to (or by) a 5-percent shareholder, the likely participation of such interest in future corporate growth is disproportionately small when compared to the value of such stock as a proportion of the total value of the outstanding stock of the corporation,

(B) Treating the interest as not constituting stock would result in an ownership change, and

(C) The amount of the pre-change loss (determined as if the testing date were the change and treating the amount of any net unrealized built-in loss as a pre-change loss) is more than twice the amount determined by multiplying (1) the value of the loss corporation (as determined under section 382(e)) on the testing date, by (2) the long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs. Stock that is not treated as stock under this paragraph (f)(18)(ii), however, is taken into account for purposes of determining the value of the loss corporation under section 382(e).

(iii) Treating interests not constituting stock as stock. Any ownership interest that would not be treated as stock under paragraph (f)(18)(i) of this section (other than an option that is subject to paragraph (h)(4) of this section) shall be treated as constituting stock if—

(A) As of the time of its issuance or transfer to (or by) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the interest not constituting stock were treated as stock), such interest offers a potential significant participation in the growth of the corporation,

(B) Treating the interest as constituting stock would result in an ownership change, and

(C) The amount of the pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) is more than twice the amount determined by multiplying

(1) The value of the loss corporation (as determined under section 382(e)) on the testing date, by

(2) The long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.

An ownership interest is that treated as stock under this paragraph (f)(18)(iii) is taken into account for purposes of determining the value of the loss corporation under section 382(e).

(iv) Stock of the loss corporation. The stock of the loss corporation means stock of such corporation within the meaning of this paragraph (f)(18) and, as the context may require, includes any indirect ownership interest in the loss corporation.

(19) Change date. The change date means the date on which a shift (or any other transaction described in paragraph (a)(2)(i) of this section) that is the last component of an ownership change occurs.

(20) Year. A year, or any multiple thereof, means a 365-day period (or a 366-day period in the case of a leap year), or any multiple thereof, unless the year is specifically identified as a taxable year.

(21) Old section 382. Old section 382 means section 382, as in effect prior to the effective date of section 382 in the Tax Reform Act of 1986 (the "Act"), but taking into account section 621(f)(2) of the Act.

(22) Pre-change loss. The term pre-change loss means—

(i) Any net operating loss carryforward of the old loss corporation to the taxable year ending on the change date or in which the change date occurs,

(ii) Any net operating loss of the old loss corporation for the taxable year in which the ownership change occurs to the extent such loss is allocable

to the period in such year on or before the change date, and

(iii) Any recognized built-in loss for any recognition period taxable year (within the meaning of section 382(h)).

(23) **Unrelated.** Any two persons are unrelated if the constructive ownership rules of paragraph (h) of this section do not apply to treat either person as owning stock that is owned, directly or constructively, by the other person.

(24) **Percentage ownership interest.** A person's percentage ownership interest in—

(i) A corporation shall be determined under the rules of this section that are applicable to the determination of a shareholder's percentage stock ownership interest in a loss corporation (see paragraphs (f)(18) (i) through (iii) of this section),

(ii) A partnership shall be equal to the relative fair market value of such person's partnership interest to the total fair market value of all outstanding partnership interests, determined without regard to any limited and preferred partnership interest that is described in paragraph (h)(2)(ii)(C) of this section,

(iii) A trust shall be determined in accordance with the principles of section 318(a)(2)(B) for determining the constructive ownership of stock,

(iv) An estate shall be determined in accordance with the principles of section 318(a)(2)(A) for determining the constructive ownership of stock, and

(v) All other entities shall be determined by reference to the person's relative economic interest in the entity, taking into account all of the relevant facts and circumstances.

(g) **5-percent shareholder—(1) In general.** Subject to the rules of paragraphs (k) (2) and (4) of this section, the term "5-percent shareholder" means—

(i) An individual that owns, at any time during the testing period,

(A) A direct ownership interest in the stock of the loss corporation of five percent or more or

(B) An indirect ownership interest in the stock of the loss corporation of five percent or more by virtue of an ownership interest in any one first tier entity or higher tier entity,

(ii) A public group, of either a first tier entity or a higher tier entity, identified as a 5-percent shareholder under paragraph (j)(1)(iv) (A) or (B) of this section,

(iii) A public group of the loss corporation identified as a 5-percent shareholder under paragraph (j)(1)(iv)(C) of this section, and

(iv) A public group, of the loss corporation, a first tier entity or a higher tier entity, identified as a 5-percent shareholder under paragraph (j) (2) or (3) of this section. An individual owning five percent or more of the stock of the loss corporation at any time during the testing period is a 5-percent shareholder notwithstanding that the individual may own less than five percent of the stock of the loss corporation on the testing date. See paragraph (g)(5)(i)(B) of this section for rules permitting a loss corporation to make an adjustment in cases described in the preceding sentence.

(2) **Determination of whether a person is a 5-percent shareholder.** Except as provided in paragraphs (k) (2) and (4) of this section, a person shall be treated as constructively owning stock of the loss corporation pursuant to paragraph (h)(2) of this section only if the loss corporation stock is attributed to such person in the person's capacity as a higher tier entity or a 5-percent owner of the first tier entity or higher tier entity from which such stock is attributed. See paragraph (k)(3) of this section for rules explaining the extent of the obligation of the loss corporation to determine the identity of its 5-percent shareholders. Nothing in this paragraph (g)(2), however, shall limit the attribution of loss corporation stock under section 318(a)(2) and paragraph (h) of this section to a public owner.

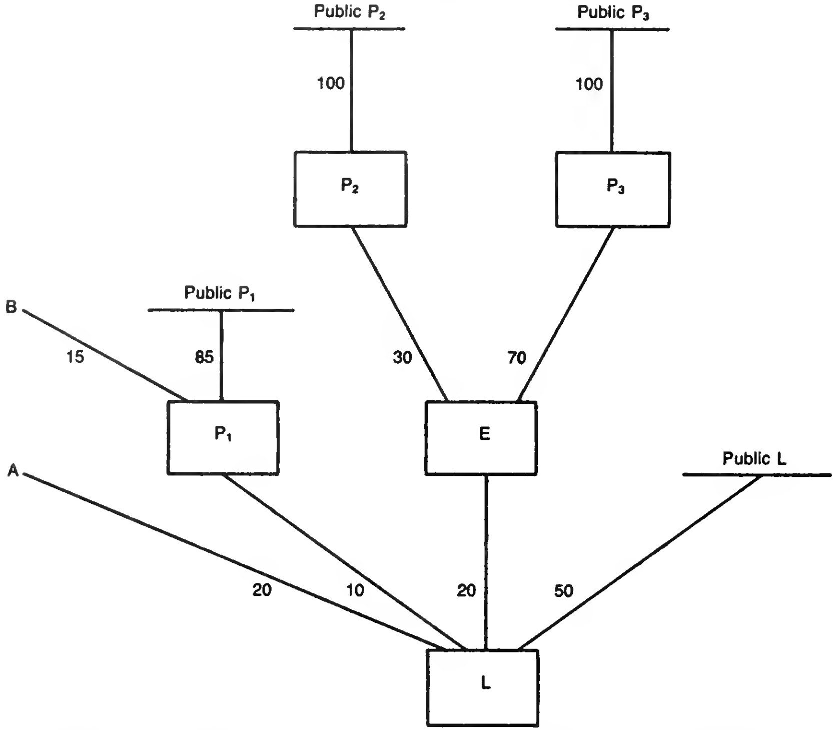
(3) **Determination of the percentage stock ownership interest of a 5-percent shareholder.** Subject to the rules of paragraphs (k)(2) and (4) of this section, in determining a 5-percent shareholder's percentage ownership interest in the loss corporation, the shareholder's direct ownership interest, if any, and each indirect ownership interest that he may have in the loss corporation in his capacity as a 5-percent owner of any one first tier entity or higher tier entity, if any, are required to be added together and taken into account with respect to such shareholder only to the extent that each such direct or indirect ownership interest constitutes five percent or more of the stock of the loss corporation.

(4) **Examples.**

Example (1). (i) Twenty percent of L stock is owned by A, 10 percent is owned by P_1, 20 percent is owned by E, a joint venture, and the remaining 50 percent of L stock is owned by Public L. P_1 is owned 15 percent by B and 85 percent by Public P_1. E is owned 30 percent by P_2 and 70 percent by P_3,

which, in turn, are owned by Public P_2 and Public P_3, respectively.

(ii) The ownership structure of L is illustrated by the following chart:

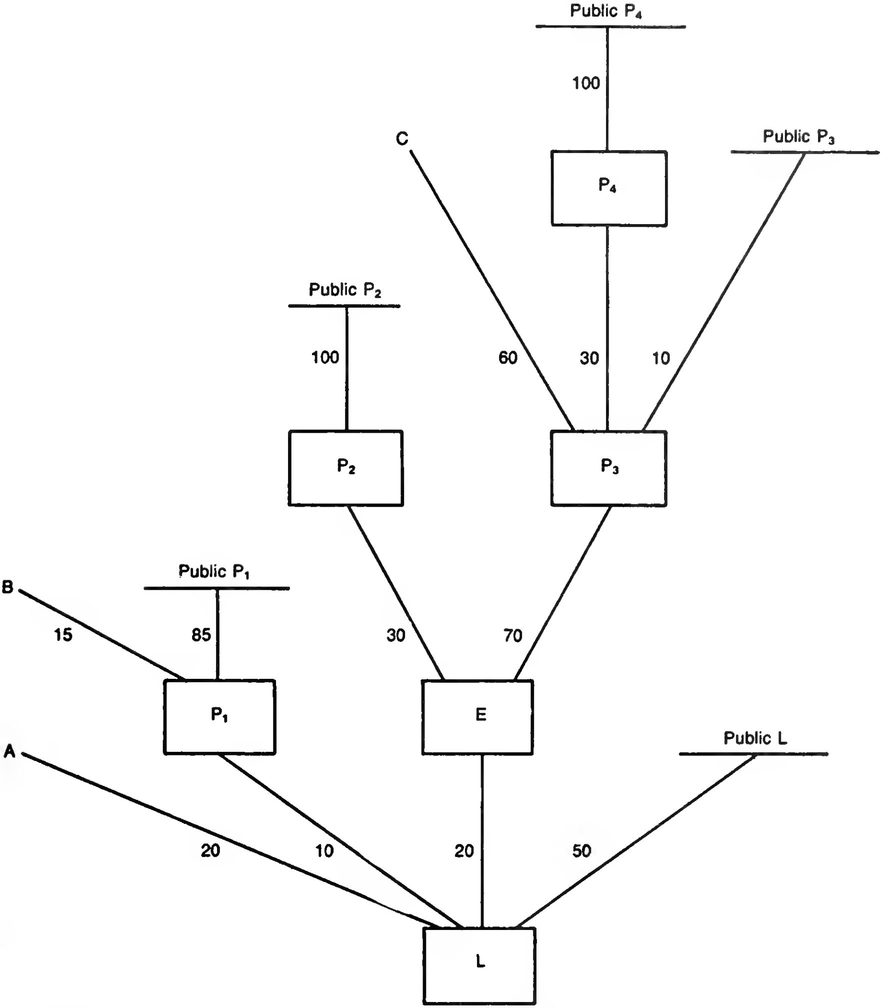


(iii) P_1 and E, each of which has a direct ownership interest in L of five percent or more, are first tier entities. The shareholders with direct ownership interests in L who individually own less than five percent of L are public shareholders (Public L). B, who has a direct ownership interest of five percent or more in P_1, is a 5-percent owner of P. P_2 and P_3, and P_3, each of which has a direct ownership interest in a first tier entity (E) of five percent or more, are higher tier entities with respect to L and, because neither entity is owned at any time during the testing period by a higher tier entity, they also are highest tier entities. The shareholders of P_2 and P_3 (Public P_2 and Public P_3, respectively) are public owners of such entities, because none of those shareholders own five percent or more of either entity at any time during the testing period.

(iv) A, who has a 20 percent direct ownership interest in L, is a 5-percent shareholder of L. Because, by application of the constructive ownership rules of paragraph (h) of this section, B owns only 1.5 percent of L stock in his capacity as a 5-percent owner of P_1 (15 percent ownership of P_1 × 10 percent ownership of L), B is not a 5-percent shareholder of L, even though he is a 5-percent owner of P_1. Under the rules of paragraph (j) of this section, therefore, B is treated as a member of Public P_1. See Example (3) of paragraph (j)(1)(vi) of this section for a determination of which public owners and public shareholders constitute public groups that are treated as 5-percent shareholders of L.

Example (2). (i) The facts are the same as in Example (1), except that P_3 is owned 60 percent by C, 30 percent by P_4, and 10 percent by Public P_3. The stock of P_4 is owned by a group of persons (Public P_4), none of whom own five percent or more of the stock of P_4.

(ii) The ownership structure of L is illustrated by the following chart:



(iii) The defined terms are the same as in Example (1), except that P_3 is a higher tier entity, not a highest tier entity, because five percent or more of P_3 is, in turn, owned by another entity (P_4). P_4, which owns five percent or more of a higher tier entity (P_3), also is a higher tier entity and, because it is not owned at any time during any testing period by any entity that is also a higher tier entity, P_4 is a highest tier entity. All of the shareholders of P_4, none of which own a direct ownership interest of five percent or more in P_4, are public owners of P_4.

(iv) C is a 5-percent owner of P_3 and, under the constructive ownership rules of paragraph (h) of this section, C indirectly owns 8.4 percent of L ([60 percent ownership of P_3] × [70 percent ownership of E] × [20 percent ownership of L]), in his capacity as a 5-percent owner of P_3. B is a 5-percent owner of P_1 and, under the constructive ownership rules of paragraph (h) of his section, B owns 1.5 percent of L ([15 percent ownership of P_1] × [10 percent ownership of L]) in his capacity as a 5-percent owner of P_1. Therefore, C is a 5-percent shareholder of L, but B is not a 5-percent shareholder of L, even though he is a 5-percent owner of P_1. See Example (4) of paragraph (j)(1)(vi) of this section for a determination of which public

owners and public shareholders constitute public groups that are treated as separate 5-percent shareholders of L.

Example (3). (i) L is owned 30 percent by A and 70 percent by P. A owns six percent of P stock and the balance (94 percent) is owned equally by 500 unrelated shareholders ("Public P").

(ii) A is a 5-percent shareholder because he directly owns 30 percent of L. Even though A is a 5-percent owner of P, A's 4.2 percent indirect ownership interest in L (six percent ownership interest in P × P's 70 percent ownership of L) is generally not taken into account in determining A's ownership interest, because such indirect ownership interest is less than five percent. Instead, A's 4.2 percent indirect interest is treated under paragraph (j)(1)(iv) of this section as owned by Public P. If, however, L has actual knowledge of A's less-than-five-percent indirect ownership interest in L and is thus subject to paragraph (k)(2) of this section, or paragraph (k)(4) of this section otherwise applies, L must take A's total 34.2 percent ownership interest into account in determining A's percentage ownership in L.

Example (4). The facts are the same as in Example (3), except that A owns ten percent of P's stock. Because A's indirect ownership interest in L in his capacity as a 5-percent owner of P is five percent or more, both A's 30 percent direct ownership interest in L and his seven percent indirect ownership interest in L (10 percent ownership interest in P × P's 70 percent ownership of L) are taken into account in determining his ownership interest in L, without regard to L's actual knowledge or whether paragraph (k)(4) of this section applies.

(5) Stock ownership presumptions in connection with certain acquisitions, and dispositions of loss corporation stock—(i) In general. For purposes of this section—

(A) If an individual owns less than five percent of the stock of a loss corporation during the testing period (excluding the testing date) and acquires an amount of such stock so that the individual becomes a 5-percent shareholder on the testing date, the loss corporation may treat any interest in the loss corporation owned by such individual prior to that acquisition as owned by a public group during the period of such individual's ownership of that interest and as not owned by the 5-percent shareholder during the same period, and

(B) If a 5-percent shareholder's percentage ownership interest in the loss corporation is reduced to less than five percent, the loss corporation may presume that the remaining stock owned by such 5-percent shareholder immediately after such reduction is the stock owned by such shareholder for each subsequent testing date having a testing period that includes the date on which the reduction occurred as long as such shareholder continues to own less than five percent of the stock of the loss corporation. In that event, such ownership interest shall be treated as owned by a separate public group for purposes of the rules of paragraph (j)(2)(vi) of this section.

(ii) Example.

L has 100,000 shares of stock outstanding. All of the L stock is owned equally by 40 unrelated, individual shareholders, including A (who owns 2.5 percent of L stock). Because no person owns as much as five percent of L stock, Public L is the only 5-percent shareholder of L. See paragraph (j)(1) of this section. A purchases 5,000 shares of L stock over a public stock exchange on June 8, 1989. The purchase is an owner shift. When added to his ownership interest before that date (the testing date), A owns 7,500 shares of L stock (7.5 percent). Under paragraph (g)(5)(i)(A) of this section, L may treat A and Public L as having owned 0 percent and 100 percent, respectively, at all times prior to June 8, 1989 (rather than having owned 2.5 percent by A and 97.5 percent by Public L, even if L has actual knowledge of A's less than five percent ownership interest). The increase in A's stock ownership of L as of June 8, 1989 thus would be 7.5 percentage points, rather than 5.0 percentage points, for purposes of determining whether an ownership change occurs on that testing date and any subsequent testing date.

(h) Constructive ownership of stock—(1) In general. Subject to certain modifications set forth in this section and section 382(*l*)(3), the constructive ownership rules of section 318(a) generally apply for purposes of determining ownership of loss corporation stock.

(2) Attribution from corporations, partnerships, estates and trusts—(i) In general. Stock owned (directly or indirectly) by an entity shall be attributed to its owners—

(A) Except as otherwise provided in this section, by treating the stock attributed pursuant to section 318(a)(2) as no longer being owned by the entity from which it is attributed, and

(B) If attribution is from a corporation, without regard to the 50 percent stock ownership limitation contained in section 318(a)(2)(C).

(ii) Limitation on attribution from entities with respect to certain interests. Section 318(a)(2) shall not apply to treat the stock of the loss corporation that is owned directly by a first tier entity (or indirectly by any higher tier entity) as being indirectly owned by any person that has an ownership interest in the first tier entity (or any higher tier entity) to the extent that such interest is (or is attributable to)—

(A) Stock of any such entity that is described in section 1504(a)(4),

(B) Any ownership interest in any such entity that does not constitute stock under paragraph (f)(18)(ii) of this section, or

(C) If the entity is not a corporation, any ownership interest in any such entity that has characteristics similar to the interests described in paragraph (h)(2)(ii) (A) or (B) of this section.

The ownership interests described in this paragraph (h)(2)(ii) shall not be taken into account in determining a person's percentage ownership interest in an entity under paragraph (f)(24) of this section.

(iii) Limitation on attribution from certain entities. For purposes of this section, except as provided in paragraphs (k)(2) and (4) of this section, each of the following shall be treated as an individual who is unrelated to any other owner (direct or indirect) of the loss corporation—

(A) Any entity other than a higher tier entity that owns five percent or more of the loss corporation stock (determined without regard to paragraph (h)(2)(i)(A) of this section) on a testing date, a first tier entity or the loss corporation,

(B) A qualified trust described in section 401(a),

(C) Any State, any possession of the United States, the District of Columbia, the United States (or any agency or instrumentality thereof), any foreign government, or any political subdivision of any of the foregoing, and

(D) Any other person designated by the Internal Revenue Service in the Internal Revenue Bulletin.

Stock of a loss corporation that is owned by any such person shall thus not be attributed to any other person for purposes of this section. See paragraph (g)(2) of this section limiting attribution from a first tier entity or a higher tier entity to any person that is not a 5-percent owner or a higher tier entity.

(iv) Examples.

Example (1). All the stock of L is owned by A. B and C respectively own 70 and 30 percent of the outstanding P stock. P acquires 60 percent of the outstanding L stock from A on July 1, 1988 (a testing date). After the acquisition, P is a first tier entity and a higher tier entity of L. B and C are each 5-percent owners of P and also are 5-percent shareholders of L having a 42 percent and 18 percent stock ownership interest in L, respectively, through the operation of the constructive ownership rules of paragraph (h) of this section. Because B and C together have increased their ownership in L by more than 50 percentage points during the testing period ending on the testing date (60 percent on the testing date and 0 percent prior thereto), an ownership change occurs with respect to L on July 1, 1988.

Example (2). The facts are the same as in Example (1), except that B and C are not shareholders in a corporation, but instead are partners in a general partnership, E. B and C respectively own 70 percent and 30 percent of E. E acquires 60 percent of the L stock on July 1, 1988. The results are the same as in Example (1).

Example (3). The facts are the same as in Example (1), except that the acquisition is accomplished in a transaction that qualifies under section 351(a). In that transaction, HC is formed through (i) a contribution of money by P in exchange for 60 shares of HC common stock and (ii) a contribution of all the outstanding shares of L stock plus cash by A in exchange for 40 shares of HC common stock and 30 shares of HC preferred stock that is described in section 1504(a)(4). The respective values of each share of HC stock, common and preferred, are equal. The stock of L is attributed to A through his interest in HC common stock, but not through his interest in HC preferred stock (see paragraph (h)(2)(ii)(A) of this section). Thus, A is treated as owning indirectly only 40 percent of L. B and C are 5-percent shareholders of L having indirect ownership interests in L of 42 percent and 18 percent, respectively, through their ownership of HC common stock. The results are therefore the same as in Example (1).

(3) Attribution to corporations, partnerships, estates and trusts. Except as otherwise provided by regulation under section 382 or by the Internal Revenue Service in the Internal Revenue Bulletin, the rules of section 318(a)(3) shall not apply in determining the ownership of stock under this section.

(4) Option attribution—(i) In general. Solely for the purpose of determining whether there is an ownership change on any testing date, stock of the loss corporation that is subject to an option shall be treated as acquired on any such date, pursuant to an exercise of the option by its owner on that date, if such deemed exercise would result in an ownership change. The preceding sentence shall be applied separately with respect to—

(A) Each class of options (i.e., options with terms that are identical, issued by the same issuer, and issued on the same date) owned by each 5-percent shareholder (or person who would be a 5-percent shareholder if the option were treated as exercised), and

(B) Each 5-percent shareholder, each owner of an option who would be a 5-percent shareholder if the option were treated as exercised, and each combination of such persons.

(ii) Examples.

Example (1). (i) A owns all of the 100 shares of outstanding L stock. A grants options for the purchase of his L stock, exercisable for 10 years from the date of issuance, in the following transactions: An option to B for four shares (issued January 1, 1988), an option to C for six shares (issued June 1, 1989), and an option to D for 15 shares (issued July 30, 1989). On July 30, 1990, A sells 41 shares of his L stock to BB.

(ii) Pursuant to paragraph (a)(2)(i) of this section, the date on which each option is acquired is a testing date. The issuance of options to acquire L stock to each of B, C, and D is not treated as an acquisition of the underlying stock on any such testing date since such treatment with respect to any one of the option owners (or any combination thereof) would not have resulted in an ownership change on any of those testing dates.

(iii) The date on which BB acquires 41 shares also is a testing date. BB's acquisition of 41 percent of the L stock, taken together with the shift in ownership that would result if the options held by B, C and D were exercised, would result in an ownership change, because the stock owned or treated as

owned by Public L (a group including only B, the sole shareholder who owns less than five percent of L stock), C, D and BB would have increased by 66 percentage points (four, six, 15, and 41 percentage points, respectively) during the testing period. Subject to paragraph (h)(4)(ix) of this section, the options are treated as exercised and an ownership change occurs on July 30, 1990, pursuant to paragraph (h)(4)(i) of this section. Accordingly, no new testing period can begin before July 31, 1990. Under paragraph (h)(4)(x)(F) of this section, the option attribution rules of paragraph (h)(4)(i) of this section shall not be applicable with respect to any of the options owned by B, C, and D immediately before the ownership change until such time, if any, that such options are transferred to (or by) 5-percent shareholder (or a person who would be a 5-percent shareholder if such option were exercised). In addition, the subsequent exercise of any of those options by A, B, or C (the persons owning such options immediately before the ownership change) is disregarded. See paragraph (h)(4)(vi) of this section. Also see paragraph (h)(4)(viii) of this section for the treatment of options that lapse or are forfeited.

(iv) The facts are the same as in (i), except that the sale of A's 41 shares of L stock to BB occurs on July 30, 1995. Because the options are treated as exercised and the related stock is treated as acquired on the July 30, 1995 testing date, the results are the same as described in (iii).

Example (2). (i) A owns all of the outstanding 100 shares of the stock of L. On July 22, 1988, the value of A's stock in L is $500 and the following agreements are entered into: (i) A sells 40 shares of his L stock to B for $200, (ii) in exchange for $10, A grants B an option to acquire the balance of his L stock for $305 at any time before July 22, 1992, and (iii) L grants A an option to acquire 100 shares of L stock at a price of $600 exercisable until such time as B's option is no longer outstanding.

(ii) If the stock subject to the options owned by both A and B were treated as acquired on the July 22, 1988 testing date, B would have increased his ownership interest in L by only 50 percentage points to 50 percent ([40 shares purchased + 60 shares acquired pursuant to the option]/200 outstanding shares of L stock, including 100 shares deemed outstanding pursuant to the option issued to A by L) as compared with 0 percent prior to July 22, 1988. In determining whether the options with respect to the stock of L would, if exercised, result in an ownership change, paragraph (h)(4)(i)(B) of this section requires that such options be treated as exercised separately with respect to each 5-percent shareholder, each person who would be a 5-percent shareholder if the option were treated as exercised or each combination of such persons. Therefore, by treating the option owned by A as not having been exercised and the option owned by B as having been exercised, B's interest in L increases by 100 percentage points during the testing period. An ownership change with respect to L therefore results from the transactions occurring on July 22, 1988.

(iii) Contingencies. Except as provided in paragraph (h)(4)(x)(D) of this section, the extent to which an option is contingent or otherwise not currently exercisable shall be disregarded for purposes of this section.

(iv) Series of options. For purposes of this section, an option to acquire an option with respect to the stock of the loss corporation, and each one of a series of such options, shall be considered as an option to acquire such stock.

(v) Interests that are similar to options. For purposes of this section,

(A) An interest that is similar to an option includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock, and

(B) Any such interest shall be treated as an option.

(vi) Actual exercise of options—(A) In general. The actual exercise of any option in existence immediately before and after an ownership change, whether or not the option was treated as exercised in connection with the ownership change under paragraph (h)(4)(i) of this section, shall be disregarded for purposes of this section, but only if the option is exercised by the 5-percent shareholder (or person who would have been a 5-percent shareholder if the options owned by such person had been exercised immediately before the ownership change) who owned the option immediately before and after such ownership change.

(B) Actual exercise within 120 days of deemed exercise. If the actual exercise of an option occurs on or before the end of the period which is 120 days after the date on which the option is treated as exercised under paragraph (h)(4)(i) of this section, the loss corporation may elect to treat paragraphs (h)(4)(i) and (vi)(A) of this section as not applying to such option and take into account only the acquisition of loss corporation stock resulting from the actual exercise of the option. An election under this paragraph (h)(4)(vi)(B) shall have no effect on the determination of whether an ownership change occurs, but shall apply only for the purpose of determining the date on which the change date occurs. An election under this paragraph (h)(4)(vi)(B) shall be made in the statement described in paragraph (a)(2)(ii) of this section.

(vii) Effect of deemed exercise of options on the outstanding stock of the loss corporation—(A) Right or obligation to issue stock. Solely for purposes of determining whether an ownership change has occurred under paragraph (h)(4)(i) of this section, the deemed exercise of an option with respect to unissued stock (or treasury stock) of a corporation shall result in a corresponding increase in the amount of its total outstanding stock.

(B) Right or obligation to acquire outstanding stock by the loss corporation. Solely for purposes of determining whether an ownership change has occurred under paragraph (h)(4)(i) of this section,

the deemed exercise of a right to transfer outstanding stock to the issuing corporation (or a right of the issuing corporation to acquire its stock) shall result in a corresponding decrease in the amount of its total outstanding stock.

(C) Effect on value of old loss corporation. The deemed exercise of an option with respect to unissued stock (or treasury stock) under paragraph (h)(4)(i) of this section shall have no effect on the determination of the value of the old loss corporation and the computation of the section 382 limitation. See section 382(*l*)(1)(B) disregarding capital contributions made during the two-year period preceding the change date for purposes of computing the section 382 limitation.

(viii) Options that lapse or are forfeited. If an option that is treated as exercised under paragraph (h)(4)(i) of this section lapses unexercised or the owner of such option irrevocably forfeits his right to acquire stock pursuant to the option, the option shall be treated for purposes of this section as if it never had been issued. In that case, the loss corporation may file an amended return for prior years (subject to any applicable statute of limitations) if the section 382 limitation was thus inapplicable. If paragraph (h)(4)(i) of this section applied to an option (or options) with respect to a taxable year for which an income tax return has not been filed by the date that the option (or options) lapses or is irrevocably forfeited, the loss corporation may treat paragraph (h)(4)(i) of this section as inapplicable to such option (or options).

(ix) Option rule inapplicable if pre-change losses are de minimis. Paragraph (h)(4)(i) of this section shall not apply to treat the stock of the loss corporation as acquired by the owner of an option if, on a testing date, the amount of pre-change losses (determined as if the testing date were a change date and treating the amount of any net unrealized built-in loss as a pre-change loss) is less than twice the amount determined by multiplying.

(A) The value of the loss corporation (as determined under section 382(e)) on the testing date, by

(B) The long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.

(x) Options not subject to attribution. Paragraph (h)(4)(i) of this section shall not apply to—

(A) Long-held options with respect to actively traded stock. Any option with respect to stock of the loss corporation which stock is actively traded on an established securities market (within the meaning of section 1273(b)) for which market quotations are readily available, if such option has been continuously owned by the same 5-percent shareholder (or a person who would be a 5-percent shareholder if such option were exercised) for at least three years, but only until the earlier of such time as—

(1) The option is transferred by or to a 5-percent shareholder (or a person who would be a 5-percent shareholder if such option were exercised), or

(2) The fair market value of the stock that is subject to the option exceeds the exercise price for such stock on the testing date. For purposes of this paragraph (h)(4)(x)(A), options with respect to the stock of a loss corporation that are assumed (or substituted) in a reorganization and converted into options with respect to the stock of another party to the reorganization shall not be treated as transferred, provided that there are no changes in the terms of the options, other than that the stock that may be acquired pursuant to the option is that of another party to the reorganization and that the amount of stock subject to the option is adjusted only to reflect the exchange ratio for the exchange of stock of the loss corporation in the reorganization.

(B) Right to receive or obligation to issue a fixed dollar amount of value of stock upon maturity of certain debt. Any right to receive or obligation to issue stock pursuant to the terms of a debt instrument that, in economic terms, is equivalent to nonconvertible debt because the right to receive stock of the issuer of a fixed dollar amount is based upon the fair market value for such stock determined at or about the date the stock is transferred pursuant to such right or obligation (i.e., the amount of the stock transferred pursuant to the option is equal to a fixed dollar amount, divided by the value of each share of such stock at or about the date of the stock transfer). This paragraph (h)(4)(x)(B) shall not apply if the method for determining the fair market value of the stock of the issuer is intended to or, in fact, provides the owner of the debt instrument with a participation in any appreciation of any stock of the issuer.

(C) Right or obligation to redeem stock of the loss corporation. Any right or obligation of the loss corporation to redeem any of its stock at the time such stock is issued, but only to the extent such stock is issued to persons who are not 5-percent shareholders immediately before the issuance.

(D) Options exercisable only upon death, disability or mental incompetency. Any option en-

tered into between owners of the same entity (or an owner and the entity in which the owner has a direct ownership interest) with respect to such owner's ownership interest in the entity that is exercisable only upon the death, complete disability or mental incompetency of such owner.

(E) Right to receive or obligation to issue stock as interest or dividends. Any right to receive or obligation to issue stock of a corporation in payment of interest or dividends by the issuing corporation. (For an example illustrating this exception, see paragraph (j)(2)(iv)(B) of this section.)

(F) Options outstanding following an ownership change—(1) In general. Any option in existence immediately before and after an ownership change, whether or not the option was treated as exercised in connection with the ownership change under paragraph (h)(4)(i) of this section, but only so long as the option continues to be owned by the 5-percent shareholder (or person who was treated as a 5-percent shareholder) who owned the option immediately before and after such ownership change.

(2) Example (i) A, B, C and D own all of the outstanding stock of L. A owns 70 shares of L stock and each of B, C and D own 10 shares of L stock. On July 12, 1988, L issues warrants to each of its shareholders entitling them to acquire an additional 8.5 shares of L stock for each share of stock owned.

(ii) If B, C and D, but not A, each exercise their respective rights to acquire an additional 85 shares of L stock (10 shares × 8.5 shares that may be acquired for each share owned) on July 12, 1988, their combined ownership interest in L on that date would exceed 80 percent (255 shares deemed to be acquired + 30 shares actually owned)/355 shares outstanding (actual and deemed). B, C and D thus would increase their ownership interest in L by 50.3 percentage points during the testing period, causing an ownership change, because, under paragraph (h)(4)(i)(B) of this section, the options are treated as exercised if the exercise would cause an ownership change.

(iii) Following the ownership change, paragraph (h)(4)(i) of this section applies to prevent A's right to acquire 595 shares of L stock (70 shares x 8.5 shares that may be acquired for each share owned) or the rights held by B, C, or D, to be treated as exercised on any subsequent testing date, except to the extent that those rights are transferred. To the extent any of those options are transferred following the ownership change, paragraph (h)(4)(i) of this section will apply to any such options on the date of the transfer and on any subsequent testing date.

(G) Right to acquire loss corporation stock pursuant to a default under a loan agreement. Any right to acquire stock of a corporation by a bank (as that term is defined in section 581), an insurance company (as that term is defined in § 1.801-3(a)), or a trust qualified under section 401(a) solely as the result of a default under a loan agreement entered into in the ordinary course of the trade or business of such bank, life insurance company or qualified trust.

(H) Agreement to acquire or sell stock owned by certain shareholders upon retirement. Any option entered into between noncorporate owners of the same entity (or a noncorporate owner and the entity in which the owner has a direct ownership interest) with respect to such owner's ownership interest in the entity, but only if each of such owners actively participate in the management of the entity's trade or business, the option is issued at a time that the loss corporation is not a loss corporation and the option is exercisable solely upon the retirement of such owner. An option with terms described in both this paragraph (h)(4)(x)(H) and in paragraph (h)(4)(x)(D) of this section shall also not be subject to paragraph (h)(4)(i) of this section.

(xi) Certain transfers of options disregarded. Transfers of options between persons who are not 5-percent shareholders (and between members of separate public groups resulting from the application of the segregation rules of paragraphs (j)(2) and (3)(iii) of this section) are not taken into account. Transfers of options in any of the circumstances described in section 382(*l*)(3)(B) are also disregarded and the transferee shall be treated as having owned the option for the period that it was owned by the transferor.

(xii) Exercise of an option that has not been treated as stock. The acquisition of stock pursuant to the actual exercise of an option (other than an option described in paragraph (h)(4)(vi)(A) of this section) shall not be disregarded.

(5) Stock transferred under certain agreements. Notwithstanding paragraph (h)(4) of this section, no shift results solely because under section 1058(a)—

(i) A shareholder transfers stock of a corporation pursuant to an agreement that meets the requirements of section 1058(b), or

(ii) A person having rights under such an agreement exchanges those rights for stock identical to the stock transferred pursuant to the agreement.

(6) Family attribution. For purposes of this section—

(i) Paragraphs (1) and (5)(B) of section 318(a) shall not apply,

(ii) An individual and all members of his family described in section 318(a)(1) shall be treated as one individual,

(iii) Subject to paragraph (k)(2) of this section, paragraph (h)(6)(ii) of this section shall not apply to members of a family who, without regard to that paragraph (h)(6)(ii), would not be 5-percent shareholders, and

(iv) If under paragraph (h)(6)(ii) of this section, an individual may be treated as a member of more than one family, and each family that is treated as one individual is a 5-percent shareholder (or would be treated as a 5-percent shareholder if such individual were treated as a member of such family), then such individual shall be treated only as a member of the family that results in the smallest increase in the total percentage stock ownership of the 5-percent shareholders on the testing date and shall not be treated as the member of any other family.

(i) [Reserved]

(j) Aggregation and segregation rules. For purposes of this section, except as provided in paragraphs (k) (2) and (4) of this section—

(1) Aggregation of public shareholders and public owners into public groups—(i) Public group. Under this paragraph (j), a loss corporation or other entity can be treated as owned, in whole or in part, by one or more public groups. A public group can include public shareholders, public owners, and 5-percent owners who are not 5-percent shareholders of the loss corporation.

(ii) Treatment of a public group that is a 5-percent shareholder. Each public group that is treated as a 5-percent shareholder under paragraph (g)(1) (ii), (iii) or (iv) of this section shall be treated as one individual. See paragraph (j)(2)(iv) for a rule combining certain de minimis public groups.

(iii) Presumption of no cross-ownership. The public owners, 5-percent owners who are not 5-percent shareholders and public shareholders in any public group, subject to paragraphs (j)(2)(iii), (k)(2) and (k)(4) of this section, are presumed not to be members of any other public group. It also is presumed that each such person is unrelated to all other shareholders (direct and indirect) of the loss corporation. See paragraph (h)(6)(iii) of this section. The members of a public group that exists by virtue of its direct ownership interest in an entity are presumed not to be members (and not to be related to a member) of any other public group that exists at any time by virtue of its direct ownership interest in any other entity. To the extent that the presumptions adopted in this paragraph (j)(1)(iii) are not applicable because the loss corporation has actual knowledge of facts to the contrary and is thus subject to paragraph (k)(2) of this section, public shareholders, public owners and 5-percent owners who are not 5-percent shareholders may be aggregated into additional public groups.

(iv) Identification of the public groups treated as 5-percent shareholders—(A) Analysis of highest tier entities. The loss corporation must identify first tier entities and higher tier entities in order to identify any highest tier entities that must be identified under paragraph (k)(3) of this section. The loss corporation must then identify any 5-percent owners of each such highest tier entity who indirectly own, at any time during the testing period, five percent or more of the loss corporation through the ownership interest in such highest tier entity. Under paragraph (g)(1)(i)(B) of this section, any such 5-percent owner is a 5-percent shareholder. See paragraph (k)(3) of this section for rules explaining the extent of the obligation of the loss corporation to determine the identity of its shareholders. Each person who has an ownership interest in any highest tier entity and who is not treated as a 5-percent shareholder (i.e., persons who are public owners or 5-percent owners who are not 5-percent shareholders) is a member of the public group of that highest tier entity. A public group, so identified, that indirectly owns five percent or more of the loss corporation on the testing date is treated under paragraph (g)(1)(ii) of this section as a 5-percent shareholder. If the public group so identified owns less than five percent of the loss corporation on the testing date, such public group is treated as part of the public group of the next lower tier entity.

(B) Analysis of other higher tier entities and first tier entities. The analysis and aggregation of public groups described in paragraph (j)(1)(iv)(A) of this section is repeated for any next lower tier entity and successively for any next lower tier entity of any entity described in this paragraph (j)(1)(iv)(B) until applied to each first tier entity.

(C) Aggregation of the public shareholders. The public shareholders are aggregated and, under paragraph (g)(1)(iii) of this section, are treated as a public group that is a 5-percent shareholder without regard to whether such group, at any time during the testing period, owns five percent or more of the loss corporation. For this purpose, if the public group of any first tier entity indirectly owns less than five percent of the loss corporation on the testing date, and is thus not treated as a 5-percent shareholder, but is treated as part of the public group of the loss corporation under paragraph (j)(1)(iv) (A) or (B) of this section, the ownership interest of that group is included in the public group of the loss corporation referred to in the preceding sentence.

(v) Appropriate adjustments. A loss corporation may apply the principles of paragraph (g)(5) of this section with respect to—

(A) Any public group that is treated as a 5-percent shareholder on the testing date if such public group, at any time during the testing period, was treated as part of the public group of the next lower tier entity, or

(B) Any public group that is treated as part of the public group of a next lower tier entity if such public group, at any time during the testing period, was part of the public group of a higher tier entity that was treated as a 5-percent shareholder and had a direct or indirect ownership interest in such lower tier entity.

(vi) Examples.

Example (1). (i) All of the stock of L is owned by 1,000 shareholders, none of whom own as much as five percent of L stock ("Public L"). All of the stock of P is owned by 150,000 shareholders, none of whom own as much as five percent of P stock ("Public P"). Between July 12, 1988 and August 13, 1988, P purchases all of the L stock through a series of transactions on the public stock exchange. P's percentage of direct stock ownership in L increases from 4.9 percent to five percent on July 15, 1988, and from 50 percent to 51 percent on July 30, 1988.

(ii) Before July 15, 1988, P is a public shareholder of L. On and after July 15, 1988, P is a first tier entity (and a highest tier entity) of L. Accordingly, under the rules of paragraph (j)(1) of this section, Public P, on and after July 15, 1988, is treated as a public group that is a 5-percent shareholder. Each acquisition by P on and after such date affects the percentage of L stock that is owned by Public P and thus constitutes an owner shift.

(iii) Immediately after the transaction on July 30, 1988, P owns 51 percent of L stock. Under paragraph (j)(1)(iv)(A) of this section, Public P thus owns 51 percent of L. Under paragraph (j)(1)(iv)(C) of this section, Public L, the public group that includes the public shareholders of L, is treated as a 5-percent shareholder that owns 49 percent of L. Under paragraph (j)(1)(iii) of this section, Public L and Public P are presumed not to have any common members and it is also presumed that no member of either public group is related to any other member of either of the two public groups.

(iv) Assuming that the presumption provided in paragraph (j)(1)(iii) of this section (i.e., that no person owns stock in both P and L) is not rebutted to any extent, Public P is treated as a 5-percent shareholder whose stock ownership in L, as of the July 30, 1988 testing date, has increased by 51 percentage points over its lowest percentage of stock ownership in L at any time during the testing period (0 percent prior to July 12, 1988). Accordingly, an ownership change with respect to L occurs as a result of P's acquisition on July 30, 1988. L is thus a new loss corporation and its pre-change losses are subject to limitation under section 382.

Example (2). (i) All of the stock of P is owned by 1,000 unrelated shareholders, none of whom owns as much as five percent of P stock. L_1 is a wholly owned subsidiary of P. On January 2, 1988, P distributes all of the L_1 stock pro rata to its shareholders.

(ii) Prior to the stock distribution, the public owners of P are members of a public group ("Public P") that is treated as a 5-percent shareholder owning 100 percent of the stock of L_1.

See paragraph (j)(1)(iv)(A) of this section. Following the stock distribution to the P shareholders, L_1 is owned by 1,000 public shareholders that are members of a public group ("Public L_1") that is treated as a 5-percent shareholder owning 100 percent of the stock of L_1. See paragraph (j)(1)(iv)(C) of this section.

(iii) Public P and Public L_1 are treated as unrelated, individual 5-percent shareholders under paragraph (j)(1)(iii) of this section. Although the members of one public group are presumed not to be members of any other public group under paragraph (j)(1)(iii) of this section, L_1 has actual knowledge that all of its public shareholders immediately following the distribution (Public L_1) received L_1 stock pro rata in respect to the outstanding P stock and thus were also members of Public P. Applying paragraph (k)(2) of this section, the loss corporation may take into account the identity of ownership interests between Public L_1 and Public P to establish that Public L_1 did not increase its percentage ownership in L_1. Accordingly, the transaction would not constitute an owner shift.

Example (3). (i) The facts are the same as in Example (1) of paragraph (g)(4) of this section. Thus, 20 percent of L stock is owned by A, 10 percent is owned by P_1, 20 percent is owned by E, a joint venture, and the remaining 50 percent of L stock is owned by Public L. P_1 is owned 15 percent by B and 85 percent by Public P_1. E is owned 30 percent by P_2 and 70 percent by P_3, which are owned by Public P_2 and Public P_3, respectively. See Example (1)(ii) of paragraph (g)(4) of this section for a chart illustrating this ownership structure.

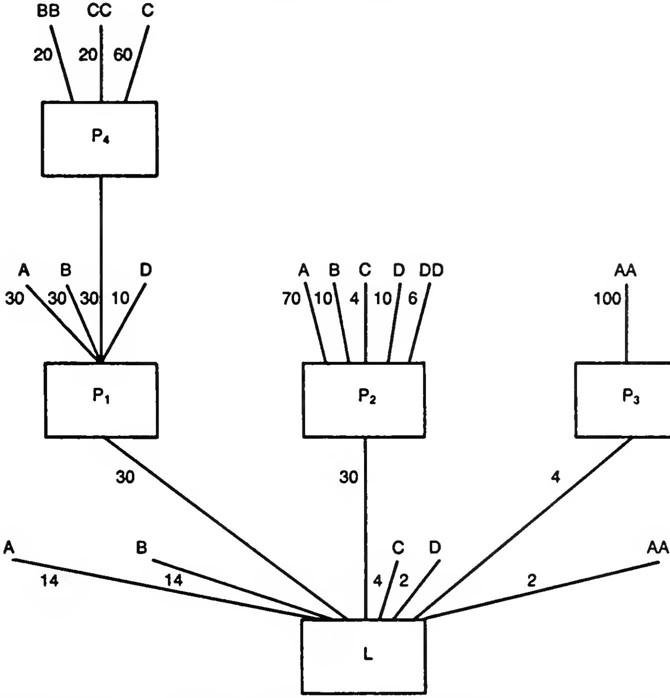
(ii) The public owners of P_2 and P_3 (Public P_2 and Public P_3, respectively), are public groups that are treated as 5-percent shareholders of L, because each such public group indirectly owns five percent or more of L stock (six percent by Public P_2 [(30 percent ownership of E)$\times$(20 percent ownership of L)] and 14 percent by Public P_3 [(70 percent ownership of E)$\times$(20 percent ownership of L)]). The public owners of P_1 ("Public P_1"), who indirectly own 8.5 percent of L stock [(85 percent ownership of P_1)$\times$(10 percent ownership of L)] and B, who indirectly owns 1.5 percent of L and is thus included in Public P_1 under paragraph (j)(1)(iv)(A) of this section, are members of a public group that is treated as a 5-percent shareholder of L that owns ten percent of L stock. Finally, the public group of L ("Public L") is a 5-percent shareholder that owns 50 percent of L. Accordingly, A, Public L, Public P_1 (including B), Public P_2, and Public P_3 are the only 5-percent shareholders of L.

Example (4). (i) The facts are the same as Example (3) above, except that P_3 is owned 60 percent by C, 30 percent by P_4, and 10 percent by P_3. The stock of P_4 is publicly traded and is owned by Public P_4. The facts are thus the same as in Example (2) in paragraph (g)(4) of this section. See Example (2)(ii) of paragraph (g)(4) of this section for a chart illustrating this ownership structure.

(ii) The public owners of P_4 (a highest tier entity) are members of a public group that indirectly owns 4.2 percent of L ([30 percent ownership of P_3]×[70 percent ownership of E]×[20 percent ownership of L]). For purposes of identifying public groups that are 5-percent shareholders, L is not required to identify P_4 as a highest tier entity under paragraph (k)(3) of this section because P_4 does not own five percent or more of L stock. Moreover, under paragraph (h)(2)(iii) of this section, P_4 generally is treated as an individual from which there is no attribution of loss corporation stock. The public group of P_3 (including P_4) indirectly owns 5.6 percent of L ([40 percent of P_3]×[70 percent ownership of E]×[20 percent of L]), and is thus a 5-percent shareholder of L. The public groups of P_2 and P_1 (both Public P_1 and B), respectively, also own five percent or more of L stock and are thus 5-percent shareholders of L. In addition, the public group of L is a 5-percent shareholder regardless of whether it owns five percent of L stock. Accordingly, A, Public L, Public P_3 (including P_4), Public P_2, and Public P_1 (including B), are the only 5-percent shareholders of L.

Example (5). (i) On September 4, 1987, L is owned 14 percent by each of A and B, 30 percent by each of P_1 and P_2, four percent by each of C and P_3, and two percent by each of D and AA. P_1 is owned 30 percent by each of A, B, and P_4 and 10 percent by D. P_2 is owned 70 percent by A, 10 percent by each of B and D, six percent by DD and four percent by C. AA owns 100 percent of the stock of P_3. P_4 is owned 60 percent by C and 20 percent by each of BB and CC.

(ii) The ownership structure of L is illustrated by the following chart:



(iii) In order to identify L's 5-percent shareholders and their respective ownership interests in L on September 4, 1987, the rules of paragraph (j)(1) of this section apply to identify the public groups that are treated as separate 5-percent shareholders. Analysis begins with any highest tier entity, such as P_4. Each of P_4's shareholders is a 5-percent owner of P_4. C^4 owns 5.4 percent of L in his capacity as a 5-percent owner of P_4 and therefore is a 5-percent shareholder. Notwithstanding that C actually owns, directly and by attribution, 10.6 percent of L (four percent directly, 5.4 percent indirectly through P_4, and 1.2 percent through P_2), C's ownership interest in L as a 5-percent shareholder is presumed to include only the 5.4 percent indirect ownership through P_4. (Under paragraphs (g) and (k)(2) of this section, however, L must account for C's direct and indirect ownership interests in determining whether an ownership change occurs on any testing date if it has actual knowledge of such ownership on or before the date that its income tax return is filed for the taxable year that includes the testing date). Although BB and CC are each 5-percent owners of P_4, they are not 5-percent shareholders and therefore are

members of the public group of P_4. Because the public group of P_4 indirectly owns only 3.6 percent of L, it is treated under paragraph (j)(1)(iv)(A) of this section as part of the public group of the next lower tier entity, P_1.

(iv) With respect to P_1, a first tier entity, each of its shareholders are 5-percent owners. Because A and B each indirectly own nine percent of L as 5-percent owners of P_1 and A indirectly owns 21 percent of L as a 5-percent owner of P_2, they are each 5-percent shareholders without regard to their direct ownership interests in L. A's ownership interest in L as a 5-percent shareholder is 44 percent (14 percent directly, nine percent in his capacity as a 5-percent owner of P_1, and 21 percent in his capacity as a 5-percent owner of P_2). B's ownership interest in L as a 5-percent shareholder is 23 percent (14 percent directly and nine percent in his capacity as a 5-percent and nine percent in his capacity as a 5-percent owner of P_1). B's ownership interest as a 5-percent shareholder does not include the three percent interest he owns indirectly through P_2. (Under paragraphs (g) and (k)(2) of this section, however, L must account for B's direct and indirect ownership interests, including his three percent interest through P_2, in determining whether an ownership change occurs on any testing date if L has actual knowledge of such ownership on or before the date that its income tax return is filed for the taxable year that includes the testing date.) D is a 5-percent owner of P_1. Although D owns eight percent of L (two percent directly, three percent indirectly through P_1, and three percent indirectly through P_2), he is not a 5-percent shareholder because he does not own five percent or more of L stock either directly or in his capacity as a 5-percent owner of either P_1 or P_2. (Under paragraphs (g) and (k)(2) of this section, however, L must account for D's direct and indirect ownership interests in determining whether an ownership change occurs on any testing date to the extent L has actual knowledge of such ownership amounting to five percent or more of L stock before the date that its income tax return is filed for the taxable year that includes the testing date.) The public group of P_1 (comprised of the public group of P_4 and D's direct ownership interest in P_1) has a 6.6 percent interest in L and is therefore treated as a separate 5-percent shareholder.

(v) With respect to highest tier entity P_2, D is a 5-percent owner who is not a 5-percent shareholder for the reason described in the preceding subdivision. DD is a 5-percent owner of P_2, who is not a 5-percent shareholder, because DD indirectly owns only 1.8 percent of L. Assuming that L does not have actual knowledge of B's and C's direct ownership interest in P_2, those interests are accounted for in computing the ownership interest of the public group of P_2. Therefore, each of P_2's shareholders, except A who is a 5-percent shareholder in his capacity as a 5-percent owner of P_2, are treated as members of the public group of P_2 that owns nine percent of L and is thus treated as a separate 5-percent shareholder.

(vi) Because the direct ownership interest of P_3 is less than five percent, it is a public shareholder. Therefore, assuming that L does not have actual knowledge of C's, D's, or AA's direct and/or indirect ownership interests in L, the public group of L is a separate 5-percent shareholder owning 12 percent of L (comprised of the direct ownership interests of C, D, AA and P_3).

(2) Segregation rules applicable to transactions involving the loss corporation—(i) In general. For purposes of this section, if—

(A) A transaction is described in paragraph (j)(2)(iii) of this section, and

(B) The loss corporation has one or more direct public groups immediately before and after the transaction,

the stock owned by such direct public group or groups is subject to the segregation rules described in paragraph (j)(2)(iii) of this section for purposes of determining whether an ownership change has occurred on the date of the transaction (and on any subsequent testing date with a testing period that includes the date of such transaction). See paragraph (j)(3) of this section for the application of the rules of this paragraph (j)(2) to transactions involving first tier entities or higher tier entities.

(ii) Direct public group. For purposes of this section, a direct public group is any public group of the loss corporation described in paragraph (j)(1)(iv)(C) of this section or any public group of the loss corporation resulting from the application of paragraph (j)(2)(iii) or (j)(3)(i) of this section.

(iii) Transactions to which segregation rules apply—(A) In general. The segregation rules of this paragraph (j)(2)(iii) apply to any transaction described in paragraph (j)(2)(iii) (B), (C), (D), (E), or (F) of this section in the manner specified. The presumptions adopted by this paragraph (j)(2)(iii) shall not apply only if, and to the extent that, the loss corporation either has actual knowledge of facts to the contrary regarding its stock ownership and is thus subject to paragraph (k)(2) of this section, or is subject to paragraph (k)(4) of this section. Any direct public group that is required to be identified as a result of a transaction described in paragraph (j)(2)(iii) of this section shall be treated as a 5-percent shareholder under paragraph (g)(1)(iv) of this section without regard to whether such group, at any time during the testing period, owns five percent or more of the loss corporation stock. To the extent that the presumptions are rebutted, the public shareholders, public owners and 5-percent owners who are not 5-percent shareholders may be aggregated into additional public groups.

(B) Certain equity structure shifts and transactions to which section 1032 applies—(*1*) In general. In the case of—

(*i*) A transaction that is an equity structure shift that also is described in section 381(a)(2) and in which the loss corporation is a party to the reorganization, or

(*ii*) A transfer of the stock of the loss corporation (including treasury stock) by the loss corporation in any other transaction to which section 1032 applies,

each direct public group that exists immediately after such transaction shall be segregated so that each direct public group that existed immediately before the transaction is treated separately from the direct public group that acquires stock of the loss corporation in the transaction. The direct public group that acquires stock of the loss corporation in the transaction is presumed not to include any members of any direct public group that existed immediately before the transaction. For purposes of this paragraph (j)(2)(iii)(B), a person is treated as acquiring stock of the loss corporation in a reorganization as the result of the person's ownership interest in another corporation that succeeds to the loss corporation's pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) in a transaction to which section 381(a)(2) applies. In determining whether a transaction is described in section 1032 for purposes of this paragraph (j)(2)(iii)(B), the transfer by the loss corporation of any interest not constituting stock that is treated as stock under paragraph (f)(18)(iii) of this section shall be treated as the transfer of stock.

(2) Examples.

Example (1). (i) P_1 owns 60 percent of the stock of L. The remaining L stock (40 percent) is owned by Public L. A owns 40 percent of the P_1 stock. The remaining P_1 stock (60 percent) is owned by Public P_1. P_2 is a publicly traded corporation owned by shareholders who each own less than five percent of P_2 stock (Public P_2).

(ii) On May 22, 1988, L merges into P_2 in a transaction described in section 368(a)(1)(A), with the shareholders of L receiving an amount of P_2 stock equal to 70 percent of the value of P_2 immediately after the reorganization.

(iii) Immediately before the merger, L's 5-percent shareholders were Public L (40 percent), Public P_1 (36 percent), and A (24 percent). Although the shareholders of P_2 (immediately before the merger) do not acquire any stock in the merger, they are treated as acquiring a direct ownership interest in the loss corporation in the reorganization because P_2 succeeds to the pre-change losses of L in a transaction to which section 381(a)(2) applies. As a result of the merger, which constitutes a transaction described in (j)(2)(iii)(B)(1) of this section, L's direct public group, Public L, must be segregated from the direct public group that would otherwise exist after the transaction (Public L and Public P_2). Public L, the direct public group that exists before the merger, has a continuing 28 percent interest in the loss corporation [70 percent of P_2 shares received in the merger x 40 percent shares of L owned prior to the merger] that must be segregated from the interests acquired by Public P_2.

(iv) In addition, Public P_1, which owns five percent or more of the stock of P_2 through P_1's ownership interest in P_2. also is segregated from any other public group (i.e., both Public L and Public P_2) under paragraph (j)(1) of this section. Therefore, under paragraphs (j)(1) and (2) of this section, Public P_2 (excluding the members of Public L and Public P_1 immediately before the merger) is treated as a separate public group and 5-percent shareholder.

(v) The only 5-percent shareholder whose interest in the loss corporation, P_2, has increased during the testing period is Public P_2. Its interest has increased by 30 percentage points. Accordingly, no ownership change results from the merger. For purposes of measuring the shift in ownership of P_2 on any subsequent testing date with a testing period that includes May 22, 1988 (the date on which L merged into P_2), Public P_2 will continue to be treated as a direct public group, separate from Public L (the members of which own P_2 stock as a result of the merger) and Public P_1 .

Example (2). (i) P and L are each owned by 21 equal shareholders. Each of 14 of the shareholders of P and L are owners of both corporations ("common owners"). L has actual knowledge of this cross ownership. therefore, as a group, these persons own 66⅔ percent of each of P and L. P stock has a value of $600 and L stock has a value of $400.

(ii) P merges into L under section 368(a)(1)(A) on June 10, 1988. Ordinarily, the direct public group of L that exists immediately before the transaction would be segregated from the direct public group that acquires stock in the merger (the public group of P immediately before the merger). In view of the common ownership of P and L, however, a third group may be created under paragraph (j)(2)(iii)(A) of this section so that L's owners following the merger would be: The common owners (66⅔ percent), Public L, less the common owners, 13 ⅓ percent), and Public P, less the common owners (20 percent). Accordingly, the only 5-percent shareholder increasing its ownership interest by 20 percentage points and no ownership change occurs as a result of the merger.

Example (3). (i) L is entirely owned by Public L. L commences and completes a public offering of common stock on January 22, 1988, with the result that its outstanding stock increases from 100,000 shares to 300,000 shares. No person owns as much as five percent of L stock following the public offering.

(ii) The public offering of L stock is a transaction to which section 1032 applies. Immediately before the public offering, L's only 5-percent shareholder was Public L, a direct public group. Therefore, Public L (as in existence immediately before the transaction) must be segregated from the direct public group that would otherwise exist immediately after the transaction. Under paragraph (j)(2)(iii)(B)(1) of this section, the acquisition of 200,000 shares of L stock in the public offering must be treated as acquired by a direct public group ("New Public L") that is separate from Public L. Each such public group is treated as an individual that is a separate 5-percent shareholder. See paragraphs (g)(1)(iv) and (j)(1)(ii) of this section.

(iii) As a result of the public offering, L has two 5-percent shareholders, Public L and New Public L, which own 33⅓ percent and 66⅔ percent of the stock of L, respectively. Because the members of New Public L are presumed not to be members of Public L (and not to be related to any such members), the ownership interest of New Public L immediately prior to the offering of stock was 0 percent.

(iv) New Public L is a 5-percent shareholder that has increased its ownership interest in L by more than 50 percentage points during the testing period (by 66⅔ percentage points). Thus, there is an ownership change with respect to L. For purposes of subsequent transactions, Public L and New Public L will not be segregated into two public groups because a new testing period commences on the day following the change date, January 23, 1988 (i.e., any subsequent testing date will not have a testing period that includes the date of the public offering).

Example (4). The facts are the same as in Example (3), but L establishes that 60,000 shares of the newly issued L stock

were acquired by its shareholders of record on the date of the stock issuance (i.e., members of Public L, referred to as Acquiring Public L) by persons owning 27 percent of the L stock immediately before the stock issuance. Accordingly, L has actual knowledge that New Public L acquired no more than 140,000 shares of L stock in the public offering. Under paragraphs (j)(2)(iii) and (k)(2) of this section, New Public L may be treated as having increased its ownership interest in L by 46⅔ percentage points (140,000 shares acquired in the offering/300,000 shares outstanding). L also has actual knowledge that the members of Public L owning 27 percent of L stock immediately before the stock issuance (27,000 shares/100,000 shares outstanding) own 29 percent of L stock immediately after such issuance ([27,000 shares + 60,000 shares acquired in the offering]/300,000 shares outstanding). Assuming that L chooses to take its actual knowledge into account for purposes of determining whether an ownership change occurred on January 22, 1988, Public L is segregated into two direct public groups immediately before the stock issuance so that the two percentage point increase in the ownership interest in L by Acquiring Public L is taken into account. The total increased ownership interest in L by New Public L and Acquiring Public L on the testing date over their lowest ownership interest during the testing period is 48 ⅔ percent. Thus, no ownership change occurs with respect to L.

Example (5). (i) L is owned entirely by 10,000 unrelated individuals, none of whom own as much as five percent of L stock ("Public L"). P is owned entirely by 1,500 unrelated individuals, none of whom own as much as five percent of P stock ("Public P"). On December 22, 1988, L acquires all of the P stock from Public P in exchange for L stock representing 25 percent of the value of L, in a transaction described in section 368(a)(1)(B).

(ii) Under paragraph (j)(2)(iii)(B)(1) of this section, Public L, the direct public group that owns L stock immediately before and after the transaction to which section 1032 applies, is treated separately from Public P, the direct public group that acquires L stock in the transaction. Because Public P's percentage ownership interest in L increases to only 25 percent (as compared with 0 percent before the acquisition), no ownership change occurs. For purposes of determining whether an ownership change occurs on any testing date with a testing period that includes December 22, 1988, Public L and Public P will continue to be treated as separate 5-percent shareholders.

(iii) See Example (4) in paragraph (j)(3)(iv) of this section for the application of paragraph (j)(2)(iii)(B) of this section to a reorganization under section 368(a)(1)(B) in which the loss corporation is acquired.

(C) Redemption-type transactions—(1) In general. In the case of a transaction in which the loss corporation acquires its stock in exchange for property, each direct public group that exists immediately before the transaction shall be segregated at that time (and thereafter) so that the stock that is acquired in the transaction is treated as owned by a separate public group from each public group that owns the stock that is not acquired. For purposes of the preceding sentence, the term property shall include stock described in section 1504(a)(4) and stock described in paragraph (f)(18)(ii) of this section. Each direct public group that owned the stock that is acquired in the transaction is presumed not to own any such stock immediately after the transaction.

(2) Examples.

Example (1). L is entirely owned by Public L. There are 500,000 shares of L stock outstanding. On July 12, 1988, L acquires 150,000 shares of its stock for cash. Because L's acquisition is a redemption, Public L is segregated into two different public groups immediately before the transaction (and thereafter) so that the redeemed interests ("Public RL") are treated as part of a public group that is separate from the ownership interests that are not redeemed ("Public CL"). Therefore, as a result of the redemption, Public CL's interest in L increases by 30 percentage points (from 70 percent (350,000/500,000) to 100 percent) on the July 12, 1988 testing date. Because the resulting increase is not more than 50 percentage points, no ownership change occurs. For purposes of determining whether an ownership change occurs on any subsequent testing date having a testing period that includes such redemption, Public CL is treated as a 5-percent shareholder whose percentage ownership interests in L increased by 30 percentage points as a result of the redemption.

Example (2). L is entirely owned by Public L. There are 250,000 shares of L common stock outstanding. On April 22, 1988, L acquires 100,000 shares of its outstanding common stock in exchange for 100,000 shares of preferred stock described in section 1504(a)(4). (The transaction thus constitutes a recapitalization within the meaning of section 368(a)(1)(E).) As a result of the recapitalization, which is a transaction described in paragraph (j)(2)(iii)(C) of this section, Public L is segregated into two different public groups immediately before the transaction (and thereafter) so that the stock acquired by L is treated as owned by a public group ("Public RL") that is separate from the public group that owns the stock that is not so acquired ("Public CL"). Therefore, as a result of the transaction, Public CL's interest in L increases by 40 percentage points (from 60 percent to 100 percent). Because the resulting increase is not more than 50 percentage points, no ownership change occurs. For purposes of determining whether an ownership change occurs on any subsequent testing date with a testing period that includes the date of the recapitalization, Public CL is treated as a separate 5-percent shareholder whose percentage ownership interest increased by 40 percentage points as a result of the redemption type transaction.

(D) Acquisition of loss corporation stock as the result of the ownership of a right to acquire stock—(1) In general. In the case of a deemed acquisition of stock of the loss corporation as the result of the ownership of a right issued by the loss corporation to acquire such stock (see paragraph (h)(4) of this section), each direct public group that exists immediately after such acquisition shall be segregated so that each direct public group that existed immediately before the transaction is treated separately from the direct public group that is deemed to acquire stock of the loss corporation as a result of the ownership of the right to acquire such stock. The direct public group that is treated as acquiring stock of the loss corporation in the transaction is presumed not to include any members of any direct public group that existed immediately before the transaction. In applying the rules of paragraph (h)(4) of this section, the segregation rules of this paragraph (j)(2)(iii)(D) shall

apply before making the determination required under that paragraph (h)(4) of this section.

(2) Example.

(i) L has 700,000 shares of common stock outstanding. Public L owns all of the outstanding L common stock. On May 20, 1988, L issues a class of debentures to the public that, in the aggregate, may be converted into 300,000 shares of L common stock. On September 7, 1988, P_1 acquires 210,000 shares of L common stock over a public stock exchange. None of the L debentures have been converted as of that date.

(ii) By virtue of L's issuance of convertible debentures, May 20, 1988 is a testing date. See paragraph (a)(2)(i) of this section. Immediately before the issuance of the convertible debentures, L's only 5-percent shareholder was Public L, a direct public group. Therefore, under paragraph (j)(2)(iii)(D) of this section, Public L must be segregated from the direct public group that would otherwise exist immediately after the transaction for the purpose of applying paragraph (h)(4) of this section, so that any acquisition of L stock through the conversion of L's debentures is treated as made by a public group other than Public L ("New Public L"). Assuming the largest increase in the total percentage stock ownership of New Public L on the testing date (see paragraph (h)(4) of this section), New Public L would have increased its ownership interest in L by 30 percentage points. Therefore, the stock of L would not be treated as acquired pursuant to a deemed conversion of the L debentures on May 20, 1988, under paragraph (h)(4) of this section, because the conversion would not cause an ownership change.

(iii) P_1's acquisition of L common stock results in second testing date. For the purpose of applying paragraph (h)(4) of this section, Public L must again be segregated from the direct public group that would otherwise result from conversion of the debentures, so that a deemed acquisition of L stock through the conversion of L's debentures on September 7, 1988 is treated as made by a public group other than Public L ("New Public L"). As on the previous testing date, New Public L would have increased its ownership interest in L by 30 percentage points if it were treated as having acquired L common stock pursuant to the conversion of the L debentures. The increase in New Public L's ownership, taken together with P_1's 21 percentage point ownership increase in L during the testing period [210,000 shares deemed converted/(700,000 (actual) + 300,000 (deemed) shares outstanding)], results in an ownership change.

(E) Transactions identified in the Internal Revenue Bulletin. Any transaction that is designated by the International Revenue Service in the Internal Revenue Bulletin shall be subject to the rules, as provided in such bulletin, similar to the rules described in this paragraph (j)(2)(iii).

(F) Issuance of rights to acquire loss corporation stock—(1) In general. In the case of any transaction that is described in paragraph (j)(2)(iii) (B), (D) or (E) of this section in which the loss corporation issues rights to acquire its stock to the members of more than one public group, those rights shall be presumed to be exercised pro rata by each such public group as those rights are actually exercised.

(2) Example.

(i) L, which has six million shares outstanding, is owned entirely by Public L and P is owned entirely by Public P. On November 30, 1988, P merges into L in a transaction qualifying under section 368(a)(1)(A) with Public P receiving four million shares of L stock as a result of the reorganization. Under paragraph (j)(2)(iii)(B) of this section, Public L and Public P continue to be treated as separate public groups following the merger. Pursuant to the plan of reorganization, L also issues an amount of warrants in L stock pro rata to Public L and Public P that, if exercised, would result in the issuance of an additional two million shares of L stock. On November 30, 1989, when only one-half of the outstanding warrants have been exercised, A acquires all of the unexercised warrants.

(ii) Without regard to the warrants distributed in reorganization, Public P's ownership interest in L increases by 40 percentage points on November 30, 1988, relative to its lowest ownership interest in L at any time during the testing period (0 percent prior to the merger). For purposes of determining whether an ownership change occurs on November 30, 1988, the segregation rules of paragraphs (j)(2)(iii) (B) and (D) of this section does not require that a third direct public group be separately identified and treated as acquiring the warrants, because L has actual knowledge that Public L and Public P acquired the distributed warrants in proportion to their respective ownership interests in L stock. Because the largest increase in the ownership of L on the testing date results from treating only Public P as exercising the distributing warrants, in which event, its ownership interest would increase by 44.4 percentage points ([four million shares acquired in the merger + 800,000 shares deemed acquired]/10.8 million (actual and deemed) shares outstanding), the issuance of the warrants by L does not cause an ownership change on November 30, 1988.

(iii) Under paragraph (j)(2)(iii)(F)(1) of this section, each actual exercise of warrants to acquire one million shares of L stock between November 30, 1988 and November 30, 1989 is treated as made pro rata by Public L and Public P (600,000 shares to Public L and 400,000 shares to Public P). Accordingly, as a result of the actual exercises of warrants during that period the ownership interests of the only 5-percent shareholders, Public L and Public P, are proportionately increased.

(iv) A's acquisition of all of the outstanding warrants on November 30, 1989 requires the determination whether there has been an ownership change with respect to L, because A would be 5-percent shareholder under paragraph (g)(1)(i) of this section owning 8⅓ percent of the L stock if the acquired warrants were exercised (one million shares deemed acquired/12 million (actual and deemed) shares outstanding). See paragraph (a)(2)(i) of this section. Under paragraph (h)(4)(i) of this section, A is not treated as having exercised those warrants, because an ownership change would not result. (Public P's 36⅔ percentage point increase [(four million shares acquired in the merger + 400,000 shares deemed acquired)/12 million (actual and deemed) shares outstanding] and A's 8⅓ percentage point increase is not greater than 50 percentage points).

(iv) Combination of de minimis public groups— (A) In general. Notwithstanding paragraph (j)(2)(iii)(A) of this section, any public group first identified during a taxable year, as a result of any transaction described in paragraph (j)(2)(iii) (B), (D), (E), or (F) of this section, that owns less than five percent of loss corporation stock may be combined, at the option of the loss corporation, with any other such groups also first identified as

a result of any such transaction that occurs during such taxable year.

(B) Example.

(i) L is widely held with no person owning as much as five percent of the L stock at any time ("Public L"). L's taxable year ends on December 31. On January 1, 1989, L issues a class of debt maturing on December 31, 2019 ("Class A Debentures") with respect to which it will semi-annually issue L stock in discharge of its interest obligation. In addition, L issues an amount of L stock to the public in two separate transactions during 1989. As a percentage of the L stock outstanding at the close of L's taxable year on December 31, 1989, L issued .45 percent of its stock on each of two dates in payment of interest with respect to the Class A Debentures, 4.5 percent of its stock in the first stock offering and six percent of its stock in the second stock offering. During 1990, L did not issue stock other than in payment of interest with respect to the Class A Debentures. As a percentage of L stock outstanding on December 31, 1990, L issued .41 percent of its stock on each of two dates during 1990 with respect to its outstanding debt.

(ii) Under paragraph (h)(4)(x)(E) of this section, L's obligation to issue stock in satisfaction of the interest with respect to the Class A Debentures until December 31, 2019, is not subject to paragraph (h)(4)(i) of this section and thus is taken into account only as such stock is issued.

(iii) The application of the segregation rules of paragraphs (j)(2) (iii)(B) and (iv) of this section require the identification of at least two additional, separate direct public groups during 1989. First, the persons who acquire six percent of L stock in a public offering to which section 1032 applies must be treated as a separate 5-percent shareholder ("Public 1L"). See paragraph (j)(2)(iii)(B) of this section. Even though this group was first identified in 1989, it may not be combined with other public groups also first identified in 1989 because it owns five percent or more of L stock. Second, although each of the three other issuances of L stock during the year ordinarily result in the identification of an additional, separate direct public group, each such direct public group may be combined with the two other such groups into a single public group ("Public 2L"). As of the end of 1989, Public 2L would own a total of 5.4 percent of the stock of L.

(iv) The application of the segregation rules of paragraphs (j)(2) (iii)(B) and (iv) of this section require the identification of at least one additional, direct public group during 1990. Because each additional, direct public group first identified in 1990 acquires less than five percent of L stock, they may be combined into a single public group ("Public 3L") owning .82 percent of the stock of L. Public 3L is treated as a five percent shareholder even though it owns less than five percent of the stock of L. See paragraph (j)(2)(iv)(A) of this section.

(v) Multiple transactions—(A) In general. If a transaction (or any part thereof) is described by more than one subdivision of paragraph (j)(2)(iii) of this section, each such subdivision shall apply to the transaction (or each part of the transaction) in the manner that results in the largest increase in the percentage stock ownership by the 5-percent shareholders.

(B) Example.

(i) All of the common stock of L is owned by 1,000 unrelated persons, none of whom owns as much as five percent of the L stock ("Public CL"). L has outstanding a class of preferred stock described in section 1504(a)(4) that is owned in equal amounts by 500 unrelated persons ("Public PL").

(ii) On September 4, 1988, L rearranges its capital structure by redeeming 70 percent of the common stock owned by 700 of the shareholders in exchange for cash. In addition, all of the preferred stock is exchanged for a new class of common stock (nonvoting) representing 40 percent of the value of L.

(iii) With respect to the part of the transaction that is treated as a redemption under paragraph (j)(2)(iii)(C) of this section (the exchange of common stock for cash), Public CL is segregated into two different public groups immediately before the transaction (and thereafter) so that the owners of the redeemed stock ("Public RCL") are treated as part of a public group that is separate from the public group comprised of the owners of the stock that is not redeemed ("Public CCL"). As a result of the redemption, Public CCL's percentage ownership interest in L thus increases by 30 percentage points from 30 percent to 60 percent (taking into account all transactions occurring on the testing date, because the change in ownership is measured under paragraph (a)(1)(i) of this section by reference to each 5-percent shareholder's ownership interest immediately after the testing date). In addition, the exchange of preferred stock for nonvoting common stock is a transaction to which section 1032 applies. Under paragraph (j)(2)(v) of this section, the part of the transaction to which section 1032 applies is also subject to the segregation rules in the manner specified in paragraph (j)(2)(iii)(B) of this section. Accordingly, Public PL, the direct public group that acquires L nonvoting common stock in exchange for L preferred stock, must be treated as a separate public group from the other direct public groups, Public CCL and Public RCL. As a separate public group, Public PL's percentage stock ownership in L increases by 40 points (as compared to 0 percent prior to the transaction).

(iv) In summary, Public CCL increases its percentage ownership in L by 30 percentage points and Public PL increases its percentage ownership by 40 percentage points. Consequently, an ownership change occurs with respect to L on September 4, 1988.

(vi) Acquisitions made by either a 5-percent shareholder or the loss corporation following application of the segregation rules. Unless a different proportion is established by either the loss corporation or the Internal Revenue Service, the acquisition of loss corporation stock by either a 5-percent shareholder or the loss corporation on any date on which more than one public group of the loss corporation exists by virtue of the application of the rules of this paragraph (j)(2) shall be treated as being made proportionately from each public group existing immediately before such acquisition. See paragraph (g)(5)(i)(B) of this section for the application of this paragraph to the ownership interest of a 5-percent shareholder that owns less than five percent of the stock of the loss corporation on the testing date.

(3) Segregation rules applicable to transactions involving first tier entities or higher tier entities—(i) Dispositions. If a loss corporation is owned, in whole or in part, by a public group (or groups), the rules of paragraphs (j)(2) (iii)(B) and (iv) of this section shall apply to any transaction in which a first tier entity or an individual that owns a

direct ownership interest in the loss corporation of five percent or more transfers a direct ownership interest in the loss corporation to public shareholders. Therefore, each direct public group that exists immediately after such a disposition shall be segregated so that the ownership interests of each public group that existed immediately before the transaction are treated separately from the public group that acquires stock of the loss corporation as a result of the disposition by the individual or first tier entity. The principles of this paragraph (j)(3)(i) shall also apply to transactions in which an ownership interest in a higher tier entity that owns five percent or more of the loss corporation (determined without regard to the application of paragraph (h)(2)(i)(A) of this section) or a first tier entity is transferred to a public owner or 5-percent owner who is not a 5-percent shareholder.

(ii) Example.

(A) L is owned equally by Public L, P and E. Public L consists of 150 equal, unrelated shareholders. P is owned by Public P, a group consisting of 1,500 equal, unrelated shareholders. E is a partnership and none of its partners are 5-percent owners. On October 22, 1988, E sells its entire interest in L over a public stock exchange. No individual or entity acquires as much as five percent of L's stock as the result of E's disposition of the L stock.

(B) The disposition of the L stock by E is a transaction that causes the segregation of L's direct public group that exists immediately before the transaction (Public L) from the direct public group that acquires L stock in the transaction (Public EL). As a result, L has three 5-percent shareholders, Public L, Public P (through the application of paragraph (j)(1) of this section) and Public EL, each of which owns 33⅓ percent of L stock. Therefore, Public EL is a 5-percent shareholder that has increased its ownership interest in L by 33⅓ percentage points during the testing period. For purposes of subsequent transactions, Public L and Public EL will continue to be treated as separate direct public groups until any subsequent testing date that does not have a testing period that includes E's disposition of L stock.

(iii) Other transactions affecting direct public groups of a first tier entity or higher tier entity. The rules of paragraphs (j)(2) (i), (iii), (iv) and (v) of this section shall apply to transactions described in such paragraphs that involve either a higher tier entity that owns five percent or more of the loss corporation (determined without regard to the application of paragraph (h)(2)(i)(A) of this section) or a first tier entity. In applying those rules for purposes of this paragraph (j)(3)(iii), each direct public group of a first tier entity or a higher tier entity is any public group of any such entity identified in paragraph (j)(1)(iv) (A) or (B) of this section or resulting from the application of this paragraph (j)(3)(iii). The principles of paragraph (j)(2)(iii)(C) of this section also shall apply to any transaction that has the effect of a redemption-type transaction (e.g., an acquisition by the loss corporation of stock in a first tier entity).

(iv) Examples.

Example (1). The facts are the same as in Example (1) of paragraph (j)(2)(iii)(B)(2) of this section, except that Public L and P_1 own 40 percent and 60 percent, respectively, of the stock of HC which, in turn, owns 100 percent of L and HC merges into P_2. Under paragraph (j)(3)(iii) of this section, the rules of paragraph (j)(2)(iii)(B) of this section apply to segregate HC's direct public group (Public L) immediately before the merger from the direct public group (Public P_2) that acquires loss corporation stock in the merger. The consequences of the merger of HC into P_2 are thus the same as in Example (1) of paragraph (j)(2)(iii)(B)(2) of this section.

Example (2). (i) Twenty-five individual shareholders each own four percent of L ("Public L"). Public L is therefore the only 5-percent shareholder of L. Each of the shareholders of L contribute their L stock to a newly formed corporation, HC. In exchange for their contribution of L stock, HC issues 100 percent of each of its two classes of common stock (voting and nonvoting).

(ii) The formation of HC, a first tier entity of L, is a transaction to which section 1032 applies. Under paragraph (j)(3)(iii) of this section, the rules of paragraphs (j)(1)(iii) and (j)(2)(iii)(B) of this section are applied to this transaction with the result that the shareholders of HC, immediately after the issuance of HC stock, are presumed not to include any persons that previously had a direct or indirect ownership interest in L. The presumption underlying those rules, however, is rebutted by establishing that all of the HC stock outstanding immediately after the transaction was issued solely in exchange for L stock. Thus, Public HC (immediately after the transaction) and Public L (immediately before the transaction) would be treated owned by the same direct public group.

Example (3). (i) All of the stock of L is owned by unrelated shareholders, none of whom owns as much as five percent of L stock. P also is owned by unrelated shareholders, none of whom owns as much as five percent of P stock. On November 22, 1988, P incorporates P_1 with a contribution of P stock. Immediately thereafter, P_1 acquires all of the properties of L in exchange for its P stock in a forward triangular merger qualifying under sections 368 (a)(1)(A) and (a)(2)(D). The P stock transferred by P_1 equals 45 percent of the total outstanding P stock.

(ii) Immediately before the merger of L into P_1, P's only 5-percent shareholder was Public P, a direct public group of P. The rules of paragraph (j)(2)(iii)(B) of this section thus apply to the transaction under paragraph (j)(3)(i) of this section since P, a first tier entity, is a party to the reorganization described in such paragraph. Although Public P does not acquire any stock in the merger, it is treated as acquiring stock in the loss corporation, P_1, because such corporation succeeds to the pre-change losses of L in a transaction to which 381(a) applies. As a result of the merger, Public P, the direct public group of P that exists immediately before the merger, must be segregated from the direct public groups acquiring P stock in the reorganization. Public P is, therefore, treated as acquiring 55 percent of the outstanding stock of the loss corporation, P_1, in the transaction. The transaction, therefore, results in an ownership change for P_1.

Example (4). (i) L is owned 20 percent by A and 80 percent by 1,000 unrelated individuals and entities, none of whom owns as much as five percent of L stock ("Public L"). P is owned 10 percent by B, 40 percent by E, and 50 percent by 5,000 unrelated individuals, none of whom owns as much as five percent of P stock ("Public P"). E is owned 30 percent by C

and 70 percent by 30 unrelated individuals, none of whom owns as much as five percent of E ("Public E").

(ii) On October 31, 1987, P acquires all of the L stock from A and Public L in exchange for P stock representing 20 percent of the value of P (determined immediately after the acquisition) in a transaction described in section 368(a)(1)(B). After the acquisition, P is owned eight percent by B, 32 percent by E, four percent by A, and 56 percent by 6,000 unrelated individuals, none of whom owns as much as five percent of P. Because L is wholly owned by P immediately after the acquisition, L, under paragraph (j)(1) of this section, is treated as owned as follows: Eight percent by B, 9.6 percent by C (through C's ownership interest in E, a highest tier entity, and E's ownership interest in P, a first tier entity), 22.4 percent by Public E (through its ownership interest in E and E's ownership interest in P), four percent by A, and 56 percent by the shareholders who each own less than five percent of L through their ownership interest in P.

(iii) Under paragraph (j)(3)(iii) of this section, the rules of paragraph (j)(2)(iii)(B) of this section apply to the reorganization since the transaction involved a first tier entity of L. Thus, the direct public group of P that exists immediately after the transaction must be segregated into two public groups—the direct public group of P that existed immediately before the acquisition (Public P) is treated separately from the direct public group consisting of the persons who acquire P stock in the transaction (Public L). Accordingly, immediately after the reorganization, Public P and Public L own 40 percent and 16 percent of L, respectively. See paragraph (h) of this section. (Under paragraph (g)(5)(ii)(B) of this section, L may treat the four percent of L stock owned by A immediately after the reorganization as the amount of L stock owned by A for each subsequent testing date having a testing period that includes the reorganization.)

(iv) In summary, after applying the rules of paragraphs (j) (1) and (3) of this section, L is treated as owned as follows:

5-percent shareholder	Percentage ownership interest
A	4.0
B	8.0
C	9.6
Public E	22.4
Public P	40.0
Public L	16.0

(v) The reorganization results in an ownership change, because B, C, Public E and Public P, all of whom are 5-percent shareholders, together have increased their percentage ownership in L by 80 percentage points as compared to their lowest percentage ownership in L at any time during the testing period (0 percent prior to the acquisition).

(v) Acquisitions made by a 5-percent shareholder, a higher tier entity, or a first tier entity following application of the segregation rules. The rules of paragraph (j)(2)(vi) of this section shall apply to the acquisition of an ownership interest in a first tier entity (or higher tier entity) if more than one direct public group of any such entity are segregated under the rules of this paragraph (j)(3). Accordingly, an acquisition by such an entity or a 5-percent shareholder of any ownership interest in such an entity shall be treated as made proportionately from the direct public groups resulting from the application of this paragraph (j)(3).

(k) Operating rules—(1) Presumptions regarding stock ownership. Subject to paragraphs (k) (2) and (4) of this section, for purposes of applying paragraphs (f), (g), (h), and (j)(1) of this section—

(i) Stock subject to regulation by the Securities and Exchange Commission. With respect to loss corporation stock that is described in Rule 13d-1(d) of Regulation 13D-G (or any rule or regulation to generally the same effect), promulgated by the Securities and Exchange Commission under the Securities and Exchange Act of 1934 ("registered stock"), a loss corporation may rely on the existence and absence of filings of Schedules 13D and 13G (or any similar schedules) as of any date to identify all of the corporation's shareholders who have a direct ownership interest of five percent or more (both individuals and first tier entities) on such date. A loss corporation may similarly rely on the existence and absence of such filings as of any date with respect to registered stock of any first tier entity or any higher tier entity to identify the 5-percent owners of any such entities on such date who indirectly own five percent or more of the loss corporation stock, and are thus 5-percent shareholders, and to identify any higher tier entities of such entities.

(ii) Statements under penalties of perjury. A loss corporation may rely on a statement, signed under penalties of perjury, by an officer, director, partner, trustee, executor or similar responsible person, on behalf of a first tier entity or a higher tier entity to establish the extent, if any, to which the ownership interests of any 5-percent owners or higher tier entities with respect to such entities have changed during a testing period. A loss corporation may not rely on such a statement (A) that it knows to be false or (B) that is made by either a first tier entity or higher tier entity that owns 50 percent or more of the stock of the loss corporation. For purposes of the preceding sentence, any first tier entities and higher tier entities that are known by the loss corporation to be members of the same controlled group (within the meaning of section 267(f)) shall be treated as one corporation.

(2) Actual knowledge regarding stock ownership. For purposes of this section (other than paragraphs (g)(5) and (j)(1)(v) of this section), to the extent that the loss corporation has actual knowledge of stock ownership on any testing date (or acquires such knowledge before the date that

the income tax return is filed for the taxable year in which the testing date occurs) by—

(i) An individual who would be a 5-percent shareholder, but for the application of paragraphs (h)(2)(iii), (h)(6)(iii) or (g)(2) of this section, or

(ii) A 5-percent shareholder that would be taken into account, but for paragraphs (h)(2)(iii), (h)(6)(iii) or (g)(3) of this section,

the loss corporation must take such stock ownership into account for purposes of determining whether an ownership change has occurred on that testing date. If a loss corporation acquires such knowledge after such income tax return is filed, the loss corporation may take such ownership into account for purposes of determining whether an ownership change occurred on that testing date and, if appropriate, file an amended income tax return (subject to any applicable statute of limitations). To the extent the loss corporation has actual knowledge on or after any testing date regarding the ownership interest in the loss corporation by members of one public group (described in paragraphs (g)(1) (ii), (iii) or (iv) of this section) and the ownership interest of those members in the loss corporation as members in another such public group, the loss corporation may take such ownership into account for purposes of determining whether an ownership change occurred on that testing date.

(3) Duty to inquire as to actual stock ownership in the loss corporation. For purposes of this section, the loss corporation is required to determine the stock ownership on each testing date (and, except as otherwise provided in this section, the changes in the stock ownership during the testing period) of—

(i) Any individual shareholder who has a direct ownership interest of five percent or more in the loss corporation,

(ii) Any first tier entity,

(iii) Any higher tier entity that has an indirect ownership interest of five percent or more in the loss corporation (determined without regard to paragraph (h)(2)(i)(A) of this section), and

(iv) Any 5-percent owner who indirectly owns five percent or more of the stock of the loss corporation in his capacity as a 5-percent owner in any one first tier entity or higher tier entity.

The loss corporation does not have any obligation to inquire or to determine facts relating to the stock ownership of any shareholders other than those described in the preceding sentence. In addition, the loss corporation does not have any obligation to inquire or to determine if the actual facts relating to the stock ownership of any shareholder are consistent with the ownership interests of the loss corporation as determined by applying the presumptions and other rules of paragraphs (g), (h), (j) or (k)(1) of this section.

(4) Ownership interest structured to avoid the section 382 limitation. For purposes of this section, if the ownership interests in a loss corporation are structured by a person with a direct or indirect ownership interest in the loss corporation to avoid treating a person as a 5-percent shareholder (or to permit the loss corporation to rely on the presumption provided in paragraph (g)(5)(i)(B) of this section) for a principal purpose of circumventing the section 382 limitation, then—

(i) Paragraph (h)(2)(iii) of this section shall not apply with respect to the ownership interests so structured and the constructive ownership rules of paragraph (h)(2)(i) of this section shall thus apply to attribute stock from any entity without regard to the amount of stock it owns in the loss corporation or any other corporation,

(ii) Paragraphs (g) (2) and (3) of this section shall be modified with respect to the ownership interests so structured so that the ownership interest of a person includes all of an individual's direct and indirect ownership in the loss corporation, without regard to whether each such interest represents five percent or more of the stock of the loss corporation, and

(iii) Paragraph (g)(5)(i)(B) of this section shall not apply with respect to the ownership interests so structured so that the ownership interest of a person takes into account his actual ownership interest in the loss corporation.

This paragraph (k)(4) shall apply, however, only if application would result in an ownership change.

(5) Example.

L is owned by 25 individuals who each own four percent of the outstanding L stock. A purchases 40 percent of L stock from such shareholders on August 13, 1988. Thereafter, B plans to acquire 15 percent of the L stock. B is advised concerning the potential application of section 382 to L. On February 1, 1989, B acquires a 15 percent interest in L pursuant to a program in which each of four corporations, P_1 through P_4, each of which is wholly-owned by B, acquire a 3.75 percent interest in L. A principal purpose of acquiring the L stock through four corporations is to avoid treating B as owning any ownership interest in L amounting to as much as five percent, and thus to circumvent the section 382 limitation by avoiding an ownership change. Under paragraph (k)(4) of this section, the limitation on the constructive ownership rules of paragraph (h)(2)(iii) of this section are disregarded and B is treated as a 5-percent shareholder owning 15 percent of the

stock of L by virtue of his ownership interests in P_1 through P_4, notwithstanding paragraph (g)(2) of this section. Accordingly, an ownership change occurs with respect to L.

(6) First tier entity or higher tier entity that is a foreign corporation or entity. [Reserved]

(*l*) Changes in percentage ownership which are attributable to fluctuations in value. [Reserved.]

(m) Effective Date—(1) In general. Except as provided in this paragraph (m), section 382 shall apply to any ownership change that occurs immediately after an owner shift or an equity structure shift that occurs after December 31, 1986, or any other event occurring after such date that requires the determination of whether an ownership change has occurred under paragraph (a)(2)(i) of this section. In the case of an equity structure shift (including an equity structure shift that also constitutes an owner shift), any equity structure shift completed pursuant to a plan of reorganization adopted before January 1, 1987, shall be treated as occurring on the date such plan was adopted. Therefore, section 382 shall apply to any ownership change occurring immediately after—

(i) An owner shift (excluding an owner shift that also constitutes an equity structure shift) that occurs on or after January 1, 1987,

(ii) An equity structure shift that occurs after December 31, 1986, if it is completed pursuant to a plan of reorganization adopted on or after January 1, 1987, or

(iii) Any transfer or issuance of an option, or other interest that is similar to an option, that occurs on or after January 1, 1987 and that is taken into account under paragraph (a)(2)(i) of this section.

With respect to equity structure shifts completed pursuant to plans adopted before January 1, 1987, section 382 shall be inapplicable only if the equity structure shift that is treated as occurring on the date the plan of reorganization for such shift was adopted (or other event occurring after the adoption of such plan) results in an ownership change before January 1, 1987. In that event, a new testing period for the loss corporation shall begin on the day after such ownership change.

(2) Plan of reorganization. For purposes of paragraph (m)(1) of this section, a plan of reorganization shall be treated as adopted on the earlier of—

(i) The first date that the boards of directors of all the parties to the reorganization have adopted the plan or have recommended adoption to their shareholders, or

(ii) The date the shareholders approve such reorganization.

If there is an ownership change with respect to a subsidiary as the result of a reorganization of the parent, the treatment of the subsidiary under this paragraph (m)(2) shall be governed by the classification of the parent-level transaction. For purposes of the preceding sentence, a corporation shall be treated as a subsidiary of another corporation only if the other corporation owns stock in that corporation meeting the requirements of section 1504(a)(2).

(3) Earliest commencement of the testing period. For purposes of determining if an ownership change has occurred at any time after May 5, 1986, the testing period shall begin no earlier than May 6, 1986. Under paragraph (d)(4) of this section, therefore, shifts in the ownership of stock of the loss corporation prior to May 6, 1986 are disregarded.

(4) Transitional rules—(i) Rules provided in paragraph (j) of this section for testing dates before September 4, 1987. For purposes of determining whether an ownership change occurs for any testing date before September 4, 1987—

(A) The rules of paragraph (j)(1) of this section shall apply only to stock of the loss corporation acquired after May 5, 1986, by any first tier entity or higher tier entity and shall not apply to any stock acquired by such an entity on or before that date,

(B) The rules of paragraph (j)(2) of this section shall apply only to equity structure shifts in which more than one corporation is a party to the reorganization and shall not apply to any other transactions, and

(C) The rules of paragraph (j)(3) of this section shall apply only to—

(1) Dispositions of stock acquired by an individual, a first tier entity or higher tier entity after May 5, 1986 (and shall not apply to dispositions of stock acquired on or before such date), and

(2) Equity structure shifts in which more than one corporation is a party to the reorganization (and shall not apply to any other transactions).

For any testing date before September 4, 1987, however, the loss corporation is permitted to apply all of the rules of paragraph (j) of this section. A loss corporation that applies the rules of paragraph (j) of this section under the preceding sentence must apply all of the rules of such paragraph in

determining whether any ownership change occurs on any testing dates after May 5, 1986.

(ii) Example.

(i) L is owned entirely by 10,000 unrelated individuals, none of whom owns as much as five percent of the stock of L ("Public L"). P is owned entirely by 1,000 unrelated individuals, none of whom owns as much as five percent of the stock of P ("Public P").

(ii) Between March 1, 1987 and June 1, 1987, P acquires 45 percent of L stock in a series of transactions. On June 15, 1987, L redeems 20 percent of the L stock from Public L.

(iii) Under paragraph (m)(4)(i)(A) of this section, the rules of paragraph (j)(1) of this section apply to the acquisitions made by P, because they occurred after May 5, 1986. Accordingly, following those acquisitions, the stock of L is owned 45 percent by Public P and 55 percent by Public L. Because the increase in the percentage ownership by Public P as a result of P's stock purchases is not more than 50 percent, no ownership change occurs as the result of P's purchases.

(iv) On or after September 4, 1987, the rules of paragraph (j)(2)(iii)(C) of this section apply to treat any L stock that is redeemed as owned by a public group that is separate from the public group owning the stock that is not redeemed. (Under paragraph (j)(2)(iii)(C) of this section, the continuing shareholders of Public L, who owned 35 percent of the stock of L before the redemption ([55 percent—20 percent]/100 percent) increase their ownership interest in L by 8.8 percentage points as a result of such redemption (43.8 percent—35 percent)). Those rules, however, do not apply to the June 15, 1987 redemption because it occurs before the date that paragraph (j)(2)(iii) of this section generally is effective. (Until September 4, 1987, paragraph (j)(2)(iii) of this section generally is effective only for equity structure shifts in which more than one corporation is a party to the reorganization.) Solely because of the application of paragraph (j)(1) of this section to P's acquisitions of L stock, Public P's ownership interest in L as a result of the redemption has increased from 45 percentage points to 56.2 percentage points which, compared to its lowest percentage ownership interest at any time during the testing period (0 percent prior to March 1, 1987), is a more than 50 percentage point increase thus causing an ownership change with respect to L on June 15, 1987.

(iii) Rules provided in paragraph (j) of this section for testing dates on or after September 4, 1987. For purposes of determining whether an ownership change occurs for any testing date on or after September 4, 1987, the rules of paragraphs (j) (2) and (3) of this section shall not apply to identify any public group resulting from—

(A) Any transaction described in such paragraphs (j) (2) and (3), unless that transaction is also described in paragraph (m)(4)(i) (B) or (C) of this section, or

(B) Any disposition of stock acquired on or before May 5, 1986, but only if such disposition or other transaction occurs before September 4, 1987. Thus, for example, the rules of paragraph (j)(2)(iii)(D) of this section shall apply only to rights to acquire stock of the loss corporation issued on or after such date.

(iv) Rules provided in paragraphs (f)(18) (ii) and (iii) of this section. For purposes of determining whether an ownership change occurs for any testing date, the rules of paragraphs (f)(18) (ii) and (iii) of this section apply only to stock (or any other ownership interest) that is—

(A) Issued on or after September 4, 1987, or

(B) Transferred to (or by) a person who is a 5-percent shareholder (or would be a 5-percent shareholder if paragraph (f)(18)(iii) of this section were applicable) on or after September 4, 1987.

(v) Rules provided in paragraph (a)(2)(ii) of this section. The information statement required under paragraph (a)(2)(ii) of this section is not required to be filed with respect to any taxable year for which the due date (including extensions) of the income tax return of the loss corporation is on or before October 5, 1987.

(5) Bankruptcy proceedings—(i) In general. In the case of a reorganization described in section 368(a)(1)(G) or an exchange of debt for stock in a Title 11 or similar case (within the meaning of section 368(a)(3)), section 382 shall not apply to any ownership change resulting from such a reorganization or proceeding if a petition in such case was filed with the court before August 14, 1986. Accordingly, any shift in ownership in the loss corporation arising out of such reorganization or proceeding shall not be taken into account for purposes of determining whether an ownership change occurs on any testing date that occurs after December 31, 1986.

(ii) Example.

(i) L filed a petition in bankruptcy on September 29, 1985. As a result of a title 11 bankruptcy reorganization of L that is confirmed by a court on February 2, 1988, there is a shift in the ownership of L so that JK increased her interest in L by 24 percentage points relative to her lowest ownership interest in L during the testing period. JK is the only 5-percent shareholder of L following the reorganization whose interest in L increased as a result of the transaction. On December 25, 1988, GK purchases 42 percent of the outstanding stock of L from shareholders other than JK.

(ii) There is no ownership change on December 25, 1988 because the 24 percentage point increase in JK's ownership interest in L is not taken into account under paragraph (m)(6)(i) of this section.

(iii) The facts are the same as in (i), except that the acquisitions by JK and GK occurred on August 5, 1986 and September 26, 1986, respectively. Because paragraph (m)(6)(i) of this section is only applicable with respect to the determination of whether an ownership change has occurred on any testing date that occurs after December 31, 1986, there is an ownership change as a result of GK's acquisition on September 26, 1986. Accordingly, section 382 is inapplicable to such ownership change under paragraph (m)(1) of this section because it occurred prior to January 1, 1987. Under paragraph

(d)(2) of this section, the testing period for determining whether an ownership change occurs on any subsequent testing date shall commence no earlier than September 27, 1986.

(6) Transactions of domestic building and loan associations. The rules of paragraph (j)(2)(iii)(B) of this section (and the application of those rules by virtue of paragraph (j)(3) of this section) shall not apply to a public offering of stock by a domestic building and loan association described in section 591 (or any corporation that owns stock in the association meeting the requirements of section 1504(a)(2)) prior to January 1, 1989. In the case of any transaction described in the preceding sentence, any transitory ownership of stock by any entity that is an underwriter shall be disregarded so that the rules of paragraph (j)(1) of this section shall not apply to treat such stock as owned by the owners of the underwriter and thus the rules of paragraph (j)(3)(i) of this section shall not apply to the disposition of such stock by the underwriter. For purposes of this paragraph (m)(7)—

(i) Ownership shall be considered transitory only with respect to an underwriter acquiring stock in a firm commitment underwriting to the extent the stock is disposed of pursuant to the offer (but in no event later than sixty (60) days after the initial offering) and,

(ii) To the extent a transaction may be described both by paragraph (j)(2)(iii)(B) of this section and any other provision of paragraph (j)(2)(iii) or (3) of this section, paragraph (j)(2)(v)(A) of this section shall not apply and the transaction shall be treated as described solely by paragraph (j)(2)(iii)(B) of this section.

(7) Transactions not subject to section 382—(i) Application of old section 382. Old section 382 shall not apply to a loss corporation on or after the date on which an ownership change occurs, but only if such ownership change results in the application of the section 382 limitation (as defined in section 382(b)) with respect to the loss corporation.

(ii) Effect on testing period. The application of old section 382 to a transaction is disregarded for purposes of paragraph (d)(2) of this section unless the transaction that results in such application is the last component of an ownership change after May 5, 1986 that is not subject to section 382 under the effective date rules of this paragraph (m) (e.g., an ownership change occurring as the result of an individual's purchase of more than 50 percent of L stock on any date on or before December 31, 1986).

(iii) Termination of old section 382. [Reserved]

(8) Options issued or transferred before January 1, 1987—(i) Options issued before May 6, 1986. An option issued before May 6, 1986, is subject to the rules of paragraph (h)(4) of this section only if it is transferred by (or to) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the option were treated as exercised) on or after such date. In all other cases, such an option shall not be subject to paragraph (h)(4)(i) of this section, but shall be subject to paragraph (h)(4)(xii) of this section. Thus, for example, a warrant to acquire stock of the loss corporation issued before May 6, 1986 shall not be subject to paragraph (h)(4) of this section unless the warrant is transferred by (or to) a 5-percent shareholder. The exercise of such a warrant, however, would be taken into account as required by this paragraph (m)(8)(i) and paragraph (h)(4)(xii) of this section.

(ii) Options issued on or after May 6, 1986 and before September 18, 1986. An option issued or transferred on or after May 6, 1986, and before September 18, 1986, is subject to the rules of paragraph (h)(4) of this section.

(iii) Options issued on or after September 18, 1986 and before January 1, 1987. An option issued or transferred on or after September 18, 1986, and before January 1, 1987, is subject to the rules of paragraph (h)(4) of this section, except that the option shall be treated for purposes of this section as if it never had been issued in the event that either—

(A) The option lapses unexercised or is irrevocably forfeited by the holder thereof, or

(B) On the date the option was issued, there was no significant likelihood that such option would be exercised within the five-year period from the date of such issuance and a purpose for the issuance of the option was to cause an ownership change prior to January 1, 1987.

(9) Examples. The rules of this paragraph (m) may be illustrated by the following examples.

Example (1). (i) A owns all 100 outstanding shares of L stock. A sells 11 shares to B on January 1, 1986. The January 1, 1986 testing date is disregarded under paragraph (m)(3) of this section. A sells another 40 shares to B on January 1, 1988. B's second stock purchase is an owner shift that does not result in an ownership change. B's percentage ownership interest on the testing date (51 percent) is only 40 percentage points greater than the lowest percentage of L stock owned by B at any time during the testing period (11 percent on and after May 6, 1986).

(ii) The facts are the same as in (i). In addition A sells 20 shares of his L stock to C on July 1, 1990. C's stock purchase is an owner shift. Because B and C together have increased

their respective ownership interests in L by 40 and 20 percentage points relative to their lowest percentage stock ownership interests in L at any time during the testing period, C's purchase causes an ownership change. The testing period for any subsequent ownership change begins on the first day following C's acquisition, July 2, 1990.

Example (2). (i) C has owned 100 percent of L since March 22, 1980. On October 13, 1986, P merges into L. As a result of the merger, 40 percent of L stock is acquired by A, the sole shareholder of P. The merger of P into L is both an equity structure shift and an owner shift. The transaction, however, is not an ownership change with respect to L, because A's percentage ownership interest has increased by only 40 percentage points. On August 22, 1987, B purchases 15 percent of the L stock from C. B's purchase constitutes an owner shift resulting in an ownership change that is subject to section 382 because the aggregate increases in percentage ownership by B and C (respectively 40 percent and 15 percent) is more than 50 percentage points.

(ii) The facts are the same as in (i), except that the plan of reorganization is adopted on October 13, 1986, and the merger is completed on July 22, 1987. The result is the same as in (i).

(iii) The facts are the same as in (ii), except that the reorganization is completed on August 22, 1987, and B's purchase of the L stock occurs one month earlier, on July 22, 1987. Assume that after the reorganization on August 22, 1987, A and B own 40 percent and 15 percent, respectively, of L stock. Although the merger occurred pursuant to a plan of reorganization adopted before 1987, L is subject to section 382 following the equity structure shift, because the merger would not have caused an ownership change if it had been completed in 1986 after the commencement of the L's testing period.

(iv) The facts are the same as in (ii), except that B's purchase occurs on June 7, 1986. Assume that immediately after the reorganization on August 22, 1987, A and B own 40 percent and 15 percent, respectively, of L stock. Since the reorganization pursuant to a plan adopted before 1987, taken together with the other shifts in the ownership of L's stock between May 5, 1986, and December 31, 1986, would have caused an ownership change, section 382 does not apply as a result of the merger. Since an ownership change occurs as a result of the merger, L's testing period for purposes of any subsequent ownership change begins on October 14, 1986.

(v) The facts are the same as in (iv), except that B makes an additional purchase from C of one percent of L's stock on February 14, 1987. The result is the same as in (iv). B's additional purchase, however, is taken into account for the purpose of determining whether there is a second ownership change with respect to L.

[T.D. 8149, 52 FR 29675, Aug. 11, 1987]

§ 1.382(a)–1 Purchase of a corporation and change in its trade or business.

(a) In general. (1) Section 382(a) provides for the complete elimination of the net operating loss carryovers of a corporation (hereinafter called a "loss corporation") if certain circumstances exist. In general, section 382(a) applies only if, at the end of a loss corporation's taxable year, there has been a change (occurring in specified ways) since the beginning of such year, or since the beginning of the prior taxable year, of at least 50 percent in the ownership of the corporation's outstanding stock (hereinafter called a "change of ownership"), and only if the corporation has not continued to carry on substantially the same trade or business as that conducted before such change. If section 382(a) is applicable at the end of a taxable year, then the entire net operating loss carryovers from prior taxable years of such corporation are excluded in computing the net operating loss deduction for such taxable year and for subsequent taxable years.

(2) For purposes of this section, (i) section 318(a) shall apply in determining ownership of stock, except that section 318(a)(2)(C) and (3)(C) shall be applied without regard to the 50-percent limitation contained therein, and (ii) stock acquired by the exercise of an option shall be considered as having been acquired on the date the option was acquired. Thus, if A acquires on December 15, 1959, an option to purchase 50 percent of the outstanding stock of X Corporation and if A acquires the stock by exercising the option on January 15, 1961, A will be considered as having purchased the stock on December 15, 1959.

(3) For the definition of the term "stock" as used in this section, see § 1.382(c)–1.

(b) Circumstances under which section 382(a) is applicable. Section 382(a) applies if, at the end of a taxable year of a loss corporation, all of the following circumstances exist:

(1) Any one or more of those persons described in paragraph (c) of this section own, actually and constructively, a percentage of the total fair market value of the outstanding stock of such corporation which is at least 50 percentage points more than such person or persons owned at the beginning of such taxable year or at the beginning of the prior taxable year;

(2) The increase in percentage points referred to in subparagraph (1) of this paragraph is attributable to (i) a purchase or purchases (as defined in section 382(a)(4) and paragraph (e) of this section) by the person or persons specified in subparagraph (1) of this paragraph of such stock or the stock of another corporation owning stock in such loss corporation, (ii) the purchase or purchases by such person or persons of an interest in a partnership or trust owning stock in such loss corporation, (iii) a decrease in the amount of outstanding stock of such loss corporation or in the amount of outstanding stock of another corporation owning stock in such loss corporation, except a decrease resulting from a redemption to pay death taxes to which section 303 applies, or (iv) a combination of

the transactions described in subdivisions (i), (ii), and (iii) of this subparagraph; and

(3) The loss corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in percentage points described in subparagraph (2) of this paragraph.

(c) Description of person or persons. (1) The persons specified in paragraph (b)(1) of this section shall be the 10 persons who own, actually and constructively, the greatest percentage of the fair market value of the outstanding stock of a loss corporation at the end of a taxable year (or such lesser number as there are persons owning the outstanding stock at the end of such taxable year), except that if any two or more persons own the same percentage of such stock and it is necessary to include one such person in order to select the 10 persons, then all of such persons shall be included. Any such persons so selected who are so related that stock owned by one is attributed to another under the constructive ownership rule specified in paragraph (a)(2) of this section shall be considered as only one person solely for the purpose of selecting such 10 persons. Although considered as one person for purposes of selecting such 10 persons, such related persons are considered as separate persons for all other purposes of section 382(a).

(2) In selecting the 10 persons (more or less) described in subparagraph (1) of this paragraph, the following procedure shall be used:

(i) First, determine those persons who own, actually and constructively, stock of the loss corporation and determine the fair market value of the stock owned, actually and constructively by such persons.

(ii) Second, select from such persons the number of persons required by the first sentence of subparagraph (1) of this paragraph.

(iii) Third, if any of the persons so selected are so related that stock of one is attributed to another under the rule specified in paragraph (a)(2) of this section, such persons shall be considered as one person.

(iv) Fourth, if, as the result of considering two or more persons as one person, the number of persons previously selected drops below ten, additional persons shall be selected in the manner prescribed in subdivision (ii) of this subparagraph.

(v) Finally, if any such additional persons are related under the rule specified in paragraph (a)(2) of this section to persons previously selected, or to one another, then the principles of subdivisions (iii) and (iv) of this subparagraph shall again be applied.

(3) The application of this paragraph may be illustrated by the following example:

Example. (i) Assume that the outstanding stock of a loss corporation (based on fair market value) is owned, actually and constructively, at the end of a taxable year by the following individuals and partnership:

Person	Percentage of stock actually owned	Percentage of stock owned actually and constructively
A	15	15
B (A's wife)	0	15
C (A's son)	0	15
D (A's daughter)	0	15
GH (a partnership)	0	20
E	16	20
F	15	15
G (a 50-percent partner in GH)	10	15
H (a 50-percent partner in GH)	10	15
I	5	5
J	5	5
K	5	5
L (E's grandson)	4	4
M	4	4
N	3	3
O	2	2
P	2	2
Q	2	2
R	2	2

(ii) The persons selected under subparagraph (2)(ii) of this paragraph are the following 12 persons: A, B, C, D, partnership GH, E, F, G, H, I, J, and K (I, J, and K must all be included because each owns the same percentage of stock). However, A, B, C, and D are considered as one person for purposes of this paragraph because they are related under the rule specified in paragraph (a)(2) of this section, and G, H, and partnership GH are considered as one person for the same reason. Therefore, it is necessary to select three additional persons, L, M, and N, in order to reach the required number of ten. However, since L is related to one of the persons previously selected, he cannot be considered a separate person. It therefore becomes necessary to select an additional person and since O, P, Q, and R each owns the same percentage of stock, they all must be selected. Accordingly, the 10 persons (more or less) who own the greatest percentage of the fair market value of the outstanding stock are individuals A through R and partnership GH.

(d) Change of ownership. (1) The determination of whether a change of ownership has occurred under section 382(a) is made as of the close of a taxable year of a loss corporation. A "change of ownership" has occurred only if the stock ownership of the 10 persons (more or less) selected under paragraph (c) of this section has increased at least 50 percentage points during a prescribed period and such increase is attributable to a transaction or transactions described in section

382(a)(1)(B) and in paragraphs (e), (f), and (g) of this section. The aggregate increase of at least 50 percentage points may occur at any one time during the taxable year or during the prior taxable year, or may take place in several transactions occurring during such 2-year period. An increase of 50 percentage points is not the same thing as an increase of 50 percent. Thus, a stockholder who owns 4 percent of the fair market value of the stock of a corporation and who increases his ownership to 6 percent has had a 50-percent increase in ownership but an increase in percentage points of only 2.

(2)(i) It is unnecessary to determine whether a "change of ownership" has occurred unless, as of the end of any taxable year (hereinafter called a "current taxable year"), the loss corporation has changed its trade or business after the date of the first increase in percentage points during such taxable year, or during the prior taxable year, which would be taken into account under subparagraph (3) of this paragraph in determining whether a "change of ownership" has occurred.

(ii) If, as of the end of the current taxable year, the loss corporation has changed its trade or business after the date of the first increase in percentage points during such current year, then in determining whether a "change of ownership" has occurred it is first necessary to compare ownership of the outstanding stock at the end of the current taxable year with such ownership at the beginning of such current taxable year. If a "change of ownership" has not occurred as a result of such comparison, then it is necessary to compare ownership of the outstanding stock at the end of the current taxable year with such ownership at the beginning of the prior taxable year.

(iii) If, as of the end of the current taxable year, the loss corporation has not changed its trade or business after the date of the first increase in percentage points during such current year, but the corporation has changed its trade or business after the date of the first increase in percentage points during the prior taxable year, then in determining whether a "change of ownership" has occurred it is necessary to compare ownership of the outstanding stock at the end of the current taxable year with such ownership at the beginning of the prior taxable year.

(iv) For purposes of subdivisions (ii) and (iii) of this subparagraph, an increase in percentage points means only an increase in percentage ownership which would be taken into account under subparagraph (3) of this paragraph in determining whether a "change of ownership" has occurred.

(v) A loss corporation has changed its trade or business during a period between one date and another date only if, as of the later date, the corporation has not continued to carry on a trade or business substantially the same as that conducted immediately before the earlier date. See paragraph (h) of this section for rules relating to change in trade or business.

(3) In determining whether a "change of ownership" has occurred, the following procedure shall be used:

(i) First, as of the close of a taxable year, the percentage of the total fair market value of stock owned, actually and constructively, by each of the 10 persons (more or less) selected under paragraph (c) of this section shall be computed. For this purpose, each person included in selecting such 10 persons shall be treated as a separate person even though any such persons are considered as only one person under such paragraph (c) in selecting the 10 persons who own the greatest percentage of the fair market value of the outstanding stock.

(ii) Second, the percentage of the total fair market value of stock owned, actually and constructively, by each of such persons as of the beginning of the current taxable year or the prior taxable year, whichever is applicable, shall be computed.

(iii) Third, after computing the percentage of the total fair market value of stock owned by each of the persons as of the close of the current taxable year and as of the beginning of the applicable year, a comparison shall be made between the percentages owned by each such person as of each such date.

(iv) Fourth, with respect to each person who sustained an increase in percentage ownership, the portion of such increase which is attributable to a transaction or transactions described in paragraphs (e), (f), and (g) of this section shall be determined.

(v) Finally, the increases in percentage ownership attributable to such transaction or transactions shall be totaled and the resulting figure shall be used in determining whether a "change of ownership" has occurred.

(4) This paragraph may be illustrated by the following examples:

Example (1). Assume that a loss corporation has changed its trade or business during the current taxable year ending on December 31, 1960. Assume further that the following table shows the percentage of the fair market value of the outstanding stock owned by each stockholder as of December 31, 1960,

and the percentages owned by such stockholders as of January 1, 1960, and January 1, 1959. The percentage of stock actually owned is followed in parentheses by the percentage owned actually and constructively under section 318(a). It is assumed that all increases in actual ownership are attributable to a purchase or purchases of stock described in paragraph (e) of this section.

Stockholder	Dec. 31, 1960 (Percent)	Jan. 1, 1960 (Percent)	Jan. 1, 1959 (Percent)
A	10(23)	15(15)	15(15)
B (A's wife)	10(23)	0(15)	0(15)
C	10(25)	10(25)	0(0)
D (C's wife)	5(25)	5(25)	0(10)
E (son of C and D)	5(20)	5(20)	0(0)
F (daughter of C and D)	5(20)	5(20)	0(0)
G	10(10)	10(10)	0(0)
H	5(5)	0(0)	0(0)
I	5(5)	0(0)	0(0)
J	5(5)	0(0)	0(0)
K	5(5)	0(0)	0(0)
L	5(5)	5(5)	5(5)
M	4(4)	0(0)	0(0)
N	4(4)	0(0)	0(0)
O	3(3)	3(3)	3(3)
P	3(3)	3(3)	3(3)
Q	3(3)	3(3)	3(3)
R (grandson of A and B)	3(3)	0(0)	0(0)
(D's father)	0(15)	0(15)	10(10)

(i) The 10 persons (more or less) who own the greatest percentage of the fair market value of the outstanding stock on December 31, 1960 (as selected under paragraph (c) of this section), are A through N and S. Each of such persons is treated as a separate person in computing increases in percentage ownership.

(ii) A and B each owns, actually and constructively, 23 percent of the outstanding stock on December 31, 1960, 15 percent on January 1, 1960, and 15 percent on January 1, 1959. Therefore, as of December 31, 1960, A and B each has sustained an increase of 8 percentage points since January 1, 1960, and a similar increase since January 1, 1959. A's increase is not attributable to a purchase by him. B's increase, however, is attributable to a purchase by her of 10 percent of the outstanding stock. Therefore, B's increase of 8 percentage points is taken into account in determining whether a "change of ownership" has occurred.

(iii) C owns, actually and constructively, 25 percent of the outstanding stock on December 31, 1960, 25 percent on January 1, 1960, and none on January 1, 1959. Therefore, as of December 31, 1960, C has sustained no increase since January 1, 1960, but he has sustained an increase of 25 percentage points since January 1, 1959. Of this increase 10 percentage points are attributable to a purchase by C.

(iv) D owns, actually and constructively, 25 percent of the outstanding stock on December 31, 1960, 25 percent on January 1, 1960, and 10 percent on January 1, 1959. Therefore, as of December 31, 1960, D has sustained no increase since January 1, 1960, but she has sustained an increase of 15 percentage points since January 1, 1959. Of this increase 5 percentage points are attributable to a purchase by D.

(v) E and F each owns, actually and constructively, 20 percent of the outstanding stock on December 31, 1960, 20 percent on January 1, 1960, and none on January 1, 1959. Therefore, as of December 31, 1960, E and F each has sustained an increase of 20 percentage points since January 1, 1959, of which 5 percentage points in each case are attributable to a purchase.

(vi) G has sustained an increase of 10 percentage points since January 1, 1959, all of which are attributable to a purchase by G.

(vii) H, I, J, and K each has sustained an increase of 5 percentage points since January 1, 1960, and a similar increase since January 1, 1959, all of which are attributable to purchases.

(viii) L has sustained no increase in percentage points.

(ix) M and N each has sustained an increase of 4 percentage points since January 1, 1960, and a similar increase since January 1, 1959, all of which are attributable to purchases.

(x) S has sustained an increase of 5 percentage points since January 1, 1959, but the increase is not attributable to a purchase by S.

(xi) The aggregate increase in percentage ownership (attributable to purchases) since January 1, 1960, is 36 percentage points (8 points from B, 5 each from H, I, J, and K, and 4 each from M and N).

(xii) Since an aggregate increase (attributable to transactions described in paragraph (e)) in stock ownership of at least 50 percentage points has not occurred since January 1, 1960, the beginning of the taxable year, it is necessary to determine whether such an increase has occurred since January 1, 1959, the beginning of the prior taxable year. The aggregate increase in percentage ownership (attributable to purchases) since January 1, 1959, is 71 percentage points (8 from B, 10 each from C and G, 5 each from D, E, F, H, I, J, and K, and 4 each from M and N). Therefore, section 382(a) applies as of December 31, 1960, to eliminate any net operating loss carryovers from 1959 and earlier taxable years to 1960 and subsequent taxable years.

Example (2). Assume that a loss corporation has changed its trade or business during the current taxable year ending on December 31, 1960. Assume further that the following table shows the percentage of the fair market value of the outstanding stock owned by each stockholder as of December 31, 1960, and the percentages owned by such stockholders as of January 1, 1960. The percentage of stock actually owned is followed in parentheses by the percentage owned actually and constructively under section 318(a). It is assumed that all increases in actual ownership are attributable to a purchase or purchases of stock described in paragraph (e) of this section.

Stockholder	Dec. 31, 1960 (Percent)	Jan. 1, 1960 (Percent)
Partnership A B	20(100)	0(40)
A (a 50-percent partner in A B)	40(70)	40(40)
B (a 50-percent partner in A B)	30(70)	0(20)
C (B's wife)	10(70)	0(20)

(i) Since there are less than 10 stockholders as of December 31, 1960, all of such stockholders are included among the persons who own the greatest percentage of stock.

(ii) Since partnership AB owns, actually and constructively, 100 percent of the outstanding stock on December 31, 1960, and 40 percent on January 1, 1960, AB has sustained an increase of 60 percentage points. Of this increase 20 percentage points are attributable to a purchase by AB.

(iii) A has sustained an increase of 30 percentage points, but none of such increase is attributable to a purchase by A.

(iv) B has sustained an increase of 50 percentage points, of which 30 are attributable to a purchase by B.

(v) C has sustained an increase of 50 percentage points, of which 10 are attributable to a purchase by C.

(vi) Since there has been an aggregate increase (attributable to transactions described in paragraph (e) of this section) of 60 percentage points since January 1, 1960, section 382(a) applies as of December 31, 1960, to eliminate any net operating loss carryovers from 1959 and earlier taxable years to 1960 and subsequent taxable years.

Example (3). (i) Assume that on June 15, 1959, A, an individual, purchases (within the meaning of section 382(a)(4) and paragraph (e) of this section) 100 percent of the outstanding stock of X Corporation, a loss corporation which makes its return on the basis of the calendar year. On June 30, 1959, A transfers such stock to Y Corporation, the entire outstanding stock of which is owned by A. During September 1959, the business of X Corporation is changed.

(ii) Since, as of December 31, 1959, A is considered under section 318(a) as owning 100 percent of the outstanding stock of X Corporation and he owned none of such stock on January 1, 1959, and since A's increase in percentage points is attributable to a purchase of such stock by him, section 382(a) applies as of December 31, 1959, to eliminate any net operating loss carryovers from 1958 and earlier taxable years to 1959 and subsequent taxable years.

(e) Meaning of "purchase". (1) In determining whether a "change of ownership" has occurred, an increase in stock ownership which is attributable to an acquisition of stock by the person sustaining the increase (whether the stock acquired is stock of the loss corporation or of a corporation owning stock in the loss corporation) shall be taken into account only if such increase is attributable to a purchase (or purchases) by such person, as defined in section 382(a)(4) and this paragraph. There is a "purchase" of stock only if—

(i) The basis of such stock is determined solely by reference to its cost to the acquirer thereof, and

(ii) Immediately before its acquisition the ownership of such stock would not be attributed to the acquirer by application of the constructive ownership rule of paragraph (a)(2) of this section.

For purposes of subdivision (i) of this subparagraph, if the basis of the stock is determined by reference to its basis in the hands of the transferor thereof or of another person, or by reference to the basis of property (other than cash or its equivalent) exchanged for such stock, then the basis of such stock is not determined solely by reference to its cost to the acquirer. Thus, an acquisition of stock by gift or bequest is not a purchase. However, if stock is received in a taxable exchange, its basis is considered to be determined solely by reference to its cost to the acquirer. Thus, if A owns a house which he exchanges for stock in a loss corporation, the basis of the stock is determined solely by reference to its cost to A. For purposes of subdivision (ii) of this subparagraph, if, immediately before any acquisition of stock, the acquirer would be considered under the constructive ownership rule of paragraph (a)(2) of this section as owning less than 100 percent of the stock owned by the transferor, then the acquirer shall be considered as owning, immediately before such acquisition, only that proportion of the stock so acquired as is equal to the proportion of the total stock owned by the transferor which the acquirer would be so considered as owning at such time. Thus, if A acquires stock from B, his wife, A has not made a "purchase" because all the stock so acquired would be considered as owned by A immediately before the acquisition. However, if C and D (who are otherwise unrelated) are equal partners in a partnership and if C acquires 50 shares of stock from D, only 25 of such shares will be considered as owned by C immediately before the acquisition.

(2) If a person acquires stock (or an interest in a partnership, trust, or estate) with a view to invoking the constructive ownership rule of paragraph (a)(2) of this section so that a later acquisition of stock by, or from, such person will not qualify as a "purchase" under section 382(a)(4), the earlier acquisition will be disregarded solely for the purpose of determining whether the later acquisition is a "purchase". Moreover, in determining whether an acquisition of stock is a "purchase" under section 382(a)(4), negligible holdings of stock or of an interest in a partnership, trust, or estate will be disregarded. This subparagraph may be illustrated by the following example:

Example. A owns all or part of the outstanding stock of X Corporation, a loss corporation. A desires to sell his stock to Y Corporation and Y Corporation desires to purchase such stock. However, Y Corporation wishes to avoid the provisions of section 382(a). Therefore, A buys stock of Y Corporation and thereafter Y Corporation acquires for cash all or part of A's stock in X Corporation. Since the purpose of A's acquisition of stock in Y Corporation is avoidance of the provisions of section 382(a), such acquisition is ignored and Y Corporation's acquisition from A of stock in X Corporation is considered a "purchase" under section 382(a)(4).

(f) Increase in percentage points attributable to an indirect purchase of stock. (1) An increase in percentage points may be attributable to a purchase of stock of a corporation which owns stock of the loss corporation. For example, if X Corporation owns 100 shares of stock of Y Corporation and if A purchases 20 percent in value of the outstanding stock of X Corporation, this will be considered a purchase by A of 20 shares of stock of Y Corporation.

(2) An increase in percentage points may also be attributable to a purchase of an interest in a

partnership or trust which owns stock of the loss corporation. For example, if a partnership owns 100 shares of the stock of Y Corporation, a purchase by A of a 20-percent interest in the partnership will be considered a purchase by A of 20 shares of the stock of Y Corporation. Similarly, if a trust owns 100 shares of stock of a loss corporation, and if A purchases an interest in the trust which on an actuarial basis is worth 20 percent, this will be considered a purchase by A of 20 shares of stock of the loss corporation.

(g) **Increase in percentage points attributable to a decrease in outstanding stock.** (1) An increase in percentage points may be attributable to a decrease in the amount of outstanding stock of a loss corporation. For example, if A and B each owns 50 percent in value of the outstanding stock of X Corporation, a redemption by X Corporation of all of B's stock will increase A's ownership of stock by 50 percentage points.

(2) An increase in percentage points may also be attributable to a decrease in the outstanding stock of a corporation owning, directly or indirectly, stock in the loss corporation. For example, if X Corporation owns 100 percent of the outstanding stock of Y Corporation, a loss corporation, and if A and B each owns 50 percent of the value of the outstanding stock of X Corporation, a redemption by X Corporation of all of B's stock will increase A's indirect ownership of the outstanding stock of Y Corporation by 50 percentage points.

(3) If a decrease in the amount of outstanding stock of a corporation (whether a loss corporation or a corporation owning, directly or indirectly, stock in a loss corporation) results from a redemption to pay death taxes to which section 303 applies, such decrease shall not be taken into account in determining whether there has occurred an increase of at least 50 percentage points under paragraph (d) of this section. For purposes of the preceding sentence, a decrease in outstanding stock results from a redemption to which section 303 applies only to the extent that the amount distributed in redemption does not exceed the sum of the items described in paragraphs (1) and (2) of section 303(a). Thus, if the amount of $100,000 is distributed in redemption of 100 shares and if the sum of the items described in paragraphs (1) and (2) of section 303(a) is $60,000, a decrease in outstanding stock of only 60 shares will be considered to result from a redemption to which section 303 applies.

(h) **Change in trade or business.** (1) The provisions of section 382(a) are applicable only if the loss corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in stock ownership which is taken into account in determining under paragraph (d) of this section whether a change of ownership has occurred. The change in trade or business may occur at any time on or after the date of the earliest such increase during the period beginning on the first day of the loss corporation's prior taxable year. For example, assume that on December 31, 1958 (the end of the corporation's taxable year), the following shareholders own a percentage of the fair market value of the outstanding stock which is greater than each owned at the beginning of the corporation's prior taxable year (January 1, 1957) and that all increases are attributable to purchases within the meaning of paragraph (e) of this section. The increase in percentage points and the date of purchase is shown for each such shareholder:

Shareholder	Increase (Percent)	Date of purchase
A	20	Sept. 15, 1958
B	20	June 15, 1958
C	10	Mar. 15, 1958
D	10	June 15, 1957

Since there have been increases in stock ownership which aggregate at least 50 percentage points, section 382(a) is applicable if the corporation has not continued to carry on a trade or business substantially the same as that conducted immediately before June 15, 1957, the date on which the first purchase occurred during the 2-year period.

(2) Section 382(a) may apply as of the close of a taxable year even though neither a change of ownership nor a change in trade or business has occurred during such year. For example, if during 1958 there is a purchase of at least 50 percent of the fair market value of a corporation's outstanding stock followed by a change in the corporation's trade or business, section 382(a) will apply as of December 31, 1958, to eliminate any net operating loss carryovers from 1957 and prior taxable years to 1958 and subsequent taxable years, and, even though no changes in stock ownership occur during 1959, section 382(a) will also apply as of December 31, 1959, to eliminate any net operating loss carryover from 1958 to 1959 and subsequent taxable years.

(3) A change in the trade or business of a corporation made in contemplation of a change in stock ownership will be treated as if such change in trade or business had occurred after such

change in stock ownership. For example, if a loss corporation changes its business as part of a plan initiated by, or on behalf of, prospective buyers of the loss corporation's stock who wish to avoid the provisions of section 382(a), a subsequent sale of stock to such buyers will cause the change in business to be treated as if it had occurred after the sale.

(4) For purposes of this paragraph, the holding, purchase, or sale for investment purposes of stock, securities, or similar property shall not be considered a trade or business unless such activities historically have constituted the primary activities of the corporation.

(5) In determining whether a corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in the ownership of its stock, all the facts and circumstances of the particular case shall be taken into account. Among the relevant factors to be taken into account are changes in the corporation's employees, plant, equipment, product, location, customers, and other items which are significant in determining whether there is, or is not, a continuity of the same business enterprise. These factors shall be evaluated in the light of the general objective of section 382(a) to disallow net operating loss carryovers where there is a purchase of the stock of a corporation and its loss carryovers are used to offset gains of a business unrelated to that which produced the losses. However, the prohibited utilization of net operating loss carryovers to offset gains of a business unrelated to that which produced the losses is not dependent upon considerations of purpose, motive, or intent, but rather is established by the objective facts of the particular case. The principles set forth in this subparagraph shall be applied in accordance with the rules set forth in the following subparagraphs of this paragraph.

(6) A corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in the ownership of its stock if the corporation is not carrying on an active trade or business at the time of such increase in ownership. Thus, if the corporation is inactive at the time of such an increase and subsequently is reactivated in the same line of business as that originally conducted, the corporation has not continued to carry on a trade or business substantially the same as that conducted before such increase in stock ownership. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation is engaged in the business of manufacturing and selling machinery. On January 1, 1958, the corporation suspends its manufacturing activities and begins to reduce its inventory of finished products because of general adverse business conditions and lack of profits. During the period between January 1 and September 1, 1958, the business of the corporation remains dormant. On September 1, 1958, A, an individual, purchases at least 50 percent in value of X Corporation's outstanding stock. On October 1, 1958, the corporation begins to manufacture the same type of machinery it manufactured before January 1, 1958. The reactivation of the corporation in the same line of business as that conducted before January 1, 1958, does not constitute the carrying on of a trade or business substantially the same as that conducted before the increase in stock ownership.

Example (2). Y Corporation is engaged in the business of manufacturing machinery. On January 1, 1958, the corporation suspends its manufacturing activities because of a fire which disrupts the operation of its plant. During the period between January 1 and June 1, 1958, substantial efforts are made to reactivate the business of the corporation by reconstructing the damaged plant. On June 1, 1958, A, an individual, purchases at least 50 percent in value of Y Corporation's outstanding stock. On July 1, 1958, the corporation resumes its normal manufacturing activities. The fact that the corporation's normal activities are temporarily suspended at the time of the increase in ownership does not of itself constitute a failure to carry on a trade or business substantially the same as that conducted before the increase in stock ownership.

(7) A corporation has not continued to carry on a trade or business substantially the same as that conducted before an increase in the ownership of its stock if the corporation discontinues more than a minor portion of its business carried on before such increase. In determining whether the discontinued activities are more than "minor" for purposes of the preceding sentence, consideration shall be given to whether the discontinuance of the activities has the effect of utilizing loss carryovers to offset gains of a business unrelated to that which produced the losses. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation, a calendar-year taxpayer, is engaged in three separate businesses, A, B, and C. Approximately one-half of X Corporation's total business activities (measured in terms of capital invested, gross income, size of payroll, and similar factors) relates to business A, 30 percent to business B, and the remaining 20 percent to business C. On December 31, 1957, X Corporation has substantial net operating loss carryovers all of which are attributable to the operation of business C. On June 1, 1958, Y Corporation purchases at least 50 percent in value of X Corporation's outstanding stock and during 1959 X Corporation discontinues business C. As of December 31, 1959, X Corporation has not continued to carry on substantially the same trade or business as that conducted prior to the increase in ownership.

Example (2). Assume the same facts as in example (1), except that all of X Corporation's net operating loss carryovers are attributable to business A and that the capital released by the discontinuance of business C is used to revitalize business A. Since the discontinuance of business C does not result in the utilization of net operating losses attributable to one business to offset gains of a business unrelated to that which produced the losses, the discontinuance of such business does not of itself constitute the failure to carry on substantially the

same trade or business as that conducted prior to the increase in ownership.

(8) If, after an increase in ownership, the corporation continues to carry on its prior business activities substantially undiminished, the addition by the corporation of a new trade or business does not constitute a failure to carry on substantially the same trade or business. This subparagraph may be illustrated by the following example:

Example. X Corporation, a calendar-year taxpayer, is engaged in the manufacture and sale of electrical appliances and has sustained substantial net operating losses. On June 30, 1958, Y Corporation purchases 100 percent of X Corporation's outstanding stock. During 1959, X Corporation continues substantially undiminished its activities in the manufacture and sale of electrical appliances and also diversifies its activities by acquiring a cement manufacturing plant. The addition of the cement manufacturing business by X Corporation does not of itself constitute a failure to carry on substantially the same trade or business even though net operating loss carryovers attributable to the electrical appliance business are used to offset profits of the cement manufacturing business. See, however, section 269 and the regulations thereunder.

(9) A corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in the ownership of its stock if the corporation changes the location of a major portion of its activities and as a result of such change in location the business of the corporation is substantially altered. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation, a calendar-year taxpayer, is engaged in the business of manufacturing in State A and has sustained substantial net operating losses. On June 30, 1958, Y Corporation purchases all of X Corporation's outstanding stock. During 1959, X Corporation transfers its operations to State B which is several hundred miles distant from State A. In order to effect the change in location, X Corporation disposes of its plant and a large portion of its machinery located in State A. The distance between State A and State B makes it necessary for the majority of the employees of X Corporation to terminate their employment with X Corporation. During 1959, X Corporation resumes its manufacturing activities in State B and continues to make the same product and to serve substantially the same group of customers. However, by reason of the changes in location, employees, plant, and equipment, X Corporation, on December 31, 1959, is not carrying on substantially the same trade or business as that conducted prior to the increase in ownership.

Example (2). Y Corporation, a calendar-year taxpayer, is engaged in the operation of a department store in city A. On June 30, 1958, Z Corporation purchases all of the outstanding stock of Y Corporation. During 1959, Y Corporation transfers its operations to town B, a suburb of city A. By reason of the change in location, Y Corporation disposes of its interest in the building formerly occupied by it in city A and also substitutes new equipment for a major portion of the equipment formerly utilized by it in city A. After the change in location, Y Corporation continues to sell substantially the same products to substantially the same customers or to customers drawn from substantially the same area and retains substantially all of the employees formerly employed in city A. Under such circumstances, the change of location does not result in a failure to carry on substantially the same trade or business as that conducted before the increase in ownership.

Example (3). Z Corporation, a calendar-year taxpayer, operates a retail liquor store in town M, utilizing the services of 10 employees. On June 30, 1958, individual A purchases all of the stock of Z Corporation. During 1959, Z Corporation transfers its operations to town O, a distance of 5 miles from its former location. By reason of the change in location, Z Corporation disposes of its interest in the premises formerly occupied by it and also disposes of the license and franchise issued by town M. During 1959, Z Corporation transfers its inventory of liquor to its new location and resumes its retail liquor activities under a license and franchise issued by town O. Z Corporation continues to employ 5 of the 10 employees formerly employed in town M, but the corporation does not serve substantially the same customers or customers drawn from substantially the same area. Under these circumstances, the change of location results in a failure to carry on substantially the same trade or business as that conducted before the increase in ownership.

(10) A corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in the ownership of its stock if the corporation is primarily engaged in the rendition of services by a particular individual or individuals and, after the increase in ownership, the corporation is primarily engaged in the rendition of services by different individuals. This subparagraph may be illustrated by the following examples:

Example (1). X Corporation, a calendar-year taxpayer, is engaged in the business of selling real estate and insurance primarily through the services of individual A as broker. On June 30, 1958, individual B purchases all of the stock of X Corporation, and individual A retires from the business. During the latter part of 1958, X Corporation is engaged primarily in rendering the brokerage services of individual B in the sale of insurance and real estate. On December 31, 1958, the corporation has not continued to carry on a trade or business substantially the same as that conducted before the increase in ownership.

Example (2). Y Corporation, a calendar-year taxpayer, is engaged in the business of operating a beauty salon with 10 employees under the supervision of individual A, who owns all of the stock of Y Corporation and who is held out to the public as the corporation's principal beauty consultant. However, the quality of the services rendered by each of the 10 employees is primarily responsible for attracting the corporation's clientele. On June 30, 1958, individual B purchases all of the outstanding stock of Y Corporation and individual A retires from the business. During 1959, Y Corporation continues to operate the beauty salon in the same location and continues to serve substantially the same group of customers with substantially the same employees under the supervision of individual B, who is held out to the public as the corporation's principal beauty consultant. On December 31, 1959, Y Corporation has continued to carry on substantially the same trade or business as that conducted before the increase in ownership.

[T.D. 6616, 27 FR 10733, Nov. 3, 1962, as amended by T.D. 6969, 33 FR 12000, Aug. 23, 1968]

§ 1.382(b)–1 Change of ownership as the result of a reorganization.

(a) *In general.* (1) Section 382(b)(1) provides that if, in the case of a reorganization described in

section 381(a)(2), either the transferor corporation or the acquiring corporation has a net operating loss carryover which is a carryover to the first taxable year of the acquiring corporation ending after the date of transfer, the amount of such carryover which may be used by the acquiring corporation is reduced unless the stockholders (immediately before the reorganization) of the corporation possessing the carryover (hereinafter called the "loss corporation") own, immediately after the reorganization, at least 20 percent of the fair market value of the outstanding stock of the acquiring corporation. See paragraph (b) of § 1.381(b)-1 for determination of the date of transfer, and paragraph (b) of this section for computation of the amount of the reduction.

(2) The ownership of at least 20 percent of the fair market value of the stock of the acquiring corporation after the reorganization must result from the ownership of stock in the loss corporation immediately before the reorganization. Thus, if stockholders of a transferor-loss corporation before the reorganization also own stock of the acquiring corporation at such time, such stock of the acquiring corporation is not considered as owned after the reorganization by such stockholders as a result of owning stock in the loss corporation in determining whether the 20-percent requirement is satisfied. Moreover, the stockholders (immediately before the reorganization) of a transferor-loss corporation shall not be regarded as owning, immediately after the reorganization, any stock of the acquiring corporation which is not distributed to such stockholders pursuant to the plan of reorganization.

(3) If the net operating loss carryovers of a loss corporation are reduced under section 382(b)(1), then in computing the net operating loss deduction of the acquiring corporation for its first taxable year ending after the date of transfer, that portion of such deduction which is attributable to the net operating loss carryovers of the loss corporation is limited to the amount of such carryovers minus the reduction. Thus, if the net operating loss carryovers of the loss corporation are $100,000 and if the amount of the reduction is $60,000, only $40,000 of such carryovers may be used by the acquiring corporation in computing its net operating loss deduction under section 172(a) for its first taxable year ending after the date of transfer. The reduction provided in section 382(b)(1) is applied to the aggregate of the allowable net operating loss carryovers of the loss corporation without regard to the taxable years in which the net operating losses were sustained.

(4) See paragraph (e) of this section for the effect of the reduction in subsequent taxable years of the acquiring corporation.

(5) The reduction provided by section 382(b)(1) may apply to the carryovers of more than one corporation as party to the reorganization. For example, assume that X Corporation acquires the assets of Y Corporation and of Z Corporation in a reorganization described in section 381(a)(2) and that both X Corporation and Y Corporation have net operating loss carryovers at the date of the reorganization. The reduction under section 382(b)(1) will apply to the net operating loss carryovers of X Corporation unless the stockholders (immediately before the reorganization) of X Corporation own, immediately after the reorganization, at least 20 percent of the fair market value of the outstanding stock of X Corporation. Similarly, the reduction under section 382(b)(1) will apply to the net operating loss carryovers from Y Corporation unless the stockholders (immediately before the reorganization) of Y Corporation own, immediately after the reorganization, at least 20 percent of the fair market value of the outstanding stock of X Corporation.

(6) Section 382(b) applies only with respect to those reorganizations described in section 381(a)(2). However, a series of transactions which purport to be a reorganization qualifying under section 368(a)(1)(B) followed by a liquidation qualifying under section 332, but which in substance comprise a reorganization qualifying under section 368(a)(1)(C), will be considered as a reorganization of the last-described type for purposes of section 382(b) and this section.

(7) See § 1.382(c)-1 for definition of the term "stock" as used in this section.

(b) Amount of reduction. (1) The amount of the reduction provided in section 382(b)(1) shall be determined as follows:

(i) Determine the percentage of the fair market value of the outstanding stock of the acquiring corporation owned, immediately after the reorganization, by the stockholders (immediately before the reorganization) of the loss corporation, which is attributable to their ownership of stock in the loss corporation immediately before the reorganization.

(ii) If the percentage determined under subdivision (i) of this subparagraph is less than 20 percent, compute the difference between such percentage and 20 percent, and multiply such difference by five. The resulting product is the percentage

by which the net operating loss carryovers are reduced.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that X Corporation acquires the assets of Y Corporation, a loss corporation, in a reorganization described in section 381(a)(2), and that immediately after the reorganization the former stockholders of Y Corporation, as the result of owning stock of Y Corporation, own 8 percent of the fair market value of X Corporation's outstanding stock. The difference between 8 percent and 20 percent is 12 percent, which when multiplied by five produces 60 percent. Therefore, the amount of the reduction is equal to 60 percent of the net operating loss carryovers from the loss corporation, so that if the net operating loss carryovers from Y Corporation amounted to $100,000, the amount of the reduction would be $60,000.

(c) Acquisitions designed to avoid section 382(b). The purpose of the 20-percent requirement of section 382(b)(1) is to ensure that the net operating loss carryovers from a corporation a party to a reorganization will be allowed in full only when the shareholders of the loss corporation have a substantial continuing interest in the acquiring corporation, thereby ensuring that the carryovers will be utilized to some extent for the benefit of those persons who were owners of the loss corporation before the reorganization. Therefore, in applying section 382(b)(1), any acquisition of stock of a loss corporation will be disregarded if made for the purpose of avoiding the 20-percent continuity of interest requirement. Moreover, two or more successive reorganizations will be treated as if they had occurred simultaneously in cases where they are undertaken with a view to avoiding the 20-percent continuity requirement. These rules may be illustrated by the following examples:

Example (1). Assume that X Corporation desires to merge into Y Corporation, a loss corporation, in a reorganization. A and B, who are the controlling stockholders of X Corporation, with a view to avoiding the 20-percent continuity of interest requirement of section 382(b)(1), acquire for cash 40 percent of the fair market value of the outstanding stock of Y Corporation (or acquire an option to purchase such stock, which option they exercise shortly after the merger). Thereafter, Y Corporation acquires the assets of X Corporation in a reorganization to which section 381(a) applies. In determining whether the 20-percent continuity requirement is satisfied (and, if not, the amount of the reduction under section 382(b)(2)), the stock of Y Corporation purchased by A and B (or acquired upon their exercise of the option) will be considered as outstanding immediately after the reorganization but will not be considered as owned by persons who were stockholders of Y Corporation immediately before the reorganization.

Example (2). Assume that X Corporation, which has a net worth of $2,000,000, desires to acquire the assets of Y Corporation, a loss corporation, which has a net worth of $100,000. X Corporation also desires to acquire the assets of Z Corporation, which has a net worth of $400,000. With a view to avoiding the 20-percent continuity requirement, Z Corporation acquires the assets of Y Corporation in a reorganization to which section 381(a) applies. Immediately after the reorganization, the former stockholders of Y Corporation own 20 percent of the fair market value of the outstanding stock of Z Corporation. Shortly thereafter, X Corporation acquires the assets of Z Corporation in a reorganization to which section 381(a) applies. Immediately after the reorganization, the former stockholders of Y Corporation own 4 percent of the fair market value of the outstanding stock of X Corporation. Under these circumstances, the application of section 382(b)(1) to the net operating loss carryovers of Y Corporation shall be determined by reference to the fair market value of the outstanding stock of X Corporation owned, immediately after the successive reorganizations, by the stockholders (immediately before the successive reorganizations) of Y Corporation. Therefore, the net operating loss carryovers from Y Corporation will be reduced by 80 percent.

(d) Exception to application of section 382(b). (1) Section 382(b)(3) provides an exception to the application of the reduction provided in section 382(b)(1). Under this exception there is no reduction if, immediately before the reorganization, the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion. If the acquiring corporation is not in existence immediately before the reorganization (as in the case of a statutory consolidation), the requirements of section 382(b)(3) are not met unless the transferor corporations immediately before the reorganization are owned substantially by the same persons in the same proportion.

(2) The transferor corporation and the acquiring corporation will be considered as owned substantially by the same persons in the same proportion only if the same persons own substantially all the stock of the corporations in substantially the same proportion. This rule may be illustrated by the following examples:

Example (1). A and B each owns 50 percent of the fair market value of the outstanding stock of X Corporation. A owns 52 percent and B owns 48 percent of the fair market value of the outstanding stock of Y Corporation. Y Corporation acquires the assets of X Corporation in a reorganization to which section 381(a) applies. The exception provided in section 382(b)(3) is applicable.

Example (2). A and B each owns 50 percent of the fair market value of the outstanding stock of X Corporation. A owns 60 percent and B owns 40 percent of the fair market value of the outstanding stock of Y Corporation. Y Corporation acquires the assets of X Corporation in a reorganization to which section 381(a) applies. The exception provided in section 382(b)(3) is not applicable.

Example (3). A and B each owns 48 percent of the fair market value of the outstanding stock of X Corporation and of Y Corporation. C owns the remaining 4 percent of X Corporation and D owns the remaining 4 percent of Y Corporation. Y Corporation acquires the assets of X Corporation in a reorganization to which section 381(a) applies. The exception provided in section 382(b)(3) is applicable.

Example (4). A and B each owns 40 percent of the fair market value of the outstanding stock of X Corporation and of Y Corporation. C owns the remaining 20 percent of X Corporation and D owns the remaining 20 percent of Y Corporation. Y Corporation acquires the assets of X Corpora-

tion in a reorganization to which section 381(a) applies. The exception provided in section 382(b)(3) is not applicable.

(3) If stock of the transferor or acquiring corporation is acquired or disposed of for the purpose of meeting the requirements of section 382(b)(3), then for purposes of such section such stock shall not be considered to be owned by the person who acquired it. For example, if A, owning 100 percent of the outstanding stock of X Corporation and 75 percent of the outstanding stock of Y Corporation, a loss corporation, acquires the remaining 25 percent of the outstanding stock of Y Corporation with a view to merging the two corporations, then for purposes of section 382(b)(3) such 25 percent shall not be considered to be owned by A.

(e) Carryovers to subsequent years. **(1)** The reduction provided in section 382(b)(1) applies only to net operating loss carryovers to the first taxable year of the acquiring corporation ending after the date of transfer. However, section 382(b)(4) contains a rule to ensure that the portion of the carryovers equal to the amount of the reduction will not be available for deduction in subsequent taxable years of the acquiring corporation. This rule provides that if a reduction is applicable under section 382(b)(1), then in computing net operating loss carryover from taxable years of the transferor and acquiring corporations ending on or before the date of transfer to taxable years of the acquiring corporation subsequent to the first taxable year ending after the date of transfer, the income of the acquiring corporation for such first taxable year, as computed under section 172(b)(2) (without regard to the fact that the deduction under section 172(a) is reduced by the amount computed under section 382(b)(2)), shall be increased by the amount of the reduction computed under section 382(b)(2) for that year. The preceding rule may be illustrated by the following example:

Example. X Corporation and Y Corporation are organized on January 1, 1957, and each makes its return on the basis of the calendar year. On December 31, 1958, Y Corporation acquires the assets of X Corporation in a reorganization to which section 381(a) applies. Immediately after the reorganization, those persons who were stockholders of X Corporation immediately before the reorganization own 10 percent of the fair market value of the outstanding stock of Y Corporation. The net operating losses and the taxable income (computed without any net operating loss deduction) of the two corporations are as follows:

		X Corporation (transferor)	Y Corporation (acquirer)
Year:			
1957		($5,000)	($5,000)
1958		(15,000)	(1,000)
1959			5,000
The computation of the carryovers to Y Corporation's calendar year 1960 may be illustrated as follows:			
(i) X Corporation's 1957 loss. The carryover to 1960 is $0, computed as follows:			
Net operating loss			$5,000
Less:			
X's 1958 taxable income		0	
Y's 1959 taxable income before adjustment under section 382(b)(4)	$5,000		
Plus amount of reduction computed under section 382(b)(2) (50% of $20,000)	10,000		
		$15,000	
			15,000
Carryover to 1960			0
(ii) Y Corporation's 1957 loss. The carryover to 1960 is $0, computed as follows:			
Net operating loss			$5,000
Less:			
Y's 1958 taxable income		0	
Y's 1959 taxable income before net operating loss deduction and adjustment under section 382(b)(4)	$5,000		
Minus Y's 1959 net operating loss deduction (i.e., X's 1957 carryover)	5,000		
Plus amount of reduction under section 382(b)(2)	10,000		
		$10,000	
			10,000
Carryover to 1960			
(iii) X Corporation's 1968 loss. The carryover to 1960 is $10,000, computed as follows:			
Net operating loss			$15,000
Less:			
X's 1957 taxable income		0	

		X Corporation (transferor)	Y Corporation (acquirer)
Y's 1959 taxable income before net operating loss deduction and adjustment under section 382(b)(4)	$5,000		
Minus Y's 1959 net operating loss deduction (i.e., X's 1957 carryover of $5,000 and Y's 1957 carryover of $5,000)	10,000		
Plus amount of reduction under section 382(b)(2)	10,000		
		$5,000	
			5,000
Carryover to 1960			10,000

(iv) Y Corporation's 1958 loss. The carryover to 1960 is $1,000, computed as follows:

Net operating loss			$1,000
Less:			
Y's 1957 taxable income		0	
Y's 1959 taxable income before net operating loss deduction and adjustment under section 382(b)(4)	$5,000		
Minus Y's 1959 net operating loss deduction (i.e., X's 1957 carryover of $5,000, Y's 1957 carryover of $5,000, and X's 1958 carryover of $15,000)	25,000		
Plus amount of reduction under section 382(b)(2)	10,000		
		0	
			0
Carryover to 1960			1,000

(v) Summary of carryovers to 1960. The aggregate of the net operating loss carryovers to 1960 is $11,000, computed as follows:

X's 1958 loss	$10,000
Y's 1958 loss	1,000
Total	11,000

(2) If the date of transfer is on a day other than the last day of a taxable year of the acquiring corporation, and if the reduction provided in section 382(b)(1) applies to net operating loss carryovers of the transferor corporation, then for purposes of section 381(c)(1)(C), the adjustment provided in section 382(b)(4) shall be considered as an increase in income of the "postacquisition part year" and no portion of such adjustment shall be considered as an increase in income of the "preacquisition part year."

(f) Attribution of ownership. (1) Section 382(b)(5) provides a special rule for determining whether the reduction provided in section 382(b)(1) applies in cases where, immediately before the reorganization, either the transferor corporation or the acquiring corporation owns outstanding stock of the loss corporation. Under this rule, the transferor or acquiring corporation (whichever owns stock of the loss corporation) is treated as owning, immediately after the reorganization, a percentage, A, of the fair market value of the acquiring corporation's outstanding stock which bears the same ratio to B (the percentage of the fair market value of the stock of the loss corporation owned, immediately before the reorganization, by such transferor or acquiring corporation) as C (the fair market value of the outstanding stock of the loss corporation immediately before the reorganization) bears to D (the fair market value of the outstanding stock of the acquiring corporation immediately after the reorganization). Stated algebraically, the percentage of the fair market value of the acquiring corporation's outstanding stock treated as owned by the transferor or acquiring corporation immediately after the reorganization, A, equals—

Value of stock of loss corporation immediately before reorganization (C)/Value of stock of acquiring corporation immediately after reorganization (D)×Percentage of stock of loss corporation owned by transferor or acquiring corporation immediately before reorganization (B).

The preceding rule may be illustrated by the following examples:

Example (1). Assume that X Corporation owns 25 percent of the fair market value of the outstanding stock of Y Corporation, a loss corporation; that X Corporation acquires the assets of Y Corporation in a reorganization to which section 381(a) applies; that immediately before the reorganization the total outstanding stock of Y Corporation has a fair market value of $10,000; and that immediately after the reorganization the total outstanding stock of X Corporation has a fair market value of $50,000. For the purpose of determining whether the reduction provided in section 382(b)(1) is applicable (and, if so, the amount of the reduction computed under section 382(b)(2)), X Corporation is treated as owning (immediately after the reorganization) 5 percent of the fair market value of its outstanding stock, determined as follows:

$$[\$10{,}000(C)/\$50{,}000(D)] \times 25\%(B) = 5\%(A)$$

Thus, if the other former stockholders of Y Corporation own, after the reorganization at least 15 percent of the fair market value of the outstanding stock of X Corporation as the result of owning stock in Y Corporation, there will be no reduction under section 382(b)(1).

Example (2). Assume the same facts as in example (1), except that Y Corporation acquires the assets of X Corporation in a reorganization to which section 381(a) applies and that immediately after the reorganization the total outstanding stock of Y Corporation has a fair market value of $50,000. The result is the same as that in example (1). X Corporation is treated as owning (immediately after the reorganization) 5 percent of the fair market value of the outstanding stock of Y Corporation. Thus, there will be no reduction under section

382(b)(1) if those persons (other than X Corporation) who were stockholders of Y Corporation immediately before the reorganization own at least 15 percent of the fair market value of the outstanding stock of Y Corporation immediately after the reorganization.

(2) The provisions of paragraph (5) of section 382(b) do not apply with respect to an interest in a loss corporation which is acquired for the purpose of avoiding the 20-percent continuity of interest requirement of section 382(b)(1). Thus, paragraph (5) of section 382(b) does not apply with respect to stock of a loss corporation which is acquired by another corporation with a view to causing a merger of the two corporations. For example, if X Corporation owns 15 percent of the fair market value of the outstanding stock of Y Corporation, a loss corporation, and if X Corporation purchases an additional 15 percent with a view to causing a merger of the two corporations, paragraph (5) of section 382(b) applies only with respect to the stock previously held by X Corporation and not to the stock so purchased.

(g) Stock of corporation controlling acquiring corporation. **(1)** Section 382(b)(6) provides a special rule for determining whether the reduction provided in section 382(b)(1) applies in cases where the transferor corporation is a loss corporation and the former stockholders of the loss corporation own, as a result of the reorganization, stock in a corporation which controls (within the meaning of section 368(c)) the acquiring corporation. In such cases, the former stockholders of the loss corporation are treated as owning, after the reorganization, stock of the acquiring corporation equal in value to the fair market value of their stock in the controlling corporation. This rule may be illustrated by the following example:

Example. X Corporation owns 100 percent of the stock of Y Corporation. In a reorganization to which section 381(a) applies, Y Corporation acquires the assets of Z Corporation, a loss corporation, in exchange for stock of X Corporation. Immediately after the reorganization the total outstanding stock of Y Corporation has a fair market value of $50,000, and the stockholders (immediately before the reorganization) of the loss corporation own, as a result of the reorganization, stock of X Corporation having a fair market value of $20,000. For the purpose of determining whether the reduction provided in section 382(b)(1) is applicable (and, if so, the amount of the reduction computed under section 382(b)(2)), the former stockholders of the loss corporation are treated as owning stock of Y Corporation worth $20,000 (the value of their stock in X Corporation), which is 40 percent ($20,000 divided by $50,000) of the fair market value of the outstanding stock of the acquiring corporation.

(2) The 20-percent continuity of interest requirement of section 382(b)(1) applies with respect to an interest in the corporation desiring to utilize the net operating loss carryovers from the loss corporation. Thus, the provisions of section 382(b)(6) and of subparagraph (1) of this paragraph apply only if, at the time of the reorganization, it is intended that the acquiring corporation itself, and not the corporation which controls the acquiring corporation, shall make use of the net operating loss carryovers from the loss corporation. Section 382(b)(6) and subparagraph (1) of this paragraph do not apply if the loss corporation is acquired by a controlled corporation with a view to the liquidation of the controlled corporation into its parent at a time when a substantial part of the net operation loss carryovers from the loss corporation remain to be utilized. (This requirement is satisfied in any case in which such action was contemplated at the time of the reorganization by those persons in a position to determine the policies of the controlled corporation.) In such case, it is the controlling corporation, instead of the controlled corporation, in which the former stockholders of the loss corporation must own a 20-percent interest. Thus, assume in the example appearing in subparagraph (1) of this paragraph, that the total fair market value of the outstanding stock of X Corporation immediately after the reorganization is $200,000 and that X Corporation causes Y Corporation to be liquidated at a time when a substantial part of the loss carryovers from Z Corporation remain to be utilized. Under these circumstances, the former stockholders of the loss corporation would own after the reorganization only 10 percent ($20,000 divided by $200,000) of the fair market value of the outstanding stock of the controlling corporation and the net operating loss carryovers from Z Corporation to the first taxable year of Y Corporation ending after the date of transfer would accordingly be reduced by 50 percent.

(h) Minimum tax for tax preferences. For purposes of the tax imposed under section 56, the acquiring corporation succeeding to and taking into account any net operating loss carryovers of the transferor corporation shall also succeed to and take into account along with such net operating loss carryover any deferred tax liability under section 56(b) and the regulations thereunder attributable to such net operating loss carryover. Any reduction of net operating loss effected pursuant to section 382 and the regulations thereunder shall, for purposes of section 56(b) and the regulations thereunder and section 1.58–7, be deemed to reduce the portions of such net operating loss described in such provisions proportionately.

[T.D. 6616, 27 FR 10738, Nov. 3, 1962, as amended by T.D. 7564, 43 FR 40493, Sept. 12, 1978]

§ 1.382(c)–1 Definition of stock.

Section 382(c) contains the definition of the term "stock" for purposes of section 382(a) and (b). For these purposes, the term "stock" means all outstanding shares except nonvoting stock which is limited and preferred as to dividends. [T.D. 6616, 27 FR 10741, Nov. 3, 1962]

§ 1.383–1 Special limitations on carryovers of unused investment credits, work incentive program credits, foreign taxes, and capital losses.

Section 383 provides that if the ownership and business of a corporation are changed in the manner described in section 382(a)(1) or, in the case of a reorganization specified in section 381(a)(2), if there is a change in ownership described in section 382(b)(1)(B), then the limitations provided in section 382 in such cases with respect to the carryover of net operating losses shall apply in the same manner, as provided under regulations prescribed by the Secretary or his delegate, with respect to any unused investment credit of the corporation which can otherwise be carried forward under section 46(b), to any unused work incentive program credit of the corporation which can otherwise be carried forward under section 50A(b), to any unused foreign taxes of the corporation which can otherwise be carried forward under section 904(d), and to any net capital loss of the corporation which can otherwise be carried forward under section 1212. Sections 1.383–2 and 1.383–3 are prescribed pursuant to the authority granted the Secretary or his delegate by section 383 to prescribe regulations governing the manner in which the limitations provided in section 382 shall apply with respect to the above-mentioned items. For the election to apply sections 382 and 383, as amended by the Tax Reform Act of 1976, see § 382–2.

[T.D. 7343, 40 FR 1698, Jan. 9, 1975, as amended by T.D. 7650, 44 FR 61573, May 26, 1979]

§ 1.383–2 Purchase of a corporation and change in its trade or business.

(a) In general. If the ownership and business of a corporation are changed in the manner described in section 382(a) and the regulations thereunder, then the limitation applicable in such cases to the carryover of the net operating losses of such corporation shall also apply to the carryover of the unused investment credits of such corporation which could otherwise be carried forward under section 46(b), the unused work incentive program credits of such corporation which could otherwise be carried forward under section 50A(b), the unused foreign taxes of such corporation which could otherwise be carried forward under section 904(d), and the net capital losses of such corporation which could otherwise be carried forward under section 1212. Thus, if the limitation provided in section 382(a) is applicable at the end of a corporation's taxable year, then all investment credit carryovers, all work incentive program credit carryovers, all unused foreign tax carryovers, and all capital loss carryovers from prior taxable years of such corporation are excluded in computing tax liability for such taxable year and for subsequent taxable years.

(b) Effective date. **(1)** The limitation provided in this section shall apply only with respect to changes in ownership occurring after December 10, 1971, pursuant to a contract entered into on or after September 29, 1971.

(2) For purposes of applying section 382(a) in determining whether the limitation provided in this section applies, the beginning of the taxable years specified in clauses (i) and (ii) of section 382(a)(1)(A) shall be the beginning of such taxable years or December 10, 1971, whichever occurs later. Thus, if X Corporation made its returns for 1971 and 1972 on the basis of the calendar year, then in determining whether section 382(a) would apply as of December 31, 1971, the beginning of the taxable years specified in clauses (i) and (ii) of section 382(a)(1)(A) would be December 10, 1971, and in determining whether section 382(a) would apply as of December 31, 1972, the beginning of the taxable year specified in clause (i) of section 382(a)(1)(A) would be January 1, 1972, and the beginning of the taxable year specified in clause (ii) of section 382(a)(1)(A) would be December 10, 1971.

[T.D. 7343, 40 FR 1698, Jan. 9, 1975]

§ 1.383–3 Change in ownership as the result of a reorganization.

(a) In general. **(1)** If, in the case of a reorganization specified in section 381(a)(2), (i) the transferor corporation or the acquiring corporation has an unused investment credit, an unused work incentive program credit, an unused foreign tax or a net capital loss which may be carried forward to the first taxable year of the acquiring corporation ending after the date of transfer, and (ii) as a result of the reorganization there is a change in ownership of such corporation within the meaning of section 382(b)(1)(B), then the limitation applicable in such cases to the carryover of the net operating

losses of such corporation shall apply in the manner provided in this section to the carryover of any unused investment credits, any unused work incentive program credits, any unused foreign taxes, and any net capital losses of such corporation. Thus, if the limitation provided in section 382(b)(1) would apply in such a case to the net operating loss carryovers of a corporation (whether or not such corporation has any such carryovers), a similar limitation, computed with the modifications provided in this paragraph, shall apply to the investment credit carryovers, to the work incentive program credit carryovers, to the foreign tax carryovers, and to the capital loss carryovers of such corporation.

(2)(i) If there is a change in ownership of a corporation within the meaning of section 382(b)(1)(B), then the amount of the reduction provided in section 382(b)(1) shall be determined with respect to the total carryovers of such corporation from taxable years ending on or before the date of transfer which may otherwise be carried to the first taxable year of the acquiring corporation ending after such date. In such a case, for purposes of computing carryovers of the transferor and acquiring corporations from taxable years ending on or before the date of transfer to taxable years of the acquiring corporation ending after the date of transfer, the amount of the reduction shall be applied against the earliest carryover, whether a carryover of the transferor corporation or of the acquiring corporation, which may otherwise be carried to the acquiring corporation's first taxable year ending after the date of transfer, then against the next earliest carryover which may otherwise be carried to such first taxable year, etc. To the extent of the amount of the reduction, such carryovers shall be eliminated and shall not be included in computing the total carryover to the acquiring corporation's first taxable year ending after the date of transfer or to subsequent taxable years.

(ii) For purposes of this subparagraph, if the date of transfer is on a day other than the last day of a taxable year of the acquiring corporation, then the amount of the reduction shall be applied only against the carryovers of the transferor corporation or of the acquiring corporation which may be carried to the acquiring corporation's postacquisition part year under the principles of § 1.381(c)(23)–1(e) (relating to investment credit carryovers).

(iii) For purposes of this subparagraph, a carryover from a taxable year of the transferor corporation ending on or before the last day of a taxable year of the acquiring corporation shall be considered to be a carryover from a taxable year prior to such taxable year of the acquiring corporation.

(3) The provisions of paragraph (a)(2) of this section may be illustrated by the following example dealing with the carryover of unused investment credit:

Example. X Corporation and Y Corporation are organized on January 1, 1970, and each makes its return on the basis of the calendar year. On December 31, 1972, Y acquires the assets of X in a reorganization described in section 381(a)(2). Immediately after the reorganization, those persons who were stockholders of X immediately before the reorganization, as the result of owning stock of X, own 10 percent of the fair market value of the outstanding stock of Y, so that the investment credit carryovers of X as of the close of the date of transfer are reduced under section 382(b)(2) by 50 percent. The investment credit carryovers as of the close of the date of transfer of X Corporation and Y Corporation for taxable years 1970 through 1972 are as follows:

Taxable years	X Corporation (transferor)	Y Corporation (acquiring)
1970	$100	$100
1971	100	100
1972	500	200

For the first taxable year ending after the date of transfer, the acquiring corporation has an excess limitation of $500 (i.e., the excess of the limitation based on the amount of tax for such year over the amount of credit earned for such year). The computation of investment credit carryovers from prior taxable years of the transferor and acquiring corporations to the acquiring corporation's first taxable year ending after the date of transfer and to subsequent taxable years is as follows:

(i) The amount of the reduction computed under subparagraph (1) of this paragraph with respect to the investment credit carryovers from prior taxable years of X Corporation is $350 ($700 × 50%). One hundred dollars of such reduction is first applied against and eliminates X's $100 carryover from 1970; $100 of such reduction is applied against and eliminates Y's $100 carryover from 1970; $100 of such reduction is applied against and eliminates X's $100 carryover from 1971; the remaining $50 of such reduction is applied against Y's $100 carryover from 1971 and reduces such carryover to $50. After the reduction, the total carryover to the first taxable year of the acquiring corporation ending after the date of transfer is $750 (i.e., Y's $50 carryover from 1971, X's $500 carryover from 1972, and Y's $200 carryover from 1972).

(ii) Since the excess limitation for the acquiring corporation's first taxable year ending after the date of transfer is $500, Y's $50 carryover from 1971 and $450 of X's carryover from 1972 may be added to the amount of credit allowed by section 38 for such year. The total carryover to taxable years of the acquiring corporation subsequent to such first taxable year is $250 (i.e., the remainder of X's carryover from 1972, $50, plus Y's $200 carryover from 1972).

(b) Special rules for foreign tax carryovers. (1) The amount of unused foreign tax of a transferor corporation which may be carried to taxable years of the acquiring corporation ending after the date of transfer shall be determined under the principles of section 381(c)(23) and the regulations thereunder (relating to the carryover of unused investment

credit). Thus, to determine the amount of such carryovers as of the close of the date of transfer, and to integrate them with any carryovers and carrybacks of the acquiring corporation for purposes of determining the amount of credit allowed by section 901 to the acquiring corporation for taxable years ending after the date of transfer, it is necessary to apply the provisions of section 904(d) in accordance with the principles of section 381(c)(23) and the regulations thereunder.

(2) If the limitation provided in section 382(b)(1) applies to the carryover of unused foreign taxes of a corporation, then for purposes of computing the amount of the reduction under paragraph (a) of this section, the following rules shall apply. If all of the unused foreign tax carryovers from prior taxable years of the corporation are of the same origin, the amount of the reduction shall be determined by applying the percentage computed under section 382(b)(2) to the total of such carryovers. If the unused foreign tax carryovers from prior taxable years of the corporation are not of the same origin, that is, where one or more carryovers originated in taxable years to which the per-country limitation applied and one or more carryovers originated in taxable years to which the overall limitation applied, or where, even though all the carryovers originated in per-country limitation years, all of such carryovers are not attributable to taxes paid or accrued to the same foreign country or possession of the United States, the amount of the reduction shall be determined separately with respect to carryovers of the same origin. That is, the percentage computed under section 382(b)(2) shall be applied separately to the total of the carryovers originating in overall limitation years and separately to the total of the carryovers attributable to taxes paid or accrued to each particular country or United States possession in per-country limitation years. Thus, if a corporation has (as of the close of the date of transfer) total unused foreign tax carryovers of $200 attributable to taxes paid or accrued to country X and total unused foreign tax carryovers of $150 attributable to taxes paid or accrued to country Y from one or more taxable years to which the per-country limitation applied, and also has total unused foreign tax carryovers of $100 from taxable years to which the overall limitation applied, and if the percentage computed under section 382(b)(2) is 50 percent, then the amount of reduction in carryovers attributable to taxes paid or accrued to country X is $100, the amount of reduction in carryovers attributable to taxes paid or accrued to country Y is $75, and the amount of reduction in carryovers from taxable years to which the overall limitation applied is $50.

(3) After having determined the reduction or reductions under subparagraph (2) of this paragraph, it is necessary, for purposes of computing unused foreign tax carryovers of the transferor and acquiring corporations from taxable years ending on or before the date of transfer to taxable years of the acquiring corporation ending after the date of transfer, to apply such reduction or reductions against the earliest carryover of the same origin, whether a carryover of the transferor corporation or of the acquiring corporation, which may otherwise be carried to the first taxable year of the acquiring corporation ending after the date of transfer, then against the next earliest carryover of the same origin which may otherwise be carried to such first taxable year, etc. To the extent of the amount of the reduction, such carryovers shall be eliminated and shall not be included in computing the total carryover to the acquiring corporation's first taxable year ending after the date of transfer or to subsequent taxable years.

(4) The provisions of subparagraphs (2) and (3) of this paragraph may be illustrated by the following example:

Example. T, a domestic corporation, and S, a domestic corporation, are organized on January 1, 1970, and each makes its return on the basis of the calendar year. On December 31, 1972, S Corporation acquires the assets of T Corporation in a reorganization described in section 381(a)(2). Immediately after the reorganization, those persons who were stockholders of T Corporation immediately before the reorganization, as the result of owning stock of T, own 10 percent of the fair market value of the outstanding stock of S, so that T's foreign tax carryovers as of the close of the date of transfer are reduced by 50 percent. The unused foreign tax carryovers as of the close of the date of transfer of T Corporation and S Corporation for taxable years 1970 through 1972 are as follows:

UNUSED FOREIGN TAX CARRYOVERS FROM YEAR(S) OF ORIGIN

Taxable year	T Corporation (transferor)	S Corporation (acquiring)
1970	Per country:	Per country:
	Country X—50	Country X—100.
	Country Y—100	Country Y—50.
	Country Z—100	
1971	Per country:	Overall:
	Country X—150	Aggregate—50.
	Country Y—100	
1972	Overall:	Overall:
	Aggregate—200	Aggregate—100.

For the first taxable year ending after the date of transfer, the acquiring corporation, which has elected the overall limitation, has an excess limitation of $200 (i.e., the excess of the limitation based on amount of tax for such year over the amount of credit earned for such year). The computation of unused foreign tax carryovers from prior taxable years of the transferor and acquiring corporations to the acquiring corporation's first

taxable year ending after the date of transfer and to subsequent taxable years is as follows:

(i) Unused foreign tax carryovers attributable to country X. The amount of the reduction computed under subparagraph (2) of this paragraph with respect to the total unused foreign tax carryovers from prior taxable years of T Corporation attributable to taxes paid or accrued to country X is $100 ($200 × 50%). Fifty dollars of such reduction is applied against and eliminates T's $50 carryover from 1970. The remaining $50 of such reduction is then applied against S's $100 carryover from 1970 and reduces such carryover to $50. After the reduction, the total carryover to the first taxable year of the acquiring corporation ending after the date of transfer attributable to taxes paid or accrued to country X is $200 (i.e., S's $50 carryover from 1970 and T's $150 carryover from 1971). Since the acquiring corporation has elected the overall limitation for its first taxable year ending after the date of transfer, the carryovers attributable to country X from per-country limitation years may not be applied in such first taxable year and the total $200 is carried to the next succeeding taxable year.

(ii) Unused foreign tax carryovers attributable to country Y. The amount of the reduction computed under subparagraph (2) of this paragraph with respect to the total unused foreign tax carryovers from prior taxable years of T Corporation attributable to taxes paid or accrued to country Y is $100 ($200 × 50%). The total $100 reduction is applied against and eliminates T's carryover from 1970. After the reduction, the total carryover to the first taxable year of the acquiring corporation ending after the date of transfer attributable to taxes paid or accrued to country Y is $150 (i.e., S's $50 carryover from 1970 and T's $100 carryover from 1971). Since the acquiring corporation has elected the overall limitation for its first taxable year ending after the date of transfer, the carryovers attributable to country Y from per-country limitation years may not be applied in such first taxable year and the total $150 is carried to the next succeeding taxable year.

(iii) Unused foreign tax carryovers attributable to country Z. The amount of reduction computed under subparagraph (2) of this paragraph with respect to the total unused foreign tax carryovers from prior taxable years of T Corporation attributable to taxes paid or accrued to country Z is $50 ($100 × 50%). The total $50 reduction is applied against T's $100 carryover from 1970 and thus reduces such carryover to the first taxable year of the acquiring corporation ending after the date of transfer to $50. Since the acquiring corporation has elected the overall limitation for its first taxable year ending after the date of transfer, the carryover attributable to country Z from the per-country limitation year may not be applied in such first taxable year and the total $50 is carried to the next succeeding taxable year.

(iv) Unused foreign tax carryovers from overall limitation years. The amount of the reduction computed under subparagraph (2) of this paragraph with respect to the total unused foreign tax carryovers from prior taxable years of T Corporation to which the overall limitation applied is $100 ($200 × 50%). Fifty dollars of such reduction is applied against and eliminates S's $50 carryover from 1971 and the remaining $50 of such reduction is applied against T's $200 carryover from 1972 and reduces such carryover to $150. After the reduction, the total carryover to the first taxable year of the acquiring corporation ending after the date of transfer attributable to taxes paid or accrued in taxable years to which the overall limitation applied is $250 (i.e., T's $150 carryover from 1972 and S's $100 carryover from 1972). Since for such first taxable year the acquiring corporation has an excess limitation of $200 with respect to carryovers arising in overall limitation years, T's $150 carryover from 1972 and $50 of S's $100 carryover from 1972 may be added to the amount of credit allowed by section 901 for such year. The total carryover to taxable years of the acquiring corporation subsequent to such first taxable year attributable to taxes paid or accrued in overall limitation years is $50 (i.e., the remainder of S's carryover from 1972, $50).

(c) Effective date. (1) The limitation provided in this section shall apply only with respect to reorganizations occurring after December 10, 1971, pursuant to a plan of reorganization or a contract entered into on or after September 29, 1971.

(2) For purposes of subparagraph (1) of this paragraph, a reorganization shall be considered to occur on the date of transfer as defined in section 381(b)(2) and § 1.381(b)–1(b).

(3) For purposes of subparagraph (1) of this paragraph, a plan of reorganization or a contract shall be considered to have been entered into on the date on which the duly authorized representatives of the transferor and acquiring corporations enter into an agreement evidencing the plan of reorganization, or on the date on which the plan of reorganization is adopted by the shareholders of the transferor and acquiring corporations, whichever occurs earlier.

[T.D. 7343, 40 FR 1699, Jan. 9, 1975]

DEFERRED COMPENSATION, ETC.

Pension, Profit-sharing, Stock Bonus Plans, Etc.

§ 1.401–0 Scope and definitions.

(a) In general. Sections 1.401 through 1.401–14 (inclusive) reflect the provisions of section 401 prior to amendment by the Employee Retirement Income Security Act of 1974. The sections following § 1.401–14 and preceding § 1.402(a)–1 (hereafter referred to in this section as the "Post-ERISA Regulations") reflect the provisions of section 401 after amendment by such Act.

(b) Definitions. For purposes of the Post-ERISA regulations—

(1) Qualified plan. The term "qualified plan" means a plan which satisfies the requirements of section 401(a).

(2) Qualified trust. The term "qualified trust" means a trust which satisfies the requirements of section 401(a).

[T.D. 7501, 42 FR 42320, Aug. 23, 1977]

§ 1.401–1 Qualified pension, profit-sharing, and stock bonus plans.

(a) Introduction. **(1)** Sections 401 through 405 relate to pension, profit- sharing, stock bonus, and annuity plans, compensation paid under a deferred-payment plan, and bond purchase plans. Section 401(a) prescribes the requirements which must be met for qualification of a trust forming part of a pension, profit-sharing, or stock bonus plan.

(2) A qualified pension, profit-sharing, or stock bonus plan is a definite written program and arrangement which is communicated to the employees and which is established and maintained by an employer—

(i) In the case of a pension plan, to provide for the livelihood of the employees or their beneficiaries after the retirement of such employees through the payment of benefits determined without regard to profits (see paragraph (b)(1)(i) of this section);

(ii) In the case of a profit-sharing plan, to enable employees or their beneficiaries to participate in the profits of the employer's trade or business, or in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404(a)(3)(B), pursuant to a definite formula for allocating the contributions and for distributing the funds accumulated under the plan (see paragraph (b)(1)(ii) of this section); and

(iii) In the case of a stock bonus plan, to provide employees or their beneficiaries benefits similar to those of profit-sharing plans, except that such benefits are distributable in stock of the employer, and that the contributions by the employer are not necessarily dependent upon profits. If the employer's contributions are dependent upon profits, the plan may enable employees or their beneficiaries to participate not only in the profits of the employer, but also in the profits of an affiliated employer who is entitled to deduct his contributions to the plan under section 404(a)(3)(B) (see paragraph (b)(1)(iii) of this section).

(3) In order for a trust forming part of a pension, profit-sharing, or stock bonus plan to constitute a qualified trust under section 401(a), the following tests must be met:

(i) It must be created or organized in the United States, as defined in section 7701(a)(9), and it must be maintained at all times as a domestic trust in the United States;

(ii) It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries (see paragraph (b)(2) through (5) of this section);

(iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan, and, in the case of a plan which covers (as defined in paragraph (a)(2) of § 1.401–10) any self-employed individual, the time and method of such distribution must satisfy the requirements of section 401(a)(9) with respect to each employee covered by the plan (see paragraph (e) of § 1.401–11);

(iv) It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus

or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries (see § 1.401-2);

(v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees (see § 1.401-3 and, in addition, see § 1.401-12 for special rules as to plans covering owner-employees);

(vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees (see § 1.401-4);

(vii) It must be part of a plan which provides the nonforfeitable rights described in section 401(a)(7) (see § 1.401-6);

(viii) If the trust forms part of a pension plan, the plan must provide that forfeitures must not be applied to increase the benefits any employee would receive under such plan (see § 1.401-7);

(ix) It must, if the plan benefits any self-employed individual who is an owner-employee, satisfy the additional requirements for qualification contained in section 401(a)(10) and (d).

(4) For taxable years beginning after December 31, 1962, self-employed individuals may be included in qualified plans. See §§ 1.401-10 through 1.401-13.

(b) General rules. (1)(i) A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees. The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants (see § 1.401-7, relating to the treatment of forfeitures under a qualified pension plan). A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits, or, as in the case of money purchase pension plans, such contributions are fixed without being geared to profits. A pension plan may provide for the payment of a pension due to disability and may also provide for the payment of incidental death benefits through insurance or otherwise. However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401-14).

(ii) A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant. A plan (whether or not it contains a definite predetermined formula for determining the profits to be shared with the employees) does not qualify under section 401(a) if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. For the rules with respect to discrimination, see §§ 1.401-3 and 1.401-4. A profit-sharing plan within the meaning of section 401 is primarily a plan of deferred compensation, but the amounts allocated to the account of a participant may be used to provide for him or his family incidental life or accident or health insurance.

(iii) A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company. For the purpose of allocating and distributing the stock of the employer which is to be shared among his employees or their beneficiaries, such a

plan is subject to the same requirements as a profit-sharing plan.

(iv) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(2) The term "plan" implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401(a). The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan. In the case of a profit-sharing plan, other than a profit-sharing plan which covers employees and owner-employees (see section 401(d)(2)(B)), it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio every year. However, merely making a single or occasional contribution out of profits for employees does not establish a plan of profit-sharing. To be a profit-sharing plan, there must be recurring and substantial contributions out of profits for the employees. In the event a plan is abandoned, the employer should promptly notify the district director, stating the circumstances which led to the discontinuance of the plan.

(3) If the plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, it will not qualify as a plan for the exclusive benefit of employees even though other employees who are not shareholders are also included under the plan. The plan must benefit the employees in general, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan is not for the exclusive benefit of employees in general if, by any device whatever, it discriminates either in eligibility requirements, contributions, or benefits in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees. See section 401(a)(3), (4), and (5). Similarly, a stock bonus or profit-sharing plan is not a plan for the exclusive benefit of employees in general if the funds therein may be used to relieve the employer from contributing to a pension plan operating concurrently and covering the same employees. All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide stock bonus, pension, or profit-sharing plan for the exclusive benefit of employees in general. The law is concerned not only with the form of a plan but also with its effects in operation. For example, section 401(a)(5) specifies certain provisions which of themselves are not discriminatory. However, this does not mean that a plan containing these provisions may not be discriminatory in actual operation.

(4) A plan is for the exclusive benefit of employees or their beneficiaries even though it may cover former employees as well as present employees and employees who are temporarily on leave, as, for example, in the Armed Forces of the United States. A plan covering only former employees may qualify under section 401(a) if it complies with the provisions of section 401(a)(3)(B), with respect to coverage, and section 401(a)(4), with respect to contributions and benefits, as applied to all of the former employees. The term "beneficiaries" of an employee within the meaning of section 401 includes the estate of the employee, dependents of the employee, persons who are the natural objects of the employee's bounty, and any persons designated by the employee to share in the benefits of the plan after the death of the employee.

(5)(i) No specific limitations are provided in section 401(a) with respect to investments which may be made by the trustees of a trust qualifying under section 401(a). Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, such a trust will be subject to tax under section 511 with respect to any "unrelated business taxable income" (as defined in section 512) realized by it from its investments.

(ii) Where the trust funds are invested in stock or securities of, or loaned to, the employer or other person described in section 503(b), full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees. The trustee

shall report any of such investments on the return which under section 6033 it is required to file and shall with respect to any such investment furnish the information required by such return. See § 1.6033-1.

(c) Portions of years. A qualified status must be maintained throughout the entire taxable year of the trust in order for the trust to obtain any exemption for such year. But see section 401(a)(6) and § 1.401-3.

(d) Plan of several employers. A trust forming part of a plan of several employers for their employees will be qualified if all the requirements are otherwise satisfied.

(e) Determination of exemptions and returns. **(1)** An employees' trust may request a determination letter as to its qualification under section 401 and exemption under section 501. For the procedure for obtaining such a determination letter see paragraph (*l*) of § 601.201 of this chapter (Statement of Procedural Rules).

(2) A trust which qualifies under section 401(a) and which is exempt under section 501(a) must file a return in accordance with section 6033 and the regulations thereunder. See §§ 1.6033-1 and 1.6033-2(a)(3). In case such a trust realizes any unrelated business taxable income, as defined in section 512, such trust is also required to file a return with respect to such income. See paragraph (e) of § 1.6012-2 and paragraph (a)(5) of § 1.6012-3 for requirements with respect to such returns. For information required to be furnished periodically by an employer with respect to the qualification of a plan, see §§ 1.404(a)-2, 1.404(a)-2A, and 1.6033-2(a)(2)(ii)(*i*.)

[T.D. 6500, 25 FR 11670, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10118, Sept. 17, 1963; T.D. 6722, 29 FR 5071, April 14, 1964; T.D. 7168, 37 FR 5024, March 9, 1972; T.D. 7428, 41 FR 34619, Aug. 16, 1976]

§ 1.401-2 Impossibility of diversion under the trust instrument.

(a) In general. **(1)** Under section 401(a)(2) a trust is not qualified unless under the trust instrument it is impossible (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries. This section does not apply to funds of the trust which are allocated to provide medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401-14. For the rules prohibiting diversion of such funds and the requirement of reversion to the employer after satisfaction of all liabilities under the medical benefits account, see paragraph (c)(4) and (5) of § 1.401-14. For rules permitting reversion to the employer of amounts held in a section 415 suspense account, see § 1.401(a)-2(b).

(2) As used in section 401(a)(2), the phrase "if under the trust instrument it is impossible" means that the trust instrument must definitely and affirmatively make it impossible for the nonexempt diversion or use to occur, whether by operation or natural termination of the trust, by power of revocation or amendment, by the happening of a contingency, by collateral arrangement, or by any other means. Although it is not essential that the employer relinquish all power to modify or terminate the rights of certain employees covered by the trust, it must be impossible for the trust funds to be used or diverted for purposes other than for the exclusive benefit of his employees or their beneficiaries.

(3) As used in section 401(a)(2), the phrase "purposes other than for the exclusive benefit of his employees or their beneficiaries" includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.

(b) Meaning of "liabilities". **(1)** The intent and purpose in section 401(a)(2) of the phrase "prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust" is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, any balance remaining in the trust which is due to erroneous actuarial computations during the previous life of the trust. A balance due to an "erroneous actuarial computation" is the surplus arising because actual requirements differ from the expected requirements even though the latter were based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan and were made by a person competent to make such determinations in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will

satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial computation.

(2) The term "liabilities" as used in section 401(a)(2) includes both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such 700 employees have nevertheless arisen which constitute "liabilities" within the meaning of that term. It must be impossible for the employer (or other nonemployee) to recover any amounts other than such amounts as remain in the trust because of "erroneous actuarial computations" after the satisfaction of all fixed and contingent obligations. Furthermore, the trust instrument must contain a definite affirmative provision to this effect, irrespective of whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and regardless of whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.

[T.D. 6500, 25 FR 11672, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5072, April 14, 1964; T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§ 1.401–3 Requirements as to coverage.

(a)(1) In order to insure that stock bonus, pension, and profit-sharing plans are utilized for the welfare of employees in general, and to prevent the trust device from being used for the principal benefit of shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance, a trust will not be qualified unless it is part of a plan which satisfies the coverage requirements of section 401(a)(3). However, if the plan covers any individual who is an owner-employee, as defined in section 401(c)(3), the requirements of section 401(a)(3) and this section are not applicable to such plan, but the plan must satisfy the requirements of section 401(d) (see § 1.401–12).

(2) The percentage requirements in section 401(a)(3)(A) refer to a percentage of all the active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(3) The application of section 401(a)(3)(A) may be illustrated by the following example:

Example. A corporation adopts a plan at a time when it has 1,000 employees. The plan provides that all full-time employees who have been employed for a period of two years and have reached the age of 30 shall be eligible to participate. The plan also requires participating employees to contribute 3 percent of their monthly pay. At the time the plan is made effective 100 of the 1,000 employees had not been employed for a period of two years. Fifty of the employees were seasonal employees whose customary employment did not exceed five months in any calendar year. Twenty-five of the employees were part-time employees whose customary employment did not exceed 20 hours in any one week. One hundred and fifty of the full-time employees who had been employed for two years or more had not yet reached age 30. The requirements of section 401(a)(3)(A) will be met if 540 employees are covered by the plan, as shown by the following computation:

(i) Total employees with respect to whom the percentage requirements are applicable (1,000 minus 175 (100 plus 50 plus 25))	825
(ii) Employees not eligible to participate because of age requirements	150
(iii) Total employees eligible to participate	675
(iv) Percentage of employees in item (i) eligible to participate	81+%
(v) Minimum number of participating employees to qualify the plan (80 percent of 675)	540

If only 70 percent, or 578, of the 825 employees satisfied the age and service requirements, then 462 (80 percent of 578) participating employees would satisfy the percentage requirements.

(b) If a plan fails to qualify under the percentage requirements of section 401(a)(3)(A), it may still qualify under section 401(a)(3)(B) provided always that (as required by section 401(a)(3) and (4)) the plan's eligibility conditions, benefits, and contributions do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.

(c) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some

event such as illness, disability, retirement, death, layoff, or severance of employment, employees who receive the amounts allocated to their accounts before the expiration of such a period of time or the occurrence of such a contingency shall not be considered covered by a profit-sharing plan in determining whether the plan meets the coverage requirements of section 401(a)(3)(A) and (B). Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or to have such amounts paid to a profit-sharing plan for them, the employees who receive the shares immediately shall not, for the purpose of section 401, be considered covered by a profit-sharing plan.

(d) Section 401(a)(5) sets out certain classifications that will not in themselves be considered discriminatory. However, those so designated are not intended to be exclusive. Thus, plans may qualify under section 401(a)(3)(B) even though coverage thereunder is limited to employees who have either reached a designated age or have been employed for a designated number of years, or who are employed in certain designated departments or are in other classifications, provided the effect of covering only such employees does not discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. For example, if there are 1,000 employees, and the plan is written for only salaried employees, and consequently only 500 employees are covered, that fact alone will not justify the conclusion that the plan does not meet the coverage requirements of section 401(a)(3)(B). Conversely, if a contributory plan is offered to all of the employees but the contributions required of the employee participants are so burdensome as to make the plan acceptable only to the highly paid employees, the classification will be considered discriminatory in favor of such highly paid employees.

(e)(1) Section 401(a)(5) contains a provision to the effect that a classification shall not be considered discriminatory within the meaning of section 401(a)(3)(B) merely because all employees whose entire annual remuneration constitutes "wages" under section 3121(a)(1) (for purposes of the Federal Insurance Contributions Act, chapter 21 of the Code) are excluded from the plan. A reference to section 3121(a)(1) for years after 1954 shall be deemed a reference to section 1426(a)(1) of the Internal Revenue Code of 1939 for years before 1955. This provision, in conjunction with section 401(a)(3)(B), is intended to permit the qualification of plans which supplement the old-age, survivors, and disability insurance benefits under the Social Security Act (42 U.S.C. ch. 7). Thus, a classification which excludes all employees whose entire remuneration constitutes "wages" under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from wages under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in making his determination with respect to discrimination in classification under section 401(a)(3)(B), the Commissioner will consider whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). If, therefore, a classification of employees under a plan results in relatively or proportionately greater benefits for employees earning above any specified salary amount or rate than for those below any such salary amount or rate, it may be found to be discriminatory within the meaning of section 401(a)(3)(B). If, however, the relative or proportionate differences in benefits which result from such classification are approximately offset by the old-age, survivors, and disability insurance benefits which are provided by the Social Security Act and which are not attributable to employee contributions under the Federal Insurance Contributions Act, the plan will be considered to be properly integrated with the Social Security Act and will, therefore, not be considered discriminatory.

(2)(i) For purposes of determining whether a plan is properly integrated with the Social Security Act, the amount of old-age, survivors, and disability insurance benefits which may be considered as attributable to employer contributions under the Federal Insurance Contributions Act is computed on the basis of the following:

(a) The rate at which the maximum monthly old-age insurance benefit is provided under the Social Security Act is considered to be the average of (1) the rate at which the maximum benefit currently payable under the Act (*i.e.*, in 1971) is provided to an employee retiring at age 65, and (2) the rate at which the maximum benefit ultimately payable under the Act (*i.e.*, in 2010) is provided to an employee retiring at age 65. The resulting figure is 43 percent of the average monthly wage on which such benefit is computed.

(b) The total old-age, survivors, and disability insurance benefits with respect to an employee is considered to be 162 percent of the employee's old-age insurance benefits. The resulting figure is 70 percent of the average monthly wage on which it is computed.

(c) In view of the fact that social security benefits are funded through equal contributions by the employer and employee, 50 percent of such benefits is considered attributable to employer contributions. The resulting figure is 35 percent of the average monthly wage on which the benefit is computed.

Under these assumptions, the maximum old-age, survivors, and disability insurance benefits which may be attributed to employer contributions under the Federal Insurance Contributions Act is an amount equal to 35 percent of the earnings on which they are computed. These computations take into account all amendments to the Social Security Act through the Social Security Amendments of 1971 (85 Stat. 6). It is recognized, however, that subsequent amendments to this Act may increase the percentages described in (a) or (b) of this subdivision (i), or both. If this occurs, the method used in this subparagraph for determining the integration formula may result in a figure under (c) of this subdivision (i) which is greater than 35 percent and a plan could be amended to adopt such greater figure in its benefit formula. In order to minimize future plan amendments of this nature, an employer may anticipate future changes in the Social Security Act by immediately utilizing such a higher figure, but not in excess of 37½ percent, in developing its benefit formula.

(ii) Under the rules provided in this subparagraph, a classification of employees under a noncontributory pension or annuity plan which limits coverage to employees whose compensation exceeds the applicable integration level under the plan will not be considered discriminatory within the meaning of section 401(a)(3)(B), where:

(a) The integration level applicable to an employee is his covered compensation, or is (1) in the case of an active employee, a stated dollar amount uniformly applicable to all active employees which is not greater than the covered compensation of any active employee, and (2) in the case of a retired employee an amount which is not greater than his covered compensation. (For rules relating to determination of an employee's covered compensation, see subdivision (iv) of this subparagraph.)

(b) The rate at which normal annual retirement benefits are provided for any employee with respect to his average annual compensation in excess of the plan's integration level applicable to him does not exceed 37½ percent.

(c) Average annual compensation is defined to mean the average annual compensation over the highest 5 consecutive years.

(d) There are no benefits payable in case of death before retirement.

(e) The normal form of retirement benefits is a straight life annuity, and if there are optional forms, the benefit payments under each optional form are actuarially equivalent to benefit payments under the normal form.

(f) In the case of any employee who reaches normal retirement age before completion of 15 years of service with the employer, the rate at which normal annual retirement benefits are provided for him with respect to his average annual compensation in excess of the plan's integration level applicable to him does not exceed 2½ percent for each year of service.

(g) Normal retirement age is not lower than age 65.

(h) Benefits payable in case of retirement or any other severance of employment before normal retirement age cannot exceed the actuarial equivalent of the maximum normal retirement benefits, which might be provided in accordance with (a) through (g) of this subdivision (ii), multiplied by a fraction, the numerator of which is the actual number of years of service of the employee at retirement or severance, and the denominator of which is the total number of years of service he would have had if he had remained in service until normal retirement age. A special disabled life mortality table shall not be used in determining the actuarial equivalent in the case of severance due to disability.

(iii)(a) If a plan was properly integrated with old-age and survivors insurance benefits on July 5, 1968 (hereinafter referred to as an "existing plan"), then, notwithstanding the fact that such plan does not satisfy the requirements of subdivision (ii) of this subparagraph, it will continue to be considered properly integrated with such benefits until January 1, 1972. Such plan will be considered properly integrated after December 31, 1971, so long as the benefits provided under the plan for each employee equal the sum of—

(1) The benefits to which he would be entitled under a plan which, on July 5, 1968, would have been considered properly integrated with old-age and survivors insurance benefits, and under which benefits are provided at the same (or a lesser) rate with respect to the same portion of compensation with respect to which benefits are provided under the existing plan, multiplied by the percentage of his total service with the employer performed before a specified date not later than January 1, 1972; and

(2) The benefits to which he would be entitled under a plan satisfying the requirements of subdivision (ii) of this subparagraph, multiplied by the percentage of his total service with the employer performed on and after such specified date.

(b) A plan which, on July 5, 1968, was properly integrated with old-age and survivors insurance benefits will not be considered not to be properly integrated with such benefits thereafter merely because such plan provides a minimum benefit for each employee (other than an employee who owns, directly or indirectly, stock possessing more than 10 percent of the total combined voting power or value of all classes of stock of the employer corporation) equal to the benefit to which he would be entitled under the plan as in effect on July 5, 1968, if he continued to earn annually until retirement the same amount of compensation as he earned in 1967.

(c) If a plan was properly integrated with old-age and survivors insurance benefits on May 17, 1971, notwithstanding the fact that such plan does not satisfy the requirements of subdivision (ii) of this subparagraph, it will continue to be considered properly integrated with such benefits until January 1, 1972.

(iv) For purposes of this subparagraph, an employee's covered compensation is the amount of compensation with respect to which old-age insurance benefits would be provided for him under the Social Security Act (as in effect at any uniformly applicable date occurring before the employee's separation from the service) if for each year until he attains age 65 his annual compensation is at least equal to the maximum amount of earnings subject to tax in each such year under the Federal Insurance Contributions Act. A plan may provide that an employee's covered compensation is the amount determined under the preceding sentence rounded to the nearest whole multiple of a stated dollar amount which does not exceed $600.

(v) In the case of an integrated plan providing benefits different from those described in subdivision (ii) or (iii) (whichever is applicable) of this subparagraph, or providing benefits related to years of service, or providing benefits purchasable by stated employer contributions, or under the terms of which the employees contribute, or providing a combination of any of the foregoing variations, the plan will be considered to be properly integrated only if, as determined by the Commissioner, the benefits provided thereunder by employer contributions cannot exceed in value the benefits described in subdivision (ii) or (iii) (whichever is applicable) of this subparagraph. Similar principles will govern in determining whether a plan is properly integrated if participation therein is limited to employees earning in excess of amounts other than those specified in subdivision (iv) of this subparagraph, or if it bases benefits or contributions on compensation in excess of such amounts, or if it provides for an offset of benefits otherwise payable under the plan on account of old-age, survivors, and disability insurance benefits. Similar principles will govern in determining whether a profit-sharing or stock bonus plan is properly integrated with the Social Security Act.

(3) A plan supplementing the Social Security Act and excluding all employees whose entire annual remuneration constitutes "wages" under section 3121(a)(1) will not, however, be deemed discriminatory merely because, for administrative convenience, it provides a reasonable minimum benefit not to exceed $20 a month.

(4) Similar considerations, to the extent applicable in any case, will govern classifications under a plan supplementing the benefits provided by other Federal or State laws. See section 401(a)(5).

(5) If a plan provides contributions or benefits for a self-employed individual, the rules relating to the integration of such a plan with the contributions or benefits under the Social Security Act are set forth in paragraph (c) of § 1.401-11 and paragraph (h) of § 1.401-12.

(f) An employer may designate several trusts or a trust or trusts and an annuity plan or plans as constituting one plan which is intended to qualify under section 401(a)(3), in which case all of such trusts and plans taken as a whole may meet the requirements of such section. The fact that such combination of trusts and plans fails to qualify as one plan does not prevent such of the trusts and plans as qualify from meeting the requirements of section 401(a).

(g) It is provided in section 401(a)(6) that a plan will satisfy the requirements of section 401(a)(3), if

on at least one day in each quarter of the taxable year of the plan it satisfies such requirements. This makes it possible for a new plan requiring contributions from employees to qualify if by the end of the quarter-year in which the plan is adopted it secures sufficient contributing participants to meet the requirements of section 401(a)(3). It also affords a period of time in which new participants may be secured to replace former participants, so as to meet the requirements of either subparagraph (A) or (B) of section 401(a)(3).

[T.D. 6500, 25 FR 11672, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10119, Sept. 17, 1963; T.D. 6982, 33 FR 16499, Nov. 13, 1968; T.D. 7134, 36 FR 13592, July 22, 1971; 36 FR 13990, July 29, 1971]

§ 1.401–4 Discrimination as to contributions or benefits.

(a)(1)(i) In order to qualify under section 401(a), a trust must not only meet the coverage requirements of section 401(a)(3), but, as provided in section 401(a)(4), it must also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees as against other employees whether within or without the plan.

(ii) Since, for the purpose of section 401, a profit-sharing plan is a plan which provides for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, layoff, or severance of employment, any amount allocated to an employee which is withdrawn before the expiration of such a period of time or the occurrence of such a contingency shall not be considered in determining whether the contributions under the plan discriminate in favor of officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees. Thus, in case a plan permits employees to receive immediately the whole or any part of the amounts allocated to their accounts, or to have the whole or any part of such amounts paid to a profit-sharing plan for them, any amounts which are received immediately shall not, for the purpose of section 401, be considered contributed to a profit-sharing plan.

(iii) Funds in a stock bonus or profit-sharing plan arising from forfeitures on termination of service, or other reason, must not be allocated to the remaining participants in such a manner as will effect the prohibited discrimination. With respect to forfeitures in a pension plan, see § 1.401–7.

(2)(i) Section 401(a)(5) sets out certain provisions which will not in and of themselves be discriminatory within the meaning of section 401(a)(3) or (4). See § 1.401–3. Thus, a plan will not be considered discriminatory merely because the contributions or benefits bear a uniform relationship to total compensation or to the basic or regular rate of compensation, or merely because the contributions or benefits based on that part of the annual compensation of employees which is subject to the Federal Insurance Contributions Act (chapter 21 of the Code) differ from the contributions or benefits based on any excess of such annual compensation over such part. With regard to the application of the rules of section 401(a)(5) in the case of a plan which benefits a self-employed individual, see paragraph (c) of § 1.401–11.

(ii) The exceptions specified in section 401(a)(5) are not an exclusive enumeration, but are merely a recital of provisions frequently encountered which will not of themselves constitute forbidden discrimination in contributions or benefits.

(iii) Variations in contributions or benefits may be provided so long as the plan, viewed as a whole for the benefit of employees in general, with all its attendant circumstances, does not discriminate in favor of employees within the enumerations with respect to which discrimination is prohibited. Thus, benefits in a stock bonus or profit-sharing plan which vary by reason of an allocation formula which takes into consideration years of service, or other factors, are not prohibited unless they discriminate in favor of such employees.

(b) A plan which excludes all employees whose entire remuneration constitutes wages under section 3121(a)(1) (relating to the Federal Insurance Contributions Act), or a plan under which the contributions or benefits based on that part of an employee's remuneration which is excluded from "wages" under such act differs from the contributions or benefits based on that part of the employee's remuneration which is not so excluded, or a plan under which the contributions or benefits differ because of any retirement benefit created under State or Federal law, will not be discriminatory because of such exclusion or difference, provided the total benefits resulting under the plan and under such law establish an integrated and correlated retirement system satisfying the tests of section 401(a).

(c)(1) Although a qualified plan may provide for termination at will by the employer or discontinuance of contributions thereunder, this will not of itself prevent a trust from being a qualified trust. However, a qualified pension plan must expressly incorporate provisions which comply with the restrictions contained in subparagraph (2) of this paragraph at the time the plan is established, unless (i) it is reasonably certain at the inception of the plan that such restrictions would not affect the amount of contributions which may be used for the benefit of any employee, or (ii) the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of any early termination of the plan. Although these provisions are the only provisions required to be incorporated in the plan to prevent the discrimination that may arise because of an early termination of the plan, the plan may in operation result in the discrimination prohibited by section 401(a)(4), unless other provisions are later incorporated in the plan. Any pension plan containing a provision described in this paragraph shall not fail to satisfy section 411(a), (d)(2) and (d)(3) merely by reason of such a plan provision. Paragraph (c)(7) of this section sets forth special early termination rules applicable to certain qualified defined benefit plans for plan years affected by the Employee Retirement Income Security Act of 1974 ("ERISA"). Paragraph (c)(7) of this section does not contain all the rules required by the enactment of ERISA.

(2)(i) If employer contributions under a qualified pension plan may be used for the benefit of an employee who is among the 25 highest paid employees of the employer at the time the plan is established and whose anticipated annual pension under the plan exceeds $1,500, such plan must provide that upon the occurrence of the conditions described in subdivision (ii) of this subparagraph, the employer contributions which are used for the benefit of any such employee are restricted in accordance with subdivision (iii) of this subparagraph.

(ii) The restrictions described in subdivision (iii) of this subparagraph become applicable if—

(a) The plan is terminated within 10 years after its establishment,

(b) The benefits of an employee described in subdivision (i) of this subparagraph become payable within 10 years after the establishment of the plan, or

(c) The benefits of an employee described in subdivision (i) of this subparagraph become payable after the plan has been in effect for 10 years, and the full current costs of the plan for the first 10 years have not been funded.

In the case of an employee described in (b) of this subdivision, the restrictions will remain applicable until the plan has been in effect for 10 years, but if at that time the full current costs have been funded the restrictions will no longer apply to the benefits payable to such an employee. In the case of an employee described in (b) or (c) of this subdivision, if at the end of the first 10 years the full current costs are not met, the restrictions will continue to apply until the full current costs are funded for the first time.

(iii) The restrictions required under subdivision (i) of this subparagraph must provide that the employer contributions which may be used for the benefit of an employee described in such subdivision shall not exceed the greater of $20,000, or 20 percent of the first $50,000 of the annual compensation of such employee multiplied by the number of years between the date of the establishment of the plan and—

(a) The date of the termination of the plan,

(b) In the case of an employee described in subdivision (ii)(b) of this subparagraph, the date the benefit of the employee becomes payable, if before the date of the termination of the plan, or

(c) In the case of an employee described in subdivision (ii)(c) of this subparagraph, the date of the failure to meet the full current costs of the plan. However, if the full current costs of the plan have not been met on the date described in (a) or (b) of this subdivision, whichever is applicable, then the date of the failure to meet such full current costs shall be substituted for the date referred to in (a) or (b) of this subdivision. For purposes of determining the contributions which may be used for the benefit of an employee when (b) of this subdivision applies, the number of years taken into account may be recomputed for each year if the full current costs of the plan are met for such year.

(iv) For purposes of this subparagraph, the employer contributions which, at a given time, may be used for the benefits of an employee include any unallocated funds which would be used for his benefits if the plan were then terminated or the employee were then to withdraw from the plan, as well as all contributions allocated up to that time exclusively for his benefits.

(v) The provisions of this subparagraph apply to a former or retired employee of the employer, as

well as to an employee still in the employer's service.

(vi) The following terms are defined for purposes of this subparagraph—

(a) The term "benefits" includes any periodic income, any withdrawal values payable to a living employee, and the cost of any death benefits which may be payable after retirement on behalf of an employee, but does not include the cost of any death benefits with respect to an employee before retirement nor the amount of any death benefits actually payable after the death of an employee whether such death occurs before or after retirement.

(b) The term "full current costs" means the normal cost, as defined in § 1.404(a)–6, for all years since the effective date of the plan, plus interest on any unfunded liability during such period.

(c) The term "annual compensation" of an employee means either such employee's average regular annual compensation, or such average compensation over the last five years, or such employee's last annual compensation if such compensation is reasonably similar to his average regular annual compensation for the five preceding years.

(3) The amount of the employer contributions which can be used for the benefit of a restricted employee may be limited either by limiting the annual amount of the employer contributions for the designated employee during the period affected by the limitation, or by limiting the amount of funds under the plan which can be used for the benefit of such employee, regardless of the amount of employer contributions.

(4) The restrictions contained in subparagraph (2) of this paragraph may be exceeded for the purpose of making current retirement income benefit payments to retired employees who would otherwise be subject to such restrictions, if—

(i) The employer contributions which may be used for any such employee in accordance with the restrictions contained in subparagraph (2) of this paragraph are applied either (a) to provide level amounts of annuity in the basic form of benefit provided for under the plan for such employee at retirement (or, if he has already retired, beginning immediately), or (b) to provide level amounts of annuity in an optional form of benefit provided under the plan if the level amount of annuity under such optional form of benefit is not greater than the level amount of annuity under the basic form of benefit provided under the plan;

(ii) The annuity thus provided is supplemented, to the extent necessary to provide the full retirement income benefits in the basic form called for under the plan, by current payments to such employee as such benefits come due; and

(iii) Such supplemental payments are made at any time only if the full current costs of the plan have then been met, or the aggregate of such supplemental payments for all such employees does not exceed the aggregate employer contributions already made under the plan in the year then current.

If disability income benefits are provided under the plan, the plan may contain like provisions with respect to the current payment of such benefits.

(5) If a plan has been changed so as to increase substantially the extent of possible discrimination as to contributions and as to benefits actually payable in event of the subsequent termination of the plan or the subsequent discontinuance of contributions thereunder, then the provisions of this paragraph shall be applied to the plan as so changed as if it were a new plan established on the date of such change. However, the provision in subparagraph (2)(iii) of this paragraph that the unrestricted amount of employer contributions on behalf of any employee is at least $20,000 is applicable to the aggregate amount contributed by the employer on behalf of such employee from the date of establishment of the original plan, and, for purposes of determining if the employee's anticipated annual pension exceeds $1,500, both the employer contributions on the employee's behalf prior to the date of the change in the plan and those expected to be made on his behalf subsequent to the date of the change (based on the employee's rate of compensation on the date of the change) are to be taken into account.

(6) This paragraph shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of an early termination of a qualified pension plan during any such taxable year, the employer contributions which may be used for the benefit of any employee must conform to the requirements of this paragraph. However, any pension plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed in this paragraph.

(7)(i) A qualified defined benefit plan subject to section 412 (without regard to section 412(h)(2)) shall not be required to contain the restriction described in paragraph (c)(2)(ii)(c) of this section

applicable to an employee in a plan whose full current costs for the first 10 years have not been funded.

(ii) A qualified defined benefit plan covered by section 4021(a) of ERISA ("qualified Title IV plan") shall satisfy the restrictions in paragraph (c)(2) of this section only if the plan satisfies this paragraph (c)(7). A plan satisfies this paragraph (c)(7) by providing that employer contributions which may be used for the benefit of an employee described in paragraph (c)(2) of this section who is a substantial owner, as defined in section 4022(b)(5) of ERISA, shall not exceed the greater of the dollar amount described in paragraph (c)(2)(iii) of this section or a dollar amount which equals the present value of the benefit guaranteed for such employee under section 4022 of ERISA, or if the plan has not terminated, the present value of the benefit that would be guaranteed if the plan terminated on the date the benefit commences, determined in accordance with regulations of the Pension Benefit Guaranty Corporation ("PBGC").

(iii) A plan satisfies this paragraph (c)(7) by providing that employer contributions which may be used for the benefit of all employees described in paragraph (c)(2) of this section (other than an employee who is a substantial owner as defined in section 4022(b)(5) of ERISA) shall not exceed the greater of the dollar amount described in paragraph (c)(2)(iii) of this section or a dollar amount which equals the present value of the maximum benefit described in section 4022(b)(3)(B) of ERISA (determined on the date the plan terminates or on the date benefits commence, whichever is earlier and determined in accordance with regulations of PBGC) without regard to any other limitations in section 4022 of ERISA.

(iv) A plan provision satisfying this paragraph (c)(7) may be adopted by amendment or by incorporation at the time of establishment. Any allocation of assets attributable to employer contributions to an employee which exceeds the dollar limitation in this paragraph (c)(7) may be reallocated to prevent prohibited discrimination.

(v) The early termination rules in the preceding subparagraphs (1) through (6) apply to a qualified Title IV plan except where such rules are determined by the Commissioner to be inconsistent with the rules of this paragraph (c)(7), § 1.411(d)–2, and section 4044(b)(4) of ERISA. The early termination rules of this paragraph (c)(7) contain some of the rules under section 401(a)(4) and (a)(7), as in effect on September 2, 1974, and section 411(d)(2) and (3). Section 1.411(d)–2 also contains certain discrimination and vesting rules which are applicable to plan terminations.

(vi) Paragraph (c)(7) of this section applies to plan terminations occurring on or after March 12, 1984. For distributions not on account of plan terminations, paragraph (c)(7) applies to distributions in plan years beginning after December 31, 1983. However, a plan may elect to apply that paragraph to distributions not on account of plan termination on or after January 10, 1984.

[T.D. 6500, 25 FR 11674, Nov. 26, 1960, as amended by T.D. 6675, 28 FR 10119, Sept. 17, 1963; T.D. 7934, 49 FR 1183, Jan. 10, 1984; 49 FR 2104, Jan. 18, 1984]

§ 1.401–5 Period for which requirements of section 401(a)(3), (4), (5), and (6) are applicable with respect to plans put into effect before September 2, 1974.

A pension, profit-sharing, stock bonus, or annuity plan shall be considered as satisfying the requirements of section 401(a)(3), (4), (5), and (6) for the period beginning with the date on which it was put into effect and ending with the 15th day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all the provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. Thus, if an employer in 1954 adopts such a plan as of January 1, 1954, and makes a return on the basis of the calendar year, he will have until March 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401(a)(3), (4), (5), and (6) for the calendar year 1954 provided that by March 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to January 1, 1954, the effective date of the plan. If an employer is on a fiscal year basis, for example, April 1 to March 31, and in 1954 adopts such a plan effective as of April 1, 1954, he will have until June 15, 1955, to amend his plan so as to make it satisfy the requirements of section 401(a)(3), (4), (5), and (6) for the fiscal year beginning April 1, 1954, provided that by June 15, 1955, all provisions of such plan necessary to satisfy such requirements are in effect and have been made retroactive for all purposes to April 1, 1954, the effective date of the plan. It should be noted that under section 401(b) the period in which a plan may be amended to qualify under section 401(a) ends before the date on which taxpayers other than corporations are required to

file income tax returns. See section 6072. This section shall not apply to any pension, profit-sharing, stock bonus, or annuity plan put into effect after September 1, 1974, and shall not apply with respect to any disqualifying provision to which § 1.401(b)–1 applies.

[T.D. 6500, 25 FR 11674, Nov. 26, 1960, as amended by T.D. 7436, 41 FR 42653, Sept. 28, 1976]

§ 1.401–6 Termination of a qualified plan.

(a) General rules. (1) In order for a pension, profit-sharing, or stock bonus trust to satisfy the requirements of section 401, the plan of which such trust forms a part must expressly provide that, upon the termination of the plan or upon the complete discontinuance of contributions under the plan, the rights of each employee to benefits accrued to the date of such termination or discontinuance, to the extent then funded, or the rights of each employee to the amounts credited to his account at such time, are nonforfeitable. As to what constitutes nonforfeitable rights of an employee, see paragraph (a)(2) of § 1.402(b)–1.

(2)(i) A qualified plan must also provide for the allocation of any previously unallocated funds to the employees covered by the plan upon the termination of the plan or the complete discontinuance of contributions under the plan. Such provision may be incorporated in the plan at its inception or by an amendment made prior to the termination of the plan or the discontinuance of contributions thereunder.

(ii) Any provision for the allocation of unallocated funds is acceptable if it specifies the method to be used and does not conflict with the provisions of section 401(a)(4) and the regulations thereunder. The allocation of unallocated funds may be in cash or in the form of other benefits provided under the plan. However, the allocation of the funds contributed by the employer among the employees need not necessarily benefit all the employees covered by the plan. For example, an allocation may be satisfactory if priority is given to benefits for employees over the age of 50 at the time of the termination of the plan, or those who then have at least 10 years of service, if there is no possibility of discrimination in favor of employees who are officers, shareholders, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees.

(iii) Subdivisions (i) and (ii) of this subparagraph do not require the allocation of amounts to the account of any employee if such amounts are not required to be used to satisfy the liabilities with respect to employees and their beneficiaries under the plan (see section 401(a)(2)).

(b) Termination defined. (1) Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. For example, a plan is terminated when, in connection with the winding up of the employer's trade or business, the employer begins to discharge his employees. However, a plan is not terminated, for example, merely because an employer consolidates or replaces that plan with a comparable plan. Similarly, a plan is not terminated merely because the employer sells or otherwise disposes of his trade or business if the acquiring employer continues the plan as a separate and distinct plan of its own, or consolidates or replaces that plan with a comparable plan. See paragraph (d)(4) of § 1.381(c)(11)–1 for the definition of comparable plan. In addition, the Commissioner may determine that other plans are comparable for purposes of this section.

(2) For purposes of this section, the term "termination" includes both a partial termination and a complete termination of a plan. Whether or not a partial termination of a qualified plan occurs when a group of employees who have been covered by the plan are subsequently excluded from such coverage either by reason of an amendment to the plan, or by reason of being discharged by the employer, will be determined on the basis of all the facts and circumstances. Similarly, whether or not a partial termination occurs when benefits or employer contributions are reduced, or the eligibility or vesting requirements under the plan are made less liberal, will be determined on the basis of all the facts and circumstances. However, if a partial termination of a qualified plan occurs, the provisions of section 401(a)(7) and this section apply only to the part of the plan that is terminated.

(c) Complete discontinuance defined. (1) For purposes of this section, a complete discontinuance of contributions under the plan is contrasted with a suspension of contributions under the plan, which is merely a temporary cessation of contributions by the employer. A complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred

will be made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees.

(2) In the case of a pension plan, a suspension of contributions will not constitute a discontinuance if—

(i) The benefits to be paid or made available under the plan are not affected at any time by the suspension, and

(ii) The unfunded past service cost at any time (which includes the unfunded prior normal cost and unfunded interest on any unfunded cost) does not exceed the unfunded past service cost as of the date of establishment of the plan, plus any additional past service or supplemental costs added by amendment.

(3) In any case in which a suspension of a profit-sharing plan is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan.

(d) Contributions or benefits which remain forfeitable. The provisions of this section do not apply to amounts which are reallocated to prevent the discrimination prohibited by section 401(a)(4) (see paragraph (c) of § 1.401–4).

(e) Effective date. This section shall apply to taxable years of a qualified plan commencing after September 30, 1963. In the case of the termination or complete discontinuance (as defined in this section) of any qualified plan during any such taxable year, the rights accorded to each employee covered under the plan must conform to the requirements of this section. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section. [T.D. 6675, 28 FR 10120, Sept. 17, 1963]

§ 1.401–7 Forfeitures under a qualified pension plan.

(a) General rules. In the case of a trust forming a part of a qualified pension plan, the plan must expressly provide that forfeitures arising from severance of employment, death, or for any other reason, must not be applied to increase the benefits any employee would otherwise receive under the plan at any time prior to the termination of the plan or the complete discontinuance of employer contributions thereunder. The amounts so forfeited must be used as soon as possible to reduce the employer's contributions under the plan. However, a qualified pension plan may anticipate the effect of forfeitures in determining the costs under the plan. Furthermore, a qualified plan will not be disqualified merely because a determination of the amount of forfeitures under the plan is made only once during each taxable year of the employer.

(b) Examples. The rules of paragraph (a) of this section may be illustrated by the following examples:

Example (1). The B Company Pension Trust forms a part of a pension plan which is funded by individual level annual premium annuity contracts. The plan requires ten years of service prior to obtaining a vested right to benefits under the plan. One of the company's employees resigns his position after two years of service. The insurance company paid to the trustees the cash surrender value of the contract—$750. The B Company must reduce its next contribution to the pension trust by this amount.

Example (2). The C Corporation's trusteed pension plan has been in existence for 20 years. It is funded by individual contracts issued by an insurance company, and the premiums thereunder are paid annually. Under such plan, the annual premium accrued for the year 1966 is due and is paid on January 2, 1966, and on July 1 of the same year the plan is terminated due to the liquidation of the employer. Some forfeitures were incurred and collected by the trustee with respect to those participants whose employment terminated between January 2 and July 1. The plan provides that the amount of such forfeitures is to be applied to provide additional annuity benefits for the remaining employees covered by the plan. The pension plan of the C Corporation satisfies the provisions of section 401(a)(8). Although forfeitures are used to increase benefits in this case, this use of forfeitures is permissible since no further contributions will be made under the plan.

(c) Effective date. This section applies to taxable years of a qualified plan commencing after September 30, 1963. However, a plan which is qualified on September 30, 1963, will not be disqualified merely because it does not expressly include the provisions prescribed by this section. [T.D. 6675, 28 FR 10121, Sept. 17, 1963]

§ 1.401–8 Custodial accounts prior to January 1, 1974.

(a) Treatment of a custodial account as a qualified trust. For taxable years of a plan beginning after December 31, 1962, a custodial account may be used, in lieu of a trust, under any pension, profit-sharing, or stock bonus plan, described in section 401 if the requirements of paragraph (b) of this section are met. A custodial account may be used under such a plan, whether the plan covers common-law employees, self-employed individuals who are treated as employees by reason of section 401(c), or both. The use of a custodial account as

part of a plan does not preclude the use of a trust or another custodial account as part of the same plan. A plan under which a custodial account is used may be considered in connection with other plans of the employer in determining whether the requirements of section 401 are satisfied. For regulations relating to the period after December 31, 1973, see § 1.401(f)–11.

(b) Rules applicable to custodial accounts. **(1)** A custodial account shall be treated for taxable years beginning after December 31, 1962, as a qualified trust under section 401 if such account meets the following requirements described in subdivisions (i) through (iii) of this subparagraph:

(i) The custodial account must satisfy all the requirements of section 401 that are applicable to qualified trusts. See subparagraph (2) of this paragraph.

(ii) The custodian of the custodial account must be a bank.

(iii) The custodial agreement provides that the investment of the funds in the account is to be made—

(a) Solely in stock of one or more regulated investment companies which is registered in the name of the custodian or its nominee and with respect to which an employee who is covered by the plan is the beneficial owner, or

(b) Solely in annuity, endowment, or life insurance contracts, issued by an insurance company and held by the custodian until distributed pursuant to the terms of the plan. For purposes of the preceding sentence, a face-amount certificate described in section 401(g) and § 1.401–9 is treated as an annuity issued by an insurance company. See subparagraphs (3) and (4) of this paragraph.

(2) As a result of the requirement described in subparagraph (1)(i) of this paragraph (relating to the requirements applicable to qualified trusts), the custodial account must, for example, be created pursuant to a written agreement which constitutes a valid contract under local law. In addition, the terms of the contract must make it impossible, prior to the satisfaction of all liabilities with respect to the employees and their beneficiaries covered by the plan, for any part of the funds of the custodial account to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries as provided for in the plan (see paragraph (a) of § 1.401–2).

(3) The requirement described in subparagraph (1)(iii) of this paragraph, relating to the investment of the funds of the plan, applies, for example, to the employer contributions under the plan, any employee contributions under the plan, and any earnings on such contributions. Such requirement also applies to capital gains realized upon the sale of stock described in (a) of such subdivision, to any capital gain dividends received in connection with such stock, and to any refunds described in section 852(b)(3)(D)(ii) (relating to undistributed capital gains of a regulated investment company) which is received in connection with such stock. However, since such requirement relates only to the investment of the funds of the plan, the custodian may deposit funds with a bank, in either a checking or savings account, while accumulating sufficient funds to make additional investments or while awaiting an appropriate time to make additional investments.

(4) The requirement in subparagraph (1)(iii)(a) of this paragraph that an employee covered by the plan be the beneficial owner of the stock does not mean that the employee who is the beneficial owner must have a nonforfeitable interest in the stock. Thus, a plan may provide for forfeitures of an employee's interest in such stock in the same manner as plans which use a trust. In the event of a forfeiture of an employee's beneficial ownership in the stock of a regulated investment company, the beneficial ownership of such stock must pass to another employee covered by the plan.

(c) Effects of qualification. **(1)** Any custodial account which satisfies the requirements of section 401(f) shall be treated as a qualified trust for all purposes of the Internal Revenue Code of 1954. Accordingly, such a custodial account shall be treated as a separate legal person which is exempt from the income tax by section 501(a). On the other hand, such a custodial account is required to file the returns described in sections 6033 and 6047 and to supply any other information which a qualified trust is required to furnish.

(2) In determining whether the funds of a custodial account are distributed or made available to an employee or his beneficiary, the rules which under section 402(a) are applicable to trusts will also apply to the custodial account as though it were a separate legal person and not an agent of the employee.

(d) Effect of loss of qualification. If a custodial account which has qualified under section 401 fails to qualify under such section for any taxable year, such custodial account will not thereafter be treated as a separate legal person, and the funds in such account shall be treated as made available

within the meaning of section 402(a)(1) to the employees for whom they are held.

(e) **Definitions.** For purposes of this section—

(1) The term "bank" means a bank as defined in section 401(d)(1).

(2) The term "regulated investment company" means any domestic corporation which issues only redeemable stock and is a regulated investment company within the meaning of section 851(a) (but without regard to whether such corporation meets the limitations of section 851(b)).

[T.D. 6675, 28 FR 10121, Sept. 17, 1963, as amended by T.D. 7565, 43 FR 41204, Sept. 15, 1978. Redesignated and amended by T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§ 1.401–9 Face-amount certificates—nontransferable annuity contracts.

(a) **Face-amount certificates treated as annuity contracts.** Section 401(g) provides that a face-amount certificate (as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 U.S.C. sec. 80a–2)) which is not transferable within the meaning of paragraph (b)(3) of this section shall be treated as an annuity contract for purposes of sections 401 through 404 for any taxable year of a plan subject to such sections beginning after December 31, 1962. Accordingly, there may be established for any such taxable year a qualified plan under which such face-amount certificates are purchased for the participating employees without the creation of a trust or custodial account. However, for such a plan to qualify, the plan must satisfy all the requirements applicable to a qualified annuity plan (see section 403(a) and the regulations thereunder).

(b) **Nontransferability of face-amount certificates and annuity contracts.** (1)(i) Section 401(g) provides that, in order for any face-amount certificate, or any other contract issued after December 31, 1962, to be subject to any provision under sections 401 through 404 which is applicable to annuity contracts, as compared to other forms of investment, such certificate or contract must be nontransferable at any time when it is held by any person other than the trustee of a trust described in section 401(a) and exempt under section 501(a). Thus, for example, in order for a group or individual retirement income contract to be treated as an annuity contract, if such contract is not held by the trustee of an exempt employees' trust, it must satisfy the requirements of this section. Furthermore, a face-amount certificate or an annuity contract will be subject to the tax treatment under section 403(b) only if it satisfies the requirements of section 401(g) and this section. Any certificate or contract in order to satisfy the provisions of this section must expressly contain the provisions that are necessary to make such certificate or contract not transferable within the meaning of this paragraph.

(ii) In the case of any group contract purchased by an employer under a plan to which sections 401 through 404 apply, the restriction on transferability required by section 401(g) and this section applies to the interest of the employee participants under such group contract but not to the interest of the employer under such contract.

(2) If a trust described in section 401(a) which is exempt from tax under section 501(a) distributes any annuity, endowment, retirement income, or life insurance contract, then the rules relating to the taxability of the distributee of any such contract are set forth in paragraph (a)(2) of § 1.402(a)–1.

(3) A face-amount certificate or an annuity contract is transferable if the owner can transfer any portion of his interest in the certificate or contract to any person other than the issuer thereof. Accordingly, such a certificate or contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the certificate or contract to any person other than the issuer thereof. On the other hand, for purposes of section 401(g), a face-amount certificate or annuity contract is not considered to be transferable merely because such certificate or contract, or the plan of which it is a part, contains a provision permitting the employee to designate a beneficiary to receive the proceeds of the certificate or contract in the event of his death, or contains a provision permitting the employee to elect to receive a joint and survivor annuity, or contains other similar provisions.

(4) A material modification in the terms of an annuity contract constitutes the issuance of a new contract regardless of the manner in which it is made.

(c) **Examples.** The rules of this section may be illustrated by the following examples:

Example (1). The P Employees' Annuity Plan is a nontrusteed plan which is funded by individual annuity contracts issued by the Y Insurance Company. Each annuity contract issued by such company after December 31, 1962, provides, on its face, that it is "NOT TRANSFERABLE". The terms of each such contract further provide that, "This contract may not be sold, assigned, discounted, or pledged as collateral for a loan or as security for the performance of an obligation or for any other purpose, to any person other than this company."

The annuity contracts of the P Employees' Annuity Plan satisfy the requirements of section 401(g) and this section.

Example (2). The R Company Pension Trust forms a part of a pension plan which is funded by individual level premium annuity contracts. Such contracts are purchased by the trustee of the R Company Pension Trust from the Y Insurance Company. The trustee of the R Company Pension Trust is the legal owner of each such contract at all times prior to the distribution of such contract to a qualifying annuitant. The trustee purchases such a contract on January 3, 1963, in the name of an employee who qualifies on that date for coverage under the plan. At the time such contract is purchased, and while the contract is held by the trustee of the R Company Pension Trust, the contract does not contain any restrictions with respect to its transferability. The annuity contract purchased by the trustee of the R Company Pension Trust satisfies the requirements of section 401(g) and this section while it is held by the trustee.

Example (3). A is the trustee of the X Corporation's Employees' Pension Trust. The trust forms a part of a pension plan which is funded by individual level premium annuity contracts. The trustee is the legal owner of such contracts, but the employees covered under the plan obtain beneficial interests in such contracts after ten years of service with the X Corporation. On January 15, 1980, A distributes to D an annuity contract issued to A in D's name on June 25, 1959, and distributes to E an annuity contract issued to A in E's name on September 30, 1963. The contract issued to D need not be nontransferable, but the contract issued to E must be nontransferable in order to satisfy the requirements of section 401(g) and this section.

Example (4). The corpus of the Y Corporation's Employees' Pension Plan consists of individual insurance contracts in the names of the covered employees and an auxiliary fund which is used to convert such policies to annuity contracts at the time a beneficiary of such trust retires. F retires on June 15, 1963, and the trustee converts the individual insurance contract on F's life to a life annuity which is distributed to him. The life annuity issued on F's life must be nontransferable in order to satisfy the requirements of section 401(g) and this section. [T.D. 6675, 28 FR 10122, Sept. 17, 1963]

§ 1.401–10 Definitions relating to plans covering self-employed individuals.

(a) In general. (1) Certain self-employed individuals may be covered by a qualified pension, annuity, or profit-sharing plan for taxable years beginning after December 31, 1962. This section contains definitions relating to plans covering self-employed individuals. The provisions of §§ 1.401–1 through 1.401–9, relating to requirements which are applicable to all qualified plans, are also generally applicable to any plan covering a self-employed individual. However, in addition to such requirements, any plan covering a self-employed individual is subject to the rules contained in §§ 1.401–11 through 1.401–13. Section 1.401–11 contains general rules which are applicable to any plan covering a self-employed individual who is an employee within the meaning of paragraph (b) of this section. Section 1.401–12 contains special rules which are applicable to plans covering self-employed individuals when one or more of such individuals is an owner-employee within the meaning of paragraph (d) of this section. Section 1.401–13 contains rules relating to excess contributions by, or for, an owner-employee. The provisions of this section and of §§ 1.401–11 through 1.401–13 are applicable to taxable years beginning after December 31, 1962.

(2) A self-employed individual is covered under a qualified plan during the period beginning with the date a contribution is first made by, or for, him under the qualified plan and ending when there are no longer funds under the plan which can be used to provide him or his beneficiaries with benefits.

(b) Treatment of a self-employed individual as an employee. (1) For purposes of section 401, a self-employed individual who receives earned income from an employer during a taxable year of such employer beginning after December 31, 1962, shall be considered an employee of such employer for such taxable year. Moreover, such an individual will be considered an employee for a taxable year if he would otherwise be treated as an employee but for the fact that the employer did not have net profits for that taxable year. Accordingly, the employer may cover such an individual under a qualified plan during years of the plan beginning with or within a taxable year of the employer beginning after December 31, 1962.

(2) If a self-employed individual is engaged in more than one trade or business, each such trade or business shall be considered a separate employer for purposes of applying the provisions of sections 401 through 404 to such individual. Thus, if a qualified plan is established for one trade or business but not the others, the individual will be considered an employee only if he received earned income with respect to such trade or business and only the amount of such earned income derived from that trade or business shall be taken into account for purposes of the qualified plan.

(3)(i) The term "employee", for purposes of section 401, does not include a self-employed individual when the term "common-law" employee is used or when the context otherwise requires that the term "employee" does not include a self-employed individual. The term "common-law" employee also includes an individual who is treated as an employee for purposes of section 401 by reason of the provisions of section 7701(a)(20), relating to the treatment of certain full-time life insurance salesmen as employees. Furthermore, an individual who is a common-law employee is not a

self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a). Thus, for example, a minister who is a common-law employee is not a self-employed individual with respect to income attributable to such employment, even though such income constitutes net earnings from self-employment as defined in section 1402(a).

(ii) An individual may be treated as an employee within the meaning of section 401(c)(1) of one employer even though such individual is also a common-law employee of another employer. For example, an attorney who is a common-law employee of a corporation and who, in the evenings maintains an office in which he practices law as a self-employed individual is an employee within the meaning of section 401(c)(1) with respect to the law practice. This example would not be altered by the fact that the corporation maintained a qualified plan under which the attorney is benefited as a common-law employee.

(4) For the purpose of determining whether an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility under a qualified plan established by an employer, such an employer may take into account past services rendered by such an employee both as a self-employed individual and as a common-law employee if past services rendered by other employees, including common-law employees, are similarly taken into account. However, an employer cannot take into account only past services rendered by employees within the meaning of section 401(c)(1) if past services rendered to such employer by individuals who are, or were, common-law employees are not taken into account. Past service as described in this subparagraph may be taken into account for the purpose of determining whether an individual who is, or was, an employee within the meaning of section 401(c)(1) satisfies the requirements for eligibility even if such service was rendered prior to January 1, 1963. On the other hand, past service cannot be taken into account for purposes of determining the contributions which may be made on such an individual's behalf under a qualified plan.

(c) Definition of earned income—(1) General rule. For purposes of section 401 and the regulations thereunder, "earned income" means, in general, net earnings from self-employment (as defined in section 1402(a)) to the extent such net earnings constitute compensation for personal services actually rendered within the meaning of section 911(b).

(2) Net earnings from self-employment. (i) The computation of the net earnings from self-employment shall be made in accordance with the provisions of section 1402(a) and the regulations thereunder, with the modifications and exceptions described in subdivisions (ii) through (iv) of this subparagraph. Thus, an individual may have net earnings from self-employment, as defined in section 1402(a), even though such individual does not have self-employment income, as defined in section 1402(b), and, therefore, is not subject to the tax on self-employment income imposed by section 1401.

(ii) Items which are not included in gross income for purposes of chapter 1 of the Code and the deductions properly attributable to such items must be excluded from the computation of net earnings from self-employment even though the provisions of section 1402(a) specifically require the inclusion of such items. For example, if an individual is a resident of Puerto Rico, so much of his net earnings from self-employment as are excluded from gross income under section 933 must not be taken into account in computing his net earnings from self-employment which are earned income for purposes of section 401.

(iii) In computing net earnings from self-employment for the purpose of determining earned income, a self-employed individual may disregard only deductions for contributions made on his own behalf under a qualified plan. However, such computation must take into account the deduction allowed by section 404 or 405 for contributions under a qualified plan on behalf of the common-law employees of the trade or business.

(iv) For purposes of determining whether an individual has net earnings from self-employment and, thus, whether he is an employee within the meaning of section 401(c)(1), the exceptions in section 1402(c)(4) and (5) shall not apply. Thus, certain ministers, certain members of religious orders, doctors of medicine, and Christian Science practitioners are treated for purposes of section 401 as being engaged in a trade or business from which net earnings from self-employment are derived. In addition, the exceptions in section 1402(c)(2) shall not apply in the case of any individual who is treated as an employee under section 3121(d)(3)(A), (C), or (D). Therefore, such individuals are treated, for purposes of section 401, as being engaged in a trade or business from which net earnings from self-employment may be derived.

(3) Compensation for personal services actually rendered. (i) For purposes of section 401, the term "earned income" includes only that portion of an individual's net earnings from self-employment which constitutes earned income as defined in section 911(b) and the regulations thereunder. Thus, such term includes only professional fees and other amounts received as compensation for personal services actually rendered by the individual. There is excluded from "earned income" the amount of any item of income, and any deduction properly attributable to such item, if such amount is not received as compensation for personal services actually rendered. Therefore, an individual who renders no personal services has no "earned income" even though such an individual may have net earnings from self-employment from a trade or business.

(ii) If a self-employed individual is engaged in a trade or business in which capital is a material income-producing factor, then, under section 911(b), his earned income is only that portion of the net profits from the trade or business which constitutes a reasonable allowance as compensation for personal services actually rendered. However, such individual's earned income cannot exceed 30 percent of the net profits of such trade or business. The net profits of the trade or business is not necessarily the same as the net earnings from self-employment derived from such trade or business.

(4) Minimum earned income when both personal services and capital are material income-producing factors. (i) If a self-employed individual renders personal services on a full-time, or substantially full-time, basis to only one trade or business, and if with respect to such trade or business capital is a material income-producing factor, then the amount of such individual's earned income from the trade or business is considered to be not less than so much of his share in the net profits of such trade or business as does not exceed $2,500.

(ii) If a self-employed individual renders substantial personal services to more than one trade or business, and if with respect to all such trades or businesses such self-employed individual actually renders personal services on a full-time, or substantially full-time, basis, then the earned income of the self-employed individual from trades or businesses for which he renders substantial personal services and in which both personal services and capital are material income-producing factors is considered to be not less than—

(a) So much of such individual's share of the net profits from all trades or businesses in which he renders substantial personal services as does not exceed $2,500, reduced by

(b) Such individual's share of the net profits of any trade or business in which only personal services is a material income-producing factor.

However, in no event shall the share of the net profits of any trade or business in which capital is a material income-producing factor be reduced below the amount which would, without regard to the provisions of this subdivision, be treated as the earned income derived from such trade or business under section 911(b). In making the computation required by this subdivision, any trade or business with respect to which the individual renders substantial personal services shall be taken into account irrespective of whether a qualified plan has been established by such trade or business.

(iii) If the provisions of subdivision (ii) of this subparagraph apply in determining the earned income of a self-employed individual, and such individual is engaged in two or more trades or businesses in which capital and personal services are material income-producing factors, then the total amount treated as the earned income shall be allocated to each such trade or business for which he performs substantial personal services in the same proportion as his share of net profits from each such trade or business bears to his share of the total net profits from all such trades or businesses. Thus, in such case, the amount of earned income attributable to any such trade or business is computed by multiplying the total earned income as determined under subdivision (ii) of this subparagraph by the individual's net profits from such trade or business and dividing that product by the individual's total net profits from all such trades or businesses.

(iv) For purposes of this subparagraph, the determination of whether an individual renders personal services on a full-time, or substantially full-time, basis is to be made with regard to the aggregate of the trades and businesses with respect to which the employee renders substantial personal services as a common-law employee or as a self-employed individual. However, for all other purposes in applying the rules of this subparagraph, a trade or business with respect to which an individual is a common-law employee shall be disregarded.

(d) Definition of owner-employee. For purposes of section 401 and the regulations thereunder, the term "owner-employee" means a proprie-

tor of a proprietorship, or, in the case of a partnership, a partner who owns either more than 10 percent of the capital interest, or more than 10 percent of the profits interest, of the partnership. Thus, an individual who owns only 2 percent of the profits interest but 11 percent of the capital interest of a partnership is an owner-employee. A partner's interest in the profits and the capital of the partnership shall be determined by the partnership agreement. In the absence of any provision regarding the sharing of profits, the interest in profits of the partners will be determined in the same manner as their distributive shares of partnership taxable income. However, a guaranteed payment (as described in section 707(c)) is not considered a distributive share of partnership income for such purpose. See section 704(b), relating to the determination of the distributive share by the income or loss ratio, and the regulations thereunder. In the absence of a provision in the partnership agreement, a partner's capital interest in a partnership shall be determined on the basis of his interest in the assets of the partnership which would be distributable to such partner upon his withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

(e) Definition of employer. (1) For purposes of section 401, a sole proprietor is considered to be his own employer, and the partnership is considered to be the employer of each of the partners. Thus, an individual partner is not an employer who may establish a qualified plan with respect to his services to the partnership.

(2) Regardless of the provision of local law, a partnership is deemed, for purposes of section 401, to be continuing until such time as it is terminated within the meaning of section 708, relating to the continuation of a partnership.

[T.D. 6675, 28 FR 10123, Sept. 17, 1963]

§ 1.401–11 General rules relating to plans covering self-employed individuals.

(a) Introduction. This section provides certain rules which supplement, and modify, the rules of §§ 1.401–1 through 1.401–9 in the case of a qualified pension, annuity, or profit-sharing plan which covers a self-employed individual who is an employee within the meaning of section 401(c)(1). The provisions of this section apply to taxable years beginning after December 31, 1962. Except as otherwise provided, paragraphs (b) through (m) of this section apply to taxable years beginning after December 31, 1962. Paragraph (n) of this section applies to plan years determined in accordance with paragraph (n)(1) of this section.

(b) General rules. (1) If the amount of employer contributions for common-law employees covered under a qualified plan is related to the earned income (as defined in section 401(c)(2)) of a self-employed individual, or group of self-employed individuals, such a plan is a profit-sharing plan (as described in paragraph (b)(1)(ii) of § 1.401–1) since earned income is dependent upon the profits of the trade or business with respect to which the plan is established. Thus, for example, a plan, which provides that the employer will contribute 10 percent of the earned income of a self-employed individual but no more than $2,500, and that the employer contribution on behalf of common-law employees shall be the same percentage of their salaries as the contribution on behalf of the self-employed individual bears to his earned income, is a profit-sharing plan, since the amount of the employer's contribution for common-law employees covered under the plan is related to the earned income of a self-employed individual and thereby to the profits of the trade or business. On the other hand, for example, a plan which defines the compensation of any self-employed individual as his earned income and which provides that the employer will contribute 10 percent of the compensation of each employee covered under the plan is a pension plan since the contribution on behalf of common-law employees is fixed without regard to whether the self-employed individual has earned income or the amount thereof.

(2) The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits self-employed individuals to be treated as employees and therefore included in qualified plans, but it is clear that such law requires such self-employed individuals to provide benefits for their employees on a non-discriminatory basis. Self-employed individuals will not be considered as providing contributions or benefits for an employee to the extent that the wages or salary of the employee covered under the plan are reduced at or about the time the plan is adopted.

(3) In addition to permitting self-employed individuals to participate in qualified plans, the Self-Employed Individuals Tax Retirement Act of 1962 extends to such individuals some of the tax benefits allowed common-law employee-participants in such plans. However, the tax benefits allowed a self-employed individual are restricted by the limits which are placed on the deductions allowed for contributions on such an individual's behalf. In view of these restrictions on the tax benefits extended to any self-employed individual, a self-em-

ployed individual participating in a qualified plan may not participate in any forfeitures. Therefore, in the case of a qualified plan which covers any self-employed individual, a separate account must be established for each self-employed individual to which no forfeitures can be allocated.

(c) Requirements as to coverage. (1) In general, section 401(a)(3) and the regulations thereunder prescribe the coverage requirements which a qualified plan must satisfy. However, if such a plan covers self-employed individuals who are not owner-employees, it must, in addition to satisfying such requirements, satisfy the requirements of this paragraph. If any owner-employee is covered under a qualified plan, the provisions of this paragraph do not apply, but the provisions of section 401(d), including section 401(d)(3), do apply (see § 1.401–12).

(2)(i) Section 401(a)(3)(B) provides that a plan may satisfy the coverage requirements for qualification if it covers such employees as qualify under a classification which is found not to discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees. Section 401(a)(5) sets forth certain classifications that will not in themselves be considered discriminatory. Under such section, a classification which excludes all employees whose entire remuneration constitutes "wages" under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion. Similarly, a plan which includes all employees will not be considered discriminatory solely because the contributions or benefits based on that part of their remuneration which is excluded from "wages" under section 3121(a)(1) differ from the contributions or benefits based on that part of their remuneration which is not so excluded. However, in determining if a classification is discriminatory under section 401(a)(3)(B), consideration will be given to whether the total benefits resulting to each employee under the plan and under the Social Security Act, or under the Social Security Act only, establish an integrated and correlated retirement system satisfying the tests of section 401(a). A plan which covers self-employed individuals, none of whom is an owner-employee, may also be integrated with the contributions or benefits under the Social Security Act. In such a case, the portion of the earned income (as defined in section 401(c)(2)) of such an individual which does not exceed the maximum amount which may be treated as self-employment income under section 1402(b)(1), and which is derived from the trade or business with respect to which the plan is established, shall be treated as "wages" under section 3121(a)(1) subject to the tax imposed by section 3111 (relating to the tax on employers) for purposes of applying the rules of paragraph (e)(2) of § 1.401–3, relating to the determination of whether a plan is properly integrated. However, if the plan covers an owner-employee, the rules relating to the integration of the plan with the contributions or benefits under the Social Security Act contained in paragraph (b) of § 1.401–12 apply.

(ii) Certain of the classifications enumerated in section 401(a)(5) do not apply to plans which provide contributions or benefits for any self-employed individual. Since self-employed individuals are not salaried or clerical employees, the provision in section 401(a)(5) permitting a plan, in certain cases to cover only this type of employee is inapplicable to plans which cover any self-employed individual.

(iii) The classifications enumerated in section 401(a)(5) are not exclusive, and it is not necessary that a qualified plan cover all employees or all full-time employees. Plans may qualify even though coverage is limited in accordance with a particular classification incorporated in the plan, provided the effect of covering only such employees as satisfy such eligibility requirement does not result in the prohibited discrimination.

(d) Discrimination as to contributions or benefits—(1) In general. In order for a plan to be qualified, there must be no discrimination in contributions or benefits in favor of employees who are officers, shareholders, supervisors, or highly compensated, as against other employees whether within or without the plan. A self-employed individual, by reason of the contingent nature of his compensation, is considered to be a highly-compensated employee, and thus is a member of the group in whose favor discrimination is prohibited. In determining whether the prohibited discrimination exists, the total employer contribution on behalf of a self-employed individual shall be taken into account regardless of the fact that only a portion of such contribution is allowed as a deduction. For additional rules relating to discrimination as to contributions or benefits with regard to plans covering any owner-employee, see § 1.401–12.

(2) Base for computing contributions or benefits. (i) A plan which is otherwise qualified is not considered discriminatory merely because the contributions or benefits provided under the plan bear a uniform relationship to the total compensation,

basic compensation, or regular rate of compensation of the employees, including self-employed individuals, covered under the plan.

(ii) In the case of a self-employed individual who is covered under a qualified plan, the total compensation of such individual is the earned income (as defined in section 401(c)(2)) which such individual derives from the employer's trade or business, or trades or businesses, with respect to which the qualified plan is established. Thus, for example, in the case of a partner, his total compensation includes both his distributive share of partnership income, whether or not distributed, and guaranteed payments described in section 707(c) made to him by the partnership establishing the plan, to the extent that such income constitutes earned income as defined in section 401(c)(2).

(iii) (a) The basic or regular rate of compensation of any self-employed individual is that portion of his earned income which bears the same ratio to his total earned income derived from the trade or business, or trades or businesses, with respect to which the qualified plan is established as the aggregate basic or regular compensation of all common-law employees covered under the plan bears to the aggregate total compensation of such employees derived from such trade or business, or trades or businesses.

(b) If an employer establishes two or more plans which satisfy the requirements of section 401(a) separately, and only one such plan covers a self-employed individual, the determination of the basic or regular rate of compensation of such self-employed individual is made with regard to the compensation of common-law employees covered under the plan which provides contributions or benefits for such self-employed individual. On the other hand, if two or more plans must be considered together in order to satisfy the requirements of section 401(a), the computation of the basic or regular rate of compensation of a self-employed individual must be made with regard to the compensation of the common-law employees covered by so many of such plans as are required to be taken together in order to satisfy the qualification requirements of section 401(a).

(3) Discriminatory contributions. If a discriminatory contribution is made by, or for, a self-employed individual who is an employee within the meaning of section 401(c)(1) because of an erroneous assumption as to the earned income of such individual, the plan will not be considered discriminatory if adequate adjustment is made to remove such discrimination. In the case of any self-employed individual who is an owner-employee, the amount of any excess contribution to be returned and the manner in which it is to be repaid are determined by the provisions of section 401(d)(8) and (e). However, if any self-employed individual, including any owner-employee, has not made the full contribution permitted to be made on his behalf as an employee, then, if the plan expressly provides, so much of any excess contribution by such self-employed individual's employer as may, under the provisions of the plan, be treated as a contribution made by such individual as an employee can be so treated.

(e) Distribution of entire interest. (1) If a trust forms part of a plan which covers a self-employed individual, such trust shall constitute a qualified trust under section 401 only if the plan of which such trust is a part expressly provides that the entire interest of each employee, including any common-law employee, will be distributed in accordance with the provisions of subparagraph (2) or (3) of this paragraph.

(2) Unless the provisions of subparagraph (3) of this paragraph apply, the entire interest of each employee (including contributions he has made on his own behalf, contributions made on his behalf by his employer, and interest thereon) must be actually distributed to such employee—

(i) In the case of an employee, other than an individual who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year of such employee in which he attains the age of 70 ½, or not later than the last day of the taxable year in which such employee retires, whichever is later, and

(ii) In the case of an employee who is, or has been, an owner-employee under the plan, not later than the last day of the taxable year in which he attains the age of 70 ½.

(3) In lieu of distributing an employee's entire interest in a qualified plan as provided in subparagraph (2) of this paragraph, such interest may be distributed commencing no later than the last taxable year described in such subparagraph (2). In such case, the plan must expressly provide that the entire interest of such an employee shall be distributed to him and his beneficiaries, in a manner which satisfies the requirements of subparagraph (5) of this paragraph, over any of the following periods (or any combination thereof)—

(i) The life of the employee, or

(ii) The lives of the employee and his spouse, or

(iii) A period certain not longer than the life expectancy of the employee, or

(iv) A period certain not longer than the joint life and last survivor expectancy of the employee and his spouse.

(4) For purposes of subparagraphs (3) and (5) of this paragraph, the determination of the life expectancy of the employee or the joint life and last survivor expectancy of the employee and his spouse is to be made either (i) only once, at the time the employee receives the first distribution of his entire interest under the plan, or (ii) periodically, in a consistent manner. Such life expectancy or joint life and last survivor expectancy cannot exceed the period computed by the use of the expected return multiples in § 1.72–9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the life expectancy tables of such company.

(5) If an employee's entire interest is to be distributed over a period described in subparagraph (3) of this paragraph, then the amount to be distributed each year must be at least an amount equal to the quotient obtained by dividing the entire interest of the employee under the plan at the time the distribution is made (expressed in either dollars or units) by the life expectancy of the employee, or joint life and last survivor expectancy of the employee and his spouse (whichever is applicable), determined in accordance with the provisions of subparagraph (4) of this paragraph. However, no distribution need be made in any year, or a lesser amount may be distributed, if the aggregate amounts distributed by the end of that year are at least equal to the aggregate of the minimum amounts required by this subparagraph to have been distributed by the end of such year.

(6) If an employee's entire interest is distributed in the form of an annuity contract, then the requirements of section 401(a)(9) are satisfied if the distribution of such contract takes place before the end of the latest taxable year described in subparagraph (2) of this paragraph, and if the employee's interest will be paid over a period described in subparagraph (3) of this paragraph and at a rate which satisfies the requirements of subparagraph (5) of this paragraph.

(7) The requirements of section 401(a)(9) do not preclude contributions from being made on behalf of an owner-employee under a qualified plan subsequent to the taxable year in which the distribution of his entire interest is required to commence. Thus, if all other requirements for qualification are satisfied, a qualified plan may provide contributions for an owner-employee who has already attained age 70 ½. However, a distribution of benefits attributable to contributions made on behalf of an owner-employee in a taxable year beginning after the taxable year in which he attains the age of 70 ½ must satisfy the requirements of subparagraph (3) of this paragraph. Thus, if an owner-employee has already attained the age of 70 ½ at the time the first contribution is made on his behalf, the distribution of his entire interest must commence in the year in which such contribution is first made on his behalf.

(8) This paragraph shall not apply and an otherwise qualified trust will not be disqualified if the method of distribution under the plan is one which was designated by a common-law employee prior to October 10, 1962, and such method of distribution is not in accordance with the provisions of section 401(a)(9). Such exception applies regardless of whether the actual distribution of the entire interest of an employee making such a designation, or any portion of such interest, has commenced prior to October 10, 1962.

[T.D. 6675, 28 FR 10124, Sept. 17, 1963, as amended by T.D. 6982, 33 FR 16500, Nov. 13, 1968]

§ 1.401–12 Requirements for qualification of trusts and plans benefiting owner-employees.

(a) Introduction. This section prescribes the additional requirements which must be met for qualification of a trust forming part of a pension or profit-sharing plan, or of an annuity plan, which covers any self-employed individual who is an owner-employee as defined in section 401(c)(3). However, to the extent that the provisions of § 1.401–11 are not modified by the provisions of this section, such provisions are also applicable to a plan which covers an owner-employee. The provisions of this section apply to taxable years beginning after December 31, 1962. Except as otherwise provided, paragraphs (b) through (m) of this section apply to taxable years beginning after December 31, 1962. Paragraph (n) of this section applies to plan years determined in accordance with paragraph (n)(1) of the section.

(b) General rules. (1) The qualified plan and trust of an unincorporated trade or business does not have to satisfy the additional requirements for qualification merely because an owner-employee derives earned income (as defined in section 401(c)(2)) from the trade or business with respect to which the plan is established. Such additional requirements need be satisfied only if an owner-

employee is actually covered under the plan of the employer. An owner-employee may only be covered under a plan of an employer if such owner-employee has so consented. However, the consent of the owner-employee may be either expressed or implied. Thus, for example, if contributions are, in fact, made on behalf of an owner-employee, such owner-employee is considered to have impliedly consented to being covered under the plan.

(2) A qualified plan covering an owner-employee must be a definite written program and arrangement setting forth all provisions essential for qualification at the time such plan is established. Therefore, for example, even though the owner-employee is the only employee covered under the plan at the time the plan is established, the plan must incorporate all the provisions relating to the eligibility and benefits of future employees.

(c) **Bank trustee.** (1)(i) If a trust created after October 9, 1962, is to form a part of a qualified pension or profit-sharing plan covering an owner-employee, or if a trust created before October 10, 1962, but not exempt from tax on October 9, 1962, is to form part of such a plan, the trustee of such trust must be a bank as defined in paragraph (c)(2) of this section, unless an exception contained in paragraph (c)(4) of this section applies, or paragraph (n) of this section applies.

(ii) The provisions of this paragraph do not apply to an employees' trust created prior to October 10, 1962, if such trust was exempt from tax on October 9, 1962, even though the plan of which such trust forms a part is amended after December 31, 1962, to cover any owner-employee. Although the trustee of a trust described in the preceding sentence need not be a bank, all other requirements for the qualification of such a trust must be satisfied at the time an owner-employee is first covered under such plan.

(2) The term "bank" as used in this paragraph means—

(i) A bank as defined in section 581;

(ii) A corporation which, under the laws of the State of its incorporation or under the laws of the District of Columbia, is subject to both the supervision of, and examination by, the authority in such jurisdiction in charge of the administration of the banking laws;

(iii) In the case of a trust created or organized outside of the United States, that is, outside the States and the District of Columbia, a bank or trust company, wherever incorporated, exercising fiduciary powers and subject to both supervision and examination by governmental authority;

(iv) Beginning on January 1, 1974, an insured credit union (within the meaning of section 101(6) of the Federal Credit Union Act, 12 U.S.C. 1752(6)).

(3) Although a bank is required to be the trustee of a qualified trust, another person, including the employer, may be granted the power in the trust instrument to control the investment of the trust funds either by directing investments, including reinvestments, disposals, and exchanges, or by disapproving proposed investments, including reinvestments, disposals, or exchanges.

(4)(i) This paragraph does not apply to a trust created or organized outside the States and the District of Columbia before October 10, 1962, if, on October 9, 1962, such trust is described in section 402(c) as an organization treated as if it was a trust exempt from tax under section 501(a).

(ii) In addition, the requirement that the trustee must be a bank does not apply to a qualified trust forming a part of a pension or profit-sharing plan if—

(a) The investments of all the funds in such trust are in annuity, endowment, or life insurance contracts, issued by a company which is a life insurance company as defined in section 801(a) during the taxable year immediately preceding the year that such contracts are originally purchased;

(b) All the proceeds which are, or may become, payable under the contract are payable directly to the employee or his beneficiary;

(c) The plan contains a provision to the effect that the employer is to substitute a bank as a trustee or custodian of the contracts if the employer is notified by the district director that such substitution is required because the trustee is not keeping such records, or making such returns, or rendering such statements, as are required by forms or regulations.

However, a qualified trust may only purchase insurance protection to the extent permitted under a qualified plan (see paragraph (b)(1)(i) and (ii) of § 1.401–1).

(5) An employer may designate several trusts (or custodial accounts) or a trust or trusts and an annuity plan or plans as constituting parts of a single plan which is intended to satisfy the requirements for qualification. However, each trust (or custodial account) so designated which is part of a plan covering an owner-employee must satisfy the

requirements of this paragraph. Thus, for example, if all other requirements for qualification are satisfied by the plan, a qualified profit-sharing plan may provide that a portion of the contributions under the plan will be paid to a custodial account, the custodian of which is a bank, for investment in stock of a regulated investment company, and the remainder of such contributions will be paid to a trust, the trustee of which is not a bank, for investment in annuity contracts.

(d) Profit-sharing plan. (1) A profit-sharing plan, as defined in paragraph (b)(1)(ii) of § 1.401–1, which covers any owner-employee must contain a definite formula for determining the contributions to be made by the employer on behalf of employees, other than owner-employees. A formula to be definite must specify the portion of profits to be contributed to the trust and must also define profits for plan purposes. A definite formula may contain a variable factor, if the value of such factor may not vary at the discretion of the employer. For example, the percentage of profits to be contributed each year may differ depending on the amount of profits. On the other hand, a formula which, for example, specifies that profits for plan purposes are not to exceed the cash on hand at the time the employer contribution is made is not a definite formula. The requirement that the plan formula be definite is satisfied if such formula limits the amount to be contributed on behalf of all employees covered under the plan to the amount which permits self-employed individuals to obtain the maximum deduction under section 404(a). However, even though the plan formula is definite, the plan must satisfy all the other requirements for qualification, including the requirement that the contributions under the plan not discriminate in favor of any self-employed individual, and the requirement that the plan be for the exclusive benefit of the employees in general.

(2) A definite contribution formula constitutes an integral part of a qualified profit-sharing plan and may not be amended except for a valid business reason.

(3) The requirement that a profit-sharing plan contain a definite formula for determining the amount of contributions to be made on behalf of employees does not apply to contributions which are made on behalf of owner-employees. However, such contributions are subject to the requirement that they be nondiscriminatory with respect to other employees and must not exceed the limitations on allowable and deductible contributions which may be made by owner-employees.

(e) Requirements as to coverage—(1) Coverage of all employees. The coverage requirements contained in section 401(a)(3) do not apply to a plan which covers any owner-employee. However, such a plan must satisfy the coverage requirements of section 401(d), including section 401(d)(3). Accordingly, a plan which covers an owner-employee must benefit each employee of the trade or business (other than any owner-employee who does not consent to be covered under the plan) whose customary period of employment has been for more than 20 hours a week for more than five months during each of three consecutive periods of twelve calendar months. Therefore, a plan may not provide, for example, that an employee, other than an owner-employee, is ineligible to participate because he does not consent to be a participant or because he does not consent to make reasonable contributions under the plan.

(2) Period of service. (i) In determining whether an employee renders service to the same employer, and, therefore, must be covered under the plan of such employer, a partnership is considered to be one employer during the entire period prior to the time it is terminated within the meaning of section 708 (see paragraph (e)(2) of § 1.401–10).

(ii) In the case of a common-law employee who becomes an employee within the meaning of section 401(c)(1) with respect to the same trade or business, his period of employment is the aggregate of his service as a common-law employee and an employee within the meaning of section 401(c)(1).

(iii) In determining whether any employee, including any owner-employee, has three years of service, past service of any such employee may be taken into account as provided in paragraph (b) of § 1.401–10. Thus, if an employer takes into account past service for any owner-employee, he must take into account the past service of all his other employees to the same extent. However, a plan may provide for coverage after a period of service which is shorter than three years, but in no case may the plan require a waiting period for employees which is longer than that required for the owner-employees.

(f) Discrimination in contributions or benefits. (1) Variations in contributions or benefits may be provided under the plan so long as the plan does not discriminate, either as to contributions or benefits, in favor of officers, employees whose principal duties consist in supervising the work of other employees, or highly compensated employees, as

against other employees (see § 1.401–4). For the purpose of determining whether the provisions of a plan which provide contributions or benefits for an owner-employee result in the prohibited discrimination, an owner-employee, like other self-employed individuals, is considered a highly compensated employee (see paragraph (d) of § 1.401–11). Whether or not a plan is discriminatory is determined by the actual operation of the plan as well as by its formal provisions.

(2) The provisions of section 401(a)(5), relating to certain plan provisions which will not in and of themselves be considered discriminatory, are not applicable to any plan which covers any owner-employee. Such a plan must, instead, satisfy the requirements of section 401(a)(10) and section 401(d)(6). Accordingly, a plan is not discriminatory within the meaning of section 401(a)(4) merely because the contributions or benefits provided for the employees covered under the plan bear a uniform relationship to the total compensation, or to the basic or regular rate of compensation, of such employees. The total compensation or the basic or regular rate of compensation of an owner-employee is computed in accordance with the provisions of paragraph (d)(2) of § 1.401–11.

(3) Even though the contributions under the plan do not bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered thereunder and the plan would otherwise be considered discriminatory within the meaning of section 401(a)(4), the plan shall not be considered discriminatory if such variation is due to employer contributions on behalf of any owner-employee which are required, under the plan, to be applied to pay premiums or other consideration on one or more level premium contracts described in section 401(e)(3)(A). In a taxable year to which the foregoing exception applies and, therefore, one in which the contributions under the plan would otherwise be discriminatory, the employer contributions to pay such premiums or other consideration must be the only employer contributions made for the owner-employee, and the contributions for such taxable year under such plan must not be in excess of the amount permitted to be paid toward the purchase of such a contract under the provisions of section 401(e)(3). Furthermore, the exception described in this subparagraph only applies to contributions made under a plan which otherwise satisfies the requirements of section 401(a)(4) and the regulations thereunder. Thus, if a plan provides for the purchase, in accordance with section 401(e)(3), of a level premium contract for an owner-employee, then such plan must provide either that the benefits for all employees are nondiscriminatory or, in the case of a money-purchase type of plan, that the contributions for all employees are based on compensation determined in a non-discriminatory manner. For example, since the contributions on behalf of the owner-employee are based on his earned income during the period preceding the purchase of the contract, the contributions for other employees must be based on their compensation during the same period if this will result in larger contributions on their behalf.

(4) In the case of a plan which covers any owner-employee, the contributions or benefits provided under the plan cannot vary with respect to years of service except as provided in subparagraph (5) of this paragraph.

(5) The provisions of section 401(d)(3) do not preclude the coverage of employees with less than three years of service if such coverage is provided on a nondiscriminatory basis. However, a plan will not be disqualified merely because the contributions or benefits for employees who have less than three years of service are not as favorable as the contributions or benefits for employees having more than three years of service.

(g) **Nonforfeitable rights.** (1)(i) Except as provided in subparagraph (2) of this paragraph, if an owner-employee is covered under the plan of his employer, each employee's rights to the contributions, or to the benefits derived from the contributions, of such employer must be nonforfeitable at the time such contributions are paid to, or under, the plan. The employees who must obtain such nonforfeitable rights include the self-employed individuals who are covered under the plan. As to what constitutes nonforfeitable rights of an employee, see paragraph (a)(2) of § 1.402(b)–1.

(ii) Under section 401(d)(2), it is necessary that each employee obtain nonforfeitable rights to the employer contributions under the plan on his behalf from the time such contributions are paid. Thus, each employee must have a nonforfeitable interest to the portion of the funds under the plan which is allocable to the employer contributions made under the plan on his behalf.

(2) The provisions of subparagraph (1) of this paragraph do not apply to the extent that employer contributions on behalf of any employee must remain forfeitable in order to satisfy the requirements of paragraph (c) of § 1.401–4. However, employer contributions on behalf of employees whose rights are required to remain forfeitable to

satisfy such requirements must be nonforfeitable except for such contingency.

(h) Integration with social security. **(1)** If a qualified plan covers any owner-employee, then the rules relating to the integration of such plan with the contributions or benefits under the Social Security Act are provided in this paragraph. Accordingly, the provisions of paragraph (e) of § 1.401–3 and paragraph (c) of § 1.401–11 do not apply to such a plan. In the case of a plan which provides contributions or benefits for any owner-employee, integration of the plan with the Social Security Act for any taxable year of the employer can take place only if not more than one-third of the employer contributions under the plan which are deductible under section 404 for that year are made on behalf of the owner-employees. If such requirement is satisfied, then the plan may be integrated with the contributions or benefits under the Social Security Act in accordance with the rules of subparagraph (3) of this paragraph.

(2)(i) For purposes of subparagraph (1) of this paragraph, in determining the total amount of employer contributions which are deductible under section 404, the provisions of section 404(a), including the provisions of section 404(a)(9) (relating to plans benefiting self-employed individuals), and section 404(e) (relating to the special limitations for self-employed individuals) are taken into account, but the provisions of section 404(a)(10) (relating to the special limitation on the amount allowed as a deduction for self-employed individuals) are not taken into account.

(ii) The amount of deductible employer contributions which are made on behalf of all owner-employees for the year is compared with the amount of deductible employer contributions for the year made on behalf of all employees covered under the plan (including self-employed individuals who are not owner-employees and owner-employees) for the purpose of determining whether the deductible contributions by the employer on behalf of owner-employees are not more than one-third of the total deductible contributions.

(3) If a plan covering an owner-employee satisfies the requirement of subparagraph (1) of this paragraph, and if the employer wishes to integrate such plan with the contributions or benefits under the Social Security Act, then—

(i) The employer contributions under the plan on behalf of any owner-employee shall be reduced by an amount determined by multiplying the earned income of such owner-employee which is derived from the trade or business with respect to which the plan is established and which does not exceed the maximum amount which may be treated as self-employment income under section 1402(b)(1), by the rate of tax imposed under section 1401(a); and

(ii) The employer contributions under the plan on behalf of any employee other than an owner-employee may be reduced by an amount not in excess of the amount determined by multiplying the employee's wages under section 3121(a)(1) by the rate of tax imposed under section 3111(a). For purposes of this subdivision, the earned income of a self-employed individual which is derived from the trade or business with respect to which the plan is established and which is treated as self-employment income under section 1402(b)(1), shall be treated as "wages" under section 3121(a)(1).

(4) A money purchase pension plan or a profit-sharing plan may provide that such plan will be integrated with the Social Security Act only for such taxable years of the employer in which the requirements for integration are satisfied. However, a qualified plan cannot provide that employer contributions are only to be made for taxable years in which the integration requirements are satisfied.

(i) Limit on contributions on behalf of an owner-employee. **(1)** Section 401(d)(5) requires that a plan which covers any owner-employee must contain provisions which restrict the employer contributions that may be made on behalf of any owner-employee for each taxable year to an amount no greater than that which is deductible under section 404. In computing the amount deductible under section 404 for purposes of section 401(d)(5) and this paragraph, the limitations contained in section 404(a)(9) and (e), relating to special limitations for self-employed individuals, are taken into account, but such amount is determined without regard to section 404(a)(10), relating to the special limitation on the amount allowed as a deduction for self-employed individuals. Accordingly, a qualified plan which covers any owner-employee cannot permit employer contributions to be made on behalf of such owner-employee in excess of 10 percent of the earned income which is derived by such owner-employee from the trade or business with respect to which the plan is established, or permit the employer to contribute more than $2,500 on behalf of any such owner-employee for any taxable year.

(2)(i) In determining whether the plan permits contributions to be made in excess of the limitations of subparagraph (1) of this paragraph, employer contributions under the plan which are

allocable to the purchase of life, accident, health, or other insurance are not to be taken into account. To determine the amount of employer contributions under the plan which are allocable to the purchase of life, accident, health, or other insurance, see paragraph (f) of § 1.404(e)–1 and paragraph (b) of § 1.72–16. However, contributions for such insurance can be made only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder.

(ii) A further exception to the limit on the amount of contributions which an employer may make under the plan on behalf of an owner-employee is made in the case of contributions which are required, under the plan, to be applied to pay premiums or other consideration for one or more annuity, endowment, or life insurance contracts described in section 401(e)(3) (see section 401(e)(3) and the regulations thereunder).

(j) **Excess contributions.** The provisions of section 401(e) define the term "excess contribution" and indicate the consequences of making such a contribution (see § 1.401–13). However, section 401(d)(8) provides that a qualified plan which provides contributions or benefits for any owner-employee must contain certain provisions which complement the rules contained in section 401(e). Under section 401(d)(8), a qualified plan must provide that—

(1) The net amount of any excess contribution (determined in accordance with the provisions of § 1.401–13) must be returned to the owner-employee on whose behalf it is made, together with the net income earned on such excess contribution;

(2) For each taxable year for which the trust is considered to be a nonqualified trust with respect to an owner-employee under section 401(e)(2) because the net amount of an excess contribution and the earnings thereon have not been returned to such owner-employee, the income of the trust for that taxable year attributable to the interest of such owner-employee is to be paid to him.

(3) If an excess contribution is determined to be willfully made (within the meaning of section 401(e)(2)(E)), the entire interest of the owner-employee on whose behalf such contribution was made is required to be distributed to such owner-employee. Furthermore, the plan must require the distribution of an owner-employee's entire interest under the plan if a willful excess contribution is determined to have been made under any other plan in which the owner-employee is covered as an owner-employee.

(k) **Contributions of property under a qualified plan.** (1) The contribution of property, other than money, prior to January 1, 1975, by the person who is the employer (within the meaning of section 401(c)(4)) to a qualified trust forming a part of a plan which covers employees some or all of whom are owner-employees who control (within the meaning of section 401(d)(9)(B) and the regulations thereunder) the trade or business with respect to which the plan is established is a prohibited transaction between such trust and the employer-grantor of such trust (see section 503(g) prior to its repeal by sec. 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)).

(2) A contribution of property, other than money, prior to January 1, 1975, to a qualified trust by an owner-employee who controls, or a member of a group of owner-employees who together control, the trade or business with respect to which the plan is established, or a contribution of property, other than money, to a qualified trust by a member of such an owner-employee's family (as defined in section 267(c)(4)), is a prohibited transaction. (See section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978)).

(3) See section 4975 and the regulations thereunder with respect to rules relating to the contribution of property, other than money, made after December 31, 1974.

(*l*) **Controlled trades or businesses—(1) Plans covering an owner-employee who controls another trade or business.** (i) A plan must not cover any owner-employee, or group of two or more owner-employees, if such owner-employee, or group of owner-employees, control (within the meaning of subparagraph (3) of this paragraph) any other trade or business, unless the employees of such other trade or business controlled by such owner-employee, or such group of owner-employees, are included in a plan which satisfies the requirements of section 401(a), including the qualification requirements of section 401(d). The employees who must be covered under the plan of the trade or business which is controlled include the self-employed individuals who are not owner-employees and the owner-employees who consent to be covered by such plan. Accordingly, the employer must determine whether any owner-employee, or group of owner-employees, who may participate in the plan which is established by such employer controls any other trade or business, and whether the requirements of this subparagraph are satisfied with respect to the plan established in such other

trade or business. The plan of an employer may exclude an owner-employee who controls another trade or business from coverage under the plan even though such owner-employee consents to be covered, if a plan which satisfies the requirements of subdivision (ii) of this subparagraph has not been established in the trade or business which such owner-employee controls.

(ii) The qualified plan which the owner-employee, or owner-employees, are required to provide for the employees of the trade or business which they control must provide contributions and benefits which are not less favorable than the contributions and benefits provided for the owner-employee, or owner-employees, under the plan of any trade or business which they do not control. Thus, for example, if the contributions or benefits for the owner-employee under the plan of the trade or business which he does not control are computed on the basis of his total (as compared to basic or regular rate) of compensation, then the contributions or benefits for employees covered under the plan of the trade or business which the owner controls must be computed on the basis of their total compensation. However, the requirements of this subdivision cannot be satisfied if the benefits and contributions provided under the plan for the employees of the trade or business which is controlled are not comparable to those provided under the plan covering the owner-employee, or group of owner-employees, in the trade or business which they do not control. Thus, for example, if the owner-employee is covered by a pension plan in the trade or business which he does not control, he may not satisfy the requirements of this subdivision by establishing a profit-sharing plan in the trade or business which he does control.

(iii) If an individual is covered as an owner-employee under the plans of two or more trades or businesses which he does not control and such individual controls a trade or business, then the contributions or benefits of the employees under the plan of the trade or business which he does control must be as favorable as those provided for him under the most favorable plan of the trade or business which he does not control.

(2) Owner-employees who control more than one trade or business. If the plan provides contributions or benefits for an owner-employee who controls, or group of owner-employees who together control, the trade or business with respect to which the plan is established, and such owner-employee, or group of owner-employees, also control as owner-employees one or more other trades or businesses, plans must be established with respect to such controlled trades or businesses so that when taken together they form a single plan which satisfies the requirements of section 401(a) and (d) with respect to the employees of all the controlled trades or businesses.

(3) Control defined. (i) For purposes of this paragraph, an owner-employee, or a group of two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such group of two or more owner-employees together—

(a) Own the entire interest in an unincorporated trade or business, or

(b) In the case of a partnership, own more than 50 percent of either the capital interest or the profits interest in such partnership.

In determining whether an owner-employee, or group of owner-employees, control a trade or business within the meaning of the preceding sentence, it is immaterial whether or not such individuals could be covered under a plan established with respect to the trade or business. For example, if an individual who is an owner-employee has a 60-percent capital interest in another trade or business, such individual controls such trade or business and the provisions of this paragraph apply even though the individual derives no earned income, as defined in section 401(c)(2), from the controlled trade or business. For purposes of determining the ownership interest of an owner-employee, or group of owner-employees, an owner-employee, or group of owner-employees, is treated as owning any interest in a partnership which is owned, directly or indirectly, by a partnership controlled by such owner-employee, or group of owner-employees.

(ii) The provisions of subparagraphs (1) and (2) of this paragraph apply only if the owner-employee who controls, or the group of owner-employees who control, a trade or business, or trades or businesses, within the meaning of subdivision (i) of this subparagraph is the same owner-employee, or group of owner-employees, covered under the plan intended to satisfy the requirements for qualification. Thus, for example, if A is a 50-percent partner in both the AB and AC partnership, and if the AB partnership wishes to establish a plan covering A and B, the provisions of subparagraphs (1) and (2) of this paragraph do not apply, since A does not control either partnership, and since B has no interest in the AC partnership.

(m) Distribution of benefits. (1)(i) Section 401(d)(4)(B) requires that a qualified plan which

provides contributions or benefits for any owner-employee must not provide for the payment of benefits to such owner-employee at any time before he has attained age 59 ½. An exception to the foregoing rule permits a qualified plan to provide for the distribution of benefits to an owner-employee prior to the time he attains age 59 ½ if he is disabled. For taxable years beginning after December 31, 1966, see section 72(m)(7) and paragraph (f) of § 1.72–17 for the meaning of disabled. For taxable years beginning before January 1, 1967, see section 213(g)(3) for the meaning of disabled. In general, both sections 72(m)(7) and 213(g)(3) provide that an individual is considered disabled if he is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. In addition, section 401(d)(4)(B) does not preclude the distribution of benefits to the estate or other beneficiary of a deceased owner-employee prior to the time the owner-employee would have attained age 59 ½ if he had lived.

(ii) A qualified plan must provide that if, despite the restrictions in the plan to the contrary, an amount is prematurely distributed, or made available, to a participant in such plan who is, or has been, an owner-employee, then no contribution shall be made under the plan by, or for, such individual during any of the 5 taxable years of the plan beginning after the distribution is made.

(2)(i) The provisions of subparagraph (1) of this paragraph preclude an owner-employee who is a participant in a qualified pension or profit-sharing plan of his employer from withdrawing any part of the funds accumulated on his behalf except as provided in such subparagraph (1). However, the distribution of an owner-employee's interest, or any portion of such interest, after he attains age 59 ½ is determined by the provisions of the plan. Thus, for example, if a qualified pension plan provides that the normal retirement age under the plan is age 65, an owner-employee would not be entitled to a distribution of an amount under the plan merely because he attained age 59 ½.

(ii) The provisions of subparagraph (1) of this paragraph do not preclude the establishment of a profit-sharing plan which provides for the distribution of all, or part, of participants' accounts after a fixed number of years. However, such a plan must not permit a distribution of any amount to any owner-employee prior to the time the owner-employee has attained age 59 ½ or becomes disabled within the meaning of section 72(m)(7) or section 213(g)(3), whichever is applicable. On the other hand, if a distribution would have been made under the plan to an owner-employee but for the fact that he had not attained age 59 ½, then the amount of such distribution (including any increment earned on such amount) must be distributed to such owner-employee at such time as he attains age 59 ½.

(3) A qualified pension, annuity, or profit-sharing plan which covers an owner-employee must provide that the distribution of an owner-employee's entire interest under the plan must begin prior to the end of the taxable year in which he attains the age of 70 ½, and such distribution must satisfy the requirements of section 401(a)(9) and paragraph (e) of § 1.401–11. Furthermore, section 401(d)(7) provides that, if an owner-employee dies prior to the time his entire interest has been distributed to him, such owner-employee's entire remaining interest under the plan must, in general, either be distributed to his beneficiary, or beneficiaries, within 5 years, or be used within that period to purchase an immediate annuity for his beneficiary, or beneficiaries. However, a distribution within 5 years of the death of the owner-employee is not required if the distribution of his interest has commenced and such distribution is for a term certain over a period not extending beyond the joint life and survivor expectancy of the owner-employee and his spouse. Thus, for example, an annuity for the joint life and survivor expectancy of an owner-employee and his spouse which guarantees payments for 10 years is a distribution which is payable over a period which does not exceed the joint life and survivor expectancy of the owner-employee and his spouse if such expectancy is at least 10 years at the time the distribution first commences.

(n) Nonbank trustee—(1) Effective dates—(i) General rule. For a plan not in existence on January 1, 1974, this paragraph shall apply to the first plan year commencing after September 2, 1974, and all subsequent plan years.

(ii) Existing plans. For a plan in existence on January 1, 1974, this paragraph shall apply to the first plan year commencing after December 31, 1975, and all subsequent plan years.

(2) In general. For plan years to which this paragraph applies, the trustee of a trust described in paragraph (c)(1)(i) of this section may be a person other than a bank if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer trusts will be consistent with the requirements of

section 401. The person must demonstrate by written application that the requirements of paragraph (n)(3) to (7) of this section will be met. The written application must be sent to the Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, D.C. 20224. For procedural and administrative rules, see paragraph (n)(8) of this section.

(3) Fiduciary ability. The applicant must demonstrate in detail its ability to act within the accepted rules of fiduciary conduct. Such demonstration must include the following elements of proof:

(i) Continuity. (A) The applicant must assure the uninterrupted performance of its fiduciary duties notwithstanding the death or change of its owners. Thus, for example, there must be sufficient diversity in the ownership of the applicant to ensure that the death or change of its owners will not interrupt the conduct of its business. Therefore, the applicant cannot be an individual.

(B) Sufficient diversity in the ownership of an incorporated applicant is demonstrated in the following circumstances:

(1) Individuals each of whom owns more than 20 percent of the voting stock in the applicant own, in the aggregate, no more than 50 percent of such stock;

(2) The applicant has issued securities registered under section 12 (b) of the Securities Exchange Act of 1934 (15 U.S.C. 78l(b)) or required to be registered under section 12(g)(1) of that Act (15 U.S.C. 78l(g)(1)); or

(3) The applicant has a parent corporation within the meaning of section 1563(a)(1) that has issued securities registered under section 12(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78l(b)) or required to be registered under Section 12(g)(1) of that Act (15 U.S.C. 78l(g)(1)).

(C) Sufficient diversity in the ownership of an applicant that is a partnership means that—

(1) Individuals each of whom owns more than 20 percent of the profits interest in the partnership own, in the aggregate, no more than 50 percent of such profits interest, and

(2) Individuals each of whom owns more than 20 percent of the capital interest in the partnership own, in the aggregate, no more than 50 percent of such capital interest.

(D) For purposes of this subdivision, the ownership of stock and of capital and profits interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 1563(e) and (f)(2). For this purpose, the rules for constructive ownership of stock provided in section 1563(e) and (f)(2) shall apply to a capital or profits interest in a partnership as if it were a stock interest.

(ii) Established location. The applicant must have an established place of business in the United States where it is accessible during every business day.

(iii) Fiduciary experience. The applicant must have fiduciary experience or expertise sufficient to ensure that it will be able to perform its fiduciary duties. Evidence of fiduciary experience must include proof that a significant part of the business of the applicant consists of exercising fiduciary powers similar to those it will exercise if its application is approved. Evidence of fiduciary expertise must include proof that the applicant employs personnel experienced in the administration of fiduciary powers similar to those the applicant will exercise if its application is approved.

(iv) Fiduciary responsibility. The applicant must assure compliance with the rules of fiduciary conduct set out in paragraph (n)(6) of this section.

(v) Financial responsibility. The applicant must exhibit a high degree of solvency commensurate with the obligations imposed by this paragraph. Among the factors to be taken into account are the applicant's net worth, its liquidity, and its ability to pay its debts as they come due.

(4) Capacity to account. The applicant must demonstrate in detail its experience and competence with respect to accounting for the interests of a large number of individuals (including calculating and allocating income earned and paying out distributions to payees). Examples of accounting for the interests of a large number of individuals include accounting for the interests of a large number of shareholders in a regulated investment company and accounting for the interests of a large number of variable annuity contract holders.

(5) Fitness to handle funds—(i) In general. The applicant must demonstrate in detail its experience and competence with respect to other activities normally associated with the handling of retirement funds.

(ii) Examples. Examples of activities normally associated with the handling of retirement funds include:

(A) To Receive, issue receipts for, and safely keep securities;

(B) To collect income;

(C) To execute such ownership certificates, to keep such records, make such returns, and render such statements as are required for Federal tax purposes;

(D) To give proper notification regarding all collections;

(E) To collect matured or called principal and properly report all such collections;

(F) To exchange temporary for definitive securities;

(G) To give proper notification of calls, subscription rights, defaults in principal or interest, and the formation of protective committees;

(H) To buy, sell, receive, or deliver securities on specific directions.

(6) Rules of fiduciary conduct. The applicant must demonstrate that under applicable regulatory requirements, corporate or other governing instruments, or its established operating procedures:

(i) Administration of fiduciary powers. (A)(1) The owners or directors of the applicant will be responsible for the proper exercise of fiduciary powers by the applicant. Thus, all matters pertinent thereto, including the determination of policies, the investment and disposition of property held in a fiduciary capacity, and the direction and review of the actions of all employees utilized by the applicant in the exercise of its fiduciary powers, will be the responsibility of the owners or directors. In discharging this responsibility, the owners or directors may assign to designated employees, by action duly recorded, the administration of such of the applicant's fiduciary powers as may be proper to assign.

(2) A written record will be made of the acceptance and of the relinquishment or closing out of all fiduciary accounts, and of the assets held for each account.

(3) If the applicant has the authority or the responsibility to render any investment advice with regard to the assets held in or for each fiduciary account, the advisability of retaining or disposing of the assets will be determined at least once during each period of 12 months.

(B) All employees taking part in the performance of the applicant's fiduciary duties will be adequately bonded. Nothing in this subdivision (i)(B) shall require any person to be bonded in contravention of section 412(d) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1112(d)).

(C) The applicant will employ or retain legal counsel who will be readily available to pass upon fiduciary matters and to advise the applicant.

(D) In order to segregate the performance of its fiduciary duties from other business activities, the applicant will maintain a separate trust division under the immediate supervision of an individual designated for that purpose. The trust division may utilize the personnel and facilities of other divisions of the applicant, and other divisions of the applicant may utilize the personnel and facilities of the trust division, as long as the separate identity of the trust division is preserved.

(ii) Adequacy of net worth. (A) The applicant will determine the value of the assets held by it in trust at least once in each calendar year and no more than 18 months after the preceding valuation. The assets will be valued at their fair market value, except that the assets of an employee pension benefit plan to which section 103(b)(3)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1023(b)(3)(A)) applies will be considered to have the value stated in the most recent annual report of the plan.

(B) No fiduciary account will be accepted by the applicant unless the applicant's net worth (determined as of the end of the most recent taxable year) exceeds the greater of—

(1) $100,000, or

(2) Four percent (or, in the case of a passive trustee described in paragraph (n)(7)(i)(A) of this section, two percent) of the value of all of the assets held by the applicant in fiduciary accounts (determined as of the most recent valuation date).

(C) The applicant will take whatever lawful steps are necessary (including the relinquishment of fiduciary accounts) to ensure that its net worth (determined as of the close of each taxable year) exceeds the greater of—

(1) $50,000, or

(2) Two percent (or, in the case of a passive trustee described in paragraph (n)(7)(i)(A) of this section, one percent) of the value of all of the assets held by the applicant in fiduciary accounts (determined as of the most recent valuation date).

(iii) Audits. (A) At least once during each period of 12 months, the applicant will cause

detailed audits of the fiduciary books and records to be made by a qualified public accountant. At that time, the applicant will ascertain whether the fiduciary accounts have been administered in accordance with law, this paragraph, and sound fiduciary principles. The audits shall be conducted in accordance with generally accepted auditing standards, and shall involve whatever tests of the fiduciary books and records of the applicant are considered necessary by the qualified public accountant.

(B) In the case of an applicant which is regulated, supervised, and subject to periodic examination by a State or Federal agency, such applicant may adopt an adequate continuous audit system in lieu of the periodic audits required by paragraph (n)(6)(iii)(A) of this section.

(C) A report of the audits and examinations required under this subdivision, together with the action taken thereon, will be noted in the fiduciary records of the applicant.

(iv) Funds awaiting investment or distribution. Funds held in a fiduciary capacity by the applicant awaiting investment or distribution will not be held uninvested or undistributed any longer than is reasonable for the proper management of the account.

(v) Custody of investments. (A) Except for investments pooled in a common investment fund in accordance with the provisions of paragraph (n)(6)(vi) of this section, the investments of each account will not be commingled with any other property.

(B) Assets of accounts requiring safekeeping will be deposited in an adequate vault. A permanent record will be kept of assets deposited in or withdrawn from the vault.

(vi) Common investment funds. The assets of an account may be pooled in a common investment fund (as defined in paragraph (n)(6)(viii)(C) of this section) if the applicant is authorized under applicable law to administer a common investment fund and if pooling the assets in a common investment fund is not in contravention of the plan documents or applicable law. The common investment fund must be administered as follows:

(A) Each common investment fund must be established and maintained in accordance with a written agreement, containing appropriate provisions as to the manner in which the fund is to be operated, including provisions relating to the investment powers and a general statement of the investment policy of the applicant with respect to the fund; the allocation of income, profits and losses; the terms and conditions governing the admission or withdrawal of participations in the funds; the auditing of accounts of the applicant with respect to the fund; the basis and method of valuing assets held by the fund, setting forth specific criteria for each type of asset; the minimum frequency for valuation of assets of the fund; the period following each such valuation date during which the valuation may be made (which period in usual circumstances may not exceed 10 business days); the basis upon which the fund may be terminated; and such other matters as may be necessary to define clearly the rights of participants in the fund. A copy of the agreement must be available at the principal office of the applicant for inspection during all business hours, and upon request a copy of the agreement must be furnished to the employer, the plan administrator, any participant or beneficiary of an account, or the individual for whose benefit the account is established or that individual's beneficiary.

(B) All participations in the common investment fund must be on the basis of a proportionate interest in all of the investments.

(C) Not less frequently than once during each period of 3 months the applicant must determine the value of the assets in the fund as of the date set for the valuation of assets. No participation may be admitted to or withdrawn from the fund except (1) on the basis of such valuation and (2) as of such valuation date. No participation may be admitted to or withdrawn from the fund unless a written request for or notice of intention of taking such action has been entered on or before the valuation date in the fiduciary records of the applicant. No request or notice may be canceled or countermanded after the valuation date.

(D)(1) The applicant must at least once during each period of 12 months cause an adequate audit to be made of the common investment fund by a qualified public accountant.

(2) The applicant must at least once during each period of 12 months prepare a financial report of the fund which, based upon the above audit, must contain a list of investments in the fund showing the cost and current value of each investment; a statement for the period since the previous report showing purchases, with cost; sales, with profit or loss; any other investment changes; income and disbursements; and an appropriate notation as to any investments in default.

(3) The applicant must transmit and certify the accuracy of the financial report to the administrator of each plan participating in the common investment fund within 120 days after the end of the plan year.

(E) When participations are withdrawn from a common investment fund, distributions may be made in cash or ratably in kind, or partly in cash and partly in kind: *Provided,* That all distributions as of any one valuation date must be made on the same basis.

(F) If for any reason an investment is withdrawn in kind from a common investment fund for the benefit of all participants in the fund at the time of such withdrawal and such investment is not distributed ratably in kind, it must be segregated and administered or realized upon for the benefit ratably of all participants in the common investment fund at the time of withdrawal.

(vii) Books and records. (A) The applicant must keep its fiduciary records separate and distinct from other records. All fiduciary records must be so kept and retained for as long as the contents thereof may become material in the administration of any internal revenue law. The fiduciary records must contain full information relative to each account.

(B) The applicant must keep an adequate record of all pending litigation to which it is a party in connection with the exercise of fiduciary powers.

(viii) Definitions. For purposes of this subparagraph, subdivision (n)(3)(v), and subparagraph (n)(8) of this section—

(A) The term "account" or "fiduciary account" means a trust described in section 401(a) (including a custodial account described in section 401(f)), a custodial account described in section 403(b)(7), or an individual retirement account described in section 408(a) (including a custodial account described in section 408(h)).

(B) The term "plan administrator" means an administrator as defined in § 1.414(g)–1.

(C) The term "common investment fund" means a trust that satisfies the following requirements:

(1) The trust consists of all or part of the assets of several accounts that have been established with the applicant, and

(2) The trust is described in section 401(a) and is exempt from tax under section 501(a), or is a trust that is created for the purpose of providing a satisfactory diversification of investments or a reduction of administrative expenses for the participating accounts and that satisfies the requirements of section 408(c).

(D) The term "fiduciary records" means all matters which are written, transcribed, recorded, received or otherwise come into the possession of the applicant and are necessary to preserve information concerning the acts and events relevant to the fiduciary activities of the applicant.

(E) The term "qualified public accountant" means a qualified public accountant, as defined in section 103(a)(3)(D) of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1023(a)(3)(D), who is independent of the applicant.

(F) The term "net worth" means the amount of the applicant's assets less the amount of its liabilities, as determined in accordance with generally accepted accounting principles.

(7) **Special rules—(i) Passive trustee.** (A) An applicant that undertakes to act only as a passive trustee may be relieved of one or more of the requirements of this paragraph upon clear and convincing proof that such requirements are not germane, under all the facts and circumstances, to the manner in which the applicant will administer any trust. A trustee is a passive trustee only if under the written trust instrument the trustee has no discretion to direct the investment of the trust funds or any other aspect of the business administration of the trust, but is merely authorized to acquire and hold particular investments specified by the trust instrument. Thus, for example, in the case of an applicant that undertakes merely to acquire and hold the stock of regulated investment companies, the requirements of paragraph (n)(6)(i)(A)(3), (i)(D), and (vi) of this section shall not apply and no negative inference shall be drawn from the applicant's failure to demonstrate its experience of competence with respect to the activities described in paragraph (n)(5)(ii)(E) to (H) of this section.

(B) The notice of approval issued to an applicant that is approved by reason of this subdivision shall state that the applicant is authorized to act only as a passive trustee.

(ii) Federal or State regulation. Evidence that an applicant is subject to Federal or State regulation with respect to one or more relevant factors shall be given weight in proportion to the extent that such regulatory standards are consonant with the requirements of section 401. Such evidence

may be submitted in addition to, or in lieu of, the specific proofs required by this paragraph.

(iii) Savings account. (A) An applicant will be approved to act as trustee under this subdivision if the following requirements are satisfied:

(*1*) The applicant is a credit union, industrial loan company, or other financial institution designated by the Commissioner;

(*2*) The investment of the trust assets will be solely in deposits in the applicant;

(*3*) Deposits in the applicant are insured (up to the dollar limit prescribed by applicable law) by an agency or instrumentality of the United States, or by an organization established under a special statute the business of which is limited to insuring deposits in financial institutions and providing related services.

(B) Any applicant that satisfies the requirements of this subdivision is hereby approved, and (notwithstanding subparagraph (2) of this paragraph) is not required to submit a written application. This approval takes effect on the first day after December 22, 1976, on which the applicant satisfies the requirements of this subdivision, and continues in effect for so long as the applicant continues to satisfy those requirements.

(C) If deposits are insured, but not in the manner provided in paragraph (n)(7)(iii)(A)(*3*) of this section, the applicant must submit an application. The application, notwithstanding subparagraph (2) of this paragraph, will be limited to a complete description of the insurance of applicant's deposits. The applicant will be approved if the Commissioner approves of the applicant's insurance.

(iv) Notification of Commissioner. The applicant must notify the Commissioner in writing of any change that affects the continuing accuracy of any representation made in the application required by this paragraph, whether the change occurs before or after the applicant receives a notice of approval. The notification must be addressed to the Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, D.C. 20224.

(v) Substitution of trustee. No applicant will be approved unless the applicant undertakes to act as trustee only under trust instruments which contain a provision to the effect that the grantor is to substitute another trustee upon notification by the Commissioner that such substitution is required because the applicant has failed to comply with the requirements of this paragraph or is not keeping such records, or making such returns, or rendering such statements as are required by forms or regulations.

(8) Procedure and administration—(i) Notice of approval. If the applicant is approved, a written notice of approval will be issued to the applicant. The notice of approval will state the day on which it becomes effective, and (except as otherwise provided therein) will remain effective until revoked. This paragraph does not authorize the applicant to accept any fiduciary account before such notice of approval becomes effective.

(ii) Notice of disapproval. If the applicant is not approved, a written notice will be furnished to the applicant containing a statement of the reasons why the applicant has not been approved.

(iii) Copy to be furnished. The applicant must not accept a fiduciary account until after the plan administrator or the person for whose benefit the account is to be established is furnished with a copy of the written notice of approval issued to the applicant. This provision is effective six months after April 20, 1979 for new accounts accepted thereafter. For accounts accepted before that date, the administrator must be notified before the later of the effective date of this provision or six months after acceptance of the account.

(iv) Grounds for revocation. The notice of approval issued to an applicant will be revoked if the Commissioner determines that the applicant is unwilling or unable to administer fiduciary accounts in a manner consistent with the requirements of this paragraph. Generally, the notice will not be revoked unless the Commissioner determines that the applicant has knowingly, willfully, or repeatedly failed to administer fiduciary accounts in a manner consistent with the requirements of this paragraph, or has administered a fiduciary account in a grossly negligent manner.

(v) Procedures for revocation. The notice of approval issued to an applicant may be revoked in accordance with the following procedures:

(A) If the Commissioner proposes to revoke the notice of approval issued to an applicant, the Commissioner will advise the applicant in writing of the proposed revocation and of the reasons therefor.

(B) Within 60 days after the receipt of such written advice, the applicant may protest the proposed revocation by submitting a written statement of facts, law, and arguments opposing such revocation to Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Wash-

ington, D.C. 20224. In addition, the applicant may request a conference in the National Office.

(C) If the applicant consents to the proposed revocation, either before or after a National Office conference, or if the applicant fails to file a timely protest, the Commissioner will revoke the notice of approval that was issued to the applicant.

(D) If, after considering the applicant's protest and any information developed in conference, the Commissioner determines that the applicant is unwilling or unable to administer fiduciary accounts in a manner consistent with the requirements of this paragraph, the Commissioner will revoke the notice of approval that was issued to the applicant and will furnish the applicant with a written statement of findings on which the revocation is based.

(E) If at any time the Commissioner determines that immediate action is necessary to protect the interest of the Internal Revenue Service or of any fiduciary account, the notice of approval issued to the applicant will be suspended at once, pending a final decision to be based on the applicant's protest and any information developed in conference.

(9) Supersession. This paragraph supersedes § 11.401(d)(1)–1 of the Temporary Income Tax Regulations Under the Employee Retirement Income Security Act of 1974.

[T.D. 6675, 28 FR 10126, Sept. 17, 1963, as amended by T.D. 6982, 33 FR 16500, Nov. 13, 1968; T.D. 6985, 33 FR 19815, Dec. 27, 1968; T.D. 7428, 41 FR 34619, Aug. 16, 1976; T.D. 7611, 44 FR 23520, April 20, 1979]

§ 1.401–13 Excess contributions on behalf of owner-employees.

(a) Introduction. **(1)** The provisions of this section prescribe the rules relating to the treatment of excess contributions made under a qualified pension, annuity, or profit-sharing plan on behalf of a self-employed individual who is an owner-employee (as defined in paragraph (d) of § 1.401–10). Paragraph (b) of this section defines the term "excess contribution". Paragraph (c) of this section describes an exception to the definition of an excess contribution in the case of contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts. Paragraph (d) of this section describes the effect of making an excess contribution which is not determined to have been willfully made, and paragraph (e) of this section describes the effect of making an excess contribution which is determined to have been willfully made.

(2) Under section 401(c)(1), certain self-employed individuals are treated as employees for purposes of section 401. In addition, under section 401(c)(4), a proprietor is treated as his own employer, and the partnership is treated as the employer of the partners. Under section 404, certain contributions on behalf of a self-employed individual are treated as deductible and taken into consideration in determining the amount allowed as a deduction under section 404(a). Such contributions are treated under section 401 and the regulations thereunder as employer contributions on behalf of the self-employed individual. However, in some cases, additional contributions may be made on behalf of a self-employed individual. Such contributions are not taken into consideration in determining the amount deductible under section 404 and are not taken into consideration in computing the amount allowed as a deduction under section 404(a). For purposes of section 401 and the regulations thereunder, such contributions are treated as employee contributions by the self-employed individual. If a self-employed individual is an owner-employee within the meaning of section 401(c)(3) and paragraph (d) of § 1.401–10, then this section prescribes the rules applicable if contributions are made in excess of those permitted to be made under section 401.

(b) Excess contributions defined. **(1)(i)** Except as provided in paragraph (c) relating to contributions which are applied to pay premiums on certain annuity, endowment, or life insurance contracts, an excess contribution is any amount described in subparagraphs (2) through (4) of this paragraph.

(ii) For purposes of determining if the amount of any contribution made under the plan on behalf of an owner-employee is an excess contribution, the amount of any contribution made under the plan which is allocable to the purchase of life, accident, health, or other insurance is not taken into account. The amount of any contribution which is allocable to the cost of insurance protection is determined in accordance with the provisions of paragraph (f) of § 1.404(e)–1 and paragraph (b) of § 1.72–16.

(2)(i) In the case of a taxable year of the plan for which employer contributions are made on behalf of only owner-employees, an excess contribution is the amount of any contribution for such taxable year on behalf of such owner-employee which is not deductible under section 404 (determined without regard to section 404(a)(10)). This rule applies irrespective of whether the plan provides for contributions on behalf of common-law

employees, or self-employed individuals who are not owner-employees, when such employees or individuals become eligible for coverage under the plan, and irrespective of whether contributions are in fact made for such employees or such individuals for other taxable years of the plan.

(ii) In the case of a taxable year of the plan for which employer contributions are made on behalf of both owner-employees and either common-law employees or self-employed individuals who are not owner-employees, an excess contribution is the amount of any employer contribution on behalf of any owner-employee for such taxable year which exceeds the amount deductible under section 404 (determined without regard to section 404(a)(10)) unless such amount may be treated as an employee contribution under the plan in accordance with the rules of paragraph (d)(3) of § 1.401–11 and is a permissible employee contribution under subparagraph (3) of this paragraph.

(3)(i) In the case of a taxable year of the plan for which employer contributions are made on behalf of both an owner-employee and either common-law employees or self-employed individuals who are not owner-employees, employee contributions on behalf of an owner-employee may be made for such taxable year of the plan. However, the amount of such contributions, if any, which is described in subdivisions (ii), (iii), or (iv) of this subparagraph is an excess contribution.

(ii) An excess contribution is the amount of any employee contribution made on behalf of any owner-employee during a taxable year of the plan at a rate in excess of the rate of contributions which may be made as employee contributions by common-law employees, or by self-employed individuals who are not owner-employees, during such taxable year of the plan.

(iii) An excess contribution is the amount of any employee contribution made on behalf of an owner-employee which exceeds the lesser of $2,500 or 10 percent of the earned income (as defined in paragraph (c) of § 1.401–10) of such owner-employee for his taxable year in which such contributions are made.

(iv) In the case of a taxable year of an owner-employee in which contributions are made on behalf of such owner-employee under more than one plan, an excess contribution is the amount of any employee contribution made on behalf of such owner-employee under all such plans during such taxable year which exceeds $2,500. If such an excess contribution is made, the amount of the excess contribution made on behalf of the owner-employee with respect to any one of such plans is the amount by which the employee contribution on his behalf under such plan for the year exceeds an amount which bears the same ratio to $2,500 as the earned income of the owner-employee derived from the trade or business with respect to which the plan is established bears to his earned income derived from the trades or businesses with respect to which all such plans are established.

(4) An excess contribution is the amount of any contribution on behalf of an owner-employee for any taxable year of the plan with respect to which the plan is treated, under section 401(e)(2), as not meeting the requirements of section 401(d) with respect to such owner-employee.

(c) Contributions for premiums on certain annuity, endowment, or life insurance contracts. (1) The term "excess contribution" does not include the amount of any employer contributions on behalf of an owner-employee which, under the provisions of the plan, is expressly required to be applied (either directly or through a trustee) to pay the premiums or other consideration for one or more annuity, endowment, or life insurance contracts, if—

(i) The employer contributions so applied meet the requirements of subparagraphs (2) through (4) of this paragraph, and

(ii) The total employer contributions required to be applied annually to pay premiums on behalf of any owner-employee for contracts described in this paragraph do not exceed $2,500. For purposes of computing such $2,500 limit, the total employer contributions includes amounts which are allocable to the purchase of life, accident, health, or other insurance.

(2)(i) The employer contributions must be paid under a plan which satisfies all the requirements for qualification. Accordingly, for example, contributions can be paid under the plan for life insurance protection only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder. However, certain of the requirements for qualification are modified with respect to a plan described in this paragraph (see section 401(a)(10)(A)(ii) and (d)(5)).

(ii) A plan described in this paragraph is not disqualified merely because a contribution is made on behalf of an owner-employee by his employer during a taxable year of the employer for which the owner-employee has no earned income. On the other hand, a plan will fail to qualify if a contribution is made on behalf of an owner-em-

ployee which results in the discrimination prohibited by section 401(a)(4) as modified by section 401(a)(10)(A)(ii) (see paragraph (f)(3) of § 1.401–12).

(3) The employer contributions must be applied to pay premiums or other consideration for a contract issued on the life of the owner-employee. For purposes of this subparagraph, a contract is not issued on the life of an owner-employee unless all the proceeds which are, or may become, payable under the contract are payable directly, or through a trustee of a trust described in section 401(a) and exempt from tax under section 501(a), to the owner-employee or to the beneficiary named in the contract or under the plan. Accordingly, for example, a nontransferable face-amount certificate (as defined in section 401(g) and the regulations thereunder) is considered an annuity on the life of the owner-employee if the proceeds of such contract are payable only to the owner-employee or his beneficiary.

(4)(i) For any taxable year of the employer, the amount of contributions by the employer on behalf of the owner-employee which is applied to pay premiums under the contracts described in this paragraph must not exceed the average of the amounts deductible under section 404 (determined without regard to section 404(a)(10)) by such employer on behalf of such owner-employee for the most recent three taxable years of the employer (ending prior to the date the latest contract was entered into or modified to provide additional benefits), in which the owner-employee derived earned income from the trade or business with respect to which the plan is established. However, if such owner-employee has not derived earned income for at least three taxable years preceding such date, then, in determining the "average of the amounts deductible", only so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom are taken into account.

(ii) For the purpose of making the computation described in subdivision (i) of this subparagraph, the taxable years taken into account include those years in which the individual derived earned income from the trade or business but was not an owner-employee with respect to such trade or business. Furthermore, taxable years of the employer preceding the taxable year in which a qualified plan is established are taken into account. If such taxable years began prior to January 1, 1963, the amount deductible is determined as if section 404 included section 404(a)(8), (9), (10), and (e).

(5) The amount of any employer contribution which is not deductible but which is not treated as an excess contribution because of the provisions of this paragraph shall be taken into account as an employee contribution made on behalf of the owner-employee during the owner-employee's taxable year with, or within which, the taxable year of the person treated as his employer under section 401(c)(4) ends. However, such contribution is only treated as an employee contribution made on behalf of the owner-employee for the purpose of determining whether any other employee contribution made on behalf of the owner-employee during such period is an excess contribution described in paragraph (b)(3) of this section.

(d) Effect of an excess contribution which is not willfully made. **(1)** If an excess contribution (as defined in paragraph (b) of this section) is made on behalf of an owner-employee, and if such contribution is not willfully made, then the provisions of this paragraph describe the effect of such an excess contribution. However, if the excess contribution made on behalf of an owner-employee is determined to have been willfully made, then the provisions of paragraph (e) of this section are applicable to such contribution.

(2)(i) This paragraph does not apply to an excess contribution if the net amount of such excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to such amount are repaid to the owner-employee on whose behalf the excess contribution was made at any time before the end of six months beginning on the day on which the district director sends notice (by certified or registered mail) of the amount of the excess contribution to the trust, insurance company, or other person to whom such excess contribution was paid. The net income attributable to the net amount of the excess contribution is the aggregate of the amounts of net income attributable to the net amount of the excess contribution for each year of the plan beginning with the taxable year of the plan within which the excess contribution is made and ending with the close of the taxable year of the plan immediately preceding the taxable year of the plan in which the net amount of the excess contribution is repaid. The amount of net income attributable to the net amount of the excess contribution for each year is the amount of net income earned under the plan during the year which is allocated in a reasonable manner to the net amount of the excess contribution. For example, the amount of net income earned under the plan for the year which is attributable to the net amount of an excess contribution can be computed as the

amount which bears the same ratio to the amount of the "net income attributable to the interest of the owner-employee under the plan" for such taxable year (determined in accordance with the provisions of subparagraph (5)(ii) of this paragraph) as the net amount of the excess contribution bears to the aggregate amount standing to the account of the owner-employee at the end of that year (including the net amount of any excess contribution).

(ii) The notice described in subdivision (i) of this subparagraph shall not be mailed prior to the time that the amount of the tax under chapter 1 of the Code of the owner-employee to whom the excess contribution is to be repaid has been finally determined for his taxable year in which such excess contribution was made. For purposes of this subdivision, a final determination of the amount of tax liability of the owner-employee includes—

(a) A decision by the Tax Court of the United States, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(b) A closing agreement authorized by section 7121; or

(c) The expiration of the period of limitation on suits by the taxpayer for refund, unless suit is instituted prior to the expiration of such period.

(iii) For purposes of this subparagraph, an amount is treated as repaid to an owner-employee if an adequate adjustment is made to the account of the owner-employee. An adequate adjustment is made to the account of an owner-employee, for example, if the amount of the excess contribution (without any reduction for any loading or other administrative charge) and the net income attributable to such amount is taken into account as a contribution under the plan for the current year. In such a case, the gross income of the owner-employee for his taxable year in which such adjustment is made includes the amount of the net income attributable to the excess contribution.

(iv) If the net amount of the excess contribution and the net income attributable thereto is repaid, within the period described in subdivision (i) of this subparagraph, to the owner-employee on whose behalf such contribution was made, then the net income attributable to the excess contribution is, pursuant to section 61(a), includible in the gross income of the owner-employee for his taxable year in which such amount is distributed, or made available, to him. However, such amount is not a distribution to which section 402 or 403 and section 72 apply (see subparagraph (6) of this paragraph).

(3)(i) If the net amount of any excess contribution (as defined in subparagraph (4) of this paragraph) and the net income attributable to that excess contribution are not repaid to the owner-employee on whose behalf the excess contribution was made before the end of the six-month period described in subparagraph (2)(i) of this paragraph, the plan under which the excess contribution has been made is considered, for purposes of section 404, as not satisfying the requirements for qualification with respect to such owner-employee for all taxable years of the plan described in subdivision (ii) of this subparagraph. However, such disqualification only applies to the interest of the owner-employee on whose behalf an excess contribution has been made and does not disqualify the plan with respect to the other participants thereunder.

(ii) The taxable years referred to in subdivision (i) of this subparagraph include the taxable year of the plan within which the excess contribution is made and each succeeding taxable year of the plan until the beginning of the taxable year of the plan in which the trust, insurance company, or other person to whom such excess contribution was paid repays to such owner-employee—

(a) The net amount of the excess contribution, and

(b) The amount of income attributable to his interest under the plan which is includible in his gross income for any taxable year by reason of the provisions of subparagraph (5) of this paragraph.

(4) For purposes of this paragraph, the net amount of an excess contribution is the amount of such excess contribution, as defined in paragraph (b) of this section, reduced by the amount of any loading charge or other administrative charge ratably allocable to such excess contribution.

(5)(i) If a plan is considered as not meeting the requirements for qualification with respect to an owner-employee by reason of the provisions of subparagraph (3) of this paragraph for any taxable year of the plan, such owner-employee's gross income for any of his taxable years with or within which such taxable year of the plan ends shall, for purposes of chapter 1 of the Code, include the portion of the net income earned under the plan for such taxable year of the plan which is attributable to the interest of the owner-employee under the plan.

(ii) For purposes of this subparagraph, the term "net income" means the net income earned under the plan determined in accordance with generally accepted accounting principles consistently applied, and the "net income attributable to the interest of the owner-employee under the plan" is the amount which bears the same ratio to the aggregate amount of net income earned under the plan for the taxable year of the plan as the amount standing to the account of the owner-employee at the end of that year (including the amount of any excess contribution which is credited to his account) bears to the aggregate amount of all funds under the plan for all employees at the end of that year (including the aggregate amount of excess contributions credited to the accounts of all owner-employees for that year).

(iii) The provisions of this subparagraph may be illustrated by the following example:

Example. A is an owner-employee covered under the X Employees' Pension Trust who files his return on the basis of a calendar year. An excess contribution was made on behalf of A during the plan year beginning on January 1, 1966. The net amount of the excess contribution and the net income attributable thereto was not repaid to A before the end of the six-month period described in subparagraph (2)(i) of this paragraph. Accordingly, the net income earned under the plan during 1966 which is attributable to A's interest is to be included in his gross income for 1966. Assume that the trust which forms a part of the pension plan of the X Company also files its returns on a calendar year basis, and that during 1966 the trust had a gross income of $4,000 (including a long-term capital gain of $2,500) and expenses of $500. Assume, further, that the amount standing to A's account on December 31, 1966 (including the amount of the excess contribution), was $20,000, and that on that date the amount funded under the plan for all employees (including A) is $140,000. Then the net income of the trust for 1966 is $3,500 ($4,000–$500). The net income attributable to the interest of A under the plan is $500 (the amount which bears the same ratio to $3,500 as $20,000 bears to $140,000). Accordingly, $500 is included in A's gross income in accordance with the provisions of section 401(e)(2)(B) as the "net income attributable to the interest of the owner-employee under the plan".

(6) The provisions of section 402 or 403 and section 72 do not apply to any amount distributed, or made available, to an owner-employee which is described in this paragraph. Accordingly, for example, the provisions of section 72(m)(5)(A)(i), relating to amounts subject to the penalty tax imposed by section 72(m), do not apply to the amount of the net income attributable to the interest of an owner-employee (as defined in subparagraph (5)(ii) of this paragraph) which is includible in his gross income. Furthermore, in such a case, the provisions of section 401(d)(5)(C) do not apply to such amount.

(7) Certain adjustments will be required with respect to the interest of an owner-employee after any amount previously allocated to his account has been returned to him pursuant to the provisions of this paragraph. For example, if the determination of whether life insurance benefits provided under the plan are incidental is made, in part, with regard to the contributions allocated to the accounts of the participants covered under the plan, an adjustment may have to be made with respect to the life insurance purchased under the plan for any owner-employee after any amount previously allocated to his account has been repaid to him. Furthermore, if, for example, an owner-employee has received annuity payments which were taxable under the exclusion ratio rule of section 72, and if such exclusion ratio took into account any amount credited to the account of the owner-employee which is subsequently repaid to him, then such exclusion ratio must be recomputed after the adjustment in such owner-employee's account has taken place.

(8) Notwithstanding any other provision of law, in any case in which the plan is treated as not satisfying the requirements for qualification with respect to any owner-employee by reason of the provisions of section 401(e), the period for assessing, with respect to such owner-employee, any deficiency arising by reason of—

(i) The disallowance of any deduction under section 404 by reason of the provisions of subparagraph (3) of this paragraph, or

(ii) The inclusion of amounts in the gross income of the owner-employee by reason of the provisions of subparagraph (5) of this paragraph,

shall not expire prior to 18 months after the day the district director mails the notice with respect to the excess contribution (described in subparagraph (2)(i) of this paragraph) which gives rise to such disallowance or inclusion. Thus, for example, notwithstanding the provisions of section 6212(c) (relating to the restriction on the determination of additional deficiencies), if, after a final determination by the Tax Court of the income tax liability of an owner-employee for a taxable year in which an excess contribution was made, the amount of such excess contribution and the net income attributable thereto is not paid to the owner-employee before the end of the six-month period described in subparagraph (2)(i) of this paragraph, an additional deficiency assessment may be made for such taxable year with respect to such excess contribution.

(e) **Effect of an excess contribution which is determined to have been willfully made.** If an excess contribution (as defined in paragraph (b) of

this section) on behalf of an owner-employee is determined to have been willfully made, then—

(1) Only the provisions of this paragraph apply to such contribution;

(2) There shall be distributed to the owner-employee on whose behalf such contribution was willfully made his entire interest in all plans in which he is a participant as an owner-employee;

(3) The amount distributed under each such plan is an amount to which section 72 does apply (see section 72(m)(5)(A)(iii)); and

(4) For purposes of section 404, no plan in which such individual is covered as an owner-employee shall be considered as meeting the requirements for qualification with respect to such owner-employee for any taxable year of the plan beginning with or within the calendar year in which it is determined that the excess contribution has been willfully made and with or within the five calendar years following such year.

(f) Years to which this section applies. This section applies to contributions made in taxable years of employers beginning before January 1, 1976. Thus, for example, in the case of willful contributions made in taxable years of employers beginning before January 1, 1976, paragraphs (e)(1), (2), and (3) of this section apply to such taxable years beginning on or after such date. However, in such a case, because the application of paragraph (e)(4) of this section affects contributions made in taxable years of employers beginning on or after January 1, 1976, paragraph (e)(4) of this section does not apply to such taxable years; see paragraph (c) of § 1.401(e)–4 (relating to transitional rules for excess contributions).

[T.D. 6676, 28 FR 10139, Sept. 17, 1963; as amended by T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401–14 Inclusion of medical benefits for retired employees in qualified pension or annuity plans.

(a) Introduction. Under section 401(h) a qualified pension or annuity plan may make provision for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents. The term "medical benefits described in section 401(h)" is used in this section to describe such payments.

(b) In general—(1) Coverage. Under section 401(h), a qualified pension or annuity plan may provide for the payment of medical benefits described in section 401(h) only for retired employees, their spouses, or their dependents. To be "retired" for purposes of eligibility to receive medical benefits described in section 401(h), an employee must be eligible to receive retirement benefits provided under the pension plan, or else be retired by an employer providing such medical benefits by reason of permanent disability. For purposes of the preceding sentence, an employee is not considered to be eligible to receive retirement benefits provided under the plan if he is still employed by the employer and a separation from employment is a condition to receiving the retirement benefits.

(2) Discrimination. A plan which provides medical benefits described in section 401(h) must not discriminate in favor of officers, shareholders, supervisory employees, or highly compensated employees with respect to coverage and with respect to the contributions or benefits under the plan. The determination of whether such a plan so discriminates is made with reference to the retirement portion of the plan as well as the portion providing the medical benefits described in section 401(h). Thus, for example, a plan will not be qualified under section 401 if it discriminates in favor of employees who are officers or shareholders with respect to either portion of the plan.

(3) Funding medical benefits. Contributions to provide the medical benefits described in section 401(h) may be made either on a contributory or noncontributory basis, without regard to whether the contributions to fund the retirement benefits are made on a similar basis. Thus, for example, the contributions to fund the medical benefits described in section 401(h) may be provided for entirely out of employer contributions even though the retirement benefits under the plan are determined on the basis of both employer and employee contributions.

(4) Definitions. For purposes of section 401(h) and this section:

(i) The term "dependent" shall have the same meaning as that assigned to it by section 152, and

(ii) The term "medical expense" means expenses for medical care as defined in section 213(e)(1).

(c) Requirements. The requirements which must be met for a qualified pension or annuity plan to provide medical benefits described in section 401(h) are set forth in subparagraphs (1) through (5) of this paragraph.

(1) Benefits. (i) The plan must specify the medical benefits described in section 401(h) which

will be available and must contain provisions for determining the amount which will be paid. Such benefits, when added to any life insurance protection provided for under the plan, must be subordinate to the retirement benefits provided by such plan. For purposes of this section, life insurance protection includes any benefit paid under the plan on behalf of an employee-participant as a result of the employee-participant's death to the extent such payment exceeds the amount of the reserve to provide the retirement benefits for the employee-participant existing at his death. The medical benefits described in section 401(h) are considered subordinate to the retirement benefits if at all times the aggregate of contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions (made after such date) other than contributions to fund past service credits.

(ii) The meaning of the term "subordinate" may be illustrated by the following example:

Example. The X Corporation amends its qualified pension plan to provide medical benefits described in section 401(h) effective for the taxable year 1964. The total contributions under the plan (excluding those for past service credits) for the taxable year 1964 are $125,000, allocated as follows: $100,000 for retirement benefits, $10,000 for life insurance protection, and $15,000 for medical benefits described in section 401(h). The medical benefits described in section 401(h) are considered subordinate to the retirement benefits since the portion of the contributions allocated to the medical benefits described in section 401(h) ($15,000) and to life insurance protection after such medical benefits were included in the plan ($10,000), or $25,000, does not exceed 25 percent of $125,000. For the taxable year 1965, the X Corporation contributes $140,000 (exclusive of contributions for past service credits) allocated as follows: $100,000 for retirement benefits, $10,000 for life insurance protection, and $30,000 for medical benefits described in section 401(h). The medical benefits described in section 401(h) are considered subordinate to the retirement benefits since the aggregate contributions allocated to the medical benefits described in section 401(h) ($45,000) and to life insurance protection after such medical benefits were included in the plan ($20,000) or $65,000 does not exceed 25 percent of $265,000, the aggregate of the contributions made in 1964 and 1965.

(2) **Separate accounts.** Where medical benefits described in section 401(h) are provided for under a qualified pension or annuity plan, a separate account must be maintained with respect to contributions to fund such benefits. The separation required by this section is for recordkeeping purposes only. Consequently, the funds in the medical benefits account need not be separately invested. They may be invested with funds set aside for retirement purposes without identification of which investment properties are allocable to each account. However, where the investment properties are not allocated to each account, the earnings on such properties must be allocated to each account in a reasonable manner.

(3) **Reasonable and ascertainable.** Section 401(h) further requires that amounts contributed to fund medical benefits therein described must be reasonable and ascertainable. For the rules relating to the deduction of such contributions, see paragraph (f) of § 1.404(a)–3. The employer must, at the time he makes a contribution, designate that portion of such contribution allocable to the funding of medical benefits.

(4) **Impossibility of diversion prior to satisfaction of all liabilities.** Section 401(h) further requires that it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide for the payment of medical benefits described in section 401(h), for any part of the corpus or income of the medical benefits account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits. Consequently, a plan which, for example, under its terms, permits funds in the medical benefits account to be used for any retirement benefit provided under the plan does not satisfy the requirements of section 401(h) and will not qualify under section 401(a). However, the payment of any necessary or appropriate expenses attributable to the administration of the medical benefits account does not affect the qualification of the plan.

(5) **Reversion upon satisfaction of all liabilities.** The plan must provide that any amounts which are contributed to fund medical benefits described in section 401(h) and which remain in the medical benefits account upon the satisfaction of all liabilities arising out of the operation of the medical benefits portion of the plan are to be returned to the employer.

(6) **Forfeitures.** The plan must expressly provide that in the event an individual's interest in the medical benefits account is forfeited prior to termination of the plan an amount equal to the amount of the forfeiture must be applied as soon as possible to reduce employer contributions to fund the medical benefits described in section 401(h).

(d) **Effective date.** This section applies to taxable years of a qualified pension or annuity plan beginning after October 23, 1962.

[T.D. 6722, 29 FR 5072, April 14, 1964]

§ 1.401(a)–1 Post-ERISA qualified plans and qualified trusts; in general.

(a) Introduction—(1) In general. This section and the following regulation sections under section 401 reflect the provisions of section 401 after amendment by the Employee Retirement Income Security Act of 1974 (Pub.L. 93–406) ("ERISA").

(b) Requirements for pension plans—(1) Definitely determinable benefits. (i) In order for a pension plan to be a qualified plan under section 401(a), the plan must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement.

(ii) Section 1.401–1(b)(1)(i), a pre-ERISA regulation, provides rules applicable to this requirement, and that regulation is applicable except as otherwise provided.

(iii) The use of the type of plan provision described in § 1.415–1(d)(1) which automatically freezes or reduces the rate of benefit accrual or the annual addition to insure that the limitations of section 415 will not be exceeded, will not be considered to violate the requirements of this subparagraph provided that the operation of such provision precludes discretion by the employer.

[T.D. 7748, 46 FR 1695, Jan. 7, 1981]

§ 1.401(a)–2 Impossibility of diversion under qualified plan or trust.

(a) General rule. Section 401(a)(2) requires that in order for a trust to be qualified, it must be impossible under the trust instrument (in the taxable year and at any time thereafter before the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of those employees or their beneficiaries. Section 1.401–2, a pre-ERISA regulation, provides rules under section 401(a)(2) and that regulation is applicable except as otherwise provided.

(b) Section 415 suspense account. Paragraph (a) of this section does not apply to amounts properly allocated to a suspense account pursuant to § 1.415–6(b)(6). The plan, or the trust forming part of the plan, may provide for the reversion to the employer, upon termination of the plan, of amounts held in the suspense account.

[T.D. 7748, 46 FR 1696, Jan. 7, 1981]

§ 1.401(a)–4 Optional forms of benefit.

Q-1: How does section 401(a)(4) apply to optional forms of benefits?

A-1: (a) In general.—(1) Scope. The nondiscrimination requirements of section 401(a)(4) apply to the amount of contributions or benefits, optional forms of benefit, and other benefits, rights and features (e.g., actuarial assumptions, methods of benefit calculation, loans, social security supplements, and disability benefits) under a plan. This section addresses the application of section 401(a)(4) only to optional forms of benefit under a plan. Generally, the determination of whether an optional form is nondiscriminatory under section 401(a)(4) is made by reference to the availability of such optional form, and not by reference to the utilization or actual receipt of such optional form. See Q&A-2 of this section. Even though an optional form of benefit under a plan may be nondiscriminatory under section 401(a)(4) and this § 1.401(a)-4 because the availability of such optional form does not impermissibly favor employees in the highly compensated group, such plan may fail to satisfy section 401(a)(4) with respect to the amount of contributions or benefits or with respect to other benefits, rights and features if, for example, the method of calculation or the amount or value of benefits payable under such optional form impermissibly favors the highly compensated group. See § 1.411(d)-4, Q&A-1 for the definition of "optional form of benefit."

(2) Nondiscrimination requirements. Each optional form of benefit provided under a plan is subject to the nondiscrimination requirement of section 401(a)(4) and thus the availability of each optional form of benefit must not discriminate in favor of the employees described in section 401(a)(4) in whose favor discrimination is prohibited (the "highly compensated group"). See paragraph (b) of this Q&A-1 for a description of the employees included in such group. This is true without regard to whether a particular optional form of benefit is the actuarial equivalent of any other optional form of benefit under the plan. Thus, for example, a plan may not condition, or otherwise limit, the availability of a single sum distribution of an employee's benefit in a manner that impermissibly favors the highly compensated group.

(b) Highly compensated group. For plan years commencing prior to the applicable effective date for the amendment made to section 401(a)(4) by section 1114 of the Tax Reform Act of 1986 (TRA '86), the highly compensated group consists of those employees who are officers, shareholders,

or highly compensated. For plan years beginning on or after the applicable effective date of the amendments to section 401(a)(4) made by TRA '86, the highly compensated group consists of those employees who are highly compensated within the meaning of section 414(q). The amendment to section 401(a)(4) made by section 1114 of TRA '86 is generally effective for plan years commencing after December 31, 1988. See section 1114(a) of TRA '86.

Q-2: How is it determined whether an optional form of benefit satisfies the nondiscrimination requirements of section 401(a)(4)?

A-2: (a) Nondiscrimination requirement.—(1) In general. An optional form of benefit under a plan is nondiscriminatory under section 401(a)(4) only if the requirements of paragraphs (a)(2) and (a)(3) of this Q&A-2 are satisfied with respect to such optional form. The determination of whether an optional form of benefit satisfies these requirements is made by reference to the availability of the optional form, and not by reference to the utilization or actual receipt of such optional form. Thus, an optional form of benefit that satisfies the requirements of paragraphs (a)(2) and (a)(3) of this Q&A-2 is nondiscriminatory under section 401(a)(2) even though the highly compensated group disproportionately utilizes such optional form. However, the composition of the group of employees who actually receive benefits in an optional form may be relevant in determining whether such optional form satisfies the requirement of paragraph (a)(3) of this Q&A-2 with respect to effective availability.

(2) Current availability—(i) Plan years prior to TRA '86 effective date. Except as provided in paragraph (a)(2)(iii) of this Q&A-2, for plan years prior to the effective date of the amendments made to section 401(b) by section 1112(a) of TRA '86, the requirement of this paragraph (a)(2) is satisfied only if the group of employees to whom the optional form is currently available satisfies either the seventy percent test of section 410(b)(1)(A) or the nondiscriminatory classification test of section 410(b)(1)(B).

(ii) Plan years commencing on or after TRA '86 effective date—(A) In general. Except as provided in paragraph (a)(2)(iii) of this Q&A-2, for plan years commencing on or after the effective date for the amendments made to section 410(b) by section 1112(a) of TRA '86, the requirement of this paragraph (a)(2) is satisfied only if the group of employees to whom the optional form is currently available satisfies either the percentage test set forth in section 410(b)(1)(A), the ratio test set forth in section 410(b)(1)(B), or the nondiscriminatory classification test set forth in section 410(b)(2)(A)(i) (and, in such case, the average benefit percentage test in section 410(b)(2)(A)(ii) is satisfied with respect to the employer).

(B) **Example.** In 1990, employer X maintains a defined benefit plan and a profit-sharing plan that is a qualified cash or deferred arrangement under section 401(k). Both plans satisfy the percentage test in section 410(b)(1)(A) with respect to coverage. The defined benefit plan provides for a single sum distribution available only to employees in the headquarters office. This group of employees fails the percentage and ratio tests of section 410(b), but satisfies the nondiscriminatory classification test set forth in section 410(b)(2)(A)(i). However, the employer does not satisfy the average benefit percentage test in section 401(b)(2)(A)(ii). Therefore, the current availability of the optional form of benefit does not satisfy the requirement of this paragraph (a)(2).

(iii) Special rule for certain governmental or church plans. Plans described in section 410(c) will be treated as satisfying the current availability test of this paragraph (a)(2) if the group of employees with respect to whom the optional form is currently available satisfies the requirements of section 401(a)(3) as in effect on September 1, 1974.

(iv) Effective data for TRA '86 amendments to section 410(b). The amendments to section 410(b) made by section 1112(a) of TRA '86 are generally effective for plan years commencing after December 31, 1988. See section 1112(e)(1) of TRA '86.

(v) Elimination of optional forms—(A) In general. Notwithstanding paragraphs (a)(2)(i) and (a)(2)(ii) of this Q&A-2, in the case of an optional form of benefit that has been eliminated under a plan with respect to specified employees for benefits accrued after the later of the eliminating amendment's adoption date or effective date, the determination of whether such optional form satisfies this paragraph (a)(2) with respect to such employees is to be made immediately prior to the elimination. Accordingly, if, as of the later of the adoption date or effective date of an amendment eliminating an optional form with respect to future benefit accruals, the current availability of such optional form immediately prior to such amendment satisfies this paragraph (a)(2), then the optional form will be treated as satisfying this paragraph (a)(2) for all subsequent years.

(B) **Example.** A profit-sharing plan that provides for a single sum distribution available to all employees on termination of employment is amended January 1, 1990, to eliminate such single sum optional form of benefit with respect to benefits accrued after January 1, 1991. As of January 1, 1991, the single sum optional form of benefit is available to a group of employees that satisfies the percentage test of section 410(b)(1)(A). As of January 1, 1995, all nonhighly compensated employees who were entitled to the single sum optional form of benefit have terminated from employment with the employer and taken a distribution of their benefits. The only remaining

employees who have a right to take a portion of their benefits in the form of a single sum distribution on termination of employment are highly compensated employees. Because the availability of the single sum optional form of benefit satisfied the current availability test as of January 1, 1991, the availability of such optional form of benefit is deemed to continue to satisfy the current availability test of this paragraph (a)(2).

(3) Effective availability—(i) In general. The requirement of this paragraph (a)(3) is satisfied only if, based on the facts and circumstances, the group of employees to whom the optional form is effectively available does not substantially favor the highly compensated group. This is the case even if the optional form is, or has been, currently available to a group of employees that satisfies the applicable requirements in paragraph (a)(2) (i) or (ii) of this Q&A-2.

(ii) Examples. The provisions of paragraph (a)(3)(i) of this Q&A-2 can be illustrated by the following examples:

Example 1. Employer X maintains a defined benefit plan that covers both of the 2 highly compensated employees of the employer and 8 of the twelve nonhighly compensated employees of the employer. Plan X provides for a normal retirement benefit payable as an annuity and based on a normal retirement age of 65, and an early retirement benefit payable upon termination in the form of an annuity to employees who terminate from service with the employer on or after age 55 with 30 or more years of service. Each of the 2 employees of employer X who are in the highly compensated group currently meet the age and service requirement, or will have 30 years of service by the time they reach age 55. All but 2 of the 8 nonhighly compensated employees of employer X who are covered by the plan were hired on or after age 35 and thus, cannot qualify for the early retirement benefit provision. Even though the group of employees to whom the early retirement benefit is currently available does not impermissibly favor the highly compensated group by reason of disregarding age and service, these facts and circumstances indicate that the effective availability of the early retirement benefit in plan X substantially favors the highly compensated group.

Example 2. Assume the same facts as in Example 1 except that the early retirement benefit is added by a plan amendment first adopted, announced and effective December 1, 1991, and is available only to employees who terminate from employment with the employer prior to December 15, 1991. Further assume that all employees were hired prior to attaining age 25, and that the group of employees who have, or will have attained age 55 with 30 years of service, by December 15, 1991, satisfies the ratio test of section 410(b)(1)(B). Finally, assume that the only employees who terminate from employment with the employer during the two week period in which the early retirement benefit is available are employees in the highly compensated group. These facts and circumstances indicate that the effective availability of the early retirement benefit substantially favors the highly compensated group. This is the case even though the limitation of the early retirement benefit to a specified period satisfies section 411(d)(6).

Example 3. Employer Y amends plan Y on June 30, 1990, to provide for a single sum distribution for employees who terminate from employment with the employer after June 30, 1990, and prior to January 1, 1991. The availability of this single sum distribution is conditioned on the employee having a particular disability at the time of termination of employment. The only employee of the employer who meets this disability requirement at the time of the amendment and thereafter through December 31, 1990, is a highly compensated employee. Generally, a disability condition with respect to the availability of a single sum distribution may be disregarded in determining whether the current availability of such optional form of benefit is discriminatory. However, these facts and circumstances indicate that the effective availability of the optional form of benefit substantially favors the highly compensated group.

Example 4. Employer Z maintains a money purchase pension plan that covers all employees of the employer. The plan provides for distribution in the form of a joint and survivor annuity, a life annuity, or equal installments over 10 years. During the 1992 calendar year the employer winds up his business. In December of 1992, only two employees remain in the employment of the employer, both of whom are highly compensated. Employer Z then amends the plan to provide for a single sum distribution to employees who terminate from employment on or after the date of the amendment. Both highly compensated employees terminate from employment on December 31, 1992, taking a single sum distribution of their benefits. These facts and circumstances indicate that the effective availability of the single sum optional form of benefit substantially favors the highly compensated group.

(b) Application of tests—(1) Current availability—(i) In general. Except as otherwise provided in this paragraph (b), in determining whether an optional form of benefit that is subject to specified eligibility conditions is currently available to an employee for purposes of paragraph (a) of this Q&A-2, the determination of current availability generally is to be based on the current facts and circumstances with respect to the employee (e.g., the employee's current compensation or the employee's current net worth). Thus, for example, the fact that an employee may, in the future, satisfy an eligibility condition generally does not cause an optional form of benefit to be treated as currently available to such employee.

(ii) Exceptions for age, service, employment termination and certain other conditions—(A) Age and service conditions. For purposes of applying paragraph (a)(2) of this Q&A-2, except as provided in paragraph (b)(1)(ii)(B) of this Q&A-2, an age condition, a service condition, or both are to be disregarded. For example, an employer that maintains a plan that provides for an early retirement benefit payable as an annuity for employees in division A, subject to a requirement that the employee has attained his or her 55th birthday and has at least twenty years of service with the employer, is to disregard the age and service conditions in determining the group of employees to whom the early retirement annuity benefit is currently available. Thus, the early retirement annuity benefit is treated as currently available to all employees of division A, without regard to their ages or years of service and without regard to whether they could potentially meet the age and

service conditions prior to attaining the plan's normal retirement age.

(B) Exception for certain age and service conditions. Age and service conditions that must be satisfied within a specified period of time may not be disregarded pursuant to paragraph (b)(1)(ii)(A) of this Q&A-2. However, in determining the current availability of an optional form of benefit subject to such an age condition, service condition, or both, an employer may project the age and service of employees to the last date on which the optional form of benefit subject to the age condition or service condition (or both) is available under the plan. An employer's ability to protect age and service to the last date on which the optional form of benefit is available under the plan is not cut off by a plan termination occurring prior to that date. Thus, for example, assume that an employer maintaining a plan that permits employees terminating from employment on or after age 55 between June 1, 1991 to May 31, 1992, to elect a single sum distribution, decides to terminate the plan on December 31, 1991. In determining the group of employees to whom the single sum optional form of benefit is currently available, this employer may project employees' ages through May 31, 1992.

(C) Certain other conditions disregarded. Conditions on the availability of optional forms of benefit requiring termination of employment, death, satisfaction of a specified health condition (or failure to meet such condition), disability, hardship, marital status, default on a plan loan secured by a participant's account balance, or execution of a covenant not to compete may be disregarded in determining the group of employees to whom an optional form of benefit is currently available.

(2) Employees taken into account. For purposes of applying paragraph (a) of this Q&A-2, the tests are to be applied on the basis of the employer's nonexcludable employees (whether or not they are participants in the plan) in the same manner as such tests would be applied in determining whether the plan providing the optional form of benefit satisfies the tests under section 410(b).

(3) Definition of "plan". For purposes of applying paragraph (a) of this Q&A-2, the term "plan" has the meaning that such term has for purposes of determining whether the amount of contributions or benefits and whether other benefits, rights, and features are nondiscriminatory under section 401(a)(4).

(4) Restructuring optional forms of benefit—(i) In general. For purposes of applying paragraph (a) of this Q&A-2, the availability of two or more optional forms of benefit under a plan may be tested by restructuring such benefits into two or more restructured optional forms of benefit and testing the availability of such restructured optional forms of benefit. If two or more optional forms of benefit under a plan contain both common and distinct components, such optional forms of benefit may be restructured as a single optional form of benefit comprising the common component, and one or more optional forms of benefit comprising each distinct component. Components of optional forms of benefit may be treated as common only if they are identical with respect to all characteristics taken into account under Q&A-1(b) of § 1.411(d)-4. The availability of each restructured optional form of benefit must satisfy the applicable nondiscrimination requirements of paragraph (a) of this Q&A-2.

(ii) **Example.** A profit-sharing plan covering all the employees of an employer provides a single sum distribution option upon termination from employment for all employees earning less than $50,000 and a single sum distribution option upon termination from employment after the attainment of age 55 for all employees earning $50,000 or more. These distribution options are identical in all other respects. For purposes of applying section 401(a)(4), such optional forms of benefit may be restructured into two different optional forms of benefit: (A) a single sum distribution option upon termination from employment after the attainment of age 55 for all employees (i.e., the common component), and (B) a single sum distribution option upon termination from employment before the attainment of age 55 for all employees earning less than $50,000. The availability of each of these restructured optional forms of benefit must satisfy section 401(a)(4).

(c) Commissioner may provide additional tests. The Commissioner may provide such additional factors, tests, and safe harbors as are necessary or appropriate for purposes of determining whether the availability of an optional form of benefit is discriminatory under section 401(a)(4). In addition, the Commissioner may provide that additional eligibility conditions not related directly or indirectly to compensation or wealth may be disregarded under paragraph (b)(1)(ii)(C) of this Q&A-2 in determining the current availability of an optional form of benefit. The Commissioner may provide such additional guidance only through the publication of revenue rulings, notices or other documents of general applicability.

Q-3: May a plan condition the availability of an optional form of benefit on employer discretion?

A-3: No. Even if the availability of an optional form of benefit that is conditioned on employer discretion satisfies the nondiscrimination requirements of section 401(a)(4), the plan providing the optional form of benefit will fail to satisfy certain other requirements of section 401(a), including, in applicable circumstances, the definitely determin-

able requirement of section 401(a) and the requirements of section 401(a)(25) and section 411(d)(6). See § 1.411(d)-4.

Q-4: Will a plan provision violate section 401(a)(4) merely because it requires that an employee who terminates from service with the employer receive a single sum distribution in the event that the present value of the employee's benefit is not more than $3,500, as permitted by sections 411(a)(11) and 417(e)?

A-4: No. A plan will not be treated as discriminatory under section 401(a)(4) merely because the plan mandates a single sum distribution when the present value of an employee's benefit is not more than $3,500, as permitted by sections 411(a)(11) and 417(e). This is an exception to the general principles of this section. (No similar provision exists excepting such single sum distributions from the limits on employer discretion under section 411(d)(6). See § 1.411(d)-4 Q&A-4.)

Q-5: If the availability of an optional form of benefit discriminates, or may reasonably be expected to discriminate, in favor of the highly compensated group, what acceptable alternatives exist for amending the plan without violating section 411(d)(6)?

A-5: (a) Transitional rules—(1) In general. The following rules apply for purposes of making necessary amendments to existing plans (as defined in Q&A-6 of this section) under which the availability of an optional form of benefit violates the nondiscrimination requirements of section 401(a)(4) or may reasonably be expected to violate such requirements. These transitional rules are provided under the authority of section 411(d)(6), which allows the elimination of certain optional forms of benefit if permitted by regulations, and section 7805(b).

(2) Nondiscrimination—(i) In general. The determination of whether the availability of an optional form of benefit violates section 401(a)(4) is to be made in accordance with Q&A-2 of this section. In addition, the availability of a particular optional form of benefit may reasonably be expected to violate the nondiscrimination requirements of section 401(a)(4) if, under the applicable facts and circumstances, there is a significant possibility that the current availability of such optional form of benefit will impermissibly favor the highly compensated group. This determination must be made on the basis of the seventy percent test of section 410(b)(1)(A) or the nondiscriminatory classification test of section 410(b)(1)(B) as such tests existed prior to the effective date of the amendments made to section 410(b) by section 1112(a) of TRA '86. Thus, a condition may not reasonably be expected to discriminate for purposes of these rules merely because it results in a significant possibility that discrimination will result because of the amendments made to section 410(b) by section 1112(a) of TRA '86. In addition, the availability of an optional form of benefit may not reasonably be expected to discriminate merely because of an age or service condition that may be disregarded in determining the current availability of such optional form of benefit under paragraph (b)(1)(ii)(A) of Q&A-2 of this section. Similarly, the availability of an optional form of benefit may not reasonably be expected to discriminate merely because of an age or service condition that, after permitted projection, does not cause such optional form to fail to satisfy the requirement of this paragraph (a)(2).

(ii) Examples. The provisions of paragraph (a)(2)(i) of this Q&A-5 can be illustrated by the following examples:

Example (1). A plan provides that a single sum distribution option is available only to (A) employees earning $50.000 or more in the final year of employment, (B) employees who furnish evidence that they have a net worth above a certain specified amount, and (C) employees who present a letter from an accountant or attorney declaring that it is in the employee's best interest to receive a single sum distribution. Whether the availability of such optional form of benefit discriminates depends on whether it meets the requirements of Q&A-2 of this § 1.401(a)-4. However, each of the specified conditions limiting the availability of the optional form of benefit may reasonably be expected to discriminate in favor of the highly compensated group in operation because of the likelihood of a significant positive correlation between the ability to meet any of the specified conditions and membership in the highly compensated group.

Example (2). A plan limits the availability of a single sum distribution option to employees employed in one particular division of the employer's company. All the employees of the company are participants in the plan. During the 1988 plan year, the division employs individuals who represent a nondiscriminatory classification of that company's employees (under section 410(b)(1)(B) prior to the effective date of the amendments made to section 410(b) by section 1112(a) of TRA '86) and is unlikely to cease employing such a nondiscriminatory classification in the future. The availability of a single sum distribution under this plan does not result in discrimination during the 1988 plan year and may not reasonably be expected to do so.

(b) Transitional alternatives. If the availability of an optional form of benefit under an existing plan is discriminatory under section 401(a)(4), the plan must be amended either to eliminate the optional form of benefit or to make the availability of the optional form of benefit nondiscriminatory. For example, the availability of an optional form of benefit may be made nondiscriminatory by making such benefit available to sufficient additional employees who are not in the highly compensated

group or by imposing nondiscriminatory objective criteria on its availability such that the group of employees to whom the benefit is available is nondiscriminatory. See Q&A-6 of § 1.411(d)-4 for requirements with respect to such objective criteria. If, under an existing plan, the availability of an optional form of benefit may reasonably be expected to discriminate, the plan may be amended in the same manner permitted where the availability of an optional form of benefit is discriminatory. See paragraph (d) of this Q&A-5 for rules limiting the period during which the availability of optional forms of benefit may be eliminated or reduced under this paragraph.

(c) Compliance and amendment date provisions—(1) Operational compliance requirement. On or before the applicable effective date for the plan (see Q&A-6 of this section), the plan sponsor must select one of the alternatives permitted under paragraph (b) of this Q&A-5 with respect to each affected optional form of benefit and the plan must be operated in accordance with this selection. This is an operational requirement and does not require a plan amendment prior to the period set forth in paragraph (c)(2) of this Q&A-5. There is no special reporting requirement under the Code or this section with respect to this selection.

(2) Deferred amendment date. If paragraph (c)(1) of this Q&A-5 is satisfied, a plan amendment conforming the plan to the particular alternative selected under paragraph (b) of this Q&A-5 must be adopted within the time period permitted for amending plans in order to meet the requirements of section 410(b) as amended by TRA '86. Such conforming amendment must be consistent with the sponsor's selection as reflected by plan practice during the period from the effective date to the date the amendment is adopted. Thus, for example, if an existing calendar year noncollectively bargained defined benefit plan has a single sum distribution form subject to a discriminatory condition, that was available as of January 30, 1986 (subject to such condition), and such employer makes one or more single sum distributions available on or after the first day of the first plan year commencing on or after January 1, 1989, and before the plan amendment, then such employer may not adopt a plan amendment eliminating the single sum distribution form. Instead, such employer must adopt an amendment making the distribution form available to a nondiscriminatory group of employees while retaining the availability of such distribution form with respect to the group of employees to whom the benefit is already available. Similarly, any objective criteria that are adopted as part of such amendment must be consistent with the plan practice for the applicable period prior to the amendment. A conforming amendment under this paragraph (c)(2) must be made with respect to each optional form of benefit for which such amendment is required and must be retroactive to the applicable effective date.

(d) Limitation on transitional alternatives. The transitional alternatives permitting the elimination or reduction of optional forms of benefit will not violate section 411(d)(6) during the period prior to the applicable effective date for the plan (see Q&A-6 of this section). After the applicable effective date, any amendment (other than one described in paragraph (c)(2) of this Q&A-5) that eliminates or reduces an optional form of benefit or imposes new objective criteria restricting the availability of such optional form of benefit will fail to qualify for the exception to section 411(d)(6) provided in this Q&A-5. This is the case without regard to whether the availability of the optional form of benefit is discriminatory or may reasonably be expected to be discriminatory.

Q-6: What are the effective dates for the rules in this section?

A-6: (a) General effective date. Except as otherwise provided in this section, the provisions of this section are effective January 30, 1986.

(b) New plans—(1) In general. Unless otherwise provided in paragraph (b)(2) of this Q&A-6, plans that are either adopted or made effective on or after January 30, 1986, are "new plans". With respect to such new plans, this section is effective January 30, 1986. This effective date is applicable to such plans whether or not they are collectively bargained.

(2) Exception with respect to certain new plans. Plans that are new plans as defined in paragraph (b)(1) of this Q&A-6, under which the availability of an optional form of benefit is discriminatory or may reasonably be expected to be discriminatory, and that receive a favorable determination letter that covered such plan provisions with respect to an application submitted prior to July 11, 1988, will be treated as existing plans with respect to such optional form of benefit for purposes of the transitional rules of this section. Thus, such plans are eligible for the compliance and amendment alternatives set forth in the transitional rule in Q&A-5 of this section.

(c) Existing plans—(1) In general. Plans that are both adopted and in effect prior to January 30, 1986, are "existing plans". In addition, new plans described in paragraph (b)(2) of this Q&A-6 are treated as existing plans with respect to certain

forms of benefit. Subject to the limitations in paragraph (d) of this Q&A-6, the effective dates set forth in paragraphs (c)(2) and (c)(3) of this Q&A-6 apply to these existing plans for purposes of this section.

(2) Existing noncollectively bargained plans. With respect to existing noncollectively bargained plans, this section is effective for the first day of the first plan year commencing on or after January 1, 1989.

(3) Existing collectively bargained plans. With respect to existing collectively bargained plans, this section is effective for the later of the first day of the first plan year commencing on or after January 1, 1989, or the first day of the first plan year that the requirements of section 410(b) as amended by TRA '86 apply to such plan.

(d) Delayed effective dates not applicable to new optional forms of benefit or conditions—(1) In general. The delayed effective dates in paragraph (c) (2) and (3) of this Q&A-6 for existing plans are applicable with respect to an optional form of benefit only if both the optional form of benefit and any applicable condition either causing the availability of such optional form of benefit to be discriminatory or making it reasonable to expect that the availability of such optional form will be discriminatory were both adopted and in effect prior to January 30, 1986. If the preceding sentence is not satisfied with respect to an optional form of benefit, this section is effective with respect to such optional form of benefit as if the plan were a new plan.

(2) Exception for certain amendments covered by a favorable determination letter. If a condition causing the availability of an optional form of benefit to be discriminatory, or to be reasonably expected to discriminate, was adopted or made effective on or after January 30, 1986, and a favorable determination letter that covered such plan provision is or was received with respect to an application submitted before July 11, 1988, the effective date of this section with respect to such provision is the applicable effective date determined under the rules with respect to existing plans, as though such provision had been adopted and in effect prior to January 30, 1986.

(e) Transitional rule effective date. The transitional rule provided in Q&A-5 of this section is effective January 30, 1986.

[T.D. 8212, 53 FR 26054, July 11, 1988]

§ 1.401(a)-11 Qualified joint and survivor annuities.

(a) General rule—(1) Required provisions. A trust, to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2), which is a part of a plan providing for the payment of benefits in any form of a life annuity (as defined in paragraph (b)(1) of this section), shall not constitute a qualified trust under section 401(a)(11) and this section unless such plan provides that:

(i) Unless the election provided in paragraph (c)(1) of this section has been made, life annuity benefits will be paid in a form having the effect of a qualified joint and survivor annuity (as defined in paragraph (b)(2) of this section) with respect to any participant who—

(A) Begins to receive payments under such plan on or after the date the normal retirement age is attained, or

(B) Dies (on or after the date the normal retirement age is attained) while in active service of the employer maintaining the plan, or

(C) In the case of a plan which provides for the payment of benefits before the normal retirement age, begins to receive payments under such plan on or after the date the qualified early retirement age (as defined in paragraph (b)(4) of this section) is attained, or

(D) Separates from service on or after the date the normal retirement age (or the qualified early retirement age) is attained and after satisfaction of eligibility requirements for the payment of benefits under the plan (except for any plan requirement that there be filed a claim for benefits) and thereafter dies before beginning to receive such benefits;

(ii) Any participant may elect, as provided in paragraph (c)(1) of this section, not to receive life annuity benefits in the form of a qualified joint and survivor annuity; and

(iii) If the plan provides for the payment of benefits before the normal retirement age, any participant may elect, as provided in paragraph (c)(2) of this section, that life annuity benefits be payable as an early survivor annuity (as defined in paragraph (b)(3) of this section) upon his death in the event that he—

(A) Attains the qualified early retirement age (as defined in paragraph (b)(4) of this section), and

(B) Dies on or before the day normal retirement age is attained while employed by an employer maintaining the plan.

(2) **Certain cash-outs.** A plan will not fail to satisfy the requirements of section 401(a)(11) and this section merely because it provides that if the present value of the entire nonforfeitable benefit derived from employer contributions of a participant at the time of his separation from service does not exceed $1,750 (or such smaller amount as the plan may specify), such benefit will be paid to him in a lump sum.

(3) **Illustrations.** The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). The X Corporation Defined Contribution Plan was established in 1960. As in effect on January 1, 1974, the plan provided that, upon the participant's retirement, the participant may elect to receive the balance of his account in the form of (1) a single-sum cash payment, (2) a single-sum distribution consisting of X Corporation stock, (3) five equal annual cash payments, (4) a life annuity, or (5) a combination of options (1) through (4). The plan also provided that, if a participant did not elect another form of distribution, the balance of his account would be distributed to him in the form of a single-sum cash payment upon his retirement. Assume that section 401(a)(11) and this section became applicable to the plan as of its plan year beginning January 1, 1976, with respect to persons who were active participants in the plan as of such date (see paragraph (f) of this section). If X Corporation Defined Contribution Plan continues to allow the life annuity payment option after December 31, 1975, it must be amended to provide that if a participant elects a life annuity option the life annuity benefit will be paid in a form having the effect of a qualified joint and survivor annuity, except to the extent that the participant elects another form of benefit payment. However, the plan can continue to provide that, if no election is made, the balance will be paid as a single-sum cash payment. If the trust is not so amended, it will fail to qualify under section 401(a).

Example (2). The Corporation Retirement Plan provides that plan benefits are payable only in the form of a life annuity and also provides that a participant may retire before the normal retirement age of 65 and receive a benefit if he has completed 30 years of service. Under this plan, an employee who begins employment at the age of 18 will be eligible to receive retirement benefits at the age of 48 if he then has 30 years of service. This plan must allow a participant to elect in the time and manner prescribed in paragraph (c)(2) of this section an early survivor annuity (defined in paragraph (b)(3) of this section) to be payable on the death of the participant if death occurs while the participant is in active service for the employer maintaining the plan and on or after the date the participant reaches the qualified early retirement age of 55 (the later of the date the participant reaches the earliest retirement age (age 48) or 10 years before normal retirement age (age 55)) but before the day after the day the participant reaches normal retirement age (age 65).

Example (3). Assume the same facts as in Example (2). A, B, and C began employment with Y Corporation when they each attained age 18. A retires and begins to receive benefit payments at age 48 after completing 30 years of service. The plan is not required to pay a qualified joint and survivor annuity to A and his spouse at any time. B does not elect an early survivor annuity at age 55, but retires at age 57 after completing 39 years of service. Unless B makes an election under subparagraph (1)(ii) of this paragraph, the plan is required to pay a qualified joint and survivor annuity to B and his spouse. C makes no elections described in subparagraph (1) of this paragraph, and dies while in active service at age 66 after completing 48 years of service. The plan is required to pay a qualified survivor annuity to C's spouse.

(b) **Definitions.** As used in this section—(1) **Life annuity.** (i) The term "life annuity" means an annuity that provides retirement payments and requires the survival of the participant or his spouse as one of the conditions for any payment or possible payment under the annuity. For example, annuities that make payments for 10 years or until death, whichever occurs first or whichever occurs last, are life annuities.

(ii) However, the term "life annuity" does not include an annuity, or that portion of an annuity, that provides those benefits which, under section 411(a)(9), would not be taken into account in the determination of the normal retirement benefit or early retirement benefit. For example, "social security supplements" described in the fourth sentence of section 411(a)(9) are not considered to be life annuities for the purposes of this section, whether or not an early retirement benefit is provided under the plan.

(2) **Qualified joint and survivor annuity.** The term "qualified joint and survivor annuity" means an annuity for the life of the participant with a survivor annuity for the life of his spouse which is neither (i) less than one-half of, nor (ii) greater than, the amount of the annuity payable during the joint lives of the participant and his spouse. For purposes of the preceding sentence, amounts described in § 1.401(a)-11(b)(1)(ii) may be disregarded. A qualified joint and survivor annuity must be at least the actuarial equivalent of the normal form of life annuity or, if greater, of any optional form of life annuity offered under the plan. Equivalence may be determined, on the basis of consistently applied reasonable actuarial factors, for each participant or for all participants or reasonable groupings of participants, if such determination does not result in discrimination in favor of employees who are officers, shareholders, or highly compensated. An annuity is not a qualified joint and survivor annuity if payments to the spouse of a deceased participant are terminated, or reduced, because of such spouse's remarriage.

(3) **Early survivor annuity.** The term "early survivor annuity" means an annuity for the life of the participant's spouse the payments under which must not be less than the payments which would have been made to the spouse under the joint and survivor annuity if the participant had made the election described in paragraph (c)(2) of this sec-

tion immediately prior to his retirement and if his retirement had occurred on the day before his death and within the period during which an election can be made under such paragraph (c)(2). For example, if a participant would be entitled to a single life annuity of $100 per month or a reduced amount under a qualified joint and survivor annuity of $80 per month, his spouse is entitled to a payment of at least $40 per month. However, the payments may be reduced to reflect the number of months of coverage under the survivor annuity pursuant to paragraph (e) of this section.

(4) **Qualified early retirement age.** The term "qualified early retirement age" means the latest of—

(i) The earliest date, under the plan, on which the participant could elect (without regard to any requirement that approval of early retirement be obtained) to receive retirement benefits (other than disability benefits).

(ii) The first day of the 120th month beginning before the participant reaches normal retirement age, or

(iii) The date on which the participant begins participation.

(5) **Normal retirement age.** The term "normal retirement age" has the meaning set forth in section 411(a)(8).

(6) **Annuity starting date.** The term "annuity starting date" means the first day of the first period with respect to which an amount is received as a life annuity, whether by reason of retirement or by reason of disability.

(7) **Day.** The term "day" means a calendar day.

(c) **Elections—(1) Election not to take joint and survivor annuity form—(i) In general.** (A) A plan shall not be treated as satisfying the requirements of this section unless it provides that each participant may elect, during the election period described in subdivision (ii) of this subparagraph, not to receive a qualified joint and survivor annuity. However, if a plan provides that a qualified joint and survivor annuity is the only form of benefit payable under the plan with respect to a married participant, no election need be provided.

(B) The election shall be in writing and clearly indicate that the participant is electing to receive all or, if permitted by the plan, part of his benefits under the plan in a form other than that of a qualified joint and survivor annuity. A plan will not fail to meet the requirements of this section merely because the plan requires the participant to obtain the written approval of his spouse in order for the participant to make this election or if the plan provides that such approval is not required.

(ii) **Election period.** (A) For purposes of the election described in paragraph (c)(1)(i) of this section, the plan shall provide an election period which shall include a period of at least 90 days following the furnishing of all of the applicable information required by subparagraph (3)(i) of this paragraph and ending prior to commencement of benefits. In no event may the election period end earlier than the 90th day before the commencement of benefits. Thus, for example, the commencement of benefits may be delayed until the end of such election period because the amount of payments to be made to a participant cannot be ascertained before the end of such period; see § 1.401(a)–14(d).

If a participant makes a request for additional information as provided in subparagraph (3)(iii) of this paragraph on or before the last day of the election period, the election period shall be extended to the extent necessary to include at least the 90 calendar days immediately following the day the requested additional information is personally delivered or mailed to the participant. Notwithstanding the immediately preceding sentence, a plan may provide in cases in which the participant has been furnished by mail or personal delivery all of the applicable information required by subparagraph (3)(i) of this paragraph, that a request for such additional information must be made on or before a date which is not less than 60 days from the date of such mailing or delivery; and if the plan does so provide, the election period shall be extended to the extent necessary to include at least the 60 calendar days following the day the requested additional information is personally delivered or mailed to the participant.

(B) In the case of a participant in a plan to which this subparagraph applies who separated from service after section 401(a)(11) and this section became applicable to such plan with respect to such participant, and to whom an election required by this subparagraph has not been previously made available (and will not become available in normal course), the plan must provide an election to receive the balance of his benefits (properly adjusted, if applicable, for payments received, prior to the exercise of such election, in the form of a qualified joint and survivor annuity) in a form other than that of a qualified joint and survivor annuity. The provisions of paragraph (c)(1)(ii)(A) shall apply except that in no event

shall the election period end before the 90th day after the date on which notice of the availability of such election and the applicable information required by subparagraph (3)(i) of this paragraph is given directly to the participant. If such notice and information is given by mail, it shall be treated as given on the date of mailing. If such participant has died, such election shall be made available to such participant's personal representative.

(2) **Election of early survivor annuity—(i) In general.** (A) A plan described in subparagraph (a)(1)(iii) of this section shall not be treated as satisfying the requirements of this section unless it provides that each participant may elect, during the period described in subdivision (ii) of this subparagraph, an early survivor annuity as described in paragraph (a)(1)(iii) of this section. Breaks in service after the participant has attained the qualified early retirement age neither invalidate a previous election or revocation nor prevent an election from being made or revoked during the election period.

(B) The election shall be in writing and clearly indicate that the participant is electing the early survivor annuity form.

(C) A plan is not required to provide an election under this subparagraph if—

(1) The plan provides that an early survivor annuity is the only form of benefit payable under the plan with respect to a married participant who dies while employed by an employer maintaining the plan,

(2) In the case of a defined contribution plan, the plan provides a survivor benefit at least equal in value to the vested portion of the participant's account balance, if the participant dies while in active service with an employer maintaining the plan, or

(3) In the case of a defined benefit plan, the plan provides a survivor benefit at least equal in value to the present value of the vested portion of the participant's normal form of the accrued benefit payable at normal retirement age (determined immediately prior to death), if the participant dies while in active service with an employer maintaining the plan. Any present values must be determined in accordance with either the actuarial assumptions or factors specified in the plan, or a variable standard independent of employer discretion for converting optional benefits specified in the plan.

(ii) **Election period.** (A) For purposes of the election described in paragraph (c)(2)(i) of this section the plan shall provide an election period which, except as provided in the following sentence, shall begin not later than the later of either the 90th day before a participant attains the qualified early retirement age or the date on which his participation begins, and shall end on the date the participant terminates his employment. If such a plan contains a provision that any election made under this subparagraph does not become effective or ceases to be effective if the participant dies within a certain period beginning on the date of such election, the election period prescribed in this subdivision (ii) shall begin not later than the later of (1) a date which is 90 days plus such certain period before the participant attains the qualified early retirement age or (2) the date on which his participation begins. For example, if a plan provides that an election made under this subparagraph does not become effective if the participant dies less than 2 years after the date of such election, the period for making an election under this subparagraph must begin not later than the later of (1) 2 years and 90 days before the participant attains the qualified early retirement age, or (2) the date on which his participation begins. However, the election period for an individual who was an active participant on the date this section became effective with regard to the plan need not begin earlier than such effective date.

(B) In the case of a participant in a plan to which this subparagraph applies who dies after section 401(a)(11) and this section became applicable to such plan with respect to such participant and to whom an election required by this subparagraph has not been previously made available, the plan must give the participant's surviving spouse or, if dead, such spouse's personal representative the option of electing an early survivor annuity. The plan may reduce the surviving spouse's annuity to take into account any benefits already received. The period for making such election shall not end before the 90th day after the date on which written notice of the availability of such election and applicable information required by subparagraph (3)(i) of this paragraph is given directly to such surviving spouse or personal representative. If such notice and information is given by mail, it shall be treated as given on the date of mailing.

(3) **Information to be provided by plan administrator.** (i) A plan which is required to provide either or both of the elections described in paragraph (c)(1) or (2) of this section must provide to the participants, at the time and in the manner

specified in subdivision (ii) of this subparagraph, the following information, as applicable to the plan, in written nontechnical language:

(A) In the case of the election described in paragraph (c)(1) of this section, a general description or explanation of the qualified joint and survivor annuity, the circumstances in which it will be provided unless the participant has elected not to have benefits provided in that form, and the availability of such election;

(B) In the case of the election described in paragraph (c)(2) of this section, a general description of the early survivor annuity, the circumstances under which it will be paid if elected, and the availability of such election; and

(C) A general explanation of the relative financial effect on a participant's annuity of either or both elections, as the case may be.

Various methods may be used to explain such relative financial effect. With regard to a qualified joint and survivor annuity, they include: information as to the benefits the participant would receive under the qualified joint and survivor annuity stated as an arithmetic or percentage reduction from a single life annuity; a table showing the difference between a straight life annuity and a qualified joint and survivor annuity in terms of a reduction in dollar amounts; a table showing a percentage reduction from the straight life annuity or, in the case of a profit-sharing plan, an approximate dollar amount reduction. The notice and explanation required by this subdivision (i) must also inform the participants of the availability of the additional information specified in subdivision (iii) of this subparagraph and how they may obtain such information.

(ii) The method or methods used to provide the information described in subdivision (i) of this subparagraph may vary. Posting which meets the requirements of § 1.7476-2(c)(1) may be used; see § 1.7476-2(c)(1) for examples of other methods which may be used. One or more methods may be used to provide the required information provided that all of the required information is provided by one method or a combination of methods by or within the time period specified in this subdivision (ii). If mail or personal delivery is used, then, whether or not the information has been previously provided, there must be a mailing or personal delivery of the information by such time as to reasonably assure that it will be received on or about: (1) in the case of a plan which does not provide for the payment of benefits before the normal retirement age, the date which is 9 months before the participant attains normal retirement age; (2) in the case of a plan which provides for the payment of benefits before the normal retirement age and which is required to provide the election described in paragraph (c)(2) of this section (whether or not it is also required to provide the election described in paragraph (c)(1) of this section), the date which is 90 days before the latest date prescribed by paragraph (c)(2)(ii)(A) for the beginning of the election period for the early survivor annuity; or (3) in the case of a plan which provides for the payment of benefits before the normal retirement age and which is required to provide only the election described in paragraph (c)(1) of this section, the date which is nine months before the participant attains the qualified early retirement age; except that in the case of a plan described in (2) or (3), if the qualified early retirement age is the date the participant begins participation in the plan, the information may be provided on or about such date. If a method other than mail or personal delivery is used to provide participants with some or all of such information, it must be a method which is reasonably calculated to reach the attention of a participant on or about the date prescribed in the immediately preceding sentence and to continue to reach the attention of such participant during the election period applicable to him for which the information is being provided (as, for example, by permanent posting, repeated publication, etc.).

(iii) The plan administrator must furnish to a particular participant, upon a timely written request, a written explanation in nontechnical language of the terms and conditions of the qualified joint and survivor annuity and the financial effect upon the particular participant's annuity of making any election under this paragraph. Such financial effect shall be given in terms of dollars per annuity payment; and in the case of a defined contribution plan, the projected annuity for a particular participant may be based on his account balance as of the most recent valuation date. The plan administrator need not comply with more than one such request made by a particular participant. This explanation must be personally delivered or mailed (first class mail, postage prepaid) to the participant within 30 days from the date of the participant's written request.

(4) **Election is revocable.** A plan to which this section applies must provide that any election made under this paragraph may be revoked in writing during the specified election period, and that after such election has been revoked, another

election under this paragraph may be made during the specified election period.

(5) Election by surviving spouse. A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it provides that the spouse of a deceased participant may elect to have benefits paid in a form other than a survivor annuity. If the plan provides that such a spouse may make such an election, the plan administrator must furnish to this spouse, within a reasonable amount of time after a written request has been made by this spouse, a written explanation in non-technical language of the survivor annuity and any other form of payment which may be selected. This explanation must state the financial effect (in terms of dollars) of each form of payment. A plan need not respond to more than one such request.

(d) Permissible additional plan provisions—(1) In general. A plan will not fail to meet the requirements of section 401(a)(11) and this section merely because it contains one or more of the provisions described in paragraphs (d)(2) through (5) of this section.

(2) Claim for benefits. A plan may provide that as a condition precedent to the payment of benefits, a participant must express in writing to the plan administrator the form in which he prefers benefits to be paid and provide all the information reasonably necessary for the payment of such benefits. However, if a participant files a claim for benefits with the plan administrator and provides the plan administrator with all the information necessary for the payment of benefits but does not indicate a preference as to the form for the payment of benefits, benefits must be paid in the form of a qualified joint and survivor annuity if the participant has attained the qualified early retirement age unless such participant has made an effective election not to receive benefits in such form. For rules relating to provisions in a plan to the effect that a claim for benefits must be filed before the payment of benefits will commence, see § 1.401(a)–14.

(3) Marriage requirements. A plan may provide that a joint and survivor annuity will be paid only if—

(i) The participant and his spouse have been married to each other throughout a period (not exceeding one year) ending on the annuity starting date.

(ii) The spouse of the participant is not entitled to receive a survivor annuity (whether or not the election described in paragraph (c)(2) of this section has been made) unless the participant and his spouse have been married to each other throughout a period (not exceeding one year) ending on the date of such participant's death.

(iii) The same spouse must satisfy the requirements of subdivisions (i) and (ii) of this subparagraph.

(iv) The participant must notify the plan administrator (as defined by section 414(g)) of his marital status within any reasonable time period specified in the plan.

(4) Effect of participant's death on an election or revocation of an election under paragraph (c). A plan may provide that any election described in paragraph (c) of this section or any revocation of any such election does not become effective or ceases to be effective if the participant dies within a period, not in excess of 2 years, beginning on the date of such election or revocation. However, a plan containing a provision described in the preceding sentence shall not satisfy the requirements of this section unless it also provides that any such election or any revocation of any such election will be given effect in any case in which—

(i) The participant dies from accidental causes,

(ii) A failure to give effect to the election or revocation would deprive the participant's survivor of a survivor annuity, and

(iii) Such election or revocation is made before such accident occurred.

(5) Benefit option approval by third party. (i) A plan may provide that an optional form of benefit elected by a participant is subject to the approval of an administrative committee or similar third party. However, the administrative committee cannot deny a participant any of the benefits required by section 401(a)(11). For example, if a plan offers a life annuity option, the committee may deny the participant a qualified joint and survivor annuity only by denying the participant access to all life annuity options without knowledge of whether the participant wishes to receive a qualified joint and survivor annuity. Alternatively, if the committee knows which form of life annuity the participant has chosen before the committee makes its decision, the committee cannot withhold its consent for payment of a qualified joint and survivor annuity event though it denies all other life annuity options. This subparagraph (5) only applies before the effective date of the amendment made to section 411(d)(6) by section 301 of the Retirement Equity Act of 1984. See

section 411(d)(6) and the regulations thereunder for rules limiting employer discretion.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. In 1980 plan M provides that the automatic form of benefit is a single sum distribution. The plan also permits, subject to approval by the administrative committee, the election of several optional forms of life annuity. On the election form that is reviewed by the administrative committee the participant indicates whether any life annuity option is preferred, without indicating the particular life annuity chosen. Thus, the committee approves or disapproves the election without knowledge of whether a qualified joint and survivor annuity will be elected. The administrative committee approval provision in Plan M does not cause the plan to fail to satisfy this section. On the other hand, if the form indicates which form of life annuity is preferred, committee disapproval of any election of the qualified joint and survivor annuity would cause the plan to fail to satisfy this section.

(e) **Costs of providing qualified joint and survivor annuity form or early survivor annuity form.** A plan may take into account in any equitable manner consistent with generally accepted actuarial principles applied on a consistent basis any increased costs resulting from providing qualified joint and survivor annuity and early survivor annuity benefits. A plan may give a participant the option of paying premiums only if it provides another option under which an out-of-pocket expense by the participant is not required.

(f) **Application and effective date.** Section 401(a)(11) and this section shall apply to a plan only with respect to plan years beginning after December 31, 1975, and shall apply only if—

(1) The participant's annuity starting date did not fall within a plan year beginning before January 1, 1976, and

(2) The participant was an active participant in the plan on or after the first day of the first plan year beginning after December 31, 1975.

For purposes of this paragraph, the term "active participant" means a participant for whom benefits are being accrued under the plan on his behalf (in the case of a defined benefit plan), the employer is obligated to contribute to or under the plan on his behalf (in the case of a defined contribution plan other than a profit-sharing plan), or the employer either is obligated to contribute to or under the plan on his behalf or would have been obligated to contribute to or under the plan on his behalf if any contribution were made to or under the plan (in the case of a profit-sharing plan).

If benefits under a plan are provided by the distribution to the participants of individual annuity contracts, the annuity starting date will be considered for purposes of this paragraph to fall within a plan year beginning before January 1, 1976, with respect to any such individual contract that was distributed to the participant during a plan year beginning before January 1, 1976, if no premiums are paid with respect to such contract during a plan year beginning after December 31, 1975. In the case of individual annuity contracts that are distributed to participants before January 1, 1978, and which contain an option to provide a qualified joint and survivor annuity, the requirements of this section will be considered to have been satisfied if, not later than January 1, 1978, holders of individual annuity contracts who are participants described in the first sentence of this paragraph are given an opportunity to have such contracts amended, so as to provide for a qualified joint and survivor annuity in the absence of a contrary election, within a period of not less than one year from the date such opportunity was offered. In no event, however, shall the preceding sentence apply with respect to benefits attributable to premiums paid after December 31, 1977.

(g) **Effect of REA 1984—(1) In general.** The Retirement Equity Act of 1984 (REA 1984) significantly changed the qualified joint and survivor annuity rules generally effective for plan years beginning after December 31, 1984. The new survivor annuity rules are primarily in sections 401(a)(11) and 417 as revised by REA 1984 and §§ 1.401(a)-20 and 417(e)-1.

(2) **Regulations after REA 1984.** (i) REA and the regulations thereunder to the extent inconsistent with pre-REA 1984 section 401(a)(11) and this section are controlling for years to which REA 1984 applies. See e.g., paragraphs (a)(1) and (2) of this section, relating to required provisions and certain cash-outs, respectively and (e), relating to costs of providing annuities, for rules that are inconsistent with REA 1984 and, therefore, are not applicable to REA 1984 years.

(ii) To the extent that the pre-REA 1984 law either is the same as or consistent with REA 1984 and the new regulations hereunder, the rules in this section shall continue to apply for years to which REA 1984 applies. (See, e.g., paragraph (c) (relating to how information is furnished participants and spouses) and paragraph (b) (defining a life annuity) for some of the rules that apply to REA 1984 years.) The rules in this section shall not apply for such year to the extent that they are inconsistent with REA 1984 and the regulations thereunder.

(iii) The Commissioner may provide additional guidance as to the continuing effect of the various

rules in this section for years to which REA applies.

[T.D. 7458, 42 FR 1466, Jan. 7, 1977; 42 FR 6367, Feb. 2, 1977, as amended by T.D. 7510, 42 FR 53956, Oct. 4, 1977; T.D. 8219, 53 FR 31841, Aug. 22, 1988]

§ 1.401(a)–12 Mergers and consolidations of plans and transfers of plan assets.

A trust will not be qualified under section 401 unless the plan of which the trust is a part provides that in the case of any merger or consolidation with, or transfer of assets or liabilities to, another plan after September 2, 1974, each participant in the plan would receive a minimum benefit if the plan terminated immediately after the merger, consolidation, or transfer. This benefit must be equal to or greater than the benefit the participant would have been entitled to receive immediately before the merger, consolidation, or transfer if the plan in which he was a participant had then terminated. This section applies to a multiemployer plan only to the extent determined by the Pension Benefit Guaranty Corporation. For additional rules concerning mergers or consolidations of plans and transfers of plan assets, see section 414(*l*) and § 1.414(*l*)–1.

[T.D. 7638, 44 FR 48195, Aug. 17, 1979]

§ 1.401(a)–13 Assignment or alienation of benefits.

(a) Scope of the regulations. This section applies only to plans to which section 411 applies without regard to section 411(e)(2). Thus, for example, it does not apply to a governmental plan, within the meaning of section 414(d); a church plan, within the meaning of section 414(e), for which there has not been made the election under section 410(a) to have the participation, vesting, funding, etc. requirements apply; or a plan which at no time after September 2, 1974, provided for employer contributions.

(b) No assignment or alienation—(1) General rule. Under section 401(a)(13), a trust will not be qualified unless the plan of which the trust is a part provides that benefits provided under the plan may not be anticipated, assigned (either at law or in equity), alienated or subject to attachment, garnishment, levy, execution or other legal or equitable process.

(2) Federal tax levies and judgments. A plan provision satisfying the requirements of subparagraph (1) of this paragraph shall not preclude the following:

(i) The enforcement of a Federal tax levy made pursuant to section 6331.

(ii) The collection by the United States on a judgment resulting from an unpaid tax assessment.

(c) Definition of assignment and alienation—(1) In general. For purposes of this section, the terms "assignment" and "alienation" include—

(i) Any arrangement providing for the payment to the employer of plan benefits which otherwise would be due the participant under the plan, and

(ii) Any direct or indirect arrangement (whether revocable or irrevocable) whereby a party acquires from a participant or beneficiary a right or interest enforceable against the plan in, or to, all or any part of a plan benefit payment which is, or may become, payable to the participant or beneficiary.

(2) Specific arrangements not considered an assignment or alienation. The terms "assignment" and "alienation" do not include, and paragraph (e) of this section does not apply to, the following arrangements:

(i) Any arrangement for the recovery of amounts described in section 4045(b) of the Employee Retirement Income Security Act of 1974, 88 Stat. 1027 (relating to the recapture of certain payments),

(ii) Any arrangement for the withholding of Federal, State or local tax from plan benefit payments,

(iii) Any arrangement for the recovery by the plan of overpayments of benefits previously made to a participant,

(iv) Any arrangement for the transfer of benefit rights from the plan to another plan, or

(v) Any arrangement for the direct deposit of benefit payments to an account in a bank, savings and loan association or credit union, provided such arrangement is not part of an arrangement constituting an assignment or alienation. Thus, for example, such an arrangement could provide for the direct deposit of a participant's benefit payments to a bank account held by the participant and the participant's spouse as joint tenants.

(d) Exceptions to general rule prohibiting assignments or alienations—(1) Certain voluntary and revocable assignments or alienations. Notwithstanding paragraph (b)(1) of this section, a plan may provide that once a participant or beneficiary begins receiving benefits under the plan, the participant or beneficiary may assign or alienate

the right to future benefit payments provided that the provision is limited to assignments or alienations which—

(i) Are voluntary and revocable;

(ii) Do not in the aggregate exceed 10 percent of any benefit payment; and

(iii) Are neither for the purpose, nor have the effect, of defraying plan administration costs.

For purposes of this subparagraph, an attachment, garnishment, levy, execution, or other legal or equitable process is not considered a voluntary assignment or alienation.

(2) **Benefits assigned or alienated as security for loans.** (i) Notwithstanding paragraph (b)(1) of this section, a plan may provide for loans from the plan to a participant or a beneficiary to be secured (by whatever means) by the participant's accrued nonforfeitable benefit provided that the following conditions are met.

(ii) The plan provision providing for the loans must be limited to loans from the plan. A plan may not provide for the use of benefits accrued or to be accrued under the plan as security for a loan from a party other than the plan, regardless of whether these benefits are nonforfeitable within the meaning of section 411 and the regulations thereunder.

(iii) The loan, if made to a participant or beneficiary who is a disqualified person (within the meaning of section 4975(e)(2)), must be exempt from the tax imposed by section 4975 (relating to the tax imposed on prohibited transactions) by reason of section 4975(d)(1). If the loan is made to a participant or beneficiary who is not a disqualified person, the loan must be one which would be exempt from the tax imposed by section 4975 by reason of section 4975(d)(1) if the loan were made to a disqualified person.

(e) **Special rule for certain arrangements**—(1) **In general.** For purposes of this section and notwithstanding paragraph (c)(1) of this section, an arrangement whereby a participant or beneficiary directs the plan to pay all, or any portion, of a plan benefit payment to a third party (which includes the participant's employer) will not constitute an "assignment or alienation" if—

(i) It is revocable at any time by the participant or beneficiary; and

(ii) The third party files a written acknowledgement with the plan administrator pursuant to subparagraph (2) of this paragraph.

(2) **Acknowledgement requirement for third party arrangements.** In accordance with paragraph (e)(1)(ii) of this section, the third party is required to file a written acknowledgement with the plan administrator. This acknowledgement must state that the third party has no enforceable right in, or to, any plan benefit payment or portion thereof (except to the extent of payments actually received pursuant to the terms of the arrangement). A blanket written acknowledgement for all participants and beneficiaries who are covered under the arrangement with the third party is sufficient. The written acknowledgement must be filed with the plan administrator no later than the later of—

(i) August 18, 1978; or

(ii) 90 days after the arrangement is entered into.

(f) **Effective date.** Section 401(a)(13) is applicable as of January 1, 1976, and the plan provision required by this section must be effective as of that date. However, regardless of when the provision is adopted, it will not affect—

(1) Attachments, garnishments, levies, or other legal or equitable process permitted under the plan that are made before January 1, 1976;

(2) Assignments permitted under the plan that are irrevocable on December 31, 1975, including assignments made before January 1, 1976, as security for loans to a participant or beneficiary from a party other than the plan; and

(3) Renewals or extensions of loans described in subparagraph (2) of this paragraph, if—

(i) The principal amount of the obligation outstanding on December 31, 1975 (or, if less, the principal amount outstanding on the date of renewal or extension), is not increased;

(ii) The loan, as renewed or extended, does not bear a rate of interest in excess of the rate prevailing for similar loans at the time of the renewal or extensions; and

(iii) With respect to loans that are renewed or extended to bear a variable interest rate, the formula for determining the applicable rate is consistent with the formula for formulae prevailing for similar loans at the time of the renewal or extension.

For purposes of subparagraphs (2) and (3) of this paragraph, a loan from a party other than the plan made after December 31, 1975, will be treated as a new loan. This is so even if the lender's security interest for the loan arises from an assignment of

the participant's accrued nonforfeitable benefit made before that date.

(g) Special rules for qualified domestic relations orders—(1) Definition. The term "qualified domestic relations order" (QDRO) has the meaning set forth in section 414(p). For purposes of the Internal Revenue Code, a QDRO also includes any domestic relations order described in section 303(d) of the Retirement Equity Act of 1984.

(2) Plan amendments. A plan will not fail to satisfy the qualification requirements of section 401(a) or 403(a) merely because it does not include provisions with regard to a QDRO.

(3) Waiver of distribution requirements. A plan shall not be treated as failing to satisfy the requirements of sections 401 (a) and (k) and 409(d) solely because of a payment to an alternate payee pursuant to a QDRO. This is the case even if the plan provides for payments pursuant to a QDRO to an alternate payee prior to the time it may make payments to a participant. Thus, for example, a pension plan may pay an alternate payee even though the participant may not receive a distribution because he continues to be employed by the employer.

(4) Coordination with section 417—(i) Former spouse. (A) In general. Under section 414(p)(5), a QDRO may provide that a former spouse shall be treated as the current spouse of a participant for all or some purposes under sections 401(a)(11) and 417.

(B) Consent. (1) To the extent a former spouse is treated as the current spouse of the participant by reason of a QDRO, any current spouse shall not be treated as the current spouse. For example, assume H is divorced from W, but a QDRO provides that H shall be treated as W's current spouse with respect to all of W's benefits under a plan. H will be treated as the surviving spouse under the QPSA and QJSA unless W obtains H's consent to waive the QPSA or QJSA or both. The fact that W married S after W's divorce from H is disregarded. If, however, the QDRO had provided that H shall be treated as W's current spouse only with respect to benefits that accrued prior to the divorce, then H's consent would be needed by W to waive the QPSA or QJSA with respect to benefits accrued before the divorce. S's consent would be required with respect to the remainder of the benefits.

(2) In the preceding examples, if the QDRO ordered that a portion of W's benefit (either through separate accounts or a percentage of the benefit) must be distributed to H rather than ordering that H be treated as W's spouse, the survivor annuity requirements of sections 401(a)(11) and 417 would not apply to the part of W's benefit awarded H. Instead, the terms of the QDRO would determine how H's portion of W's accrued benefit is paid. W is required to obtain S's consent if W elects to waive either the QJSA or QPSA with respect to the remaining portion of W's benefit.

(C) Amount of the QPSA or QJSA. (1) Where, because of a QDRO, more than one individual is to be treated as the surviving spouse, a plan may provide that the total amount to be paid in the form of a QPSA or survivor portion of a QJSA may not exceed the amount that would be paid if there were only one surviving spouse. The QPSA or survivor portion of the QJSA, as the case may be, payable to each surviving spouse must be paid as an annuity based on the life of each such spouse.

(2) Where the QDRO splits the participant's accrued benefit between the participant and a former spouse (either through separate accounts or percentage of the benefit), the surviving spouse of the participant is entitled to a QPSA or QJSA based on the participant's accrued benefit as of the date of death or the annuity starting date, less the separate account or percentage that is payable to the former spouse. The calculation is made as if the separate account or percentage had been distributed to the participant prior to the relevant date.

(ii) Current spouse. Under section 414(p)(5), even if the applicable election periods (i.e., the first day of the year in which the participant attains age 35 and 90 days before the annuity starting date) have not begun, a QDRO may provide that a current spouse shall not be treated as the current spouse of the participant for all or some purposes under sections 401(a)(11) and 417. A QDRO may provide that the current spouse waives all future rights to a QPSA or QJSA.

(iii) Effects on benefits. (A) A plan is not required to provide additional vesting or benefits because of a QDRO.

(B) If an alternative payee is treated pursuant to a QDRO as having an interest in the plan benefit, including a separate account or percentage of the participant's account, then the QDRO cannot provide the alternate payee with a greater right to designate a beneficiary for the alternate payee's benefit amount than the participant's right. The

QJSA or QPSA provisions of section 417 do not apply to the spouse of an alternate payee.

(C) If the former spouse who is treated as a current spouse dies prior to the participant's annuity starting date, then any actual current spouse of the participant is treated as the current spouse, except as otherwise provided in a QDRO.

(iv) Section 415 requirements. Even though a participant's benefits are awarded to an alternate payee pursuant to a QDRO, the benefits are benefits of the participant for purposes of applying the limitations of section 415 to the participant's benefits.

[T.D. 7534, 43 FR 6943, Feb. 17, 1978; T.D. 8219, 53 FR 31850, Aug. 22, 1988]

§ 1.401(a)–14 Commencement of benefits under qualified trusts.

(a) In general. Under section 401(a)(14), a trust to which section 411 applies (without regard to section 411(e)(2) is not qualified under section 401 unless the plan of which such trust is a part provides that the payment of benefits under the plan to the participant will begin not later than the 60th day after the close of the plan year in which the latest of the following events occurs—

(1) The attainment by the participant of age 65, or, if earlier, the normal retirement age specified under the plan,

(2) The 10th anniversary of the date on which the participant commenced participation in the plan,

(3) The termination of the participant's service with the employer, or

(4) The date specified in an election made pursuant to paragraph (b) of this section.

Notwithstanding the preceding sentence, a plan may require that a participant file a claim for benefits before payment of benefits will commence.

(b) Election of later date—(1) General rule. A plan may permit a participant to elect that the payment to him of any benefit under a plan will commence at a date later than the dates specified under paragraphs (a)(1), (2), and (3) of this section.

(2) Manner of election. A plan permitting an election under this paragraph shall require that such election must be made by submitting to the plan administrator a written statement, signed by the participant, which describes the benefit and the date on which the payment of such benefit shall commence.

(3) Restriction. An election may not be made pursuant to a plan provision permitted by this paragraph if the exercise of such election will cause benefits payable under the plan with respect to the participant in the event of his death to be more than "incidental" within the meaning of paragraph (b)(1)(i) of § 1.401–1.

(c) Special early retirement rule—(1) Separation prior to early retirement age. A trust forming part of a plan which provides for the payment of an early retirement benefit is not qualified under section 401 unless, upon satisfaction of the age requirement for such early retirement benefit, a participant who—

(i) Satisfied the service requirements for such early retirement benefit, but

(ii) Separated from service (with any nonforfeitable right to an accrued benefit) before satisfying such age requirement,

is entitled to receive not less than the reduced normal retirement benefit described in paragraph (c)(2) of this section. A plan may establish reasonable conditions for payments of early retirement benefits (including for example, a requirement that a claim for benefits be made) if the conditions are equally applicable to participants who separate from service when eligible for an early retirement benefit and participants who separate from service earlier.

(2) Reduced normal retirement benefit. For purposes of this section, the reduced normal retirement benefit is the benefit to which the participant would have been entitled under the plan at normal retirement age, reduced in accordance with reasonable actuarial assumptions.

(3) Separation prior to effective date of this section. The provisions of this paragraph shall not apply in the case of a plan participant who separates from service before attainment of early retirement age and prior to the effective date of this section set forth in paragraph (e) of this section.

(4) Illustration. The provisions of this paragraph may be illustrated by the following example:

Example. The X Corporation Defined Benefit Plan provides that a normal retirement benefit will be payable to a participant upon attainment of age 65. The plan also provides that an actuarially reduced retirement benefit will be payable, upon application, to any participant who has completed 10 years of service with the X Corporation and attained age 60. When he is 55 years of age and has completed 10 years of service with X Corporation, A, a participant in the plan, leaves the service of X Corporation and does not return. The plan will not be

qualified under section 401 unless, upon attainment of age 60 and application for benefits, A is entitled to receive a reduced normal retirement benefit described in subparagraph (2) of this paragraph.

(d) Retroactive payment rule. If the amount of the payment required to commence on the date determined under this section cannot be ascertained by such date, or if it is not possible to make such payment on such date because the plan administrator has been unable to locate the participant after making reasonable efforts to do so, a payment retroactive to such date may be made no later than 60 days after the earliest date on which the amount of such payment can be ascertained under the plan or the date on which the participant is located (whichever is applicable).

(e) Effective date. This section shall apply to a plan for those plan years to which section 411 of the Code applies without regard to section 411(e)(2).

[T.D. 7436, 41 FR 42651, Sept. 28, 1976; 41 FR 44690, Oct. 12, 1976]

§ 1.401(a)–15 Requirement that plan benefits are not decreased on account of certain Social Security increases.

(a) In general. Under section 401(a)(15), a trust which is part of a plan to which section 411 applies (without regard to section 411(e)(2)) is not qualified under section 401 unless, under the plan of which such trust is a part:

(1) Benefit being received by participant or beneficiary. A benefit (including a death or disability benefit) being received under the plan by a participant or beneficiary (other than a participant to whom subparagraph (2)(ii) of this paragraph applies, or a beneficiary of such a participant) is not decreased by reason of any post-separation social security benefit increase effective after the later of—

(i) September 2, 1974, or

(ii) The date of first receipt of any retirement benefit, death benefit, or disability benefit under the plan by the participant or by a beneficiary of the participant (whichever receipt occurs first).

(2) Benefit to which participant separated from service has nonforfeitable right. In the case of a benefit to which a participant has a nonforfeitable right under such plan—

(i) If such participant is separated from service and does not subsequently return to service and resume participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after the later of September 2, 1974, or separation from service, or

(ii) If such participant is separated from service and subsequently returns to service and resumes participation in the plan, such benefit is not decreased by reason of any post-separation social security benefit increase effective after September 2, 1974, which occurs during separation from service and which would decrease such benefit to a level below the level of benefits to which he would have been entitled had he not returned to service after his separation.

(b) Post-separation social security benefit increase. For purposes of this section, the term "post-separation social security benefit increase" means, with respect to a participant or a beneficiary of the participant, an increase in a benefit level or wage base under title II of the Social Security Act (whether such increase is a result of an amendment of such title II or is a result of the application of the provisions of such title II) occurring after the earlier of such participant's separation from service or commencement of benefits under the plan.

(c) Illustrations. The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title II of the Social Security Act at age 65, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan does not satisfy the requirements of section 401(a)(15), because social security increases that occur after a participant's separation from service will reduce the benefit the participant will receive under the plan.

Example (2). A plan to which section 401(a)(15) applies provides an annual benefit at the normal retirement age, 65, in the form of a stated benefit formula amount less a specified percentage of the primary insurance amount payable under title II of the Social Security Act. The plan provides no early retirement benefits. In the case of a participant who separates from service before age 65 with a nonforfeitable right to a benefit under the plan, the plan defines the primary insurance amount as the amount which the participant is entitled to receive under title II of the Social Security Act at age 65 based upon the assumption that he will continue to receive until reaching age 65 compensation which would be treated as wages for purposes of the Social Security Act at the same rate as he received such compensation at the time he separated from service, but determined without regard to any post-separation

social security benefit increase, multiplied by the ratio of the number of years of service with the employer to the number of years of service the participant would have had if he had worked for the employer until age 65. The plan satisfies the requirements of section 401(a)(15), because social security increases that occur after a participant's separation from service will not reduce the benefit the participant will receive under the plan.

(d) Other Federal or State laws. To the extent applicable, the rules discussed in this section will govern classifications under a plan supplementing the benefits provided by other Federal or State laws, such as the Railroad Retirement Act of 1937. See section 206(b) of the Employee Retirement Income Security Act of 1974 (Public Law 93–406, 88 Stat. 864).

(e) Effect on prior law. Nothing in this section shall be construed as amending or modifying the rules applicable to post-separation social security increases prior to September 2, 1974. See paragraph (e) of § 1.401–3.

(f) Effective date. Section 401(a)(15) and this section shall apply to a plan only with respect to plan years to which section 411 (relating to minimum vesting standards) is applicable to the plan without regard to section 411(e)(2).

[T.D. 7434, 41 FR 42650, Sept. 28, 1976]

§ 1.401(a)–16 Limitations on benefits and contributions under qualified plans.

A trust will not be a qualified trust and a plan will not be a qualified plan if the plan provides for benefits or contributions which exceed the limitations of section 415. Section 415 and the regulations thereunder provide rules concerning these limitations on benefits and contributions.

[T.D. 7748, 46 FR 1696, Jan. 7, 1981]

§ 1.401(a)–19 Nonforfeitability in case of certain withdrawals.

(a) Application of section. Section 401(a)(19) and this section apply to a plan to which section 411(a) applies. (See section 411(e) and § 1.411(a)–2 for applicability of section 411).

(b) Prohibited forfeitures—(1) General rule. A plan to which this section applies is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if, under such plan, any part of a participant's accrued benefit derived from employer contributions is forfeitable solely because a benefit derived from the participant's contributions under the plan is voluntarily withdrawn by him after he has become a 50 percent vested participant.

(2) 50 percent vested participant. For purposes of subparagraph (1) of this paragraph, a participant is a 50 percent vested participant when he has a nonforfeitable right (within the meaning of section 411 and the regulations thereunder) to at least 50 percent of his accrued benefit derived from employer contributions. Whether or not a participant is 50 percent vested shall be determined by the ratio of the participant's total nonforfeitable employer-derived accrued benefit under the plan to his total employer-derived accrued benefit under the plan.

(3) Certain forfeitures. Paragraph (b)(1) of this section does not apply in the case of a forfeiture permitted by section 411(a)(3)(D)(iii) and § 1.411(a)–7(d)(3) (relating to forfeitures of certain benefits accrued before September 2, 1974).

(c) Supersession. Section 11.401(a)–(19) of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this section.

[T.D. 7501, 42 FR 42320, Aug. 23, 1977]

§ 1.401(a)–20 Requirements of qualified joint and survivor annuity and qualified preretirement survivor annuity.

Q-1: What are the survivor annuity requirements added to the Code by the Retirement Equity Act of 1984 (REA 1984)?

A-1: REA 1984 replaced section 401(a)(11) with a new section 401(a)(11) and added section 417. Plans to which new section 401(a)(11) applies must comply with the requirements of sections 401(a)(11) and 417 in order to remain qualified under sections 401(a) or 403(a). In general, these plans must provide both a qualified joint and survivor annuity (QJSA) and a qualified preretirement survivor annuity (QPSA) to remain qualified. These survivor annuity requirements are applicable to any benefit payable under a plan, including a benefit payable to a participant under a contract purchased by the plan and paid by a third party.

Q-2: Must annuity contracts purchased and distributed to a participant or spouse by a plan subject to the survivor annuity requirements of sections 401(a)(11) and 417 satisfy the requirements of those sections?

A-2: Yes. Rights and benefits under section 401(a)(11) or 417 may not be eliminated or reduced because the plan uses annuity contracts to provide benefits merely because (a) such a contract is held by a participant or spouse instead of a plan trustee, or (b) such contracts are distributed upon plan termination. Thus, the requirements of sec-

tions 401(a)(11) and 417 apply to payments under the annuity contracts, not to the distributions of the contracts.

Q-3: What plans are subject to the survivor annuity requirements of section 401(a)(11)?

A-3: (a) Section 401(a)(11) applies to any defined benefit plan and to any defined contribution plan that is subject to the minimum funding standards of section 412. This section also applies to any participant under any other defined contribution plan unless all of the following conditions are satisfied—

(1) The plan provides that the participant's nonforfeitable accrued benefit is payable in full, upon the participant's death, to the participant's surviving spouse (unless the participant elects, with spousal consent that satisfies the requirements of section 417(a)(2), that such benefit be provided instead to a designated beneficiary);

(2) The participant does not elect the payment of benefits in the form of a life annuity; and

(3) With respect to the participant, the plan is not a transferee or an offset plan. (See Q&A 5 of this section.)

(b) A defined contribution plan not subject to the minimum funding standards of section 412 will not be treated as satisfying the requirement of paragraph (a)(1) unless both of the following conditions are satisfied—

(1) The benefit is available to the surviving spouse within a reasonable time after the participant's death. For this purpose, availability within the 90-day period following the date of death is deemed to be reasonable and the reasonableness of longer periods shall be determined based on the particular facts and circumstances. A time period longer than 90 days, however, is deemed unreasonable if it is less favorable to the surviving spouse than any time period under the plan that is applicable to other distributions. Thus, for example, the availability of a benefit to the surviving spouse would be unreasonable if the distribution was required to be made by the close of the plan year including the participant's death while distributions to employees who separate from service were required to be made within 90 days of separation.

(2) The benefit payable to the surviving spouse is adjusted for gains or losses occurring after the participant's death in accordance with plan rules governing the adjustment of account balances for other plan distributions. Thus, for example, the plan may not provide for distributions of an account balance to a surviving spouse determined as of the last day of the quarter in which the participant's death occurred with no adjustments of an account balance for gains or losses after death if the plan provides for such adjustments for a participant who separates from service within a quarter.

(c) For purposes of determining the extent to which section 401(a)(11) applies to benefits under an employee stock ownership plan (as defined in section 4975(e)(7)), the portion of a participant's accrued benefit that is subject to section 409(h) is to be treated as though such benefit were provided under a defined contribution plan not subject to section 412.

(d) The requirements set forth in section 401(a)(11) apply to other employee benefit plans that are covered by applicable provisions under Title I of the Employee Retirement Income Security Act of 1974. For purposes of applying the regulations under sections 401(a)(11) and 417, plans subject to ERISA section 205 are treated as if they were described in section 401(a). For example, to the extent that section 205 covers section 403(b) contracts and custodial accounts they are treated as section 401(a) plans. Individual retirement plans (IRAs), including IRAs to which contributions are made under simplified employee pensions described in section 408(k) and IRAs that are treated as plans subject to Title I, are not subject to these requirements.

Q-4: What rules apply to a participant who elects a life annuity option under a defined contribution plan not subject to section 412?

A-4: If a participant elects at any time (irrespective of the applicable election period defined in section 417(a)(6)) a life annuity option under a defined contribution plan not subject to section 412, the survivor annuity requirements of sections 401(a)(11) and 417 will always thereafter apply to all of the participant's benefits under such plan unless there is a separate accounting of the account balance subject to the election. A plan may allow a participant to elect an annuity option prior to the applicable election period described in section 417(a)(6). If a participant elects an annuity option, the plan must satisfy the applicable written explanation, consent, election, and withdrawal rules of section 417, including waiver of the QJSA within 90 days of the annuity starting date. If a participant selecting such an option dies, the surviving spouse must be able to receive the QPSA benefit described in section 417(c)(2) which is a life annuity, the actuarial equivalent of which is not less than 50 percent of the nonforfeitable account balance (adjusted for loans as described in

Q&A 24(d) of this section). The remaining account balance may be paid to a designated nonspouse beneficiary.

Q-5: How do sections 401(a)(11) and 417 apply to transferee plans which are defined contribution plans not subject to section 412?

A-5: (a) Transferee plans. Although the survivor annuity requirements of sections 401(a)(11) and 417 generally do not apply to defined contribution plans not subject to section 412, such plans are subject to the survivor annuity requirements to the extent that they are transferee plans with respect to any participant. A defined contribution plan is a transferee plan with respect to any participant if the plan is a direct or indirect transferee of such participant's benefits held on or after January 1, 1985, by:

(1) A defined benefit plan,

(2) A defined contribution plan subject to section 412

or

(3) A defined contribution plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 with respect to that participant.

If through a merger, spinoff, or other transaction having the effect of a transfer, benefits subject to the survivor annuity requirements of sections 401(a)(11) and 417 are held under a plan that is not otherwise subject to such requirements, such benefits will be subject to the survivor annuity requirements even though they are held under such plan. Even if a plan satisfies the survivor annuity requirements, other rules apply to these transactions. See, e.g., section 411(d)(6) and the regulations thereunder. A transfer made before January 1, 1985, and any rollover contribution made at any time, are not transactions that subject to the transferee plan to the survivor annuity requirements with respect to a participant. If a plan is a transferee plan with respect to a participant, the survivor annuity requirements do not apply with respect to other plan participants solely because of the transfer. Any plan that would not otherwise be subject to the survivor annuity requirements of sections 401(a)(11) and 417 whose benefits are used to offset benefits in a plan subject to such requirements is subject to the survivor annuity requirements with respect to those participants whose benefits are offset. Thus, if a stock bonus or profit-sharing plan offsets benefits under a defined benefit plan, such a plan is subject to the survivor annuity requirements.

(b) Benefits covered. The survivor annuity requirements apply to all accrued benefits held for a participant with respect to whom the plan is a transferee plan unless there is an acceptable separate accounting between the transferred benefits and all other benefits under the plan. A separate accounting is not acceptable unless gains, losses, withdrawals, contributions, forfeitures, and other credits or charges are allocated on a reasonable and consistent basis between the accrued benefits subject to the survivor annuity requirements and other benefits. If there is an acceptable separate accounting between transferred benefits and any other benefits under the plan, only the transferred benefits are subject to the survivor annuity requirements.

Q-6: Is a frozen or terminated plan required to satisfy the survivor annuity requirements of sections 401(a)(11) and 417?

A-6: In general, benefits provided under a plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 must be provided in accordance with those requirements even if the plan is frozen or terminated. However, any plan that has a termination date prior to September 17, 1985, and that distributed all remaining assets as soon as administratively feasible after the termination date, is not subject to the survivor annuity requirements. The date of termination is determined under section 411(d)(3) and § 1.411(d)-2(c).

Q-7: If the Pension Benefit Guaranty Corporation (PBGC) is administering a plan are benefits payable in the form of a OPSA or QJSA?

A-7: Yes, the PBGC will pay benefits in such forms.

Q-8: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply to participants?

A-8: (a) If a participant dies before the annuity starting date with vested benefits attributable to employer or employee contributions (or both), benefits must be paid to the surviving spouse in the form of a QPSA. If a participant survives until the annuity starting date with vested benefits attributable to employer or employee contributions (or both), benefits must be provided to the participant in the form of a QJSA.

(b) A participant may waive the QPSA or the QJSA (or both) if the applicable notice, election, and spousal consent requirements of section 417 are satisfied.

(c) Benefits are not required to be paid in the form of a QPSA or QJSA if at the time of death or distribution the participant was vested only in

employee contributions and such death occurred, or distribution commenced, before October 22, 1986.

(d) Certain mandatory distributions. A distribution may occur without satisfying the spousal consent requirements of section 417 (a) and (e) if the present value of the nonforfeitable benefit does not exceed $3,500. See § 1.417(e)-1.

Q-9: May separate portions of a participant's accrued benefit be subject to QPSA and QJSA requirements at any particular point in time?

A-9: (a) Dual QPSA and QJSA rights. One portion of a participant's benefit may be subject to the QPSA and another portion to the QJSA requirements at the same time. For example, in order for a money purchase pension plan to distribute any portion of a married participant's benefit to the participant, the plan must distribute such portion in the form of a QJSA (unless the plan satisfies the applicable consent requirements of section 417 (a) and (e) with respect to such portion of the participant's benefit). This rule applies even if the distribution is merely an in-service distribution attributable to voluntary employee contributions and regardless of whether the participant has attained the normal retirement age under the plan. The QJSA requirements apply to such a distribution because the annuity starting date has occurred with respect to this portion of the participant's benefit. In the event of a participant's death following the commencement of a distribution in the form of a QJSA, the remaining payments must be made to the surviving spouse under the QJSA. In addition, the plan must satisfy the QPSA requirements with respect to any portion of the participant's benefits for which the annuity starting date had not yet occurred.

(b) Example. Assume that participant A has a $100,000 account balance in a money purchase pension plan. A makes an in-service withdrawal of $20,000 attributable to voluntary employee contributions. The QJSA requirements apply to A's withdrawal of the $20,000. Accordingly, unless the QJSA form is properly waived such amount must be distributed in the form of a QJSA. A's remaining account balance ($80,000) remains subject to the QPSA requirements because the annuity starting date has not occurred with respect to the $80,000. (If A survives until the annuity starting date, the $80,000 would be subject to the QJSA requirements.) If A died on the day following the annuity starting date for the withdrawal, A's spouse would be entitled to a QPSA with a value equal to at least $40,000 with respect to the $80,000 account balance, in addition to any survivor benefit without respect to the $20,000. If the $20,000 payment to A had been the first payment of an annuity purchased with the entire $100,000 account balance rather than an in-service distribution, then the QJSA requirements would apply to the entire account balance at the time of the annuity starting date. In such event, the plan would have no obligation to provide A's spouse with a QPSA benefit upon A's death. Of course, A's spouse would receive the QJSA benefit (if the QJSA had not been waived) based on the full $100,000.

Q-10: What is the relevance of the annuity starting date with respect to the survivor benefit requirements?

A-10: (a) Relevance. The annuity starting date is relevant to whether benefits are payable as either a QJSA or QPSA, or other selected optional form of benefit. If a participant is alive on the annuity starting date, the benefits must be payable as a QJSA. If the participant is not alive on the annuity starting date, the surviving spouse must receive a QPSA. The annuity starting date is also used to determine when a spouse may consent to and a participant may waive a QJSA. A waiver is only effective if it is made 90 days before the annuity starting date. Thus, a deferred annuity cannot be selected and a QJSA waived until 90 days before payments commence under the deferred annuity. In some cases, the annuity starting date will have occurred with respect to a portion of the participant's accrued benefit and will not have occurred with respect to the remaining portion. (See Q&A-9.)

(b) Annuity starting date—(1) General rule. For purposes of sections 401(a)(11), 411(a)(11) and 417, the annuity starting date is the first day of the first period for which an amount is paid as an annuity or any other form.

(2) Annuity payments. The annuity starting date is the first date for which an amount is paid, not the actual date of payment. Thus, if participant A is to receive annuity payments as of the first day of the first month after retirement but does not receive any payments until three months later, the annuity starting date is the first day of the first month. For example, if an annuity is to commence on January 1, January 1 is the annuity starting date even though the payment for January is not actually made until a later date. In the case of a deferred annuity, the annuity starting date is the date for which the annuity payments are to commence, not the date that the deferred annuity is elected or the date the deferred annuity contract is distributed.

(3) Administrative delay. A payment shall not be considered to occur after the annuity starting date merely because actual payment is reasonably delayed for calculation of the benefit amount if all payments are actually made.

(4) Forfeitures on death. Prior to the annuity starting date, section 411(a)(3)(A) allows a plan to provide for a forfeiture of a participant's benefit, except in the case of a QPSA or a spousal benefit described in section 401(a)(11)(B)(iii)(I). Once

the annuity starting date has occurred, even if actual payment has not yet been made, a plan must pay the benefit in the distribution form elected.

(5) Surviving spouses, alternate payees, etc. The definition of "annuity starting date" for surviving spouses, other beneficiaries and alternate payees under section 414(p) is the same as it is for participants.

(c) Disability auxiliary benefit—(1) General rule. The annuity starting date for a disability benefit is the first day of the first period for which the benefit becomes payable unless the disability benefit is an auxiliary benefit. The payment of any auxiliary disability benefits is disregarded in determining the annuity starting date. A disability benefit is an auxiliary benefit if upon attainment of early or normal retirement age, a participant receives a benefit that satisfies the accrual and vesting rules of section 411 without taking into account the disability benefit payments up to that date.

(2) **Example.** (i) Assume that participant A at age 45 is entitled to a vested accrued benefit of $100 per month commencing at age 65 in the form of a joint and survivor annuity under Plan X. If prior to age 65 A receives a disability benefit under Plan X and the payment of such benefit does not reduce the amount of A's retirement benefit of $100 per month commencing at age 65, any disability benefit payments made to A between ages 45 and 65 are auxiliary benefits. Thus, A's annuity starting date does not occur until A attains age 65. A's surviving spouse B would be entitled to receive a QPSA if A died before age 65. B would be entitled to receive the survivor portion of a QJSA (unless waived) if A died after age 65. The QPSA payable to B upon A's death prior to age 65 would be computed by reference to the QJSA that would have been payable to A and B had A survived to age 65.

(ii) If in the above example A's benefit payable at age 65 is reduced to $99 per month because a disability benefit is provided to A prior to age 65, the disability benefit would not be an auxiliary benefit. The benefit of $99 per month payable to A at age 65 would not, without taking into account the disability benefit payments to A prior to age 65, satisfy the minimum vesting and accrual rules of section 411. Accordingly, the first day of the first period for which the disability payments are to be made to A would constitute A's annuity starting date, and any benefit paid to A would be required to be paid in the form of a QJSA (unless waived by A with the consent of B).

(d) Other rules—(1) Suspension of benefits. If benefit payments are suspended after the annuity starting date pursuant to a suspension of benefits described in section 411(a)(3)(B) after an employee separates from service, the recommencement of benefit payments after the suspension is not treated as a new annuity starting date unless the plan provides otherwise. In such case, the plan administrator is not required to provide new notices nor to obtain new waivers for the recommenced distributions if the form of distribution is the same as the form that was appropriately selected prior to the suspension. If benefits are suspended for an employee who continues in service without a separation and who never receives payments, the commencement of payments after the period of suspension is treated as the annuity starting date unless the plan provides otherwise.

(2) Additional accruals. In the case of an annuity starting date that occurs on or after normal retirement age, such date applies to any additional accruals after the annuity starting date, unless the plan provides otherwise. For example, if a participant who continues to accrue benefits elects to have benefits paid in an optional form at normal retirement age, the additional accruals must be paid in the optional form selected unless the plan provides otherwise. In the case of an annuity starting date that occurs prior to normal retirement age, such date does not apply to any additional accruals after such date.

Q-11: Do the survivor annuity requirements apply to benefits derived from both employer and employee contributions?

A-11: Yes. The survivor annuity benefit requirements apply to benefits derived from both employer and employee contributions. Benefits are not required to be paid in the form of a QPSA or QJSA if the participant was vested only in employee contributions at the time of death or distribution and such death or distribution occurred before October 22, 1986. All benefits provided under a plan, including benefits attributable to rollover contributions, are subject to the survivor annuity requirements.

Q-12: To what benefits do the survivor annuity requirements of sections 401(a)(11) and 417 apply?

A-12: (a) Defined benefit plans. Under a defined benefit plan, sections 401(a)(11) and 417 apply only to benefits in which a participant was vested immediately prior to death. They do not apply to benefits to which a participant's beneficiary becomes entitled by reason of death or to the proceeds of a life insurance contract to the extent such proceeds exceed the present value of the participant's nonforfeitable benefits that existed immediately prior to death.

(b) Defined contribution plans. Sections 401(a)(11) and 417 apply to all nonforfeitable benefits which are payable under a defined contribution plan, whether nonforfeitable before or upon death, including the proceeds of insurance contracts.

Q-13: Does the rule of section 411(a)(3)(A) which permits forfeitures on account of death

apply to a QPSA or the spousal benefit described in section 401(a)(11)(B)(iii)?

A-13: No. Section 411(a)(3)(A) permits forfeiture on account of death prior to the time all the events fixing payment occur. However, this provision does not operate to deprive a surviving spouse of a QPSA or the spousal benefit described in section 401(a)(11)(B)(iii). Therefore, sections 401(a)(11) and 417 apply to benefits that were nonforfeitable immediately prior to death (determined without regard to section 411(a)(3)(A)). Thus, in the case of the death of a married participant in a defined contribution plan not subject to section 412 which provides that, upon a participant's death, the entire nonforfeitable accrued benefit is payable to the participant's spouse, the nonforfeitable benefit is determined without regard to the provisions of section 411(a)(3)(A).

Q-14: Do sections 411(a)(11), 401(a)(11) and 417 apply to accumulated deductible employee contributions, as defined in section 72(*o*)(5)(B) (Accumulated DECs)?

A-14: (a) Employee consent, section 411. The requirements of section 411(a)(11) apply to Accumulated DECs. Thus, Accumulated DECs may not be distributed without participant consent unless the applicable exemptions apply.

(b) Survior requirements. Accumulated DECs are treated as though held under a separate defined contribution plan that is not subject to section 412. Thus, section 401(a)(11) applies to Accumulated DECs only as provided in section 401(a)(11)(B)(iii). All Accumulated DECs are treated in this manner, including Accumulated DECs that are the only benefit held under a plan and Accumulated DECs that are part of a defined benefit or a defined contribution plan.

(c) Effective date. Sections 401(a)(11) and 411(a)(11) shall not apply to distributions of accumulated DECs until the first plan year beginning after December 31, 1988.

Q-15: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply to a defined benefit plan that includes an accrued benefit based upon a contribution to a separate account or mandatory employee contributions?

A-15: (a) 414(k) plans. In the case of a section 414(k) plan that includes both a defined benefit plan and a separate account, the rules of sections 401(a)(11) and 417 apply separately to the defined benefit portion and the separate account portion of the plan. The separate account portion is subject to the survivor annuity requirements of sections 401(a)(11) and 417 and the special QPSA rules in section 417(c)(2).

(b) Employee contributions—(1) Voluntary. In the case of voluntary employee contributions to a defined benefit plan, the plan must maintain a separate account with respect to the voluntary employee contributions. This separate account is subject to the survivor annuity requirements of sections 401(a)(11) and 417 and the special QPSA rules in section 417(c)(2).

(2) Mandatory. In the case of a defined benefit plan providing for mandatory employee contributions, the entire accrued benefit is subject to the survivor annuity requirements of sections 401(a)(11) and 417 as a defined benefit plan.

(c) Accumulated DECs. See Q&A 14 of this section for the rule applicable to accumulated deductible employee contributions.

Q-16: Can a plan provide a benefit form more valuable than the QJSA and if a plan offers more than one annuity option satisfying the requirements of a QJSA, is spousal consent required when the participant chooses among the various forms?

A-16: In the case of an unmarried participant, the QJSA may be less valuable than other optional forms of benefit payable under the plan. In the case of married participant, the QJSA must be at least as valuable as any other optional form of benefit payable under the plan at the same time. Thus, if a plan has two joint and survivor annuities that would satisfy the requirements for a QJSA, but one has a greater actuarial value than the other, the more valuable joint and survivor annuity is the QJSA. If there are two or more actuarially equivalent joint and survivor annuities that satisfy the requirements for a QJSA, the plan must designate which one is the QJSA and, therefore, the automatic form of benefit payment. A plan, however, may allow a participant to elect out of such a QJSA, without spousal consent, in favor of another actuarially equivalent joint and survivor annuity that satisfies the QJSA conditions. Such an election is not subject to the requirement that it be made within the 90-day period before the annuity starting date. For example, if a plan designates a joint and 100% survivor annuity as the QJSA and also offers an actuarially equivalent joint and 50% survivor annuity that would satisfy the requirements of a QJSA, the participant may elect the joint and 50% survivor annuity without spousal consent. The participant, however, does need spousal consent to elect a joint and survivor annuity that was not actuarially equivalent to the automatic QJSA.

Q-17: When must distributions to a participant under a QJSA commence?

A-17: (a) QJSA benefits upon earliest retirement. A plan must permit a participant to receive a distribution in the form of a QJSA when the participant attains the earliest retirement age under the plan. Written consent of the participant is required. However, the consent of the participant's spouse is not required. Any payment not in the form of a QJSA is subject to spousal consent. For example, if the participant separates from service under a plan that allows for distributions on separation from service or if a plan allows for in-service distributions, the participant may receive a QJSA without spousal consent in such events. Payments in any other form, including a single sum, would require waiver of the QJSA by the participant's spouse.

(b) Earliest retirement age. (1) This paragraph (b) defines the term "earliest retirement age" for purposes of sections 401(a)(11), 411(a)(11) and 417.

(2) In the case of a plan that provides for voluntary distributions that commence upon the participant's separation from service, earliest retirement age is the earliest age at which a participant could separate from service and receive a distribution. Death of a participant is treated as a separation from service.

(3) In the case of a plan that provides for in-service distributions, earliest retirement age is the earliest age at which such distributions may be made.

(4) In the case of a plan not described in subparagraph (2) or (3) of this paragraph, the rule below applies. Earliest retirement age is the early retirement age determined under the plan, or if no early retirement age, the normal retirement age determined under the plan. If the participant dies or separates from service before such age, then only the participant's actual years of service at the time of the participant's separation from service or death are taken into account. Thus, in the case of a plan under which benefits are not payable until the attainment of age 65, or upon attainment of age 55 and completion of 10 years of service, the earliest retirement age of a participant who died or separated from service with 8 years of service is when the participant whould have attained age 65 (if the participant had survived). On the other hand, if a participant died or separated from service after 10 years of service, the earliest retirement age is when the participant would have attained age 55 (if the participant had survived).

Q-18: What is a qualified preretirement survivor annuity (QPSA) in a defined benefit plan?

A-18: A QPSA is an immediate annuity for the life of the surviving spouse of a participant. Each payment under a QPSA under a defined benefit plan is not to be less than the payment that would have been made to the survivor under the QJSA payable under the plan if (a) in the case of a participant who dies after attaining the earliest retirement age under the plan, the participant had retired with a QJSA on the day before the participant's death, and (b) in the case of a participant who dies on or before the participant's earliest retirement age under the plan, the participant had separated from service at the earlier of the actual time of separation or death, survived until the earliest retirement age, retired at that time with a QJSA, and died on the day thereafter. If the participant elects before the annuity starting date a form of joint and survivor annuity that satisfies the requirements for a QJSA and dies before the annuity starting date, the elected form is treated as the QJAS and the QPSA must be based on such form.

Q-19: What rules apply in determining the amount and forfeitability of a QPSA?

A-19: The QPSA is calculated as of the earliest retirement age if the participant dies before such time, or at death if the participant dies after the earliest retirement age. The plan must make reasonable actuarial adjustments to reflect a payment earlier or later than the earliest retirement age. A defined benefit plan may provide that the QPSA is forfeited if the spouse does not survive until the date prescribed under the plan for commencement of the QPSA (i.e., the earliest retirement age). Similarly, if the spouse survives past the participant's earliest retirement age (or other earlier QPSA distribution date under the plan) and elects after the death of the participant to defer the commencement of the QPSA to a later date, a defined benefit plan may provide for a forfeiture of the QPSA benefit if the spouse does not survive until the deferred commencement date. The account balance in a defined contribution plan may not be forfeited even though the spouse does not survive until the time the account balance is used to purchase the QPSA. See Q&A-17 of this section for the meaning of earliest retirement age.

Q-20: What preretirement survivor annuity benefits must a defined contibution plan subject to the survivor annuity requirements of sections 401(a)(11) and 417 provide?

A-20: A defined contribution plan that is subject to the survivor annuity requirements of sections 401(a)(11) and 417 must provide a preretirement

survivor annuity with a value which is not less than 50 percent of the nonforfeitable account balance of the participant as of the date of the participant's death. If a contributory defined contribution plan has a forfeiture provision permitted by section 411(a)(3)(A), not more than a proportional percent of the account balance attributable to contributions that may not be forfeited at death (for example, employee and section 401(k) contributions) may be used to satisfy the QPSA benefit. Thus, for example, if the QPSA benefit is to be provided from 50 percent of the account balance, not more than 50 percent of the nonforfeitable contributions may be used for the QPSA.

Q-21: May a defined benefit plan charge the participant for the cost of the QPSA benefit?

A-21: Prior to the later of the time the plan allows the participant to waive the QPSA or provides notice of the ability to waive the QPSA, a defined benefit plan may not charge the participant for the cost of the QPSA by reducing the participant's plan benefits or by any other method. The preceding sentence does not apply to any charges prior to the first plan year beginning after December 31, 1988. Once the participant is given the opportunity to waive the QPSA or the notice of the QPSA is later, the plan may charge the participant for the cost of the QPSA. A charge for the QPSA that reasonably reflects the cost of providing the QPSA will not fail to satisfy section 411 even if it reduces the accrued benefit.

Q-22: When must distributions to a surviving spouse under a QPSA commence?

A-22: (a) In the case of a defined benefit plan, the plan must permit the surviving spouse to direct the commencement of payments under QPSA no later than the month in which the participant would have attained the earliest retirement age. However, a plan may permit the commencement of payments at an earlier date.

(b) In the case of a defined contribution plan, the plan must permit the surviving spouse to direct the commencement of payments under the QPSA within a reasonable time after the participant's death.

Q-23: Must a defined benefit plan obtain the consent of a participant and the participant's spouse to commence payments in the form of a QJSA in order to avoid violating section 415 or 411(b)?

A-23: No. A defined benefit plan may commence distributions in the form of a QJSA without the consent of the participant and spouse, even if consent would otherwise be required (see § 1.417(e)-1(b)), to the extent necessary to avoid a violation of section 415 or 411(b). For example, assume a plan has a normal retirement age of 55. A is a married participant, age 55, and has accrued a $75,000 joint and 100 percent survivor annuity that satisfies section 415. If an actuarial increase would be required under section 411 because of deferred commencement and the increase would cause the benefit to exceed the applicable limit under section 415, the plan may commence payment of a QJSA at age 55 without the participant's election or consent and without the spouse's consent.

Q-24: What are the rules under sections 401(a)(11) and 417 applicable to plan loans?

A-24: (a) Consent rules. (1) A plan does not satisfy the survivor annuity requirements of sections 401(a)(11) and 417 unless the plan provides that, at the time the participant's accrued benefit is used as security for a loan, spousal consent to such use is obtained. Consent is required even if the accrued benefit is not the primary security for the loan. No spousal consent is necessary if, at the time the loan is secured, no consent would be required for a distribution under section 417(a)(2)(B). Spousal consent is not required if the plan or the participant is not subject to section 401(a)(11) at the time the accrued benefit is used as security, or if the total accrued benefit subject to the security is not in excess of $3,500. The spousal consent must be obtained no earlier than the beginning of the 90-day period that ends on the date on which the loan is to be so secured. The consent is subject to the requirements of section 417(a)(2). Therefore, the consent must be in writing, must acknowledge the effect of the loan and must be witnessed by a plan representative or a notary public.

(2) Participant consent is deemed obtained at the time the participant agrees to use his accrued benefit as security for a loan for purposes of satisfying the requirements for participant consent under sections 401(a)(11), 411(a)(11) and 417.

(b) Change in status. If spousal consent is obtained or is not required under paragraph (a) of this Q&A 24 at the time the benefits are used as security, spousal consent is not required at the time of any setoff of the loan against the accrued benefit resulting from a default, even if the participant is married to a different spouse at the time of the setoff. Similarly, in the case of a participant who secured a loan while unmarried, no consent is required at the time of a setoff of the loan against the accrued benefit even if the participant is married at the time of the setoff.

(c) Renegotiation. For the purposes of obtaining any required spousal consent, any renegotiation, extension, renewal, or other revision of a loan shall be treated as a new loan made on the date of the renegotiation, extension, renewal, or other revision.

(d) Effect on benefits. For purposes of determining the amount of a QPSA or QJSA, the accrued benefit of a participant shall be reduced by any security interest held by the plan by reason of a loan outstanding to the participant at the time of death or payment, if the security interest is treated as payment in satisfaction of the loan under the plan. A plan may offset any loan outstanding at the participant's death which is secured by the participant's account balance against the spousal benefit required to be paid under section 401(a)(11)(B)(iii).

(e) Effective date. Loans made prior to August 19, 1985, are deemed to satisfy the consent requirements of paragraph (a) of this Q&A 24.

Q-25: How do the survivor annuity requirements of sections 401(a)(11) and 417 apply with respect to participants who are not married or to surviving spouses and participants who have a change in marital status?

A-25: (a) Unmarried participant rule. Plans subject to the survivor annuity requirements of sections 401(a)(11) and 417 must satisfy those requirements applicable to QJSAs with respect to participants who are not married. A QJSA for a participant who is not married is an annuity for the life of the participant. Thus, an unmarried participant must be provided the written explanation described in section 417(a)(3)(A) and a single life annuity unless another form of benefit is elected by the participant. An unmarried participant is deemed to have waived the QPSA requirements. This deemed waiver is null and void if the participant later marries.

(b) Marital status change.—(1) Remarriage. If a participant is married on the date of death, payments to a surviving spouse under a QPSA or QJSA must continue even if the surviving spouse remarries.

(2) One-year rule. (i) A plan is not required to treat a participant as married unless the participant and the participant's spouse have been married throughout the one-year period ending on the earlier of (A) the participant's annuity starting date or (B) the date of the participant's death. Nevertheless, for purposes of the preceding sentence, a participant and the participant's spouse must be treated as married throughout the one-year period ending on the participant's annuity starting date even though they are married to each other for less than one year before the annuity starting date if they remain married to each other for at least one year. See section 417(d)(2). If a plan adopts the one-year rule provided in section 417(d), the plan must treat the participant and spouse who are married on the annuity starting date as married and must provide benefits which are to commence on the annuity starting date in the form of a QJSA unless the participant (with spousal consent) elects another form of benefit. The plan is not required to provide the participant with a new or retroactive election or the spouse with a new consent when the one-year period is satisfied. If the participant and the spouse do not remain married for at least one year, the plan may treat the participant as having not been married on the annuity starting date. In such event, the plan may provide that the spouse loses any survivor benefit right; further, no retroactive correction of the amount paid the participant is required.

(ii) Example. Plan X provides that participants who are married on the annuity starting date for less than one year are treated as unmarried participants. Plan X provides benefits in the form of a QJSA or an optional single sum distribution. Participant A was married 6 months prior to the annuity starting date. Plan X must treat A as married and must commence payments to A in the form of a QJSA unless another form of benefit is elected by A with spousal consent. If a QJSA is paid and A is divorced from his spouse S, within the first year of the marriage, S will no longer have any survivor rights under the annuity (unless a QDRO provides otherwise). If A continues to be married to S, and A dies within the one-year period, Plan X may treat A as unmarried and forfeit the OJSA benefit payable to S.

(3) Divorce. If a participant divorces his spouse prior to the annuity starting date, any elections made while the participant was married to his former spouse remain valid, unless otherwise provided in a QDRO, or unless the participant changes them or is remarried. If a participant dies after the annuity starting date, the spouse to whom the participant was married on the annuity starting date is entitled to the QJSA protection under the plan. The spouse is entitled to this protection (unless waived and consented to by such spouse) even if the participant and spouse are not married on the date of the participant's death, except as provided in a QDRO.

Q-26: In the case of a defined contribution plan not subject to section 412, does the requirement that a participant's nonforfeitable accrued benefit be payable in full to a surviving spouse apply to a spouse who has been married to the participant for less than one year?

A-26: A plan may provide that a spouse who has not been married to a participant throughout

the one-year period ending on the earlier of (a) the participant's annuity starting date or (b) the date of the participant's death is not treated as a surviving spouse and is not required to receive the participant's account balance. The special exception described in section 417(d)(2) and Q&A 25 of this section does not apply.

Q-27: Are there circumstances when spousal consent to a participant's election to waive the QJSA or the QPSA is not required?

A-27: Yes. If it is established to the satisfaction of a plan representative that there is no spouse or that the spouse cannot be located, spousal consent to waive the QJSA or the QPSA is not required. If the spouse is legally incompetnent to give consent, the spouse's legal guardian, even if the guardian is the participant, may give consent. Also, if the participant is legally separated or the participant has been abandoned (within the meaning of local law) and the participant has a court order to such effect, spousal consent is not required unless a QDRO provides otherwise. Similar rules apply to a plan subject to the requirements of section 401(a)(11)(B)(iii)(I).

Q-28: Does consent contained in an antenuptial agreement or similar contract entered into prior to marriage satisfy the consent requirements of sections 401(a)(11) and 417?

A-28: No. An agreement entered into prior to marriage does not satisfy the applicable consent requirements, even if the agreement is executed within the applicable election period.

Q-29: If a participant's spouse consents under section 417(a)(2)(A) to the participant's waiver of a survivor annuity form of benefit, is a subsequent spouse of the same participant bound by the consent?

A-29: No. A consent under section 417(a)(2)(A) by one spouse is binding only with respect to the consenting spouse. See Q&A-24 of this section for an exception in the case of plan benefits securing plan loans.

Q-30: Does the spousal consent requirement of section 417(a)(2)(A) require that a spouse's consent be revocable?

A-30: No. A plan may preclude a spouse from revoking consent once it has been given. Alternatively, a plan may also permit a spouse to revoke a consent after it has been given, and thereby to render ineffective the participant's prior election not to receive a QPSA or QJSA. A participant must always be allowed to change his election during the applicable election period. Spousal consent is required in such cases to the extent provided in Q&A 31, except that spousal consent is never required for a QJSA or QPSA.

Q-31: What rules govern a participant's waiver of a QPSA or QJSA under section 417(a)(2)?

A-31: (a) Specific beneficiary. Both the participant's waivers of a QPSA and QJSA and the spouse's consents thereto must state the specific nonspouse beneficiary (including any class of beneficiaries or any contingent beneficiaries) who will receive the benefit. Thus, for example, if spouse B consents to participant A's election to waive a QPSA, and to have any benefits payable upon A's death before the annuity starting date paid to A's children, A may not subsequently change beneficiaries without the consent of B (except if the change is back to a QPSA). If the designated beneficiary is a trust, A's spouse need only consent to the designation of the trust and need not consent to the designation of trust beneficiaries or any changes of trust beneficiaries.

(b) Optional form of benefit—(1) QJSA. Both the participant's waiver of a QJSA (and any required spouse's consent thereto) must specify the particular optional form of benefit. The participant who has waived a QJSA with the spouse's consent in favor of another form of benefit may not subsequently change the optional form of benefit without obtaining the spouse's consent (except back to a QJSA). Of course, the participant may change the form of benefit if the plan so provides after the spouse's death or a divorce (other than as provided in a QDRO). A participant's waiver of a QJSA (and any required spouse's consent thereto) made prior to the first plan year beginning after December 31, 1986, is not required to specify the optional form of benefit.

(2) QPSA. A participant's waiver of a QPSA and the spouse's consent thereto are not required to specify the optional form of any preretirement benefit. Thus, a participant who waives the QPSA with spousal consent may subsequently change the form of the preretirement benefit, but not the nonspouse beneficiary, without obtaining the spouse's consent.

(3) Change in form. After the participant's death, a beneficiary may change the optional form of survivor benefit as permitted by the plan.

(c) General consent. In lieu of satisfying paragraphs (a) and (b) of this Q&A 31, a plan may permit a spouse to execute a general consent that satisfies the requirements of this paragraph (c). A general consent permits the participant to waive QPSA or QJSA, and change the designated beneficary or the optional form of benefit payment

without any requirement of further consent by such spouse. No general consent is valid unless the general consent acknowledges that the spouse has the right to limit consent to a specific beneficiary and a specific optional form of benefit, where applicable, and that the spouse voluntarily elects to relinquish both of such rights. Notwithstanding the previous sentence, a spouse may execute a general consent that is limited to certain beneficiaries or forms of benefit payment. In such case, paragraphs (a) and (b) of this Q&A 31 shall apply to the extent that the limited general consent is not applicable and this paragraph (c) shall apply to the extent that the limited general consent is applicable. A general consent, including a limited general consent, is not effective unless it is made during the applicable election period. A general consent executed prior to October 22, 1986 does not have to satisfy the specificity requirements of this Q&A 31.

Q-32: What rules govern a participant's waiver of the spousal benefit under section 401(a)(11)(B)?

A-32: (a) Application. In the case of a defined contribution plan that is not subject to the survivor annuity requirements of sections 401(a)(11) and 417, a participant may waive the spousal benefit of section 401(a)(11)(B)(iii) if the conditions of paragraph (b) are satisfied. In general, a spousal benefit is the nonforfeitable account balance on the participant's date of death.

(b) Conditions. In general, the same conditions, other than the age 35 requirement, that apply to the participant's waiver of a QPSA and the spouse's consent thereto apply to the participant's waiver of the spousal benefit and the spouse's consent thereto. See Q&A-31. Thus, the participant's waiver of the spousal benefit must state the specific nonspouse beneficiary who will receive such benefit. The waiver is not required to specify the optional form of benefit. The participant may change the optional form of benefit, but not the nonspouse beneficiary, without obtaining the spouse's consent.

Q-33: When and in what manner, may a participant waive a spousal benefit or a QPSA?

A-33: (a) Plans not subject to section 401(a)(11). A participant in a plan that is not subject to the survivor annuity requirements of section 401(a)(11) (because of subparagraph (B)(iii) thereof) may waive the spousal benefit at any time, provided that no such waiver shall be effective unless the spouse has consented to the waiver. The spouse may consent to a waiver of the spousal benefit at any time, even prior to the participant attaining age 35. No spousal consent is required for a payment to the participant or the use of the accrued benefit as security for a plan loan to the participant.

(b) Plans subject to section 401(a)(11). A participant in a plan subject to the survivor annuity requirements of section 401(a)(11) generally may waive the QPSA benefit (with spousal consent) only on or after the first day of the plan year in which the participant attains age 35. However, a plan may provide for an earlier waiver (with spousal consent), provided that a written explanation of the QPSA is given to the participant and such waiver becomes invalid upon the beginning of the plan year in which the participant's 35th birthday occurs. If there is no new waiver after such date, the participant's spouse must receive the QPSA benefit upon the participant's death.

Q-34: Must the written explanations required by section 417(a)(3) be provided to nonvested participants?

A-34: Such written explantions must be provided to nonvested participants who are employed by an employer maintaining the plan. Thus, they are not required to be provided to those nonvested participants who are no longer employed by such an employer.

Q-35: When must a plan provide the written explanation, required by section 417(a)(3)(B), of the QPSA to a participant?

A-35: (a) General rule. A plan must provide the written explanation of the QPSA to a participant within the applicable period. Except as provided in paragraph (b), the applicable period means, with respect to a participant, whichever of the following periods ends last:

(1) The period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35.

(2) A reasonable period ending after the individual becomes a participant.

(3) A reasonable period ending after the QPSA is no longer fully subsidized.

(4) A reasonable period ending after section 401(a)(11) first applies to the participant. Section 401(a)(11) would first apply when a benefit is transferred from a plan not subject to the survivor annuity requirements of section 401(a)(11) to a plan subject to such section or at the time of a election of an annuity under a defined contribution plan described in section 401(a)(11)(B)(iii).

(b) Pre-35 separations. In the case of a participant who separates from service before attaining age 35, the applicable period means the period beginning one year before the separation from service and ending one year after such separation. If such a participant returns to service, the plan must also comply with paragraph (a).

(c) Reasonable period. For purposes of applying paragraph (a), a reasonable period ending after the enumerated events described in paragraphs (a) (2), (3) and (4) is the end of the one-year period beginning with the date the applicable event occurs. The applicable period for such events begins one year prior to the occurrence of the enumerated events.

(d) Transition rule. In the case of an individual who was a participant in the plan on August 23, 1984, and, as of that date had attained age 34, the plan will satisfy the requirement of section 417(a)(3)(B) if it provided the explanation not later than December 31, 1985.

Q-36: How do plans satisfy the requirements of providing participants explanations of QPSAs and QJSAs?

A-36: Section 417(a)(3) sets forth the requirements for providing plan participants written explanations of QPSAs and QJSAs. The requirement that the terms and conditions of the QJSA or QPSA, as the case may be, be furnished to participants is not satisfied unless the written explanation complies with the requirements set forth in § 1.401(a)-11(c)(3). Also, for plan years beginning after December 31, 1988, participants must be furnished a general description of the eligibility conditions and other material features of the optional forms of benefit and sufficient additional information to explain the relative values of the optional forms of benefit available under the plan (e.g., the extent to which optional forms are subsidized relative to the normal form of benefit or the interest rates used to calculate the optional forms).

Q-37: What are the consequences of fully subsidizing the cost of either a QJSA or a QPSA in accordance with section 417(a)(5)?

A-37: If a plan fully subsidizes a QJSA or QPSA in accordance with section 417(a)(5) and does not allow a participant to waive such QJSA or QPSA or to select a nonspouse beneficiary, the plan is not required to provide the written explanation required by section 417(a)(3). However, if the plan offers an election to waive the benefit or designate a beneficiary, it must satisfy the election, consent, and notice requirements of section 417(a) (1), (2), and (3), with respect to such subsidized QJSA or QPSA, in accordance with section 417(a)(5).

Q-38: What is a fully subsidized benefit?

A-38: (a) QJSA—(1) General rule. A fully subsidized QJSA is one under which no increase in cost to, or decrease in actual amounts received by, the participant may result from the participant's failure to elect another form of benefit.

(2) Examples.

Example (1). If a plan provides a joint and survivor annuity and a single sum option, the plan does not fully subsidize the joint and survivor annuity, regardless of the actuarial value of the joint and survivor annuity because, in the event of the participant's early death, the participant would have received less under the annuity than he would have received under the single sum option.

Example (2). If a plan provides for a life annuity of $100 per month and a joint and 100% survivor benefit of $99 per month, the plan does not fully subsidize the joint and survivor benefit.

(b) QPSA. A QPSA is fully subsidized if the amount of the participant's benefit is not reduced because of the QPSA coverage and if no charge to the participant under the plan is made for the coverage. Thus, a QPSA is fully subsidized in a defined contribution plan.

Q-39: When do the survivor annuity requirements of sections 401(a)(11) and 417 apply to plans?

A-39: Sections 401(a)(11) and 417 generally apply to plan years beginning after December 31, 1984. Sections 302 and 303 of REA 1984 provide specific effective dates and transitional rules under which the QJSA or QPSA (or pre-REA 1984 section 401(a)(11)) requirements may be applicable to particular plans or with respect to benefits provided to (as amended by REA 1984) particular participants. In general, the section 401(a)(11) (as amended by REA 1984) survivor annuity requirements do not apply with respect to a participant who does not have at least one hour of service or one hour of paid leave under the plan after August 22, 1984.

Q-40: Are there special effective dates for plans maintained pursuant to collective bargaining agreements?

A-40: Yes. Section 302(b) of REA 1984 as amended by section 1898(g) of the Tax Reform Act of 1986 provides a special deferred effective date for such plans. Whether a plan is described in section 302(b) of REA 1984 is determined under the principles applied under section 1017(c) of the Employee Retirement Income Security Act of 1974. See H.R. Rep. No. 1280, 93d Cong., 2d Sess. 266 (1974). In addition, a plan will not be treated as maintained under a collective bargaining

agreement unless the employee representatives satisfy section 7701(a)(46) of the Internal Revenue Code after March 31, 1984. See § 301.7701-17T for other requirements for a plan to be considered to be collectively bargained. Nothing in section 302(b) of REA 1984 denies a participant or spouse the rights set forth in sections 303(c)(2), 303(c)(3), 303(e)(1), and 303(e)(2) of REA 1984.

Q-41: What is one hour of service or paid leave under the plan for purposes of the transition rules in section 303 of REA 1984?

A-41: One hour of service or paid leave under the plan is one hour of service or paid leave recognized or required to be recognized under the plan for any purpose, e.g., participation, vesting percentage, or benefit accrual purposes. For plans that do not compute hours of service, one hour of service or paid leave means any service or paid leave recognized or required to be recognized under the plan for any purpose.

Q-42: Must a plan be amended to provide for the QPSA required by section 303(c)(2) of REA 1984, or for the survivor annuities required by section 303(e) of REA 1984?

A-42: A plan will not fail to satisfy the qualification requirements of section 401(a) or 403(a) merely because it is not amended to provide the QPSA required by section 303(c)(2) or the survivor annuities required by section 303(e). The plan must, however, satisfy those requirements in operation.

Q-43: Is a participant's election, or a spouse's consent to an election, with respect to a QPSA, made before August 23, 1984, valid?

A-43: No.

Q-44: Is spousal consent required for certain survivor annuity elections made by the participant after December 31, 1984, and before the first plan year to which new sections 401(a)(11) and 417 apply?

A-44: Yes. Section 303(c)(3) of REA 1984 provides that any election not to take a QJSA made after December 31, 1984, and before the date sections 401(a)(11) and 417 apply to the plan by a participant who has 1 hour of service or leave under the plan after August 23, 1984, is not effective unless the spousal consent requirements of section 417 are met with respect to such election. Unless the participant's annuity starting date occurred before January 1, 1985, the spousal consent required by section 417 (a)(2) and (e) must be obtained even though the participant elected the benefit prior to January 1, 1985. The plan is not required to be amended to comply with section 303(c)(3) of REA 1984, but the plan must satisfy this requirement in operation.

Q-45: Are there special rules for certain participants who separated from service prior to August 23, 1984?

A-45: Yes. Section 303(e) of REA 1984 provides special rules for certain participants who separated from service before August 23, 1984. Section 303(e)(1), which applies only to plans subject to section 401(a)(11) of the Code (as in effect on August 22, 1984), provides that participants whose annuity starting date did not occur before August 24, 1984, and who had one hour of service on or after September 2, 1974, but not in a plan year beginning after December 31, 1975, may elect to receive the benefits required to be provided under section 401(a)(11) of the Code (as in effect on August 22, 1984). Section 303(e)(2) provides that certain participants who had one hour of service in a plan year beginning on or after January 1, 1976, but not after August 22, 1984, may elect QPSA coverage under new sections 401(a)(11) and 417 in plans subject to these provisions. Section 303(e)(4)(A) requires plans or plan administrators to notify those participants of the provisions of section 303(e).

Q-46: When must a plan provide the notice required by section 303(e)(4)(A) of REA 1984?

A-46: The notice required by section 303(e)(4)(A) must be provided no later than the earlier of:

(a) The date the first summary annual report provided after September 17, 1985, is distributed to participants; or

(b) September 30, 1985.

A plan will not fail to satisfy the preceding sentence if the plan provides a fully subsidized QPSA with respect to any participant described in section 303(e) who dies on or after July 19, 1985, and before the notice is received. If the plan ceases to fully subsidize the QPSA, the cessation must not be effective until the notice is given. For this purpose, an annuity payable to a nonspouse beneficiary elected by the participant, in lieu of a spouse, shall satisfy the QPSA requirement, so long as the survivor benefit is fully subsidized. The notice required by this paragraph must be in writing and sent to the participant's last known address.

Q-47: Is there another time when plans must provide notice of the right, described in section 303(e)(1) of REA '84, to elect a pre-REA 1984 qualified joint and survivor annuity?

A-47: Yes. Notice of this right must also be provided to a participant at the time the participant applies for benefit payments.

[T.D. 8219, 53 FR 31842, Aug. 22, 1988]

§ 1.401(a)–50 Puerto Rican trusts; election to be treated as a domestic trust.

(a) In general. Section 401(a) requires, among other things, that a trust forming part of a pension, profit-sharing, or stock bonus plan must be created or organized in the United States to be a qualified trust. Section 1022(i)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 942) provides that trusts under certain pension, etc., plans created or organized in Puerto Rico whose administrators have made the election referred to in section 1022(i)(2) are to be treated as trusts created or organized in the United States for purposes of section 401(a). Thus, if a plan otherwise satisfies the qualification requirements of section 401(a), any trust forming part of the plan for which an election is made will be treated as a qualified trust under that section.

(b) Manner and effect of election. A plan administrator may make an election under ERISA section 1022(i)(2) by filing a statement making the election, along with a copy of the plan, with the Director's Representative of the Internal Revenue Service in Puerto Rico. The statement making the election must indicate that it is being made under ERISA section 1022(i)(2). The statement may also be filed in conjunction with a written request for a determination letter. If the election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will be irrevocable upon issuance of such letter. Otherwise, once made, an election is irrevocable. It is generally effective for plan years beginning after the date it has been made. However, an election made before March 3, 1983 may, at the option of the plan administrator at the time he or she makes the election, be considered to have been made on any date between September 2, 1974, and the actual date of the election. The election will then be effective for plan years beginning on or after the date chosen by the plan administrator.

(c) Annuities, custodial accounts, etc. See section 401(f) for rules relating to the treatment of certain annuities, custodial accounts or other contracts, as trusts for purposes of section 401(a).

(d) Source of plan distributions to participants and beneficiaries residing outside the United States. Except as provided under section 871(f) (relating to amounts received as an annuity by nonresident aliens), the amount of a distribution from an electing plan that is to be treated as income from sources within the United States is determined as described below. The portion of the distribution considered to be a return of employer contributions is to be treated as income from sources within the United States in an amount equal to the portion of the distribution considered to be a return of employer contributions multiplied by the following fraction:

$$\frac{\text{Days of performance of labor or services within the United States for the employer.}}{\text{Total days of performance of labor or services for the employer.}}$$

The days of performance of labor or services within the United States shall not include the time period for which the employee's compensation is deemed not to be income from sources within the United States under subtitle A of the Code. Thus, for example, if an employee's compensation was not deemed to be income from sources within the United States under section 861(a)(3), then the time the employee was present in the United States while such compensation was earned would not be included in determining the days of performance of labor or services within the United States in the numerator of the above fraction. In addition, days of performance of labor or services for the employer in both the numerator and denominator of the above fraction are limited to days of plan participation by the employee and any service used for determining an employee's accrued benefit under the plan. The remaining portion of the distribution, that is, any amount other than the portion of the distribution considered to be a return of employer contributions, is not to be treated as income from sources within the United States. For example, if a distribution consists of amounts representing employer contributions, employee contributions, and earnings on employer and employee contributions, no part of the portion of the distribution attributable to employee contributions, or earnings on employer and employee contributions, will be treated as income from sources within the United States.

[T.D. 7859, 47 FR 54297, Dec. 2, 1982]

§ 1.401(b)–1 Certain retroactive changes in plan.

(a) General rule. Under section 401(b) a stock bonus, pension, profit-sharing, annuity, or bond purchase plan which does not satisfy the requirements of section 401(a) on any day solely as a result of a disqualifying provision (as defined in paragraph (b) of this section) shall be considered

to have satisfied such requirements on such date if, on or before the last day of the remedial amendment period (as determined under paragraphs (c), (d) and (e) of this section) with respect to such disqualifying provision, all provisions of the plan which are necessary to satisfy all requirements of sections 401(a), 403(a), or 405(a) are in effect and have been made effective for all purposes for the whole of such period. Under some facts and circumstances, it may not be possible to amend a plan retroactively so that all provisions of the plan which are necessary to satisfy the requirements of section 401(a) are in fact made effective for the whole remedial amendment period. If it is not possible, the requirements of this section will not be satisfied even if the employer adopts a retroactive plan amendment which, in form, appears to satisfy such requirements. Section 401(b) does not permit a plan to be made retroactively effective, for qualification purposes, for a taxable year prior to the taxable year of the employer in which the plan was adopted by such employer.

(b) Disqualifying provisions. For purposes of this section, with respect to a plan described in paragraph (a) of this section, the term "disqualifying provision" means:

(1) A provision of a new plan, the absence of a provision from a new plan, or an amendment to an existing plan, which causes such plan to fail to satisfy the requirements of the Code applicable to qualification of such plan as of the date such plan or amendment is first made effective or

(2) A plan provision which results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in such requirements—

(i) Effected by the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, 88 Stat. 829), hereafter referred to as "ERISA," or the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248, 96 Stat. 324), hereafter referred to as "TEFRA," or

(ii) Effective before the first day of the first plan year beginning after December 31, 1989 and that is effected by the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085, 2489), hereafter referred to as "TRA '86," the Omnibus Budget Reconciliation Act of 1986, (Pub. L. 99-509, 100 Stat. 1874), hereafter referred to as "OBRA '86," or the Omnibus Budget Reconciliation Act of 1987 (Pub. L. 100-203, 101 Stat. 1330), hereafter referred to as "OBRA '87." For purposes of this paragraph (b)(2)(ii), a disqualifying provision includes any plan provision that is integral to a qualification requirement changed by TRA '86, OBRA '86, or OBRA '87 or any requirement treated by the Commissioner, directly or indirectly, as if section 1140 of TRA '86 applied to it, but only to the extent such provision is effective before the first day of the first plan year beginning after December 31, 1989. With respect to disqualifying provisions described in this paragraph (b)(2)(ii) effective before the first day of the first plan year which begins after December 31, 1988, there must be compliance with the conditions of section 1140 of TRA '86 (other than the requirement that the plan amendment be made on or before the last day of the first plan year beginning after December 31, 1988), including operation in accordance with the plan provision as of its effective date with respect to the plan.

(iii) Effected by amendments to the Code that are designated by the Commissioner, at his discretion, as disqualifying provisions described in this paragraph (b)(2). For purposes of this paragraph (b)(2), a disqualifying provision includes the absence from a plan of a provision required by such change if the plan was in effect on the date such change became effective with respect to such plan.

(c) Remedial amendment period. **(1)** The remedial amendment period with respect to a disqualifying provision begins:

(i) In the case of a provision of, or absence of a provision from, a new plan, described in paragraph (b)(1) of this section, the date the plan is put into effect,

(ii) In the case of an amendment to an existing plan, described in paragraph (b)(1) of this section, the date the plan amendment is adopted or put into effect (whichever is earlier), or

(iii) In the case of a disqualifying provision described in paragraph (b)(2) of this section, the date on which the change effected by ERISA, TEFRA, TRA '86, OBRA '86, OBRA '87, or a qualification requirement that is treated, directly or indirectly, as subject to the conditions of section 1140 of TRA '86 described in paragraph (b)(2) of this section, became effective with respect to such plan or, in the case of a provision, described in paragraph (b)(2)(ii) of this section, that is integral to such qualification requirement, the first day on which the plan was operated in accordance with such provision.

(2) Unless further extended as provided by paragraph (d) of this section, the remedial amendment period ends with the latest of:

(i) In the case of a plan maintained by one employer, the time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the latest of:

(A) The date on which the remedial amendment period begins.

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(ii) In the case of a plan maintained by one employer, the last day of the plan year within which falls the latest of:

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date on which a plan amendment described in paragraph (b)(1) of this section is made effective,

(iii) In the case of a plan maintained by more than one employer, the last day of the tenth month following the last day of the plan year in which falls the latest of:

(A) The date on which the remedial amendment period begins,

(B) The date on which a plan amendment described in paragraph (b)(1) of this section is adopted, or

(C) The date of which a plan amendment described in paragraph (b)(1) of this section is made effective, or

(iv) December 31, 1976, but only in the case of a plan to which section 411 (relating to minimum vesting standards) applies without regard to section 411(e)(2), and only in the case of a remedial amendment period which began on or after September 2, 1974.

For purposes of paragraphs (c)(2)(i), (c)(2)(ii), and (c)(2)(iii) of this section, for any disqualifying provision described in paragraph (b)(2)(ii) of this section, the remedial amendment period shall be deemed to have begun with the first day of the first plan year which begins after December 31, 1988. For purposes of this paragraph (c)(2) of this section, a master or prototype plan shall not be considered to be a plan maintained by more than one employer, and whether or not a plan is maintained by more than one employer, shall be determined without regard to section 414 (b) and (c) except that if a plan is maintained solely by an affiliated group of corporations (within the meaning of section 1504) which files a consolidated income tax return pursuant to section 1501 for a taxable year within which falls the latest of the dates described in paragraph (c)(2)(i) of this section, such plan shall be deemed to be maintained by one employer.

(d) Extensions of remedial amendment period—(1) Opinion letter request by sponsoring organization of master or prototype plan. In the case of an employer who has adopted a master or prototype plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of:

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which:

(A) The opinion letter with respect to the request of the sponsoring organization is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph apply only if the sponsoring organization of such master or prototype plan has, after September 2, 1974, and on or before December 31, 1976, filed a request for an opinion letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this paragraph (d)(1) apply to a master or prototype plan adopted to replace another plan even though the remedial amendment period applicable to the replaced plan has expired at the time of adoption of the replacement plan.

(2) Notification letter request by law firm sponsor of district-approved plan. In the case of an employer who has adopted a pattern plan, a remedial amendment period that began on or after September 2, 1974, shall not end prior to the later of:

(i) June 30, 1977, or

(ii) The last day of the month that is six months after the month in which:

(A) The notification letter with respect to the request of the sponsoring law firm is issued by the Internal Revenue Service,

(B) Such request is withdrawn, or

(C) Such request is otherwise disposed of by the Internal Revenue Service. The rules contained in this subparagraph shall apply only if the sponsoring law firm of such pattern plan has, on or before December 31, 1976, filed a request for a notification letter with the Internal Revenue Service with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan). The provisions of this paragraph (d)(2) apply to a pattern plan adopted to replace another plan even though the remedial amendment period applicable to the replaced plan has expired at the time of the adoption of the replacement plan.

(3) Determination letter request by employer or plan administrator. If on or before the end of a remedial amendment period determined without regard to this paragraph (d), or in a case to which paragraph (d)(1) or (2) of this section applies, on or before the 90th day following the later of the dates described in paragraph (d)(1) or (2) of this section, the employer or plan administrator files a request pursuant to § 601.201(s) of this chapter (Statement of Procedural Rules) for a determination letter with respect to the initial or continuing qualification of the plan, or a trust which is part of such plan, such remedial amendment period shall be extended until the expiration of 91 days after:

(i) The date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service, or

(ii) If a petition is timely filed with the United States Tax Court for a declaratory judgment under section 7476 with respect to the final determination (or the failure of the Internal Revenue Service to make a final determination) in response to such request, the date on which the decision of the United States Tax Court in such proceeding becomes final.

(4) Transitional rule. In the case of a request for a determination letter described in and filed within the time prescribed in paragraph (d)(3) of this section with respect to which a final determination is issued by the Internal Revenue Service on or before September 28, 1976 the remedial amendment period described in paragraph (c) of this section shall not end prior to the expiration of 150 days beginning on the date of such final determination by the Internal Revenue Service.

(5) Disqualifying provision prior to September 2, 1974. If the remedial amendment period with respect to a disqualifying provision described in paragraph (b)(1) of this section began prior to September 2, 1974, and the provisions of subdivisions (i), (ii) and (iii) of this subparagraph are satisfied, the remedial amendment period described in paragraph (c) shall not end prior to December 31, 1976. This subparagraph shall apply only if—

(i) A request pursuant to § 601.201 of this chapter for a determination letter with respect to the initial or continuing qualification of the plan (or a trust which is part of the plan) was filed not later than the later of:

(A) The time prescribed by law, including extensions, for filing the income tax return (or partnership return of income) of the employer for the employer's taxable year in which falls the date on which the remedial amendment period began, or

(B) The date 6 months after the close of such taxable year,

(ii) The employer, either:

(A) While such request for a determination letter is or was under consideration by the Internal Revenue Service or,

(B) Promptly after the date on which notice of the final determination with respect to such request for a determination letter is issued by the Internal Revenue Service, such request is withdrawn, or such request is otherwise finally disposed of by the Internal Revenue Service, adopts or adopted either a plan amendment retroactive to the date on which the remedial amendment period began, or a prospective plan amendment, and

(iii) The amendment described in paragraph (d)(5)(ii) of this section would have resulted in the plan's satisfying the requirements of section 401(a) of the Code from the beginning of the remedial amendment period to the date such amendment was made if this section had been in effect during such period, and in the case of a prospective amendment, if such amendment had been made retroactive to such beginning date.

(e) **Discretionary extensions.** At his discretion, the Commissioner may extend the remedial amendment period or may allow a particular plan to be amended after the expiration of its remedial amendment period and any applicable extension of such period. In determining whether such an

extension will be granted, the Commissioner shall consider, among other factors, whether substantial hardship to the employer would result if such an extension were not granted, whether such an extension is in the best interest of plan participants, and whether the granting of the extension is adverse to the interests of the Government. The mere absence of final regulations with respect to issues covered under the Special Reliance Procedure announced by the Internal Revenue Service in Technical Information Release 1416 on November 5, 1975, and as extended by Internal Revenue Service News Release IR–1616 on May 14, 1976, shall not be deemed to satisfy the criteria of this paragraph. With regard to a particular plan, a request for extension of time pursuant to this paragraph shall be submitted prior to the expiration of the remedial amendment period determined without regard to this paragraph, or within such time thereafter as the Internal Revenue Service may consider reasonable under the circumstances. The request should be submitted to the appropriate District Director, determined under § 601.201(s)(3)(xii) of this chapter (Statement of Procedural Rules). This subparagraph applies to disqualifying provisions that were adopted or became effective prior to September 2, 1974, as well as disqualifying provisions adopted or made effective on or after September 2, 1974.

[T.D. 7437, 41 FR 42653, Sept. 28, 1976, as amended by T.D. 7896, 48 FR 23817, May 27, 1983; T.D. 7997, 49 FR 50645, Dec. 31, 1984; T.D. 8217, 53 FR 29662, Aug. 8, 1988]

§ 1.401(e)–1 Definitions relating to plans covering self-employed individuals.

(a) "Keogh" or "H.R. 10" plans, in general—(1) Introduction and organization of regulations. Certain self-employed individuals may be covered by a qualified pension, annuity, or profit-sharing plan. This section contains definitions contained in section 401(c) relating to plans covering self-employed individuals and is applicable to employer taxable years beginning after December 31, 1975, unless otherwise specified.

The provisions of section 401(a) relating to qualification requirements which are generally applicable to all qualified plans, and other provisions relating to the special rules under section 401(b), (f), (g), (h), and (i), are also generally applicable to any plan covering a self-employed individual. However, in addition to such requirements and special rules, any plan covering a self-employed individual is subject to the rules contained in §§ 1.401(e)–2, (e)–5, and (j)–1 through (j)–5. Section 1.401(e)–2 contains general rules, § 1.401(e)–5 contains a special rule limiting the contribution and benefit base to the first $100,000 of annual compensation, and § 1.401 (j)–1 through (j)–5 contains special rules for defined benefit plans. Section 1.401(e)–3 contains special rules which are applicable to plans covering self-employed individuals when one or more of such individuals is an owner-employee within the meaning of section 401(c)(3). Section 1.401(e)–4 contains rules relating to contributions on behalf of owner-employees for premiums on annuity, etc., contracts and a transitional rule for certain excess contributions made on behalf of owner-employees for employer taxable years beginning before January 1, 1976. The provisions of this section and of §§ 1.401(e)–2 through 1.401(e)–5 are applicable to employer taxable years beginning after December 31, 1975, unless otherwise specified.

(2) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)–2 General rules relating to plans covering self-employed individuals.

(a) "Keogh" or "H.R. 10" plans; introduction and organization of regulations. This section provides certain rules which supplement, and modify, the qualification requirements of section 401(a) and the special rules provided by § 1.401(b)–1 and other special rules under subsections (f), (g), (h), and (i) of section 401 in the case of a qualified pension, annuity, or profit-sharing plan which covers a self-employed individual who is an employee within the meaning of section 401(c)(1). Section 1.401(e)–1(a)(1) sets forth other provisions which also supplement, and modify, these requirements and special rules in the case of a plan described in this section. The provisions of this section apply to employer taxable years beginning after December 31, 1975, unless otherwise specified.

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)–3 Requirements for qualification of trusts and plans benefiting owner-employees.

(a) "Keogh" or "H.R. 10" plans covering owner-employees; introduction and organization of regulations. This section prescribes the additional requirements which must be met for qualification of a trust forming part of a pension or profit-sharing plan, or of an annuity plan, which covers any self-employed individual who is an owner-employee as defined in section 401(c)(3). These additional requirements are prescribed in section 401(d)

and are made applicable to such a trust by section 401(a)(10)(B) and to an annuity plan by section 404(a)(2). However, to the extent that the provisions of §§ 1.401(e)–1 and 1.401(e)–2 are not modified by the provisions of this section such provisions are also applicable to a plan which covers an owner-employee. The provisions of this section apply to taxable years beginning after December 31, 1975, unless otherwise specified.

(b) [Reserved]

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)–4 Contributions for premiums on annuity, etc., contracts and transitional rule for certain excess contributions.

(a) In general. The provisions of this section prescribe the rules specified in section 401(e) relating to certain contributions made under a qualified pension, annuity, or profit-sharing plan on behalf of a self-employed individual who is an owner-employee (as defined in section 401(c)(3) and the regulations thereunder) in taxable years of the employer beginning after December 31, 1975. In addition, such plans are also subject to the limitations on contributions and benefits under section 415 for years beginning after December 31, 1975. However, the defined contribution compensation limitation described in section 415(c)(1)(B) will not apply to any contribution described in this section provided that the requirements specified in section 415(c)(7) and § 1.415–6(h) are satisfied. Solely for the purpose of applying section 4972(b) (relating to excise tax on excess contributions for self-employed individuals) to other contributions made by an owner-employee as an employee, the amount of any employer contribution which is not deductible under section 404 for the employer's taxable year but which is described in section 401(e) and this section shall be taken into account as a contribution made by such owner-employee as an employee during the taxable year of his employer in which such contribution is made.

(b) Contributions described in section 401(e)—(1) An employer contribution on behalf of an owner-employee is described in section 401(e), if—

(i) Under the provisions of the plan, the contribution is expressly required to be applied (either directly or through a trustee) to pay the premiums or other consideration for one or more annuity, endowment, or life insurance contracts on the life of the owner-employee.

(ii) The employer contributions so applied meet the requirements of subparagraphs (2) through (5) of this paragraph.

(iii) The amount of the contribution exceeds the amount deductible under section 404 with respect to contributions made by the employer on behalf of the owner-employee under the plan, and

(iv) The total employer contributions required to be applied annually to pay premiums on behalf of any owner-employee for contracts described in this paragraph do not exceed $7,500. For purposes of computing such $7,500 limit, the total employer contributions include amounts which are allocable to the purchase of life, accident, health, or other insurance.

(2)(i) The employer contributions must be paid under a plan which satisfies all the requirements for qualification. Accordingly, for example, contributions can be paid under the plan for life insurance protection only to the extent otherwise permitted under sections 401 through 404 and the regulations thereunder. However, certain of the requirements for qualification are modified with respect to a plan described in this paragraph (see section 401(a)(10)(A)(ii) and (d)(5)).

(ii) A plan described in this paragraph is not disqualified merely because a contribution is made on behalf of an owner-employee by his employer during a taxable year of the employer for which the owner-employee has no earned income. On the other hand, a plan will fail to qualify if a contribution is made on behalf of an owner-employee which results in the discrimination prohibited by section 401(a)(4) as modified by section 401(a)(10)(A)(ii).

(3) The employer contributions must be applied to pay premiums or other consideration for a contract issued on the life of the owner-employee. For purposes of this subparagraph, a contract is not issued on the life of an owner-employee unless all the proceeds which are, or may become, payable under the contract are payable directly, or through a trustee of a trust described in section 401(a) and exempt from tax under section 501(a), to the owner-employee or to the beneficiary named in the contract or under the plan. For example, a nontransferable face-amount certificate described in section 401(g) and the regulations thereunder is considered an annuity on the life of the owner-employee if the proceeds of such contract are payable only to the owner-employee or his beneficiary.

(4)(i) For any taxable year of the employer, the amount of contributions by the employer on behalf of the owner-employee which is applied to pay premiums under the contracts described in this paragraph must not exceed the average of the

amounts deductible under section 404 by such employer on behalf of such owner-employee for the most recent three taxable years of the employer which are described in the succeeding sentence. The three employer taxable years described in the preceding sentence must be years, ending prior to the date the latest contract was entered into or modified to provide additional, benefits, in which the owner-employee derived earned income from the trade or business with respect to which the plan is established. However, if such owner-employee has not derived earned income for at least three taxable years preceding such date, then, in determining the "average of the amounts deductible", only so many of such taxable years as such owner-employee was engaged in such trade or business and derived earned income therefrom are taken into account.

(ii) For the purpose of making the computation described in subdivision (i) of this subparagraph, the taxable years taken into account include those years in which the individual derived earned income from the trade or business but was not an owner-employee with respect to such trade or business. Furthermore, taxable years of the employer preceding the taxable year in which a qualified plan is established are taken into account.

(iii) For purposes of making the computations described in subdivisions (i) and (ii) of this subparagraph for any taxable year of the employer the average of the amounts deductible under section 404 by the employer on behalf of an owner-employee for the most recent three relevant taxable years of the employer shall be determined as if section 404, as in effect for the taxable year for which the computation is to be made, had been in effect for all three such years.

(5) For any taxable year of an employer in which contributions are made on behalf of an individual as an owner-employee under more than one plan, the amount of contributions described in this section by the employer on behalf of such an owner-employee under all such plans must not exceed $7,500.

(c) Transitional rule for excess contributions—(1)(i) The rules of this paragraph are inapplicable to a plan which was not in existence for any taxable year of an employer which begins before January 1, 1976. For taxable years of an employer which begin before January 1, 1976, the rules with respect to excess contributions on behalf of owner-employees set forth in section 401(d)(5) and (8) and in section 401(e), as these sections were in effect on September 1, 1974, prior to their amendment by section 2001(e) of the Employee Retirement Income Security Act of 1974 (hereinafter in this paragraph referred to as the "Act") (88 Stat. 954), shall apply except as provided by subparagraph (2) of this paragraph. Section 1.401–13 generally provides the rules for excess contributions on behalf of owner-employees set forth in these sections.

(ii) Notwithstanding the provisions of subdivision (i) of this subparagraph, the rules set forth in such subsections (d)(5) and (8) and (e) of section 401 with respect to excess contributions for such taxable years beginning before January 1, 1976, apply even though the application of those rules affects a subsequent taxable year. Thus, for example, if, in 1975, a nonwillful excess contribution described in section 401(e)(1) (prior to such amendment) is made on behalf of an owner-employee, the plan will not be qualified unless the provisions required by subparagraphs (A) and (B) of such 401(d)(8) are contained in the plan and made applicable to excess contributions made for such taxable years beginning before January 1, 1976. In such case, the effect of such contribution on the plan, the employer, and the owner-employee would be determined under paragraph (2) of section 401(e), as in effect on September 1, 1974. By reason of section 401(e)(2)(F), as in effect on September 1, 1974, the period for assessing any deficiency by reason of the excess contribution will not expire until the expiration of the 6-month period described in section 401(e)(2)(C), as in effect on September 1, 1974, even if the first day of such 6-month period falls in a taxable year beginning after December 31, 1975. For the rules applicable to a willful excess contribution, which generally divide an owner-employee's interest in a plan into two parts on the basis of employer taxable years beginning before and after December 31, 1975, see § 1.72–17A(e)(2)(v). In the case of a willful excess contribution, the rule specified in section 401(e)(2)(E)(iii), as in effect on September 1, 1974, shall not apply to any taxable year of an employer beginning on or after January 1, 1976. Thus, for example, if a willful excess contribution was made to a plan on behalf of an owner-employee with respect to his employer's taxable year beginning January 1, 1975, the plan would not meet, for purposes of section 404, the requirements of section 401(d) with respect to that owner-employee for such year, but the 5 taxable years following such year would be unaffected because those years begin on or after January 1, 1976.

(2)(i) For purposes of applying the excess contribution rules with respect to the employer taxable years specified in subparagraph (1) of this

paragraph for such an employer taxable year which begins after December 31, 1973, see section 404(e) and § 1.404(e)-1A for rules increasing the limitation on the amount of allowable employer deductions on behalf of owner-employees under section 404. For purposes of applying subparagraphs (A) and (B)(i) of section 401(e)(1) prior to the amendment made by section 2001(e)(3) of the Act (88 Stat. 954), the employer deduction allowable by section 404(e)(4) with respect to an owner-employee in a defined contribution plan shall be deemed not to be an excess contribution (see § 1.404(e)-1A(c)(4)).

(ii) For purposes of applying the excess contribution rules with respect to the employer taxable years specified in subparagraph (1) of this paragraph to an employer's plan which was not in existence on January 1, 1974, or to a plan in existence on January 1, 1974, which elects under section 1017(d) of the Act (88 Stat. 934), in accordance with regulations, to have the funding provisions of section 412 apply to such an existing plan, see section 404(a)(1), (a)(6), and (a)(7), as amended by section 1013(c)(1), (2), and (3) of the Act (88 Stat. 922 and 923) for rules modifying the amount of employer deductions on behalf of owner-employees.

[T.D. 7636, 44 FR 47053, Aug. 10, 1979]

§ 1.401(e)-5 Limitation of contribution and benefit bases to first $100,000 of annual compensation in case of plans covering self-employed individuals.

(a) General rules—(1) General rule. Under section 401(a)(17), a plan maintained by an employer which provided contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1) is a qualified plan only if the annual compensation of each employee taken into account under the plan does not exceed the first $100,000 of such compensation. For purposes of applying section 401(a)(17) and the preceding sentence, all plans maintained by such an employer with respect to the same trade or business shall be treated as a single plan. See also sections 401(d)(9) and (10) (relating to controlled trades or businesses where a plan covers an owner-employee who controls more than one trade or business); section 404(e) (relating to special limitations for self-employed individuals); section 413(b)(7) (relating to determination of limitations provided by section 404(a) in the case of certain plans maintained pursuant to a collective bargaining agreement); and section 413(c)(6) (relating to determination of limitations provided by section 404(a) in the case of certain plans maintained by more than one employer).

(2) Special section 414(b), (c) rule. This subparagraph (2) applies to plans maintained by employers that are trades or businesses (whether or not incorporated) that are under common control within the meaning of section 414(c). All such plans that are described in paragraph (a)(1) and § 1.401(e)-6(a) (so called "Subchapter S plans") shall be treated as a single plan in applying the limitation of paragraph (a)(1).

(b) Integrated plans. (1) In the case of a qualified plan, other than a plan described in section 414(j), which is integrated with the Social Security Act (chapter 21 of the Code), or with contributions or benefits under chapter 2 of the Code (relating to tax on self-employment income) or under any other Federal or State law, the $100,000 limitation described in subparagraph (a) shall be determined without regard to any adjustments to contributions or benefits under the plan on account of such integration. See also subsections (a)(5), (a)(15), and (d)(6) of section 401 and the regulations thereunder for other rules with respect to plans which are integrated.

(2) In the case of a qualified defined benefit plan described in section 414(j), see section 401(j)(4) for a special prohibition against integration.

(c) Application of nondiscrimination requirement. (1) This paragraph shall apply—

(i) In the case of a plan which provides contributions or benefits for employees some or all of whom are employees within the meaning of section 401(c)(1) and

(ii) For a year in which the compensation of any employee covered by the plan exceeds $100,000. In the case of an employee who is an employee within the meaning of section 401(c)(1), compensation includes earned income within the meaning of section 401(c)(2).

(2) In applying section 401(a)(4) under the circumstances described in subparagraph (1) of this paragraph, the determination whether the rate of contributions or benefits under the plan discriminates in favor of highly compensated employees shall be made as if the compensation for the year of each employee described in the first sentence of subparagraph (1)(ii) of this paragraph were $100,000, rather than the compensation actually received by him for such year.

(d) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). A, a self-employed individual, has established the P Profit-Sharing Plan, which covers A and his two commonlaw employees, B and C. A's taxable year and the plan's plan year are both the calendar year. For 1976, A has earned income of $150,000, and B and C each receive compensation of less than $100,000 from A. If he wishes to contribute $7,500 to the plan on his behalf for 1976, A must also contribute to the accounts of B and C under the plan amounts at least equal to 7½ percent of their respective compensation for 1976.

Example (2). D, an owner-employee within the meaning of section 401(c)(3), is a participant in the Q Qualified Defined Contribution Plan, which, in 1975, satisfies the requirements of section 401(d)(6) and all other integration requirements applicable to qualified defined contribution plans. The taxable years of D, the employer of D within the meaning of section 401(c)(4), and the plan are all calendar years. The plan provides for an integration level of $13,200 and a contribution rate of 5 percent of compensation in excess of $13,200. For 1975, D has earned income of $115,000. The maximum amount of earned income upon which D's contribution can be determined is $86,800, and the contribution based upon this maximum amount of earned income is $4,340, computed as follows:

Maximum annual compensation which may be taken into account	$100,000
Less: Social Security Act integration level	13,200
Plan contribution base	$86,800
Multiplied by: Contribution rate (percent)	5
Total	$4,340

(e) Years to which section applies. This section applies to taxable years of an employer beginning after December 31, 1975. However, if employer contributions made under a plan for any employee for taxable years of an employer beginning after December 31, 1973, exceed the amounts permitted to be deducted for that employee under section 404(e), as in effect on September 1, 1974, this section applies to such taxable years of an employer.

Thus, for example, a plan of a calendar year employer which was adopted on January 1, 1974, would be subject to this section in 1974, if the employer made a contribution on behalf of any employee within the meaning of section 401(c)(1) for such year in excess of the $2,500 or 10 percent earned income limit, whichever is applicable to that employee, specified in section 404(e)(1) as in effect prior to the amendment to such Code section made by section 2001(a)(1)(A) of the Employee Retirement Income Security Act of 1974 (88 Stat. 952). The plan described in the proceeding sentence would also be subject to this section in 1974, if the employer made a contribution on behalf of any employee within the meaning of section 401(c)(1) which is allowable as a deduction only because of the addition of paragraph (4) to Code section 404(e) made by section 2001(a)(3) of such Act (88 Stat. 952).

[T.D. 7636, 44 FR 47055, Aug. 10, 1979]

§ 1.401(e)–6 Special rules for shareholder-employees.

(a) Limitation of contributions and benefit bases to first $100,000 of annual compensation in case of plans covering shareholder-employees. (1) Under section 401(a)(17), a plan which provides contributions or benefits for employees, some or all of whom are shareholder-employees within the meaning of section 1379(d), is subject to the same limitation on annual compensation as a plan which provides such contributions or benefits for employees some or all of whom are self-employed individuals within the meaning of section 401(c)(1). Thus, a plan which provides contributions or benefits for such shareholder-employees is subject to the rules provided by § 1.401(e)–5, unless otherwise specified. See also section 1379. In the case of plans maintained by employers that are corporations described in section 414(b) and that are described in this subparagraph (1), the same rule described in § 1.401(e)–5(a)(2) shall apply.

(2) Subparagraph (1) applies to taxable years of an electing small business corporation beginning after December 31, 1975. However, if corporate contributions made under a plan on behalf of any shareholder-employee for corporate taxable years beginning after December 31, 1973, exceed the lesser of the amount of contributions specified in section 1379(b)(1)(A) or (B), as in effect on September 1, 1974, for that shareholder-employee, subparagraph (1) applies to such corporate taxable years. Thus, for example if an electing small business corporation whose taxable year is the calendar year adopted a plan on January 1, 1974, the plan would be subject to the provisions of subparagraph (1) of this section in 1974, if the corporation made a contribution in excess of $2,500 on behalf of any shareholder-employee for such year.

(b) [Reserved]

[T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.401(f)–1 Certain custodial accounts and annuity contracts.

(a) Treatment of a custodial account or an annuity contract as a qualified trust. Beginning on January 1, 1974, a custodial account or an annuity contract may be used, in lieu of a trust, under any qualified pension, profit-sharing, or stock bonus plan if the requirements of paragraph (b) of this

section are met. A custodial account or an annuity contract may be used under such a plan, whether the plan covers common-law employees, self-employed individuals who are treated as employees by reason of section 401(c), or both. The use of a custodial account or annuity contract as part of a plan does not preclude the use of a trust or another custodial account or another annuity contract as part of the same plan. A plan under which a custodial account or an annuity contract is used may be considered in connection with other plans of the employer in determining whether the requirements of section 401 are satisfied. For regulations relating to the period before January 1, 1974, see § 1.401–8.

(b) Rules applicable to custodial accounts and annuity contracts. (1) Beginning on January 1, 1974, a custodial account or an annuity contract is treated as a qualified trust under section 401 if the following requirements are met:

(i) The custodial account or annuity contract would, except for that fact that it is not a trust, constitute a qualified trust under section 401; and

(ii) In the case of a custodial account, the custodian either is a bank or is another person who demonstrates, to the satisfaction of the Commissioner, that the manner in which he will hold the assets will be consistent with the requirements of section 401. This demonstration must be made in the same manner as the demonstration required by section 401(d)(1) and the regulations thereunder.

(2) If a custodial account would, except for the fact that it is not a trust, constitute a qualified trust under section 401, it must, for example, be created pursuant to a written agreement which constitutes a valid contract under local law. In addition, the terms of the contract must make it impossible, prior to the satisfaction of all liabilities with respect to the employees and their beneficiaries covered by the plan. For any part of the funds of the custodial account to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries as provided for in the plan (see paragraph (a) of § 1.401–2).

(3) An annuity contract would, except for the fact that it is not a trust, constitute a qualified trust under section 401 if it is purchased by an employer for an employee under a plan which meets the requirements of section 404(a)(2) and the regulations thereunder, except that the plan may be either a pension or a profit-sharing plan.

(c) Effect of this section. (1)(i) Any custodial account or annuity contract which satisfies the requirements of paragraph (b) of this section is treated as a qualified trust for all purposes of the Internal Revenue Code of 1954. Such a custodial account or annuity contract is treated as a separate legal person which is exempt from the income tax under section 501(a). In addition, the person holding the assets of such account or holding such contract is treated as the trustee thereof. Accordingly, such person is required to file the returns described in sections 6033 and 6047 and to supply any other information which the trustee of a qualified trust is required to furnish.

(ii) Any procedure which has the effect of merely substituting one custodian for another shall not be considered as terminating or interrupting the legal existence of a custodial account which otherwise satisfies the requirements of paragraph (b) of this section.

(2)(i) The beneficiary of a custodial account which satisfies the requirements of paragraph (b) of this section is taxed in accordance with section 402. In determining whether the funds of a custodial account are distributed or made available to an employee or his beneficiary, the rules which under section 402(a) are applicable to trusts will also apply to the custodial account as though it were a separate legal person and not an agent of the employee.

(ii) If a custodial account which has qualified under section 401 fails to qualify under such section for any taxable year, such custodial account will not thereafter be treated as a separate legal person, and the funds in such account shall be treated as made available within the meaning of section 402(a)(1) to the employees for whom they are held.

(3) The beneficiary of an annuity contract which satisfies the requirements of paragraph (b) of this section is taxed as if he were the beneficiary of an annuity contract described in section 403(a).

(d) Definitions. For purposes of this section—

(1) The term "bank" means a bank as defined in section 401(d)(1).

(2) The term "annuity" means an annuity as defined in section 401(g). Thus, any contract or certificate issued after December 31, 1962, which is transferable is not treated as a qualified trust under this section.

(e) Other contracts. For purposes of this section, other than the non-transferability restriction

of paragraph (d)(2), a contract issued by an insurance company qualified to do business in a state shall be treated as an annuity contract. For purposes of the preceding sentence, the contract does not include a life, health or accident, property, casualty or liability insurance contract. For purposes of this paragraph, a contract which is issued by an insurance company will not be considered a life insurance contract merely because the contract provides incidental life insurance protection. The provisions of this paragraph are effective for taxable years beginning after December 31, 1975.

(f) Cross reference. For the requirement that the assets of an employee benefit plan be placed in trust, and exceptions thereto, see section 403 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. 1103, and the regulations prescribed thereunder by the Secretary of Labor.

[43 FR 41204, Sept. 15, 1978. Redesignated and amended by T.D. 7748, 46 FR 1687–1696, Jan. 7, 1981]

§ 1.401 (k)–0 Certain cash or deferred arrangements, table of contents.

This section contains the captions that appear in § 1.401(k)-1.

[T.D. 8217, 53 FR 29663, Aug. 8, 1988]

§ 1.401(k)-1 Certain cash or deferred arrangements.

(a) In general—(1) General rule. A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural electric cooperative plan, will fail to satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural electric cooperative plan will not fail to satisfy the requirements of section 401(a) merely because the plan includes a cash or deferred arrangement.

(2) Cash or deferred arrangement—(i) In general. Except as provided in paragraph (a)(2)(ii), a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election to have the employer either contribute an amount to a trust under a plan that meets (or is intended to meet) the requirements of section 401(a) or provide an amount to the employee in cash or in the form of some other taxable benefit. An arrangement under which the employee may make a cash or deferred election to have the employer contribute an amount to a trust under a plan that meets (or is intended to meet) the requirements of section 401(a) includes an arrangement under which the employee may elect either to receive cash or a taxable amount or to accrue a benefit under a defined benefit plan that is intended to meet the requirements of section 401(a), and an arrangement under which the employee may elect either to receive cash or a taxable amount or to have the employer contribute an amount to a contract that meets the requirements or section 401(a) or 403(a).

(ii) After-tax employee contributions. A cash or deferred arrangement does not include an arrangement pursuant to which amounts contributed under a plan at an employee's election are designated or treated at the time of deferral or contribution as after-tax employee contributions (e.g., by reporting

the contributions as taxable income subject to applicable withholding requirements). See also section 414(h)(1). This is the case even if the employee's election to make after-tax employee contributions is made before the amounts subject to the election are currently available to the employee.

(3) Cash or deferred election—(i) General rule. A cash or deferred election is an election (or modification of an earlier election) that is made at any time permitted by the plan with respect to cash or other taxable amounts that are not currently available to the electing employee as of the date of the election and are not designated or treated as after-tax employee contributions at the time of deferral or contribution. A cash or deferred election includes a salary reduction agreement between an eligible employee and the employer under which a contribution is made under the plan only if the employee elects to reduce his cash compensation or to forgo an increase in his cash compensation.

(ii) Amounts currently available. Cash or another taxable amount is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at his discretion. An amount is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future.

(iii) Certain one-time elections. A cash or deferred election does not include a one-time irrevocable election, upon an employee's commencement of employment or upon an employee's first becoming eligible under any plan of the employer, to have a specified amount or percentage of compensation (including no amount of compensation) contributed by the employer, on behalf of the employee to the plan and any other plan of the employer (including plans not yet established) for the duration of the employee's employment with the employer. Thus, employer contributions pursuant to such a one-time election are not treated as having been made pursuant to a cash or deferred arrangement.

(iv) Tax treatment. An amount generally is includible in an employee's gross income for the taxable year in which the employee actually receives, or is treated as having received, such amount. But for section 402(a)(8) and section 401(k), an employee is treated as having received an amount that is contributed under a plan pursuant to the employee's cash or deferred election. This is the case even if the election to defer is made before the year in which such amount has been earned or becomes currently available. See § 1.402(a)-1(d).

(v) Examples. The provisions of this subparagraph (a)(3) are illustrated by the following examples:

Example (1). An employer maintains a profit-sharing plan under which each eligible employee has an election with respect to an annual bonus of ten percent of his compensation payable on January 30 each year with respect to the prior calendar year's profits. Deferred amounts are not treated as after-tax employee contributions. An election made prior to January 30 to defer all or part of the bonus is a cash or deferred election and the bonus deferral arrangement is a cash or deferred arrangement.

Example (2). An employer maintains a profit-sharing plan under which each eligible employee may elect to defer up to 10 percent of compensation for each payroll period during the plan year. An election to defer compensation for a payroll period is a cash or deferred election if such election is made prior to the date on which such compensation is to be paid to the employee and if such deferred amount is not treated as an after-tax employee contribution at the time of deferral.

(4) Qualified cash or deferred arrangement—(i) In general. A qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of this section and that is part of a plan that otherwise meets the requirements of section 401(a).

(ii) Treatment of elective contributions as employer contributions. Except as provided in paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are treated as employer contributions under the Internal Revenue Code of 1986. Thus, for example, such elective contributions are treated as employer contributions for purposes of sections 401(a), 401(k), 404, 409, 411, 412, 415, 416, and 417.

(iii) Tax treatment of employees. Except as provided in section 402(g) and paragraph (f) of this section, elective contributions under a qualified cash or deferred arrangement are not includible in an employee's gross income at the time such contributions would have been received in cash (but for the cash or deferred election) or at the time contributed under the plan. See § 1.402(a)-1(d).

(iv) Nondiscrimination requirement. The amount of elective contributions under a qualified cash or deferred arrangement must satisfy section 401(a)(4). For plan years beginning after December 31, 1984, the amount of elective contributions

will satisfy section 401(a)(4) only if such elective contributions satisfy the special nondiscrimination test in paragraph (b)(2) of this section.

(v) Plan assets. The extent to which elective contributions under a cash or deferred arrangement constitute plan assets for purposes of the prohibited transaction provisions of section 4975 of the Internal Revenue Code and Title I of the Employee Retirement Income Security Act of 1974 shall be determined in accordance with regulations and rulings issued by the Department of Labor.

(5) Nonqualified cash or deferred arrangement —(i) In general. A nonqualified cash or deferred arrangement is a cash or deferred arrangement that is not a qualified cash or deferred arrangement. Thus, if a cash or deferred arrangement fails to satisfy one or more of the requirements in paragraph (b), (c), (d) or (e) of this section, such arrangement is a nonqualified cash or deferred arrangement.

(ii) Treatment of elective contributions as employer contributions. Except as specifically provided otherwise, elective contributions under a nonqualified cash or deferred arrangement are treated as employer contributions under the Internal Revenue Code of 1986. Thus, for example, such elective contributions are treated as employer contributions for purposes of sections 401(a) (including section 401(a)(4)), 401(k), 404, 409, 411, 412, 415, 416, and 417.

(iii) Tax treatment of employees. Elective contributions under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time such contributions would have been received (but for the cash or deferred election). See § 1.402(a)-1(d).

(iv) Qualification of plan that includes a nonqualified cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural electric cooperative plan will not fail to satisfy section 401(a) merely because such plan includes a nonqualified cash or deferred arrangement. In determining whether such a plan satisfies the requirements of section 401(a)(4), elective contributions under the nonqualified cash or deferred arrangement are to be treated as employer contributions to the extent that such contributions would be treated as employer contributions if the arrangement were a qualified cash or deferred arrangement, but the special nondiscrimination test of paragraph (b)(2) may not be used.

(b) Coverage and discrimination requirements— (1) Coverage. (i) For plan years which begin before January 1, 1989, or such later date provided under paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if the eligible employees under the arrangement satisfy the 70 percent test of section 410(b)(1)(A) or the nondiscriminatory classification test of section 410(b)(1)(B). For purposes of this subdivision, all eligible employees under the arrangement are treated as benefiting under the arrangement. For purposes of this subdivision, section 410(b) means section 410(b) prior to its amendment by section 1112 of the Tax Reform Act of 1986 (TRA '86).

(ii) For plan years which begin after December 31, 1988, or on or after the later date provided under paragraph (h) of this section, a cash or deferred arrangement satisfies this paragraph (b) for a plan year only if the eligible employees under the arrangement satisfy either the percentage test of section 410(b)(1)(A), the ratio test of section 410(b)(1)(B), or the reasonable classification test of section 410(b)(2)(A)(i) (and, in such case, the average benefit percentage test of section 410(b)(2)(A)(ii) is satisfied). For purposes of applying section 410(b), all eligible employees under the arrangement are treated as benefiting under the arrangement.

(iii) A plan described in section 410(c)(1) will be treated as satisfying the requirements of section 410 if such plan meets the requirements of section 401(a)(3) as in effect on September 1, 1974.

(2) Nondiscriminatory elective contributions. A cash or deferred arrangement satisfies this paragraph (b) for a plan year only if—

(i) The elective contributions under the arrangement, or

(ii) The elective contributions, in combination with qualified nonelective contributions and qualified matching contributions that are treated as elective contributions under the arrangement,

satisfy the actual deferral percentage test in paragraph (b)(4) of this section. If a cash or deferred arrangement satisfies this paragraph (b)(2), such arrangement will be treated as satisfying section 401(a)(4) with respect to the amount of elective contributions. See paragraph (e)(1) of this section with respect to the application of section 401(a)(4) to other benefits, rights and features under a cash or deferred arrangement. Employee contributions may not be treated as elective contributions under a cash or deferred arrangement for purposes of this paragraph (b)(2).

(3) Qualified nonelective contributions and qualified matching contributions that may be treated as elective contributions. Except as specifically provided otherwise, for purposes of paragraph (b)(2)(ii) of this section, all or part of the qualified nonelective contributions and qualified matching contributions made with respect to those employees who are eligible employees under the cash or deferred arrangement being tested may be treated as elective contributions provided that each of the following (to the extent applicable) is satisfied:

(i) The nonelective contributions, including those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(ii) The nonelective contributions, excluding those qualified nonelective contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(iii) The matching contributions, including those qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(iv) The matching contributions, excluding those qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test, satisfy the requirements of section 401(a)(4).

(v) Except as provided in subdivisions (i) and (iii) of this paragraph (b)(3), the qualified nonelective contributions and qualified matching contributions treated as elective contributions for purposes of the actual deferral percentage test are not taken into account in determining whether any other contributions or benefits satisfy section 401(a)(4).

(vi) The qualified nonelective contributions and qualified matching contributions satisfy paragraph (b)(6)(i) for the plan year as if such contributions were elective contributions.

Qualified matching contributions taken into account for plan years which begin after December 31, 1986, or on or after the later date provided under paragraph (h) of this section, are also to be treated in accordance with the requirements of section 401(m) and the regulations thereunder.

(4) Actual deferral percentage tests. (i) For plan years which begin after December 31, 1979, and before January 1, 1987, or such later date provided under paragraph (h) of this section, the actual deferral percentage test is satisfied if either of the following tests is met:

(A) The actual deferral percentage for the group of eligible highly compensated employees (top one-third) is not more than the actual deferral percentage for the group of all other eligible employees (lower two-thirds) multiplied by 1.5, or

(B) The excess of the actual deferral percentage for the top one-third over the actual deferral percentage for the lower two-thirds is not more than three percentage points, and the actual deferral percentage for the top one-third is not more than the actual deferral percentage for the lower two-thirds multiplied by 2.5.

(ii) For plan years which begin after December 31, 1986, or such later date provided under paragraph (h) of this section, the actual deferral percentage test is satisfied if either of the following tests is met:

(A) The actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all other eligible employees multiplied by 1.25, or

(B) The excess of the actual deferral percentage for the group of eligible highly compensated employees over the actual deferral percentage for the group of all other eligible employees is not more than two percentage points, and the actual deferral percentage for the group of eligible highly compensated employees is not more than the actual deferral percentage for the group of all other eligible employees multiplied by two.

For plan years which begin after December 31, 1986, or such later date provided in paragraph (h) of this section, the plan must provide that the actual deferral percentage test will be met. For purposes of this paragraph (b)(4)(ii), the plan may incorporate by reference the provisions of section 401(k)(3) and this section.

(5) Aggregation rules—(i) Permissive aggregation of arrangements and plans. Two or more cash or deferred arrangements may be considered as a single arrangement for purposes of determining whether or not such arrangements satisfy sections 401(a)(4), 410(b), and 401(k). In such a case, the case or deferred arrangements included in such plans and the plans including such arrangements shall be treated as one arrangement and as one plan for purposes of this paragraph (b) and sections 401(a)(4), 401(k) and 410(b). If an employer maintains two or more plans that are treated as a single plan for purposes of section 401(a)(4) or

410(b) (other than section 410(b)(2)(A)(ii) as in effect for plan years which begin after December 31, 1988), all cash or deferred arrangements that are included in such plans are treated as a single arrangement for purposes of this paragraph (b) and sections 401(a)(4), 401(k), and 410(b).

(ii) Impermissible aggregation of arrangements and plans. For plan years which begin after December 31, 1988, notwithstanding paragraphs (b)(2), (b)(3) and (b)(5)(i) of this section, contributions and allocations under a plan described in section 4975(e)(7) (an ESOP) may not be combined with contributions or allocations under any plan not described in section 4975(e)(7) (a non-ESOP) for purposes of determining whether either the ESOP or the non-ESOP satisfies this paragraph (b) and sections 401(a)(4), 401(k), and 410(b). See § 54.4975-11(e), which includes an exception to this rule for certain plans in existence on November 1, 1977. See also § 54.4975-11(a)(5), which provides that an ESOP may form a portion of a plan the balance of which includes a qualified pension, profit-sharing, or stock bonus plan which is not an ESOP. For example, in determining whether elective contributions under a cash or deferred arrangement that is included in the portion of a plan that is not an ESOP satisfy paragraph (b) and section 401(a)(4) and whether nonelective contributions under the portion of the plan that is an ESOP satisfy section 401(a)(4), such elective contributions and nonelective contributions may not be considered together. Thus, with respect to such elective contributions, the nonelective contributions may not be treated as qualified nonelective contributions. Similarly, for plan years which begin after December 31, 1988, contributions for which a tax credit is provided may not be treated as elective contributions under paragraphs (b)(2) and (b)(3) of this section.

(6) Elective contributions taken into account for a plan year. An elective contribution may be taken into account under paragraph (b)(2) of this section for a plan year only if it satisfies paragraphs (b)(6)(i) and (b)(6)(ii) of this section.

(i) The elective contribution is allocated to the employee under the plan as of a date within that plan year. For purposes of this rule, an elective contribution is considered allocated as of a date within a plan year only if—

(A) The allocation is not contingent upon the employee's participation in the plan or performance of services on any date subsequent to that date, and

(B) The elective contribution is actually paid to the trust no later than the end of the twelve-month period immediately following the plan year to which the contribution relates.

(ii) The elective contribution relates to compensation that either—

(A) Would have been received by the employee in the plan year but for the employee's election to defer under the arrangement, or

(B) Is attributable to services performed by the employee in the plan year and, but for the employee's election to defer, would have been received by the employee within two and one-half months after the close of the plan year.

Elective contributions that do not satisfy the requirements of paragraphs (b)(6) (i) and (ii) of this section may not be taken into account under paragraph (b)(2) for the plan year with respect to which the contributions were made or for any other plan year. Instead, such elective contributions must satisfy section 401(a)(4) (without regard to the special nondiscrimination test in paragraph (b)(2) of this section) for the plan year for which allocated under the plan as if such elective contributions were the only employer contributions for such year.

(7) Examples. The provisions of this paragraph (b) are illustrated by the following examples. The examples apply the rules in paragraph (b)(4) of this section for plan years beginning after December 31, 1979, and before January 1, 1987, or such later date provided in paragraph (h) of this section.

Example (1). (i) Employees A, B, and C are eligible employees and earn $30,000, $15,000 and $10,000 per year respectively. In addition, their employer, X, contributes a bonus of up to 10 percent of their regular compensation to a trust under a profit-sharing plan that includes a cash or deferred arrangement. Under the arrangement, each eligible employee may elect to receive none, all, or any part of the 10 percent in cash. The employer will contribute the remainder to the trust. For the 1985 plan year, A, B, and C make the following elections:

Employee	Compensation	Elective contribution	Cash election
A	$30,000	$2,000	$1,000
B	15,000	750	750
C	10,000	400	600

(ii) The ratios of employer contributions to the trust on behalf of each eligible employee to the employee's compensation for the plan year (calculated separately for each employee) are:

Employee	Ratio of elective contribution to compensation	Individual's actual deferral percentage (percent)
A	$2,000/$30,000	6.67
B	750/15,000	5.00
C	400/10,000	4.00

(iii) The actual deferral percentage for the top one-third is 6.67 percent (2,000/30,000). The actual deferral percentage for the lower two-thirds is 4.5 percent ((5% + 4%)/2)). Because 6.67 percent is less than 6.75 percent (4.50% multiplied by 1.5), the first percentage test is satisfied.

Example (2). (i) The facts are the same as in Example (1) except that elective contributions are made pursuant to a salary reduction agreement. Compensation includes amounts that are contributed by salary reduction. In addition, A wishes to defer $2.250. Thus, the compensation and elective contributions for A, B, and C are as shown below:

Employee	Compensation (A)	Elective contribution (B)	Actual deferral percentage (B/A) (percent)
A	$30,000	$2,250	7.50
B	15,000	750	5.00
C	10,000	400	4.00

(ii) The actual deferral percentage (ADP) for the top one-third is 7.5 percent. The ADP for the lower two-thirds is 4.5 percent ((5.00% + 4.00%/2). Because 7.5 percent exceeds 6.75 percent (4.50 × 1.5), the first percentage test is not satisfied. Because 7.5 percent is not more than 11.25 percent (4.50% × 2.5) and not more than 7.5 percent (4.50% + 3), the second percentage test is satisfied.

Example (3). (i) Employees 1 through 9 are eligible employees who participate in a profit-sharing plan maintained by employer A. Each eligible employee may elect to defer up to six percent of compensation under the plan. The compensation and elective contributions of these employees for the 1983 plan year are shown below:

Employee	Compensation	Elective contributions
1	$100,000	$6,000
2	80,000	4,800
3	60,000	3,600
4	40,000	1,200
5	30,000	900
6	20,000	600
7	20,000	600
8	10,000	300
9	5,000	150

(ii) For the 1983 plan year, the ratios of the elective contributions on behalf of each employee to the employee's compensation are:

Employee	Ratio of elective contributions to compensation	Individual's deferral percentage (percent)
1	$6,000/ $100,000	6
2	4,800/ 80,000	6
3	3,600/ 60,000	6
4	1,200/ 40,000	3
5	900/ 30,000	3
6	600/ 20,000	3
7	600/ 20,000	3
8	300/ 10,000	3
9	150/ 5,000	3

(iii) The actual deferral percentage for the top one-third, consisting of employees 1, 2, and 3, is six percent. The actual deferral percentage for the lower two-thirds, consisting of employees 4 through 9, is three percent. Because six percent is greater than 4.5 percent (3% multiplied by 1.5), the first percentage test is not satisfied. However, because six percent is not more than three percentage points greater than three percent and six percent is less than 7.5 percent (3% × 2.5), the second percentage test is satisfied.

Example (4). (i) Employees 1 through 9 are the only employees of Employer D. Employer D maintains and contributes to a profit-sharing plan the following amounts:

(A) Six percent of each employee's compensation. These contributions do not satisfy the requirements for qualified nonelective contributions.

(B) Two percent of each employee's compensation. These contributions satisfy the requirements for qualified nonelective contributions.

(C) Up to three percent of each employee's compensation which the employee may elect to receive as a direct cash payment or to defer under the plan.

(ii) For the 1984 plan year, employees 1 through 9 received compensation and plan contributions as indicated in the table below:

Employee	Compensation	Six percent nonqualified nonelective contribution	Two percent qualified nonelective contribution	Elective contributions
1	$100,000	$6,000	$2,000	$3,000
2	80,000	4,800	1,600	2,400
3	60,000	3,600	1,200	1,800
4	40,000	2,400	800	0
5	30,000	1,800	600	0
6	20,000	1,200	400	0
7	20,000	1,200	400	0
8	10,000	600	200	0
9	5,000	300	100	0

(iii) Both types of nonelective contributions are made for all employees. Thus both the six percent and the two percent nonelective employer contributions satisfy the requirements of section 401(a)(4) and paragraph (b)(3)(i) of this section.

(iv) However, the elective contributions under the plan do not by themselves satisfy the special rules in paragraph (b)(4) of this section because, based solely on such elective deferrals, the actual deferral percentage for the top one-third, consisting of employees 1, 2, and 3, is three percent and the actual deferral percentage for the lower two-thirds is zero. Nevertheless, the

two percent nonelective contribution may also be taken into account in applying the special rules because those contributions are qualified nonelective contributions that satisfy paragraph (b)(3) of this section. The six percent nonelective contribution may not be taken into account because it is not a qualified nonelective contribution.

(v) If the two percent qualified nonelective contributions are taken into account, the actual deferral percentage for the top one-third is five percent, and the actual deferral percentage for the lower two-thirds is two percent. Because five percent is not more than three percentage points greater than two percent, and not more than two percent multiplied by 2.5, the actual deferral percentage test in paragraph (b)(4)(i)(B) of this section is satisfied. Thus, the plan satisfies this paragraph (b).

(c) Nonforfeitability—(1) General rule. A cash or deferred arrangement satisfies this paragraph (c) only if each employee's right to the amount attributable to elective contributions—

(i) Is immediately nonforfeitable within the meaning of section 411, without regard to section 411(a)(3), and would be nonforfeitable under the plan regardless of the age and service of the employee or whether the employee is employed on a specific date;

(ii) Is disregarded for purposes of applying section 411(a) to other contributions or benefits; and

(iii) Remains nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) Example. This paragraph may be illustrated by the following example:

Example. Employees B and C are covered by Employer Y's stock bonus plan, which includes a qualified cash or deferred arrangement. Under the plan, Employer Y makes a nonelective contribution on behalf of each employee equal to four percent of their compensation. All employees participating in the plan have a nonforfeitable right to a percentage of their accrued benefit derived from this contribution according to the following table:

Years of service	Nonforfeitable percentage (percent)
Less than 1	0
1	20
2	40
3	60
4	80
5 or more	100

B and C have three and six years of service, respectively. Employer Y also permits employees to elect to defer up to six percent of their compensation through salary reduction agreements. Amounts deferred under these agreements are nonforfeitable at all times. In accordance with paragraph (c)(1)(i), the nonforfeitable percentage of Employer Y's nonelective contribution on behalf of B and C may not be treated as a qualified nonelective contribution under paragraph (b)(3) of this section, because these amounts are nonforfeitable by reason of the completion by B and C of a stated number of years of service, and not regardless of the age and service of B and C.

(d) Distribution limitation—(1) General rule. For plan years which begin before January 1, 1985, a cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions are not distributable earlier than upon one of the following events:

(i) The employee's retirement, death, disability, or separation from service; or

(ii) In the case of a profit-sharing or stock bonus plan, the employee's hardship or attainment of age $59\frac{1}{2}$.

A plan will not fail to satisfy this paragraph by reason of a dividend distribution described in section 404(k)(2).

(2) Hardship—(i) General rule. For purposes of this section, a distribution is on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy such financial need. The determinations of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan. See section 411(d)(6) and the regulations thereunder.

(ii) Immediate and heavy financial need—(A) In general. The determination of whether an employee has an immediate and heavy financial need is to be made on the basis of all relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need shall not fail to qualify as immediate and heavy merely because such need was reasonably foreseeable or voluntarily incurred by the employee.

(B) Deemed immediate and heavy financial need. A distribution will be deemed to be made on account of an immediate and heavy financial need of the employee if the distribution is on account of:

(1) Medical expenses described in section 213(d) incurred by the employee, the employee's spouse, or any dependents of the employee (as defined in section 152);

(2) Purchase (excluding mortgage payments) of a principal residence for the employee; or

(3) Payment of tuition for the next semester or quarter of post-secondary education for the employee, his or her spouse, children, or dependents.

(4) The need to prevent the eviction of the employee from his principal residence or foreclosure on the mortgage of the employee's principal residence.

The Commissioner may expand this list of deemed immediate and heavy financial needs only through the publication of revenue rulings, notices, and other documents of general applicability, rather than on an individual basis.

(iii) Distribution necessary to satisfy financial need—

(A) In general. A distribution will not be treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent such need may be satisfied from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all relevant facts and circumstances. A distribution generally may be treated as necessary to satisfy a financial need if the employer reasonably relies upon the employee's representation that the need cannot be relieved—

(1) Through reimbursement or compensation by insurance or otherwise,

(2) By reasonable liquidation of the employee's assets, to the extent such liquidation would not itself cause an immediate and heavy financial need,

(3) By cessation of elective contributions or employee contributions under the plan, or

(4) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms.

For purposes of this subdivision, the employee's resources shall be deemed to include those assets of his spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act will not be treated as a resource of the employee.

(B) Distribution deemed necessary to satisfy financial need. A distribution will be deemed to be necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied:

(1) The distribution is not in excess of the amount of the immediate and heavy financial need of the employee,

(2) The employee has obtained all distributions, other than hardship distributions, and all nontaxable loans currently available under all plans maintained by the employer,

(3) The plan, and all other plans maintained by the employer, provide that the employee's elective contributions and employee contributions will be suspended for at least 12 months after receipt of the hardship distribution, and

(4) The plan, and all other plans maintained by the employer, provide that the employee may not make elective contributions for the employee's taxable year immediately following the taxable year of the hardship distribution in excess of the applicable limit under section 402(g) for such next taxable year less the amount of such employee's elective contributions for the taxable year of the hardship distribution.

An employee shall not fail to be treated as an eligible employee for purposes of paragraph (b) of this section merely because he is suspended in accordance with this provision. The Commissioner may prescribe additional methods under which distributions will be deemed to be necessary to satisfy an immediate and heavy financial need only through the publication of revenue rulings, notices, and other documents of general applicability.

(iv) Adoption of deemed hardship standards— (A) Exception to section 411(d)(6). Subject to the requirements of paragraph (d)(2)(iv)(B), a plan that permits hardship distributions of amounts subject to the requirements of paragraph (d) of this section will not be treated as violating section 411(d)(6) merely because such plan is amended to permit hardship distributions only in accordance with the deemed hardship standards set forth in paragraphs (d)(2)(ii)(B) and (d)(2)(iii)(B).

(B) Required effective and amendment dates. The exception to section 411(d)(6) set forth in paragraph (d)(2)(iv)(A) is available only with respect to an amendment that is effective on or before the first day of the first plan year commencing on or after January 1, 1989. In the case of a plan maintained pursuant to a collective bargaining agreement, such exception is available only

with respect to an amendment that is effective on or before the later of the first day of the first plan year commencing on or after January 1, 1989, or the first day of the first plan year that the requirements of section 410(b), as modified by the Tax Reform Act of 1986, first apply to such plan. A plan amendment conforming a plan to the deemed hardship standard selected by an employer in accordance with paragraph (d)(2)(iv)(A) and effective by the applicable required effective date must be adopted within the time period permitted for required amendments to the plan under section 1140 of the Tax Reform Act of 1986 (as extended in the regulations under section 401(b)). Such conforming amendment must be consistent with the plan's operation during the period from the applicable required effective date to the date the amendment is required.

(3) Impermissible distributions. Amounts attributable to elective contributions may not be distributed on account of any event not described in this paragraph (d), such as completion of a stated period of plan participation or the lapse of a fixed number of years.

(4) Deemed distributions. The cost of life insurance (P.S. 58 costs) will not be treated as a distribution for purposes of section 401(k)(2) and this paragraph. The making of a loan is not treated as a distribution, even if the loan is secured by the employee's accrued benefit attributable to elective contributions or is includible in the employee's income under section 72(p). However, the reduction, by reason of default on a loan, of an employee's accrued benefit derived from elective contributions is treated as a distribution.

(5) Example. The provisions of this paragraph (d) are illustrated by the following example:

Example. Employer C maintains a profit-sharing plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be withdrawn for any reason after two years following the end of the plan year in which the contributions were made. Because the plan permits distributions of elective contributions before the occurrence of one of the events specified in section 401(k)(2)(B) and this paragraph (d), the plan includes a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income.

(e) Additional requirements—(1) Qualified profit-sharing, stock bonus, pre-ERISA money purchase, and rural electric cooperative plan requirement—(i) General rule. A cash or deferred arrangement satisfies this paragraph (e) only if the elective contributions under such arrangement are treated as contributions under a profit-sharing, stock bonus, pre-ERISA money purchase pension or rural electric cooperative plan that satisfies the requirements of section 401(a). The plan of which a cash or deferred arrangement is a part may provide for other contributions, including employer contributions (other than elective contributions), employee contributions, or both. The plan will be treated as satisfying the requirements of section 401(a) only if such plan, taking into account any cash or deferred arrangement that is part of such plan and any elective contributions under such arrangement, satisfies the requirements of section 401(a). See paragraph (b) of this section for certain limitations on the extent to which elective contributions under a cash or deferred arrangement may be taken into account in determining the extent to which other contributions satisfy the requirements of section 401(a).

(ii) Nondiscrimination requirements. A cash or deferred arrangement satisfies this paragraph (e)(1) only if, in addition to satisfying paragraph (b)(2) of this section with respect to the amount of elective contributions, the plan of which the arrangement is a part satisfies section 401(a)(4) with respect to other benefits, rights, and features under the plan, including, for example, the availability of elective contributions to eligible employees. Thus, for example, the percentage of compensation available under a cash or deferred arrangement for deferral as elective contributions by eligible employees may not discriminate in favor of the group of employees described in section 401(a)(4). Furthermore, for example, if all employees are eligible to make elective contributions under an arrangement, but such contributions may be made only from compensation in excess of a stated amount, such as the Social Security taxable wage base, such arrangement would favor highly compensated employees with respect to the availability of elective contributions and thus would not satisfy section 401(a)(4). In such a case, the plan of which the arrangement is a part fails to satisfy section 401(a). See also §1.401(a)-4 with respect to optional forms of benefit.

(2) Cash availability. A cash or deferred arrangement satisfies this paragraph (e) only if such arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is provided the option to receive a taxable benefit (other than cash) or to have the employer contribute on the employee's behalf to a profit-sharing plan an amount equal to the value of the taxable benefit, such arrangement is not a qualified cash or deferred arrangement. Similarly, if an employee has the option to receive a specified amount in cash or

to have the employer contribute on his behalf to a profit-sharing plan an amount in excess of the specified cash amount, any contribution made by the employer on the employee's behalf in excess of the specified cash amount is not treated as made pursuant to a qualified cash or deferred arrangement. This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(3) Separate accounting—(i) General rule. A cash or deferred arrangement satisfies this paragraph (e) only if all amounts held under a plan that includes a cash or deferred arrangement or under another plan whose contributions are taken into account under the arrangement for purposes of paragraph (b) (including amounts contributed for plan years which begin prior to January 1, 1980, contributions made other than on account of a cash or deferred election, and contributions made for years when the cash or deferred arrangement is not qualified) are treated as attributable to elective contributions subject to the requirements of paragraphs (c) and (d) of this section.

(ii) Exception. The requirements of subdivision (i) of this paragraph (e)(3) will be treated as satisfied if the portion of an employee's benefit that is actually attributable to elective contributions subject to the requirements of paragraphs (c) and (d) of this section, and to qualified nonelective contributions and qualified matching contributions treated as elective contributions, is determined by an acceptable separate accounting between such portion and any other benefits. Separate accounting is not acceptable unless gains, losses, withdrawals, and other credits or charges are separately allocated on a reasonable and consistent basis to the accounts in which accrued benefits are subject to paragraphs (c) and (d) of this section and to the accounts for other benefits. Subject to section 401(a)(4), forfeitures are not required to be allocated to the accounts in which benefits are subject to paragraphs (c) and (d) of this section.

(f) Correction of excess contributions—(1) General rule. A cash or deferred arrangement will not be treated as failing to satisfy section 401(k)(3) or paragraph (b)(2) of this section with respect to the amount of elective contributions under the arrangement if the employer, in accordance with the terms of the plan and paragraph (b)(3) of this section, makes qualified nonelective contributions or qualified matching contributions that are treated as elective contributions under the arrangement and that, in combination with the elective contributions, satisfy the requirements of paragraph (b)(2) of this section. In addition, a cash or deferred arrangement will not be treated as failing to satisfy section 401(k)(3) or paragraph (b)(2) of this section with respect to the amount of the elective contributions if, in accordance with the terms of the plan that includes the arrangement, excess contributions on behalf of highly compensated employees are recharacterized in accordance with paragraph (f)(3) of this section. Excess contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year.

(2) Amount of excess contributions. The amount of excess contributions for a highly compensated employee for a plan year is to be determined by the following leveling method, under which the actual deferral ratio of the highly compensated employee with the highest actual deferral ratio is reduced to the extent required to—

(i) Enable the arrangement to satisfy the actual deferral percentage test, or

(ii) Cause such highly compensated employee's actual deferral ratio to equal the ratio of the highly compensated employee with the next highest actual deferral ratio.

This process must be repeated until the cash or deferred arrangement satisfies the actual deferral percentage test. For each highly compensated employee, the amount of excess contributions is equal to the total elective contributions, plus qualified nonelective contributions and qualified matching contributions treated as elective contributions, on behalf of the employee (determined prior to the application of this paragraph (f)(2)) minus the amount determined by multiplying the employee's actual deferral ratio (determined after application of this subparagraph) by his compensation used in determining such ratio. In no case shall the amount of excess contributions to be recharacterized for a plan year with respect to any highly compensated employee exceed the amount of elective contributions made on behalf of such highly compensated employee for such plan year.

(3) Recharacterization of excess contributions—(i) General rule. Excess contributions are recharacterized in accordance with this paragraph (f)(3) only if the excess contributions are treated as described in paragraph (f)(3)(ii) of this section and all of the conditions set forth in paragraph (f)(3)(iii) of this section are satisfied.

(ii) Treatment of recharacterized excess contributions. Excess contributions recharacterized under this paragraph (f)(3) are includible in the

employee's gross income on the earliest dates any elective contribution made on behalf of the employee during the plan year would have been received by the employee had he originally elected to receive the amounts in cash or on such later date permitted in paragraph (f)(3)(iv) of this section. Such recharacterized excess contributions must be treated as employee contributions for the following purposes:

(A) The payor or plan administrator must report such recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by—

(1) Timely providing such forms as the Commissioner shall designate to the employer and to employees whose excess contributions are recharacterized under this paragraph (f)(3); and

(2) Timely taking such other action as the Commissioner shall require; and

(B) The plan administrator must account for such amounts as contributions by the employee for purposes of sections 72 and 6047.

For purposes of section 401(a)(4) and paragraph (b) of this section, recharacterized excess contributions are to be treated as employee contributions. For all other purposes under the Code, however, including sections 404, 409, 411, 412, 415, 416, and 417, and, with respect to recharacterized excess contributions for plan years which begin after December 31, 1988, section 401(k)(2), recharacterized excess contributions continue to be treated as employer contributions that are elective contributions. Thus, for example, recharacterized excess contributions remain subject to the requirements of paragraphs (c) and (d) of this section; must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and § 1.415-6(b). In addition, these amounts are not treated as compensation for purposes of sections 404 and 415, and may be treated as compensation for purposes of sections 401(a)(4), 401(a)(5), 401(k), 401(*l*) and 414(s) only to the extent that elective contributions may be treated, and are treated under the plan, as compensation. Recharacterized excess contributions which relate to plan years ending on or before October 24, 1988 may be treated as either employer contributions or employee contributions for purposes of paragraph (d) of this section.

(iii) Additional requirements—(A) Time of recharacterization. Excess contributions may not be recharacterized under this subparagraph after the later of (1) two and one-half months after the close of the plan year to which the recharacterization relates, or (2) October 24, 1988. Recharacterization will be deemed to have occurred on the date on which the last of those highly compensated employees with excess contributions to be recharacterized is notified in accordance with paragraph (f)(3)(ii). Such notification may be provided by such means as the Commissioner may designate.

(B) [Reserved.]

(C) [Reserved.]

(iv) Transition rules. If amounts recharacterized for any plan year were not previously included in income, they are to be treated as received by employees for income tax purposes on the first day of the first plan year ending in 1988.

If notice of recharacterization is provided to the affected highly compensated employees by October 24, 1988, recharacterization is deemed to have occurred 2½ months after the close of the plan year and the penalty tax of section 4979 will not be imposed. The rules in this subdivision (iv) are effective only for plan years which end on or before August 8, 1988.

(v) Example. The principles of this paragraph (f)(3) are illustrated by the following example:

Example. (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrangement. Under Plan Y, each eligible employee may elect to defer up to 10 percent of his compensation under a salary reduction agreement. These are the only contributions to the plan. X pays the amounts deferred under the arrangement to the trust under Plan Y each month on the last day of the month. Salaries are paid on the same date.

(ii) In January 1989, X determines that, during 1988, the compensation and actual deferral percentages (ADPs) of X's six employees were as follows:

Employee	Compensation (A)	Elective contribution (B)	ADP (B/A) (percent)
A	$70,000	$7,000	10.00
B	60,000	4,500	7.50
C	20,000	1,000	5.00
D	15,000	0	0
E	10,000	350	3.50
F	10,000	350	3.50

The ADP for X's highly compensated employees, A and B, is 8.75 percent ((10.00% + 7.50%)/2). The ADP for X's other employees is three percent (5.00 percent) + 0% + 3.50% + 3.50%)/4). Because 8.75 percent is more than 2.0 times three percent and more than three percent plus two percent, the plan fails to satisfy paragraph (b)(4) of this section.

(iii) Plan Y provides that each highly compensated participant will have his excess contributions, as defined in paragraph (g)(13) of this section, recharacterized. The amount to be so treated will be determined according to the method described in paragraph (f)(2)(ii) of this section.

(iv) In order to satisfy paragraph (b)(4) of this section, Plan Y must reduce the ADP for X's highly compensated employees to not more than five percent. This will satisfy the test described in paragraph (b)(5)(iii) of this section, because five percent is not more than 2.0 times three percent and is not more than two percentage points greater than three percent. Plan Y does this by reducing A's ADP to 7.5 percent (the ADP of the highly compensated employee having the next highest ADP). Since this is not sufficient to satisfy the ADP test in paragraph (b)(4)(iii) of this section, the ADP of both A and B must be reduced to five percent.

(v) The maximum dollar amount that may be deferred by each employee is determined by using the formula D = (ADP × S) where D is the maximum allowable deferral, ADP is the reduced ADP, and S is the compensation. Thus, A's maximum allowable deferral is $3,500 (.05 × $70,000), and B's maximum allowable deferral is $3,000 (.05 × $60,000). The balance of the original deferrals by A and B ($3,500 and $1,500 respectively) must be included in their taxable wages for 1988, the year in which X would have paid cash to A and B.

(vi) A deferred $583.33 per month, except for January, February, March, and April, when he deferred $583.34. Pursuant to the first-in, first-out rule in paragraph (f)(3)(ii) of this paragraph, the deferrals made in January, February, March, April, May, and June as well as $.02 of the deferral made in July, are treated as employee contributions. A similar procedure is undertaken with respect to B. X and the plan administrator provide A and B with such forms and notices as the Commissioner may require. If A and B had already filed income tax returns for 1988, they must file amended returns. In addition, the plan administrator must satisfy paragraph (f)(3)(ii)(B) of this section.

(g) Definitions. For purposes of this section, the following definitions shall apply:

(1) Employee. The term "employee" means an individual who performs services for the employer and who is either a common law employee of the employer or a self-employed individual treated as an employee pursuant to section 401(c)(1). The term "employee" also includes a leased employee who is treated as an employee of the employer-recipient pursuant to the provisions of section 414(n)(2) or 414(*o*)(2) other than individuals covered by a plan described in section 414(n)(5). Individuals that an employer treats as leased employees under section 414(n), pursuant to the requirements of section 414(*o*), are considered to be leased employees for purposes of this rule.

(2) Employer. The term "employer" means the employer maintaining the plan and those employers required to be aggregated with such employer under sections 414(b), (c), (m), or (*o*).

(3) Eligible employee—(i) In general. The term "eligible employee" means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. For example, if an employee must perform certain acts in order to be eligible to make a cash or deferred election for a plan year, such employee is an eligible employee for such plan year without regard to whether the employee performs such acts. An employee is an eligible employee if he is unable to make a cash or deferred election merely because his compensation is less than a stated dollar amount.

(ii) Certain one-time elections. An employee is not an eligible employee merely because such employee, upon commencing employment with the employer or upon the employee's first becoming eligible to make a cash or deferred election under any arrangement of the employer, is given the one-time opportunity to elect, and such employee did in fact elect, not to be eligible to make a cash or deferred election under such plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer.

(4) Elective contributions. The term "elective contributions" means employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement (whether or not such arrangement is a qualified cash or deferred arrangement under paragraph (a)(4)). No amount that has become currently available to an employee or that is designated or treated, at the time of deferral or contribution, as an after-tax contribution may be treated as an elective contribution. See paragraphs (a)(2) and (a)(3).

(5) Nonelective contributions. The term "nonelective contributions" means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

(6) Matching contributions. The term "matching contributions" means employer contributions made to a plan on behalf of an employee on account of employee contributions or elective contributions of such employee.

(7) Qualified matching contributions and qualified nonelective contributions—(i) Qualified matching contributions. The term "qualified matching contributions" means matching contributions that satisfy the additional requirements of paragraph (g)(7)(iii) of this section.

(ii) Qualified nonelective contributions. The term "qualified nonelective contributions" means employer contributions, other than elective contributions and matching contributions, that satisfy the additional requirements of paragraph (g)(7)(iii) of this section.

(iii) Additional requirements. Except to the extent that paragraphs (c) and (d) of this section specifically provide otherwise, the matching contributions and the nonelective contributions must satisfy the requirements of paragraphs (c) and (d) as though such contributions were elective contributions without regard to whether such contributions are actually taken into account as elective contributions under paragraphs (b)(2) and (b)(3).

(8) Actual deferral percentage—(i) General rule. The actual deferral percentage for the group of eligible highly compensated employees, as well as the actual deferral percentage for the group of other eligible employees, for a plan year is the average of the actual deferral ratios, calculated separately for each employee in the group, of the amount of elective contributions (including qualified nonelective contributions and qualified matching contributions treated as elective contributions under paragraph (b)(3)) made on behalf of each employee for the plan year to the employee's compensation for the plan year. For plan years which begin after December 31, 1988, or such later date provided in paragraph (h) of this section, such actual deferral ratios and the actual deferral percentage for each group shall be calculated to the nearest one-hundredth of one percent of the employee's compensation. The actual deferral ratio of an eligible employee who makes no elective contribution is zero.

(ii) Employee eligible under more than one arrangement. In the case of an employee who is eligible to participate in more than one cash or deferred arrangement of the same employer, the actual deferral ratio shall be calculated by treating all the cash or deferred arrangements in which the employee is eligible to participate as one arrangement. For example, if an employee with compensation of $80,000 may make elective contributions under two separate cash or deferred arrangements, the actual deferral ratio for such employee under each arrangement is to be calculated by dividing the total elective contributions by the employee under both arrangements by $80,000. This paragraph (g)(8)(ii) is effective for plan years beginning after December 31, 1984. For plan years which begin after December 31, 1986, or such later date provided under paragraph (h) of this section, this paragraph (g)(8)(ii) shall apply only to employees who are highly compensated employees. See paragraph (b)(5) of this section for the treatment of certain multiple plans and cash or deferred arrangements.

(9) Compensation—(i) Years before January 1, 1987—(A) In general. An employee's compensation for a plan year beginning before January 1, 1987, or such later date provided under paragraph (h) of this section, is the amount taken into account under the plan (or plans) in calculating the elective contribution that may be made on behalf of the employee. In a plan that is top-heavy (as defined in section 416), such compensation may not exceed $200,000. Compensation may not exclude amounts less than a stated amount, such as the integration level under the plan. Compensation may include all compensation for the plan year, including compensation for the period when an employee was ineligible to make a cash or deferred election.

(B) Nondiscrimination. (1) If the plan's definition of compensation has the effect of discriminating in favor of employees who are highly compensated, a nondiscriminatory definition shall be determined by the Commissioner.

(2) A plan's definition of compensation will be treated as nondiscriminatory if the plan defines compensation for a plan year either as (i) an employee's total nondeferred compensation includible in gross income plus elective contributions under the plan and/or elective contributions under a plan described in section 125 or (ii) an employee's W-2 or total nondeferred compensation includible in gross income.

(ii) Years after December 31, 1986. For plan years which begin after December 31, 1986, or such later date provided in paragraph (h) of this section, "compensation" has the meaning given such term by section 414(s). For plan years beginning after December 31, 1988, or on or after the later date provided under paragraph (h) of this section, the applicable period under section 414(s) for purposes of applying section 401(k) and this section is the plan year for which a determination under paragraph (b) is being made.

(10) Highly compensated employees. (i) For plan years which begin after December 31, 1979, and before January 1, 1987, or such later date provided under paragraph (h) of this section, for purposes of the actual deferral percentage test, highly compensated employees are the one-third of all eligible employees (rounded to the nearest integer) who receive the most compensation. When one or more employees of a group would be highly compensated employees except that each member of the group receives the same amount of compensation, the employer shall designate which employees of the group are highly compensated, so that one-third of all eligible employees are considered highly compensated.

(ii) For plan years beginning after December 31, 1986, or such later date provided under paragraph (h) of this section, the term "highly compensated employee" has the meaning given such term by section 414(q).

(11) Pre-ERISA money purchase pension plan. (i) A pre-ERISA money purchase pension plan is a pension plan—

(A) That is a defined contribution plan (as defined in section 414(i));

(B) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement described in paragraph (a)(3) of this section; and

(C) Under which neither the employee contributions nor the employer contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(ii) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the plan.

(12) Rural electric cooperative plan. For purposes of this section, a rural electric cooperative plan is a plan described in section 401(k)(7).

(13) Excess contributions. The term "excess contributions" means, with respect to a plan year, the excess of the elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions under paragraphs (b)(2) and (b)(3), on behalf of eligible highly compensated employees for the plan year over the maximum amount of such contributions permitted under paragraphs (b)(2) and (b)(4). The amount of excess contributions for each highly compensated employee is determined by using the method described in paragraph (f)(2) of this section.

(h) Effective dates—(1) In general. Except as otherwise provided, in this paragraph (h), or as specifically provided elsewhere in this section, this section shall apply to plan years beginning after December 31, 1979.

(2) Collectively bargained plans. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986,

(i) The provisions of this section first effective for plan years which begin after December 31, 1986, shall not apply to years which begin before the earlier of—

(A) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(B) January 1, 1989; and

(ii) The provisions of this section first effective for plan years which begin after December 31, 1988, shall not apply to years which begin before the earlier of—

(A) The later of—

(*1*) January 1, 1989, or,

(*2*) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986) or

(B) January 1, 1991.

(3) Transitional rules. (i) See § 1.402(a)-1(d)(3) for a transitional rule applicable to cash or deferred arrangements in existence on June 27, 1974.

(ii) For plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase pension plan, plan years beginning after July 18, 1984) and before January 1, 1988, a reasonable interpretation of the rules set forth in section 401(k) of the Code (as in effect during those years) may be relied upon to determine whether a cash or deferred arrangement was qualified during those years. Operation in accordance with the proposed regulations published in the Federal Register on November 10, 1981, 46 FR 55544, will be deemed a reasonable interpretation of section 401(k).

(4) Transitional rules for plans of state and local governments. (i) A plan adopted by a state or local government prior to May 6, 1986, that is not a collectively bargained plan is subject to the transitional rules of paragraphs (h)(4) (ii), (iii), and (iv) of this section.

(ii) For plan years beginning before January 1, 1989, the plan is subject to the ADP test in section 401(k)(3) prior to its amendment by section 1116(a) of TRA '86. For plan years beginning after December 31, 1988, the plan is subject to the ADP test in paragraph (b)(4)(i) of this section.

(iii) (A) For plan years beginning before January 1, 1989, in the case of an employee who is eligible to participate in more than one cash or deferred arrangement of the same employer, the actual

deferral percentage shall be calculated by treating all cash or deferred arrangements in which the employee is eligible to participate as one cash or deferred arrangement.

(B) For plan years beginning after December 31, 1988, in the case of a highly compensated employee who is eligible to participate in more than one cash or deferred arrangement of the same employer, the actual deferral percentage shall be calculated by treating all cash or deferred arrangements in which the highly-compensated employee is eligible to participate as one cash or deferred arrangement.

(iv) For plan years beginning before January 1, 1989, the plan must use the definition of "highly compensated employee" contained in paragraph (g)(10)(i) of this section, and the definition of compensation contained in paragraph (g)(9)(i) of this section. For plan years which begin after December 31, 1988, the plan must use the definitions of "highly compensated employee" and "compensation" contained in sections 414(q) and (s), respectively, for purposes of the participation and discrimination standards of paragraph (b) of this section and must follow the rules pertaining to compensation in paragraph (g)(9)(ii) of this section.

(v) In the case of a plan that is maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers adopted by a state or local government prior to May 6, 1986, the provisions in paragraphs (h)(4) (ii), (iii) and (iv) of this section and other provisions of this section that would be subject to paragraph (h)(2) if they were not a state or local plan described above, effective for plan years beginning after December 31, 1988, shall not apply to years beginning before the earlier of—

(A) The later of—

(1) January 1, 1989, or

(2) The date on which the last such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(B) January 1, 1991.

[T.D. 8217, 53 FR 29664, Aug. 8, 1988; 53 FR 34194, Sept. 2, 1988; 53 FR 34285, Sept. 6, 1988; 53 FR 36391, Sept. 19, 1988; 53 FR 43688, Oct. 28, 1988]

§ 1.402(a)–1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) In general. (1)(i) Section 402 relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter.

(ii) The provisions of section 402(a) relate only to a distribution by a trust described in section 401(a) which is exempt under section 501(a) for the taxable year of the trust in which the distribution is made. With two exceptions, the distribution from such an exempt trust when received or made available is taxable to the distributee to the extent provided in section 72 (relating to annuities). First, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such distributions. For taxable years beginning after December 31, 1963, such distributions may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). Secondly, certain total distributions described in section 402(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see subparagraph (6) of this paragraph. Under certain circumstances, an amount representing the unrealized appreciation in the value of the securities of the employer is excludable from gross income for the year of distribution. For the rules relating to such exclusion, see paragraph (b) of this section. Furthermore, the exclusion provided by section 105(d) is applicable to a distribution from a trust described in section 401(a) and exempt under section 501(a) if such distribution constitutes wages or payments in lieu of wages for a period during which an employee is absent from work on account of a personal injury or sickness. See § 1.72–15 for the rules relating to the tax treatment of accident or health benefits received under a plan to which section 72 applies.

(iii) Except as provided in paragraph (b) of this section, a distribution of property by a trust described in section 401(a) and exempt under section 501(a) shall be taken into account by the distributee at its fair market value.

(iv) If a trust is exempt for the taxable year in which the distribution occurs, but was not so exempt for one or more prior taxable years under section 501(a) (or under section 165(a) of the Internal Revenue Code of 1939 for years to which such section was applicable), the contributions of the employer which were includible in the gross income of the employee for the taxable year when made shall, in accordance with section 72(f), also be treated as part of the consideration paid by the employee.

(v) If the trust is not exempt at the time the distribution is received by or made available to the employee, see section 402(b) and paragraph (b) of § 1.402(b)-1.

(vi) For the treatment of amounts paid to provide medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401-14, see paragraph (h) of § 1.72-15.

(2) If a trust described in section 401(a) and exempt under section 501(a) purchases an annuity contract for an employee and distributes it to the employee in a year for which the trust is exempt, the contract containing a cash surrender value which may be available to an employee by surrendering the contract, such cash surrender value will not be considered income to the employee unless and until the contract is surrendered. For the rule as to nontransferability of annuity contracts issued after 1962, see paragraph (b)(2) of § 1.401-9. If, however, the contract distributed by such exempt trust is a retirement income, endowment, or other life insurance contract and is distributed after October 26, 1956, the entire cash value of such contract at the time of distribution must be included in the distributee's income in accordance with the provisions of section 402(a), except to the extent that, within 60 days after the distribution of such contract, all or any portion of such value is irrevocably converted into a contract under which no part of any proceeds payable on death at any time would be excludable under section 101(a) (relating to life insurance proceeds). If the contract distributed by such trust is a transferable annuity contract issued after 1962, or a retirement income, endowment, or other life insurance contract which is distributed after 1962 (whether or not transferable), then notwithstanding the preceding sentence the entire cash value of the contract is includible in the distributee's gross income, unless within such 60 days such contract is also made nontransferable.

(3) For the rules applicable to premiums paid by a trust described in section 401(a) and exempt under section 501(a) for the purchase of retirement income, endowment, or other contracts providing life insurance protection payable upon the death of the employee-participant, see paragraph (b) of § 1.72-16.

(4) For the rules applicable to the amounts payable by reason of the death of an employee under a contract providing life insurance protection, or an annuity contract, purchased by a trust described in section 401(a) and exempt under section 501(a), see paragraph (c) of § 1.72-16.

(5) If pension or annuity payments or other benefits are paid or made available to the beneficiary of a deceased employee or a deceased retired employee by a trust described in section 401(a) which is exempt under section 501(a), such amounts are taxable in accordance with the rules of section 402(a) and this section. In case such amounts are taxable under section 72, the "investment in the contract" shall be determined by reference to the amount contributed by the employee and by applying the applicable rules of sections 72 and 101(b)(2)(D). In case the amounts paid to, or includible in the gross income of, the beneficiaries of the deceased employee or deceased retired employee constitute a distribution to which subparagraph (6) of this paragraph is applicable, the extent to which the distribution is taxable is determined by reference to the contributions of the employee, by reference to any prior distributions which were excludable from gross income as a return of employee contributions, and by applying the applicable rules of sections 72 and 101(b).

(6)(i) If the total distributions payable with respect to any employee under a trust described in section 401(a) which in the year of distribution is exempt under section 501(a) are paid to, or includible in the gross income of, the distributee within one taxable year of the distributee on account of the employee's death or other separation from the service, or death after such separation from service, the amount of such distribution, to the extent it exceeds the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The total distributions payable are includible in the gross income of the distributee within one taxable year if they are made available to such distributee and the distributee fails to make a timely election under section 72(h) to receive an annuity in lieu of such total distributions. The "net amount contributed by the employee" is the amount actually contributed by the employee plus any amounts considered to be con-

tributed by the employee under the rules of sections 72(f), 101(b), and subparagraph (3) of this paragraph, reduced by any amounts theretofore distributed to him which were excludable from gross income as a return of employee contributions. See, however, paragraph (b) of this section for rules relating to the exclusion of amounts representing net unrealized appreciation in the value of securities of the employer corporation. In addition, all or part of the amount otherwise includible in gross income under this paragraph by a non-resident alien individual in respect of a distribution by the United States under a qualified pension plan may be excludable from gross income under section 402(a)(4). For rules relating to such exclusion, see paragraph (c) of this section. For additional rules relating to the treatment of total distributions described in this subdivision in the case of a nonresident alien individual, see sections 871 and 1441 and the regulations thereunder.

(ii) The term "total distributions payable" means the balance to the credit of an employee which becomes payable to a distributee on account of the employee's death or other separation from the service or on account of his death after separation from the service. Thus, distributions made before a total distribution (for example, annuity payments received by the employee after retirement), will not defeat application of the capital gains treatment with respect to the total distributions received by a beneficiary upon the death of the employee after retirement. However, a distribution on separation from service will not receive capital gains treatment unless it constitutes the total amount in the employee's account at the time of his separation from service. If the total amount in the employee's account at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the distributee within one taxable year of the distributee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount, attributable to the last year of service, is credited to the account of the employee and distributed.

(iii) If an employee retires and commences to receive an annuity but subsequently, in some succeeding taxable year, is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(iv) If the "total distributions payable" are paid or includible in the gross income of several distributees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. The total distributions payable are paid within one taxable year of the distributees when, for example, a portion of such total is distributed in cash to one distributee and the balance is used to purchase an annuity contract which is distributed to the other distributee. However, if the share of any distributee is not paid or includible in his gross income within the same taxable year in which the shares of the other distributees are paid or includible in their gross income, none of the distributees is entitled to the capital gains treatment, since the total distributions payable are not paid or includible in the distributees' gross income within one taxable year. For example, if the total distributions payable are made available to each of two distributees and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share in installment payments from the trust, the capital gains treatment does not apply to either distributee.

(v) For regulations as to certain plan terminations, see § 1.402(e)–1.

(vi) The term "total distributions payable" does not include United States Retirement Plan Bonds held by a trust to the credit of an employee. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains retirement plan bonds registered in the name of such employee. Similarly, the proceeds of a retirement plan bond received as a part of the total amount to the credit of an employee will not be entitled to capital gains treatment. See section 405(e) and paragraph (a)(4) of § 1.405–3.

(vii) For purposes of determining whether the total distributions payable to an employee have been distributed within one taxable year, the term "total distributions payable" includes amounts held by a trust to the credit of an employee which are attributable to contributions on behalf of the employee while he was a self-employed individual in the business with respect to which the plan was established. Thus, a distribution by a qualified trust is not a total distributions payable with respect to an employee if the trust retains amounts which are so attributable.

(viii) The term "total distributions payable" does not include any amount which has been placed in a separate account for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14. Thus, a distribution by a qualified trust may constitute a total distributions payable with respect to an employee even though the trust retains amounts attributable to the funding of medical benefits described in section 401(h).

(7) The capital gains treatment provided by section 402(a)(2) and subparagraph (6) of this paragraph is not applicable to distributions paid to a distributee to the extent such distributions are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see § 1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

(8) For purposes of this section, the term "employee" includes a self-employed individual who is treated as an employee under section 401(c)(1), and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4).

(b) Distributions including securities of the employer corporation—(1) In general. (i) If a trust described in section 401(a) which is exempt under section 501(a) makes a distribution to a distributee, and such distribution includes securities of the employer corporation, the amount of any net unrealized appreciation in such securities shall be excluded from the distributee's income in the year of such distribution to the following extent:

(a) If the distribution constitutes a total distribution to which the regulations of paragraph (a)(6) of this section are applicable, the amount to be excluded is the entire net unrealized appreciation attributable to that part of the total distribution which consists of securities of the employer corporation; and

(b) If the distribution is other than a total distribution to which paragraph (a)(6) of this section is applicable, the amount to be excluded is that portion of the net unrealized appreciation in the securities of the employer corporation which is attributable to the amount considered to be contributed by the employee to the purchase of such securities.

The amount of net unrealized appreciation which is excludable under the regulations of (a) and (b) of this subdivision shall not be included in the basis of the securities in the hands of the distributee at the time of distribution for purposes of determining gain or loss on their subsequent disposition. In the case of a total distribution the amount of net unrealized appreciation which is not included in the basis of the securities in the hands of the distributee at the time of distribution shall be considered as a gain from the sale or exchange of a capital asset held for more than six months to the extent that such appreciation is realized in a subsequent taxable transaction. However, if the net gain realized by the distributee in a subsequent taxable transaction exceeds the amount of the net unrealized appreciation at the time of distribution, such excess shall constitute a long-term or short-term capital gain depending upon the holding period of the securities in the hands of the distributee.

(ii) For purposes of section 402(a) and of this section, the term "securities" means only shares of stock and bonds or debentures issued by a corporation with interest coupons or in registered form, and the term "securities of the employer corporation" includes securities of a parent or subsidiary corporation (as defined in subsections (e) and (f) of section 425) of the employer corporation.

(2) Determination of net unrealized appreciation. (i) The amount of net unrealized appreciation in securities of the employer corporation which are distributed by the trust is the excess of the market value of such securities at the time of distribution over the cost or other basis of such securities to the trust. Thus, if a distribution consists in part of securities which have appreciated in value and in part of securities which have depreciated in value, the net unrealized appreciation shall be considered to consist of the net increase in value of all of the securities included in the distribution. For this purpose, two or more distributions made by a trust to a distributee in a single taxable year of the distributee shall be treated as a single distribution.

(ii) For the purpose of determining the net unrealized appreciation on a distributed security of the employer corporation, the cost or other basis of such security to the trust shall be computed in accordance with whichever of the following rules is applicable:

(a) If a security was earmarked for the account of a particular employee at the time it was purchased by or contributed to the trust so that the cost or other basis of such security to the trust is

reflected in the account of such employee, such cost or other basis shall be used.

(b) If as of the close of each taxable year of the trust (or other specified period of time not in excess of 12 consecutive calendar months) the trust allocates among the accounts of participating employees all securities acquired by the trust during the period (exclusive of securities unallocated under a plan providing for allocation in whole shares only), the cost or other basis to the trust of any securities allocated as of the close of a particular allocation period shall be the average cost or other basis to the trust of all securities of the same type which were purchased or otherwise acquired by the trust during such allocation period. For purposes of determining the average cost to the trust of securities included in a subsequent allocation, the actual cost to the trust of the securities unallocated as of the close of a prior allocation period shall be deemed to be the average cost or other basis to the trust of securities of the same type allocated as of the close of such prior allocation period.

(c) In a case where neither (a) nor (b) of this subdivision is applicable, if the trust fund, or a specified portion thereof, is invested exclusively in one particular type of security of the employer corporation, and if during the period the distributee participated in the plan none of such securities has been sold except for the purpose of paying benefits under the trust or for the purpose of enabling the trustee to obtain funds with which to exercise rights which have accrued to the trust, the cost or other basis to the trust of all securities distributed to such distributee shall be the total amount credited to the account of such distributee (or such portion thereof as was available for investment in such securities) reduced by the amount available for investment but uninvested on the date of distribution. If at the time of distribution to a particular distributee a portion of the amount credited to his account is forfeited, appropriate adjustment shall be made with respect thereto in determining the cost or other basis to the trust of the securities distributed.

(d)(1) In all other cases, there shall be used the average cost (or other basis) to the trust of all securities of the employer corporation of the type distributed to the distributee which the trust has on hand at the time of the distribution, or which the trust had on hand on a specified inventory date which date does not precede the date of distribution by more than twelve calendar months. If a distribution includes securities of the employer corporation of more than one type, the average cost (or other basis) to the trust of each type of security distributed shall be determined. The average cost to the trust of securities of the employer corporation on hand on a specified inventory date (or on hand at the time of distribution) shall be computed on the basis of their actual cost, considering the securities most recently purchased to be those on hand, or by means of a moving average calculated by subtracting from the total cost of securities on hand immediately preceding a particular sale or distribution an amount computed by multiplying the number of securities sold or distributed by the average cost of all securities on hand preceding such sale or distribution.

(2) These methods of computing average cost may be illustrated by the following examples:

Example (1). A, a distributee who makes his income tax returns on the basis of a calendar year, receives on August 1, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, ten shares of class D stock of the employer corporation. On July 1, 1954 (the specified inventory date of the trust), the trust had on hand 80 shares of class D stock. The average cost of the 10 shares distributed, on the basis of the actual cost method, is $100 computed as follows:

Shares	Purchase date	Cost per share	Total cost
20	June 24, 1954	$101	$2,020
40	Jan. 10, 1953	102	4,080
20	Oct. 20, 1952	95	1,900
80			$8,000

Example (2). B, a distributee who makes his income tax returns on the basis of a calendar year, receives on October 31, 1954, in a total distribution, to which paragraph (a)(6) of this section is applicable, 20 shares of class E stock of the employer corporation. The specified inventory date of the trust is the last day of each calendar year. The trust had on hand on December 31, 1952, 1,000 shares of class E stock of the employer corporation. During the calendar year 1953 the trust distributed to four distributees a total of 100 shares of such stock and acquired, through a number of purchases, a total of 120 shares. The average cost of the 20 shares distributed to B, on the basis of the moving average method, is $52 computed as follows:

	Shares	Total cost	Average cost
On hand Dec. 31, 1952	1,000	$50,000	$50
Distributed during 1953 at average cost of $50	100	5,000	(0)
	900	45,000	(0)
Purchased during 1953	120	8,040	(0)
On hand Dec. 31, 1953	1,020	53,040	52

(3) Unrealized appreciation attributable to employee contributions. In any case in which it is necessary to determine the amount of net unrealized appreciation in securities of the employer

corporation which is attributable to contributions made by an employee:

(i) The cost or other basis of the securities to the trust and the amount of net unrealized appreciation shall first be determined in accordance with the regulations in subparagraph (2) of this paragraph;

(ii) The amount contributed by the employee to the purchase of the securities shall be solely the portion of his actual contributions to the trust properly allocable to such securities, and shall not include any part of the increment in the trust fund expended in the purchase of the securities;

(iii) The amount of net unrealized appreciation in the securities distributed which is attributable to the contributions of the employee shall be that proportion of the net unrealized appreciation determined under the regulations of subparagraph (2) of this paragraph which the contributions of the employee properly allocable to such securities bear to the cost or other basis to the trust of the securities;

(iv) If a distribution consists solely of securities of the employer corporation, the contributions of the employee expended in the purchase of such securities shall be allocated to the securities distributed in a manner consistent with the principles set forth in subparagraph (2)(ii)(a), (b), (c), or (d) of this paragraph, whichever is applicable. Thus, the amount of the employee's contribution which can be identified as having been expended in the purchase of a particular security shall be allocated to such security, and the amount of such contribution which cannot be so identified shall be allocated ratably among the securities distributed. If a distribution consists in part of securities of the employer corporation and in part of cash or other property, appropriate allocation of a portion of the employee's contribution to such cash or other property shall be made unless such a location is inconsistent with the terms of the plan or trust.

(v) The application of this subparagraph may be illustrated by the following example:

Example. A trust distributes ten shares of stock issued by the employer corporation each of which has an average cost to the trust of $100, consisting of employee contributions in the amount of $60 and employer contributions in the amount of $40, and on the date of distribution has a fair market value of $180. The portion of the net unrealized appreciation attributable to the contributions of the employee with respect to each of the shares of stock is $48 computed as follows:

(1) Value of one share of stock on distribution date	$180
(2) Employee contributions	60
(3) Employer contributions	40
(4) Total contributions	100
(5) Net unrealized appreciation	80
(6) Portion of net unrealized appreciation attributable to employee contributions, 60/100 (amount of employee contributions (item 2) over total contributions (item 4) of $80 (item 5))	48

(vi) For the purpose of determining gain or loss to the distributee in the year or years in which any share of stock referred to in the example in subdivision (v) of this subparagraph is sold or otherwise disposed of in a taxable transaction, the basis of each such share in the hands of the distributee at the time of the distribution by the trust will be $132 computed as follows:

(a) Employee contributions	$60
(b) Employer contributions (taxable as ordinary income in the year the securities were distributed)	40
(c) Portion of net unrealized appreciation attributable to employer contributions (item (5) minus item (6)) (taxable as ordinary income in the year the securities were distributed)	32
(d) Basis of stock	132

(4) **Change in exempt status of trust.** For principles applicable in making appropriate adjustments if the trust was not exempt for one or more years before the year of distribution, see paragraph (a) of this section.

(c) **Certain distributions by United States to nonresident alien individuals.** (1) This paragraph applies to a distribution—

(i) Which is made by the United States under a pension plan described in section 401(a);

(ii) Which is made in respect of services performed by an employee of the United States; and

(iii) Which is received by, or made available to, a nonresident alien individual (including a nonresident alien individual who is a beneficiary of a deceased employee) during a taxable year beginning after December 31, 1959.

The amount of such a distribution that is includible in the gross income of the nonresident alien individual under section 402(a)(1) or (2) shall not exceed an amount which bears the same ratio to the amount which would be includible in gross income if it were not for this paragraph, as—

(a) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made, reduced by the amount of such basic salary which was not includible in the employee's gross income by rea-

son of being from sources without the United States, bears to

(b) The aggregate basic salary paid by the United States to the employee for his services in respect of which the distribution is being made.

See section 402(a)(4). See, also, paragraph (a) of this section for rules relating to the amount that is includible in gross income under section 402(a)(1) or (2) in the case of a distribution under a pension plan described in section 401(a).

(2) For purposes of applying section 402(a)(4) and this paragraph to distributions under the Civil Service Retirement Act (5 U.S.C. 2251), the term "basic salary" shall have the meaning provided in section 1(d) of such Act. In applying section 402(a)(4) and this paragraph to distributions under any other qualified pension plan of the United States, such term shall have a similar meaning. Thus, for example, "basic salary" does not, in any case, include bonuses, allowances, or overtime pay.

(3) The rules in this paragraph may be illustrated by the following examples:

Example (1). A, a retired employee of the United States who performed all of his services for the United States in a foreign country, receives, in respect of such services, a monthly pension of $200 under the Civil Service Retirement Act (a pension plan described in section 410(a)). A received an aggregate basic salary for his services for the United States of $100,000. A was a nonresident alien individual during the whole of his employment with the United States and, therefore, his basic salary from the United States was not includible in his gross income by reason of being from sources without the United States. A would be required, under section 72 but without regard to section 402(a)(4) and this paragraph, to include $60 of each monthly pension payment in his gross income. The amount that is includible in A's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while A is a nonresident alien individual, is computed as follows:

(i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4)	$60
(ii) Aggregate basic salary for services for United States	100,000
(iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in A's gross income by reason of being from sources without the United States	0
(iv) Amount includible in A's gross income under section 402(a)(1) ((iii) ÷ (ii) × (i), or $0/$100,000 × $60)	0

Example (2). B, a retired employee of the United States who performed services for the United States both in a foreign country and in the United States, receives, in respect of such services, a monthly pension of $240 under the Civil Service Retirement Act. B received an aggregate basic salary for his services for the United States of $120,000; $80,000 of which was for his services performed in the United States, and $40,000 of which was for his services performed in the foreign country. B was a nonresident alien individual during the whole of his employment with the United States and, consequently, the $40,000 basic salary for his services performed in the foreign country was not includible in his gross income by reason of being from sources without the United States. B would be required, under section 72 but without regard to section 402(a)(4) and this paragraph, to include $165 of each monthly pension in his gross income. The amount that is includible in B's gross income under section 402(a)(1) with respect to the monthly payments received during taxable years beginning after December 31, 1959, and while B is a nonresident alien individual, is computed as follows:

(i) Amount of distribution includible in gross income under section 72 without regard to section 402(a)(4)	$165
(ii) Aggregate basic salary for services for United States	120,000
(iii) Aggregate basic salary for services for United States reduced by amount of such salary not includible in B's gross income by reason of being from sources without the United States ($120,000–$40,000)	80,000
(iv) Amount includible in B's gross income under section 402(a)(1) ((iii) ÷ (ii) × (i), or $80,000/$120,000 × $165)	110

(d) Salary reduction, cash or deferred arrangements—

(1) Inclusion in income. Whether a contribution to an exempt trust or plan described in section 401(a) or 403(a) is made by the employer or the employee must be determined on the basis of the particular facts and circumstances of each case. Nevertheless, an amount contributed to a plan or trust will, except as otherwise provided under paragraph (d)(2) of this section, be treated as contributed by the employee if such amount was contributed at the employee's election, even though the election was made before the year in which the amount was earned by the employee or before the year in which the amount has become currently available to the employee. Any amount treated as contributed by the employee is includible in the gross income of the employee for the year in which the amount would have been received by the employee but for the election. Thus, for example, if amounts are contributed to an exempt trust or plan by reason of a salary reduction agreement under a cash or deferred arrangement, such amounts are treated as received by the employee at such time as such amounts would have been received by the employee but for the election to defer, and thus are includible in the gross income of the employee for the year that includes such time (except as provided under paragraph (d)(2) of this section). A matching contribution described in section 401(m)(4) is not treated as an employee contribution merely because it is made by the employer as a result of the employee's

election. See § 1.401(k)-1(g) for definitions applicable to this paragraph (d)(1).

(2) Qualified cash or deferred arrangement. Elective contributions for a plan year made by an employer on behalf of an employee to a trust pursuant to a cash or deferred election under a qualified cash or deferred arrangement, as defined in section 401(k)(2), shall not be treated as received by or distributed to the employee or as employee contributions. See § 1.401(k)-1(g) for definitions and restrictions applicable to this paragraph (d)(2).

(3) Effective date and transitional rule. (i) In the case of a plan or trust that does not include a salary reduction or cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to taxable years ending after such date.

(ii) In the case of a plan or trust that includes a salary reduction or a cash or deferred arrangement in existence on June 27, 1974, this paragraph applies to plan years beginning after December 31, 1979 (or, in the case of a pre-ERISA money purchase plan, as defined in § 1.401(k)-1(g), plan years beginning after July 18, 1984). For plan years of such plans or trusts beginning prior to January 1, 1980 (or, in the case of a pre-ERISA money purchase plan, plan years beginning before July 19, 1984), the taxable year of inclusion in gross income of the employee of any amount so contributed by the employer to the trust shall be determined in a manner consistent with Rev. Rul. 56-497, 1956-2 CB 284, Rev. Rul. 63-180, 1963-1 CB 189, and Rev. Rul. 68-89, 1968-1 CB 402.

(iii) A cash or deferred arrangement shall be considered as in existence on June 27, 1974, if, on or before such date, it was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed pursuant to the terms of the arrangement as of such date.

(iv) For plan years beginning after December 31, 1979 (or in the case of a pre-ERISA money purchase plan, plan years beginning after July 18, 1984) and before January 1, 1988, a reasonable interpretation of the rules set forth in section 401(k) of the Code (as in effect during those years) may be relied upon to determine whether contributions were made under a qualified cash or deferred arrangement. Operation in accordance with the proposed regulations published in the Federal Register on November 10, 1981, 46 FR 55544, will be deemed a reasonable interpretation of section 401(k).

[T.D. 6500, 25 FR 11675, Nov. 26, 1960, as amended by T.D. 6497, 25 FR 10021, Oct. 20, 1960; T.D. 6676, 28 FR 10142, Sept. 17, 1963; T.D. 6717, 29 FR 4092, March 28, 1964; T.D. 6722, 29 FR 5073, April 14, 1964; T.D. 6823, 30 FR 6340, May 6, 1965; T.D. 6885, 31 FR 7800, June 2, 1966; T.D. 6887, 31 FR 8786, June 24, 1966; T.D. 8217, 53 FR 29673, Aug. 8, 1988; 53 FR 34194, Sept. 2, 1988]

§ 1.402(a)(5)–1T Rollovers of partial distributions from qualified trusts and annuities (temporary).

Q–1: Can an employee or the surviving spouse of a deceased employee roll over to an individual retirement account or annuity, described in section 408(a) or (b), the taxable portion of a partial distribution from a qualified trust described in section 401(a), a qualified plan described in section 403(a), or a tax-sheltered annuity contract under section 403(b)?

A–1: Yes. For distributions made after July 18, 1984, the taxable portion of a partial distribution may be rolled over within 60 days of the distribution to an individual retirement account or annuity.

Q–2: Are there special requirements applicable to rollovers of partial distributions?

A–2: Yes. Section 402(a)(5)(D)(i) specifies that no part of a partial distribution may be rolled over unless the distribution is equal to at least 50 percent of the balance to the credit of the employee in the contract or plan immediately before the distribution, and the distribution is not one of a series of periodic payments. For purposes of this section, the balance to the credit of an employee does not include any accumulated deductible employee contributions (within the meaning of section 72(*o*)). In addition, in calculating the balance to the credit for purposes of the 50 percent test, qualified plans are not to be aggregated with other qualified plans and tax-sheltered annuity contracts are not to be aggregated with other tax-sheltered annuity contracts. Also, in applying the 50 percent test to a surviving spouse, the balance to the credit is the maximum amount the spouse is entitled to receive under the plan or contract, rather than the total balance to the credit of the employee. The rollover of a partial distribution may result in adverse tax consequences; see section 402(a)(5)(D) (iii) and (iv).

Q–3: Are there any other requirements applicable to rollovers of partial distribution?

A–3: Yes. Section 402(a)(5)(D)(i)(III) requires the employee to elect, in conformance with Treasury regulations, to treat a contribution of a partial distribution to an IRA as a rollover contribution. An election is made by designating, in writing, to the trustee or issuer of the IRA at the time of the contribution that the contribution is to be treated as a rollover contribution. This requirement of a written designation to the trustee or issuer of the IRA is effective for contributions paid to the trustee or issuer of the IRA after March 20, 1986. For contributions paid to the trustee or issuer before March 21, 1986, an election is made by computing the individual's income tax liability on the income tax return for the taxable year in which the distribution occurs in a manner consistent with not including the distribution (or portion thereof) in gross income. Both such elections are irrevocable, except that an election made on an income tax return filed before March 21, 1986 is revocable.

Q–4: Does the election requirement apply to rollovers of qualified total distributions or rollover contributions described in section 402(a)(5) or (7), 403(a)(4), 403(b)(8), 405(d)(3), or 408(d)(3) to individual retirement accounts and annuities (IRAs)?

A–4: Yes. No amounts may be treated as a rollover contribution to an IRA under section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), 405(d)(3) (as amended by section 491(c) of the TRA of 1984), or 408(d)(3) unless the requirements described in Q & A-3 of this section are satisfied. Thus, once any portion of a total distribution is irrevocably designated as a rollover contribution, such distribution is not taxable under section 402 or 403 and, therefore, is not eligible for the special capital gains and separate tax treatment under section 402(a) and (e). Election requirements for rollover contributions to IRAs described in this Q &A-4 are subject to the same effective date rules set forth in Q &A-3.

[T.D. 8073, 51 FR 4320, Feb. 4, 1986]

§ 1.402(b)–1 Treatment of beneficiary of trust not exempt under section 501(a).

(a) Taxation by reason of employer contributions made after August 1, 1969—(1) Taxation of contributions. Section 402(b) provides rules for taxing an employee on contributions made on his behalf by an employer to an employees' trust that is not exempt under section 501(a). In general, any such contributions made after August 1, 1969, during a taxable year of the employer which ends within or with a taxable year of the trust for which it is not so exempt shall be included as compensation in the gross income of the employee for his taxable year during which the contribution is made, but only to the extent that the employee's interest in such contribution is substantially vested at the time the contribution is made. The preceding sentence does not apply to contracts referred to in the transitional rule of paragraph (d)(1)(ii) or (iii) of this section. For the definition of the terms "substantially vested" and "substantially nonvested" see § 1.83–3(b).

(2) Determination of amount of employer contributions. If, for an employee, the actual amount of employer contributions referred to in paragraph (a)(1) of this section for any taxable year of the employee is not known, such amount shall be either an amount equal to the excess of—

(i) The amount determined in accordance with the formula described in § 1.403(b)–1(d)(4) as the end of such taxable year, over

(ii) The amount determined in accordance with the formula described in § 1.403(b)–1(d)(4) as of the end of the prior taxable year,

or the amount determined under any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan.

(b) Taxability of employee when rights under nonexempt trust change from nonvested to vested—(1) In general. If rights of an employee under a trust become substantially vested during a taxable year of the employee (ending after August 1, 1969), and a taxable year of the trust for which it is not exempt under section 501(a) ends with or within such year, the value of the employee's interest in the trust on the date of such change shall be included in his gross income for such taxable year, to the extent provided in paragraph (b)(3) of this section. When an employees' trust that was exempt under section 501(a) ceases to be so exempt, an employee shall include in his gross income only amounts contributed to the trust during a taxable year of the employer that ends within or with a taxable year of the trust in which it is not so exempt (to the same extent as if the trust had not been so exempt in all prior taxable years).

(2) Value of an employee's interest in a trust. (i) For purposes of this section, the term "the value of an employee's interest in a trust" means the amount of the employee's beneficial interest in the net fair market value of all the assets in the

trust as of any date on which some or all of the employee's interest in the trust becomes substantially vested. The net fair market value of all the assets in the trust is the total amount of the fair market values (determined without regard to any lapse restriction, as defined in § 1.83-3(h)) of all the assets in the trust, less the amount of all the liabilities (including taxes) to which such assets are subject or which the trust has assumed (other than the rights of any employee in such assets), as of the date on which some or all of the employee's interest in the trust becomes substantially vested.

(ii) If a separate account in a trust for the benefit of two or more employees is not maintained for each employee, the value of an employee's interest in such trust shall be determined in accordance with the formula described in § 403(b)-1(d)(4) or any other method utilizing recognized actuarial principles that are consistent with the provisions of the plan under which the contributions are made and the method adopted by the employer for funding the benefits under the plan.

(iii) If there is no valuation of a nonexempt trust's assets on the date of the change referred to in paragraph (b)(1) of this section, the value of an employee's interest in such trust is determined by taking the weighted average of the values on the nearest valuation dates occurring before and after the date of such change. The average is to be determined in the manner described in § 20.2031-2(b)(1).

(3) **Extent to which value of an employee's interest is includible in gross income.** For purposes of paragraph (b)(1) of this section, there shall be included in the gross income of the employee for his taxable year in which his rights under the trust become substantially vested only that portion of the value of his interest in the trust that is attributable to contributions made by the employer after August 1, 1969. However, the preceding sentence shall not apply—

(i) To the extent such value is attributable to a contribution made on the date of such change, and

(ii) To the extent such value is attributable to contributions described in paragraph (d)(1)(ii) or (iii) of this section (relating to contributions made pursuant to a binding contract entered into before April 22, 1969).

For purposes of this (3), if the value of an employee's interest in a trust which is attributable to contributions made by the employer after August 1, 1969, is not known, it shall be deemed to be an amount which bears the same ratio to the value of the employee's interest as the contributions made by the employer after such date bear to the total contributions made by the employer.

(4) **Partial vesting.** For purposes of paragraph (b)(1) of this section, if only part of an employee's interest in the trust becomes substantially vested during any taxable year, then only the corresponding part of the value of the employee's interest in such trust is includible in his gross income for such year. In such a case, it is first necessary to compute, under the rules in paragraphs (b)(1) and (2) of this section, the amount that would be includible if his entire interest had changed to a substantially vested interest during such a year. The amount that is includible under this paragraph (4) is the amount determined under the preceding sentence multiplied by the percent of the employee's interest which became substantially vested during the taxable year.

(5) **Basis.** The basis of any employee's interest in a trust to which this section applies shall be increased by the amount included in his gross income under this section.

(6) **Treatment as owner of trust.** In general, a beneficiary of a trust to which this section applies may not be considered to be the owner under subpart E, part I, subchapter J, chapter I of the Code of any portion of such trust which is attributable to contributions to such trust made by the employer after August 1, 1969, or to incidental contributions made by the employee after such date. However, where contributions made by the employee are not incidental when compared to contributions made by the employer, such beneficiary shall be considered to be the owner of the portion of the trust attributable to contributions made by the employee, if the applicable requirements of such subpart E are satisfied. For purposes of this paragraph (6), contributions made by an employee are not incidental when compared to contributions made by the employer if the employee's total contributions as of any date exceed the employer's total contributions on behalf of the employee as of such date.

(7) **Example.** The provisions in this paragraph may be illustrated by the following example:

Example. On January 1, 1968 M corporation establishes an employees' trust, which is not exempt under section 501(a), for some of its employees, including A, reserving the right to discontinue contributions at any time. M corporation contributes $5,000 on A's behalf to the trust on February 1, 1968. At the time of contribution 50 percent of A's interest was substantially vested. On January 1, 1971, and January 1, 1974, M corporation makes additional $5,000 contributions to the trust on A's behalf. A's interest in the trust changed from a 50

percent substantially vested to a 100 percent substantially vested interest in the trust on December 31, 1974. Assume that the value of A's interest in the trust on December 31, 1974, which is attributable to employer contributions made after August 1, 1969, is calculated to be $11,000 under paragraph (b)(3) of this section. The amount includible in A's gross income for 1971 and 1974 is computed as follows:

(i) Amount of M corporation's contribution made on January 1, 1971, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times $5,000 contribution)—$2,500.

1974

(i) Amount of M corporation's contribution made on January 1, 1974, to the trust which is includible in A's gross income under paragraph (b)(1) of this section (50 percent substantially vested interest in the trust times $5,000 contribution)—$2,500.

(ii) Amount which would have been includible if A's entire interest had changed to a substantially vested interest (value of employee's interest in the trust attributable to employer contributions made after August 1, 1969—) $11,000.

(iii) Percent of A's interest that became substantially vested on December 31, 1974—50 percent.

(iv) Amount includible in A's gross income for 1974 in respect of his percentage change from a substantially nonvested to a substantially vested interest in the trust (50 percent of $11,000)—$5,500.

(v) Total amount includible in A's gross income for 1974 ((i) plus (iv))—$8,000.

(c) Taxation of distributions from trust not exempt under section 501(a)—(1) In general. Any amount actually distributed or made available to any distributee by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be taxable under section 72 (relating to annuities) to the distributee in the taxable year in which it is so distributed or made available. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). If, for example, the distribution from such a trust consists of an annuity contract, the amount of the distribution shall be considered to be the entire value of the contract at the time of distribution. Such value is includible in the gross income of the distributee to the extent that such value exceeds the investment in the contract, determined by applying sections 72 and 101(b). The distributions by such a trust shall be taxed as provided in section 72 whether or not the employee's rights to the contributions become substantially vested beforehand. For rules relating to the treatment of employer contributions to a nonexempt trust as part of the consideration paid by the employee, see section 72(f). For rules relating to the treatment of the limited exclusion allowable under section 101(b)(2)(D) as additional consideration paid by the employee, see the regulations under that section.

(2) Distributions before annuity starting date. Any amount distributed or made available to any distributee before the annuity starting date (as defined in section 72(c)(4)) by an employees' trust in a taxable year in which it is not exempt under section 501(a) shall be treated as distributed in the following order—

(i) First, from that portion of the employee's interest in the trust attributable to contributions made by the employer after August 1, 1969 (other than those referred to in paragraph (d)(1)(ii) or (iii) of this section) that has not been previously includible in the employee's gross income, to the extent that such a distribution is permitted under the trust (or the plan of which the trust is a part);

(ii) Second, from that portion of the employee's interest in the trust attributable to contributions made by the employer on or before August 1, 1969 (or contributions referred to in paragraph (d)(1)(ii) or (iii) of this section);

(iii) Third, from the remaining portion of the employee's interest in the trust attributable to contributions made by the employer.

If the employee has made contributions to the trust, amounts attributable thereto shall be treated as distributed prior to any amounts attributable to the employer's contributions, to the extent provided by the trust (or the plan of which the trust is a part). However, the portion of such amounts attributable to income earned on the employee's contributions made after August 1, 1969, shall be treated as distributed prior to any return of such contributions.

(d) Taxation by reason of employer contributions made on or before August 1, 1969. (1) Except as provided in section 402(d) (relating to taxable years beginning before January 1, 1977), any contribution to a trust made by an employer on behalf of an employee—

(i) On or before August 1, 1969, or

(ii) After such date, pursuant to a binding contract (as defined in § 1.83–3(b)(2)) entered into before April 22, 1969, or

(iii) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969, and under which the obligation of the employer on such date was essentially the same as under a binding written contract, during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a) shall be included in income of the employee for his taxable year during which the contribution is made, if the employee's

beneficial interest in the contribution is nonforfeitable at the time the contribution is made. If the employee's beneficial interest in the contribution is forfeitable at the time the contribution is made, even though his interest becomes nonforfeitable later the amount of such contribution is not required to be included in the income of the employee at the time his interest becomes nonforfeitable.

(2)(i) An employee's beneficial interest in the contribution is nonforfeitable, within the meaning of sections 402(b), 403(c), and 404(a)(5) prior to the amendments made thereto by the Tax Reform Act of 1969 and section 403(b), at the time the contribution is made if there is no contingency under the plan that may cause the employee to lose his rights in the contribution. Similarly, an employee's rights under an annuity contract purchased for him by his employer change from forfeitable to nonforfeitable rights within the meaning of section 403(d) prior to the repeal thereof by the Tax Reform Act of 1969 at that time when, for the first time, there is no contingency which may cause the employee to lose his rights under the contract. For example, if under the terms of a pension plan, an employee upon termination of his services before the retirement date, whether voluntarily or involuntarily, is entitled to a deferred annuity contract to be purchased with the employer's contributions made on his behalf, or is entitled to annuity payments which the trustee is obligated to make under the terms of the trust instrument based on the contributions made by the employer on his behalf, the employee's beneficial interest in such contributions is nonforfeitable.

(ii) On the other hand, if, under the terms of a pension plan, an employee will lose the right to any annuity purchased from or to be provided by, contributions made by the employer if his services should be terminated before retirement, his beneficial interest in such contributions is nonforfeitable.

(iii) The mere fact that an employee may not live to the retirement date, or may live only a short period after the retirement date, and may not be able to enjoy the receipt of annuity or pension payments, does not make his beneficial interest in the contributions made by the employer on his behalf forfeitable. If the employer's contributions have been irrevocably applied to purchase an annuity contract for the employee, or if the trustee is obligated to use the employer's contributions to provide an annuity for the employee provide only that the employee is alive on the dates the annuity payments are due, the employee's rights in the employer's contributions are nonforfeitable.

[T.D. 6500, 25 FR 11679, Nov. 26, 1960, as amended by T.D. 6783, 29 FR 18359, Dec. 24, 1964; T.D. 6885, 31 FR 7801, June 2, 1966; T.D. 7554, 43 FR 31922, July 24, 1978]

§ 1.402(c)–1 Taxability of beneficiary of certain foreign situs trusts.

Section 402(c) has the effect of treating, for purposes of section 402, the distributions from a trust which at the time of the distribution is located outside the United States in the same manner as distributions from a trust which is located in the United States. If the trust would qualify for exemption from tax under section 501(a) except for the fact that it fails to comply with the provisions of paragraph (a)(3)(i) of § 1.401–1, which restricts qualification to trusts created or organized in the United States and maintained here, section 402(a) and § 1.402(a)–1 are applicable to the distributions from such a trust. Thus, for example, a total distribution from such a trust is entitled to the long-term capital gains treatment of section 402(a)(2), except in the case of a nonresident alien individual (see section 871 and 1441 and the regulations thereunder). However, if the plan fails to meet any requirement of section 401 and the regulations thereunder in addition to paragraph (a)(3)(i) of § 1.401–1, section 402(b) and § 1.402(b)–1 are applicable to the distributions from such a trust.

[T.D. 6500, 25 FR 11679, Nov. 26, 1960]

§ 1.402(d)–1 Effect of section 402(d).

(a) If the requirements of section 402(d) are met, a contribution made by an employer on behalf of an employee to a trust which is not exempt under section 501(a) shall not be included in the income of the employee in the year in which the contribution is made. Such contribution will be taxable to the employee, when received in later years, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such contributions. For taxable years beginning after December 31, 1963, such contributions, when received, may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). See paragraph (b) of § 1.403(c)–1. The intent and purpose of section 402(d) is to give those employees, covered under certain non-exempt trusts to which such section applies, essentially the same tax treatment as those covered by trusts described

in section 401(a) and exempt under section 501(a), except that the capital gains treatment referred to in section 402(a)(2) does not apply.

(b) Every person claiming the benefit of section 402(d) must be able to demonstrate to the satisfaction of the Commissioner that all of the provisions of such section are met. The taxpayer must produce sufficient evidence to prove:

(1) That, before October 21, 1942, he was employed by the particular employer making the contribution in question and was at such time definitely covered by a written agreement, entered into before October 21, 1942, between himself and the employer, or between the employer and the trustee of a trust established by the employer before October 21, 1942, and that the contribution by the employer was made pursuant to such agreement. The fact that an employee may have been potentially covered is not sufficient. Evidence that the employment was entered into, or the agreement executed, "as of" a date before October 21, 1942, or that the agreement or trust instrument which did not theretofore meet the requirements of section 402(d) was modified or amended after October 20, 1942, so as to come within the provisions of such section, will not satisfy the requirements of section 402(d).

(2) That such contribution, pursuant to the terms of such agreement, was to be applied for the purchase of an annuity contract for the taxpayer. In the case of a contribution by the employer of an annuity contract purchased by such employer and transferred by him to the trustee of the trust, evidence should be presented to prove that such contract was purchased for the taxpayer by the employer pursuant to the terms of a written agreement between the employer and the employee or between the employer and the trustee, entered into before October 21, 1942.

(3) That under the written terms of the trust agreement the taxpayer is not entitled during his lifetime, except with the consent of the trustee, to any payments other than annuity payments under the annuity contract or contracts purchased by the trustee or by the employer and transferred to the trustee, and that the trustee may grant or withhold such consent free from control by the taxpayer, the employer, or any other person. However, such control will not be presumed from the fact that the trustee is himself an officer or employee of the employer. As used in section 402(d) the phrase "if * * * under the terms of the trust agreement the employee is not entitled" means that the trust instrument must make it impossible for the prohibited distribution to occur whether by operation or natural termination of the trust, whether by power of revocation or amendment, other than with the consent of the trustee, whether by the happening of a contingency, by collateral arrangement, or any other means. It is not essential that the employer relinquish all power to modify or terminate the trust but it must be impossible, except with the consent of the trustee, to be received by the taxpayer contracts purchased by the trustee, or by the employer and transferred to the trustee, to be received by the taxpayer directly or indirectly, other than as annuity payments.

(4) The nature and amount of such contribution and the extent to which income taxes have been paid thereon before January 1, 1949, and not credited or refunded.

(5) If it is claimed that section 402(d) applies to amounts contributed to a trust after June 1, 1949, the taxpayer must prove to the satisfaction of the Commissioner that the trust did not, on June 1, 1949, qualify for exemption under section 165(a) of the Internal Revenue Code of 1939. Where an employer buys an annuity contract which is transferred to the trustee, the date of the purchase of the annuity contract and not the date of the transfer to the trustee is the controlling date in determining whether or not the contribution was made to the trust after June 1, 1949.

[T.D. 6500, 25 FR 11679, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7801, June 2, 1966]

§ 1.402(e)–1 Certain plan terminations.

Distributions made after December 31, 1953, and before January 1, 1955, as a result of the complete termination of an employees' trust described in section 401(a) which is exempt under section 501(a) shall be considered distributions on account of separation from service for purposes of section 402(a)(2) if the employer who established the trust is a corporation, and the termination of the plan is incident to the complete liquidation of the corporation before August 16, 1954, regardless of whether such liquidation is incident to a reorganization as defined in section 368.

[T.D. 6500, 25 FR 11680, Nov. 26, 1960]

§ 1.402(f)–1 Required explanation of rollovers, capital gains, and the separate tax on lump sum distributions.

(a) General rules. Section 402(f) requires plan administrators to give recipients of certain distributions a written explanation of the rules relating

to the taxation of certain amounts as capital gains under section 402(a)(2), the separate tax on the ordinary income portion of lump sum distributions under section 402(e), and the exclusion from gross income under section 402(a)(5) for amounts rolled over into eligible retirement plans. This notice must be provided to the recipient of any qualified total distribution or any partial distribution satisfying section 402(a)(5)(D)(i) that is made after December 31, 1984, not later than two weeks after the distribution is made.

(b) **Future safe-harbor notices.** The Commissioner may publish safe-harbor notices to aid plan administrators in complying with the section 402(f) requirements.

[T.D. 8219, 53 FR 31851, Aug. 22, 1988]

§ 1.403(a)–1 Taxability of beneficiary under a qualified annuity plan.

(a) An employee or retired or former employee for whom an annuity contract is purchased by his employer is not required to include in his gross income the amount paid for the contract at the time such amount is paid, whether or not his rights to the contract are forfeitable, if the annuity contract is purchased under a plan which meets the requirements of section 404(a)(2). For purposes of the preceding sentence, it is immaterial whether the employer deducts the amounts paid for the contract under such section 404(a)(2). See § 1.403(b)–1 for rules relating to annuity contracts which are not purchased under qualified plans but which are purchased by organizations described in section 501(c)(3) and exempt under section 501(a) or which are purchased for employees who perform services for certain public schools.

(b) The amounts received by or made available to any employee referred to in paragraph (a) of this section under such annuity contract shall be included in gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities), except that certain total distributions described in section 403(a)(2) are taxable as long-term capital gains. For the treatment of such total distributions, see § 1.403(a)–2. However, for taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(c) If upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under section 403(a) shall be determined in accordance with the rules presented in paragraph (a)(5) of § 1.402(a)–1.

(d) An individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection may be purchased under a qualified annuity plan. For the rules as to nontransferability of such contracts issued after December 31, 1962, see § 1.401–9. For the rules relating to the taxation of the cost of the life insurance protection and the proceeds thereunder, see § 1.72–16. Section 403(a) is not applicable to premiums paid after October 26, 1956, for individual contracts which were issued prior to January 1, 1963, and which provide life insurance protection.

(e) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(f) For purposes of this section and § 1.403(a)–2, the term "employee" includes a self-employed individual who is treated as an employee under section 401(c)(1) and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4). For the rules relating to annuity plans covering self-employed individuals, see section 404(a)(2) and §§ 1.404(a)–8 and 1.401–10 through 1.401–13.

(g) For the treatment of amounts paid to provide medical benefits described in section 401(h) as defined in § 1.401–14, see paragraph (h) of § 1.72–15.

[T.D. 6500, 25 FR 11680, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, April 14, 1964; T.D. 6783, 29 FR 18359, Dec. 24, 1964; T.D. 6885, 31 FR 7801, June 2, 1966]

§ 1.403(a)–2 Capital gains treatment for certain distributions.

(a) If the total amounts payable with respect to any employee for whom an annuity contract has been purchased by an employer under a plan which—

(1) Is a plan described in section 403(a)(1) and § 1.403(a)–1, and

(2) Requires that refunds of contributions with respect to annuity contracts purchased under such plan be used to reduce subsequent premiums on the contracts under the plan,

are paid to, or includible in gross income of, the payee within one taxable year of the payee by reason of the employee's death or other separation from the service, or death after such separation from the service, such total payments, to the extent they exceed the net amount contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than six months. The "net amount contributed by the employee" is the amount actually contributed by the employee plus any amounts considered to be contributed by the employee under the rules of sections 72(f), 101(b), and paragraph (d) of § 1.403(a)–1, reduced by any amounts theretofore distributed to him which were excludable from his gross income as a return of employee contributions. For example, if under an annuity contract purchased under a plan described in this section, the total distributions payable to the employee's widow are paid to her in the year in which the employee dies, in the amount of $8,000, and if $5,000 thereof is excludable under section 101(b), and if the employee made contributions of $600 and had received no payments, the remaining amount of $2,400 will be considered a gain from the sale or exchange of a capital asset held for more than six months.

(b)(1) The term "total amounts" means the balance to the credit of an employee with respect to all annuities under the annuity plan which becomes payable to the payee by reason of the employee's death or other separation from the service, or by reason of his death after separation from the service. If an employee commences to receive annuity payments on retirement and then a lump sum payment is made to his widow upon his death, the capital gains treatment applies to the lump sum payment, but it does not apply to amounts received before the time the "total amounts" become payable. However, if the total amount to the credit of the employee at the time of his death or other separation from the service or death after separation from the service is paid or includible in the gross income of the payee within one taxable year of the payee, such amount is entitled to the capital gains treatment notwithstanding that in a later taxable year an additional amount is credited to the employee and paid to the payee.

(2) If more than one annuity contract is received under the plan, the capital gains treatment does not apply to any amount received on the surrender thereof unless all contracts under the plan with respect to a particular employee are surrendered either at the time of the employee's death or other separation from the service or death after separation from the service. Thus, if an employee receives two contracts on separation from the service and surrenders one of them in the year of separation and receives payments under the other until his death, the capital gains treatment is applicable to the balance paid to his beneficiary on his death if paid within one taxable year of the beneficiary. The amount received by the employee on surrender of the contract in the year of his separation from the service, however, would not receive capital gains treatment since the balance to the credit of the employee with respect to all amounts under the plan did not become payable at that time.

(3) If an employee retires and commences to receive an annuity but subsequently in some succeeding taxable year, he is paid a lump sum in settlement of all future annuity payments, the capital gains treatment does not apply to such lump sum settlement paid during the lifetime of the employee since it is not a payment on account of separation from the service, or death after separation, but is on account of the settlement of future annuity payments.

(4) If the "total amounts" payable under all annuity contracts under the plan with respect to a particular employee are paid or includible in the gross income of several payees within one taxable year on account of the employee's death or other separation from the service or on account of his death after separation from the service, the capital gains treatment is applicable. Thus, if the balance to the credit of a deceased employee under all annuity contracts provided under an annuity plan becomes payable to two payees, the capital gains treatment is applicable provided the "total amounts" payable are received by or includible in the gross income of both payees within the same taxable year. However, if the "total amounts" payable are made available to each payee and one elects to receive his share in cash while the other makes a timely election under section 72(h) to receive his share as an annuity, the capital gains treatment does not apply to either payee.

(5) For purposes of determining whether the total amounts payable to an employee have been paid within one taxable year, the term "total amounts" includes amounts under a plan which are attributable to contributions on behalf of an individual while he was self-employed in the busi-

ness with respect to which the plan was established. Thus, the "total amounts" payable are not paid within one taxable year if amounts remain payable which are so attributable.

(6) The term "total amounts" does not include any amount which has been placed in a separate account for the funding of benefits described in section 401(h). Thus, a distribution under a qualified annuity plan may constitute a distribution of the total amounts payable with respect to an employee even though amounts attributable to the funding of section 401(h) medical benefits as defined in paragraph (a) of § 1.401–14 are not so distributed.

(c) The provisions of this section are not applicable to any amounts paid to a payee to the extent such amounts are attributable to contributions made on behalf of an employee while he was a self-employed individual in the business with respect to which the plan was established. For the taxation of such amounts, see § 1.72–18. For the rules for determining the amount attributable to contributions on behalf of an employee while he was self-employed, see paragraphs (b)(4) and (c)(2) of such section.

[T.D. 6500, 25 FR 11681, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10143, Sept. 17, 1963; T.D. 6722, 29 FR 5073, April 14, 1964]

§ 1.403(b)–1 Taxability of beneficiary under annuity purchased by a section 501(c)(3) organization or public school.

(a) Amounts paid by employer during taxable years beginning before January 1, 1958—(1) In general. If an amount is paid during a taxable year of an employee (or a retired or former employee) beginning before January 1, 1958, toward the purchase for such employee of an annuity contract and such purchase is not part of an annuity plan which meets the requirements of section 404(a)(2), then such amount is not required to be included in the gross income of such employee for such taxable year—

(i) If such amount is paid by an employer which, at the time of the payment, is an organization described in section 501(c)(3) and exempt from tax under section 501(a), and

(ii) If the purchase of the annuity contract is merely a supplement to the past or current compensation of such employee (within the meaning of subparagraph (2) of this paragraph).

For purposes of this paragraph, it is immaterial whether or not the employee's rights to the annuity contract are forfeitable.

(2) Supplement to past or current compensation. For purposes of this paragraph, whether the purchase of an annuity contract is merely a "supplement to past or current compensation" is to be determined by all the surrounding facts and circumstances. One of the pertinent facts to be taken into consideration is the ratio of the consideration paid by the employer for an employee's contract to the amount of his past or current compensation. For example, if the annual premium paid for an employee's contract is $1,000 and his annual salary is $10,000, the ratio indicates that the premium paid for the contract is merely a supplement to the employee's current compensation. If, however, an employee receives no current compensation, or the annual premiums paid for his annuity contract approximate his annual salary, the amount paid for his contract will be considered to be current compensation and taxable to the employee in the year in which it is paid by the employer. Other pertinent considerations are whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's annual salary, or whether it is purchased at his request in lieu of an increase in current compensation to which he otherwise might be entitled. In such cases, the amount paid for the contract shall also be considered to be current compensation.

(b) Amounts paid by employer during taxable years beginning after December 31, 1957—(1) In general. If amounts are contributed by an employer during a taxable year of an employee (or a retired or former employee) beginning after December 31, 1957, toward the purchase for such employee of an annuity contract and such purchase is not part of an annuity plan which meets the requirements of section 404(a)(2), then, to the extent such amounts do not exceed the exclusion allowance for such taxable year, they are not required to be included in the gross income of such employee for such taxable year, if at the time of the contribution—

(i) The employer is an organization described in section 501(c)(3) and exempt from tax under section 501(a), or

(ii) The employer is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing, and the employee is performing (or has performed) services for an educational institution (as defined in section 151(e)(4)), and

(iii) The employee's rights under the annuity contract are nonforfeitable except for failure to pay future premiums.

See paragraph (d) of this section for rules relating to the computation of an employee's exclusion allowance for a taxable year.

(2) Forfeitable rights which change to nonforfeitable rights. If an employee's rights under an annuity contract change from forfeitable to nonforfeitable rights, the amount which, under section 403(d), is includible in the gross income of such employee by reason of such change (computed without regard to subparagraph (1) of this paragraph) shall, for purposes of subparagraph (1) of this paragraph, be considered an amount contributed by the employer for such annuity contract as of the time the employee's rights under the contract change to nonforfeitable rights. Such amount will, therefore, be excludable from the employee's gross income for the taxable year in which the change occurs to the extent that it is so excludable under the rules contained in this section. In determining the extent to which such amount is excludable, this section shall be applied in the same manner as in the case of current employer contributions. Thus, no part of such amount is excludable if the employer is not an employer described in subparagraph (1) of this paragraph at the time the employee's rights under the annuity contract change from forfeitable to nonforfeitable rights. In addition, such amount will be excludable only to the extent it does not exceed the employee's exclusion allowance for the taxable year in which the change occurs. Since such an amount is considered as an amount contributed by the employer at the time the change occurs, it is immaterial whether the employer was an employer described in subparagraph (1) of this paragraph at the time the actual contributions were made.

(3) Agreement to take a reduction in salary or to forego an increase in salary. (i) There is no requirement that the purchase of an annuity contract for an employee must be merely a "supplement to past or current compensation" in order for the exclusion provided by this paragraph to apply to employer contributions for such annuity contract. Thus, the exclusion provided by this paragraph is applicable to amounts contributed by an employer for an annuity contract as a result of an agreement with an employee to take a reduction in salary, or to forego an increase in salary, but only to the extent such amounts are earned by the employee after the agreement becomes effective. Such an agreement must be legally binding and irrevocable with respect to amounts earned while the agreement is in effect. Except as provided in subdivision (ii) of this subparagraph, the employee must not be permitted to make more than one agreement with the same employer during any taxable year of such employee beginning after December 31, 1963; the exclusion provided by this paragraph shall not apply to any amounts which are contributed under any further agreement made by such employee during the same taxable year beginning after such date. However, the employee may be permitted to terminate the entire agreement with respect to amounts not yet earned.

(ii) An individual who is employed by an organization described in section 415(c)(4) may make a salary reduction agreement for his taxable year beginning in 1976 or 1977 at any time before the end of the 1976 or 1977 taxable year, respectively, without the agreement's being considered a new agreement within the meaning of this subparagraph. The agreement for 1976 may be made on or before June 15, 1977, and the agreement for 1977 may be made on or before April 17, 1978. This special rule only applies if the individual makes a statement of intention in accordance with § 11.415(c)(4)–1(b) electing, or determines his income tax liability for the taxable year in a way which is consistent with, one of the alternative limitations under section 415(c)(4) for 1976 or 1977 (as the case may be). The salary reduction agreement for 1976 may be made effective with respect to any amount earned during the taxpayer's most recent one-year period of service (as defined in paragraph (f) of this section) ending not later than the end of the 1976 taxable year, notwithstanding subdivision (i) of this subparagraph. Similarly, the salary reduction agreement for 1977 may be made effective with respect to such period of service ending not later than the end of the 1977 taxable year. If the salary reduction agreement for 1976 is entered into at any time after December 31, 1976, or if the salary reduction agreement for 1977 is entered into at any time after December 31, 1977, an amended Form W–2 must be filed on behalf of the individual.

(iii) The rules of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A is an employee of X Organization (an employer described in section 501(c)(3) and exempt from tax under section 501(a)) for the entire calendar year 1964. A uses the calendar year as a taxable year. A's annual salary as of January 1, 1964, is $12,000. On February 1, 1964, A and his employer enter a binding and irrevocable agreement whereby A is to take a 10-percent reduction in salary (from $1,000 per month to $900 per month) and X Organization is to contribute $100 per month for an annuity contract described in section

403(b). The agreement also provides that A may terminate the entire agreement with respect to amounts not yet earned. Since the agreement to reduce A's salary and invest the amount of such reduction in an annuity contract was made after A earned his salary for January, A's current compensation for January is $1,000 even though the agreement may provide that X Organization shall contribute $100 with respect to January for the benefit of A for an annuity contract described in section 403(b). For February and subsequent months ending before July 1, 1964, X Organization contributes $100 per month for A's annuity. Thus, A's current compensation for each of these months is $900, and the $100 which is contributed during such months by X Organization for an annuity contract for A is an employer contribution to which the exclusion provided in this paragraph applies. On July 1, 1964, A becomes entitled to a salary increase of $200 per month and, pursuant to the agreement of February 1, 1964, X Organization contributes 10 percent of such increase or an additional $20 per month for a section 403(b) annuity. For July and subsequent months ending before October 1, 1964, X Organization contributes $120 per month for A's annuity. Thus, A's current compensation for each of these months is $1,080, and the $120 which is contributed during such months by X Organization for an annuity contract for A is an employer contribution to which the exclusion provided in this paragraph applies. On November 1, 1964, A terminates the entire agreement with respect to amounts not yet earned. Since the termination occurred after A earned his salary for the month of October, the contribution for October is an employer contribution to which the exclusion provided in this paragraph applies. For the months November and December, A's full salary of $1,200 per month is includible in his gross income whether or not his employer makes contributions for a section 403(b) annuity.

(4) Two or more annuity contracts. If, during a taxable year of an employee, this paragraph applies to amounts contributed (including amounts which are considered to be contributed under subparagraph (2) of this paragraph) by his employer for two or more annuity contracts for such employee, such two or more annuity contracts shall, for such taxable year, be considered a single contract for purposes of applying the rules contained in this paragraph.

(5) Employees performing services for public schools. For purposes of this section, a person shall be considered an employee who performs services for an educational institution (as defined in section 151(e)(4)) if he is performing services as an employee directly or indirectly for such an institution. Thus, for example, the principal, clerical employees, custodial employees, and teachers at a public elementary school are employees performing services directly for such an educational institution. An employee who performs services involving the operation or direction of a State's, or political subdivision's, education program as carried on through educational institutions (as defined in section 151(e)(4)) is an employee performing services indirectly for such institutions. An employee participating in an "in-home" teaching program is included since such program is merely an extension of the activities carried on by such educational institutions. On the other hand, a person occupying an elective or appointive public office is not an employee performing services for an educational institution unless such office is one to which an individual is elected or appointed only if he has received training, or is experienced, in the field of education. The term "public office" includes any elective or appointive office of a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing. Thus, for example, a regent or trustee of a State university or a member of a board of education is not an employee performing services for an educational institution. On the other hand, a commissioner or superintendent of education will generally be considered an employee performing services for an educational institution.

(c) Taxation of amounts received under annuity contracts—(1) In general. The amounts received by or made available to any employee under an annuity contract to which paragraph (a) or (b) of this section applies shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to any such employee under such an annuity contract. For taxable years beginning after December 31, 1963, amounts received or made available to any such employee under such annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging).

(2) Taxation of beneficiaries. If, upon the death of an employee or of a retired employee, the widow or other beneficiary of such employee is paid, in accordance with the terms of the annuity contract relating to the deceased employee, an annuity or other death benefit, the extent to which the amounts received by or made available to the beneficiary must be included in the beneficiary's income under subparagraph (1) of this paragraph shall be determined in accordance with the rules presented in paragraph (a)(5) of § 1.402(a)-1.

(3) Life insurance protection. An individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection may be purchased as an annuity contract to which paragraph (a) or (b) of this section applies. For the rules as to nontransferability of such contracts issued after December 31,

1962, see § 1.401-9. For the rules relating to the taxation of the cost of the life insurance protection and the proceeds thereunder, see § 1.72-16. Section 403(b) is not applicable to premiums paid after October 26, 1956, for individual contracts which were issued prior to January 1, 1963, and which provide life insurance protection.

(d) Exclusion allowance—(1) In general. For purposes of paragraph (b) of this section, an employee's exclusion allowance for a taxable year is an amount equal to the excess, if any, of—

(i) The amount determined by multiplying (a) 20 percent of such employee's includible compensation in respect of such taxable year, by (b) such employee's total number of years of service as of the close of such taxable year, over

(ii) The aggregate of (*a*) the amounts which have been contributed by the employer for annuity contracts for such employee and which were excludable from the gross income of the employee for any taxable year prior to the taxable year for which the exclusion allowance is being determined, and (*b*) the amounts of compensation excludable from the gross income of the employee under section 457(a) (relating to eligible State deferred compensation plans) for any prior taxable year that is taken into account as a year of service under paragraph (f) of this section.

Compensation deferred under an eligible State deferred compensation plan shall be taken into account as described in subdivision (ii) of this subparagraph even if the entity sponsoring the eligible plan is not the employer purchasing the annuity contract with respect to which the employee's exclusion allowance is to be determined. See paragraph (e) of this section for the definition of an employee's includible compensation in respect of a taxable year and paragraph (f) of this section for rules for computing an employee's total number of years of service for an employer.

(2) More than one employer. If, during a taxable year of an employee, amounts are contributed for annuity contracts for such employee by two or more employers described in paragraph (b)(1)(i) or (ii) of this section, a separate exclusion allowance shall be computed with respect to each employer. In such a case, therefore, there shall not be taken into account, in computing the exclusion allowance with respect to one employer, the "includible compensation" received by the employee from any other employer, the employee's years of service with any other employer, or amounts which have been contributed by any other employer for annuity contracts for such employee.

(3) Amounts previously contributed by the employer which were excludable from the employee's gross income. In computing, for purposes of subparagraph (1)(ii) of this paragraph, the aggregate of the amounts which have been contributed by an employer for annuity contracts for an employee and which were excludable from the gross income of the employee for any taxable year prior to the taxable year for which the exclusion allowance is being determined, there shall be included all contributions made by the employer for the benefit of the employee—

(i) Which, under section 402(a) or section 403(a), were excludable from the employee's gross income for any such prior taxable year by reason of being contributions to a trust described in section 401(a) and exempt from tax under section 501(a) or contributions toward the purchase of an annuity contract under a plan which meets the requirements of section 404(a)(2) (whether forfeitable or nonforfeitable); or

(ii) Which, under section 405(d), were excludable from the employee's gross income for any such prior taxable year by reason of being contributions toward the purchase of United States bonds under a plan which meets the requirements of section 405(a)(1); or

(iii) Which were excludable from the employee's gross income for any such prior taxable year by reason of being contributions described in paragraph (a) or (b) of this section; or

(iv)(a) Which were excludable from the employee's gross income for the taxable year when made solely by reason of the fact that the employee's rights to such contributions were forfeitable at the time they were made (and not for any of the reasons described in subdivisions (i), (ii), and (iii) of this subparagraph);

(b) With respect to which the employee's rights changed to nonforfeitable rights prior to the taxable year for which the exclusion allowance is being determined; and

(c) Which were not, under section 403(d) and without regard to paragraph (b) of this section, includible in the employee's gross income for the taxable year in which his rights to such contributions changed from forfeitable to nonforfeitable rights.

For purposes of subdivisions (i) and (iii) of this subparagraph, all references to provisions of the Internal Revenue Code of 1954 and to provisions of the regulations under such Code shall also be

considered references to the corresponding provisions of prior law and regulations. See subparagraph (4) of this paragraph for rules relating to the allocation of employer contributions to an employee where the actual contributions are not allocated among individual employees; or

(v) Which were contributions to a section 403(b) annuity contract for a prior taxable year and which exceeded the limitations of section 415(c)(1) applicable to the employee. See § 1.415–6(e)(1)(ii) for a more detailed discussion of this rule. See also § 1.415–9(c) for rules relating to the treatment of certain contributions to a section 403(b) annuity contract which are excess contributions because of the aggregation of the annuity contract with a qualified plan.

(4) Determination of excludable amounts by allocation of contributions. If, for any employee, the actual amounts of employer contributions to a defined benefit plan described in subparagraph (3) of this paragraph are not known, such amounts shall be determined under the formula described in this subparagraph or under any other method utilizing recognized actuarial principles which are consistent with the provisions of the plan under which such contributions are made and the method adopted by the employer for funding the benefits under the plan. If the formula described in this subparagraph is to be used, the contributions made by the employer for the benefit of the employee as of the end of any taxable year shall be deemed to be the product of the quantities described in subdivisions (i), (ii), (iii), and (iv) of this subparagraph. Such quantities are—

(i) The projected annual amount of the employee's pension (as of the end of the taxable year) to be provided at normal retirement age from employer contributions, based upon the provisions of the plan in effect at such time and upon the assumption of the employee's continued employment with his present employer at his then current salary rate.

(ii) The value, from Table I below, at normal retirement age of an annuity of $1.00 per annum payable in equal monthly installments during the life of the employee, based upon normal retirement age as defined in the plan.

(iii) The amount from Table II below (representing the level annual contribution which will accumulate to $1.00 at normal retirement age) for the sum of (a) the number of years remaining from the end of the taxable year to normal retirement age and (b) the lesser of the number of years of service credited through the end of the taxable year or the number of years that the plan has been in existence at such time.

(iv) The lesser of the number of years of service credited through the end of the taxable year or the number of years that the plan has been in existence at such time.

TABLE I—VALUE AT NORMAL RETIREMENT AGES OF ANNUITY OF $1.00 PER ANNUM PAYABLE IN EQUAL MONTHLY INSTALLMENTS DURING THE LIFE OF THE EMPLOYEE

[For taxable years beginning after July 1, 1986]

Ages	Values
40	11.49
41	11.40
42	11.31
43	11.22
44	11.12
45	11.01
46	10.91
47	10.79
48	10.68
49	10.56
50	10.43
51	10.30
52	10.18
53	10.04
54	9.89
55	9.75
56	9.60
57	9.44
58	9.28
59	9.13
60	8.96
61	8.79
62	8.62
63	8.44
64	8.25
65	8.08
66	7.88
67	7.70
68	7.50
69	7.29
70	7.10
71	6.88
72	6.68
73	6.46
74	6.25
75	6.03
76	5.82
77	5.61
78	5.40
79	5.20
80	4.99

NOTE—If the normal form of retirement benefit under the plan is other than a straight life annuity, the value from Table I above should be divided by the figure set forth below opposite the normal form of retirement benefit provided by the plan:

Annuity for 5 years certain and life thereafter	0.97
Annuity for 10 years certain and life thereafter	0.90
Annuity for 15 years certain and life thereafter	0.80
Annuity for 20 years certain and life thereafter	0.70
Life annuity with installment refund	0.80
Life annuity with cash refund [1]	0.75

[1] The term "cash refund" refers to refund of accumulated employer contributions, and does not refer to refund of employee contributions only, often referred to as "modified cash refund."

TABLE II—LEVEL ANNUAL CONTRIBUTION WHICH WILL ACCUMULATE TO $1.00 AT END OF NUMBER OF YEARS

[For taxable years beginning after July 1, 1986]

Number of years	Amounts
1	$1.0000
2	.4808
3	.3080
4	.2219
5	.1705
6	.1363
7	.1121
8	.0940
9	.0801
10	.0690
11	.0601
12	.0527
13	.0465
14	.0413
15	.0368
16	.0330
17	.0296
18	.0267
19	.0241
20	.0219
21	.0198
22	.0180
23	.0164
24	.0150
25	.0137
26	.0125
27	.0114
28	.0105
29	.0096
30	.0088
31	.0081
32	.0075
33	.0069
34	.0063
35	.0058
36	.0053
37	.0049
38	.0045
39	.0042
40	.0039
41	.0036
42	.0033
43	.0030
44	.0028
45	.0026
46	.0024
47	.0022
48	.0020
49	.0019
50	.0017

(5) Election to have allowance determined under section 415 rules. Under section 415(c)(4)(D), an employee may elect to have the provisions of section 415(c)(4)(C) (relating to special limitations for annuity contracts purchased by educational organizations, hospitals and home health service agencies) apply for a taxable year. If the employee so elects, his exclusion allowance is the maximum amount under section 415 that could be contributed by the employer for the benefit of the employee if the annuity contract for the benefit of the employee were treated as a defined contribution plan maintained by the employer. Thus, the exclusion allowance for the taxable year of an employee who makes the election may not exceed the limitation on contributions and other additions (as described in § 1.415-6) applicable to the employee for that taxable year. See § 1.415-7 for provisions applicable in the event an employer maintains a defined benefit plan and a defined contribution plan for the same employee. See § 1.415-8 for provisions applicable in the event an employer maintains more than one defined contribution plan covering the same employee.

(e) **Includible compensation—(1) In general.** For purposes of computing, under paragraph (d) of this section, an employee's exclusion allowance for a taxable year, such employee's includible compensation in respect of such taxable year means the amount of compensation from the employer—

(i) Which was earned during the most recent period (ending not later than the close of the employee's taxable year for which the exclusion allowance is being determined) that, under paragraph (f) of this section, may be counted as one-year of service,

(ii) Which is includible in the employee's gross income, and

(iii) In the case of an employee of an employer described in paragraph (b)(1)(ii) of this section, which is attributable to services performed for an educational institution (as defined in section 151(e)(4)).

See subparagraph (2) of this paragraph for special rules for determining the amount of compensation which is includible in the employee's gross income.

(2) Special rules for determining the amount of compensation includible in the employee's gross

income. For purposes of subparagraph (1) of this paragraph, the amount of compensation which is includible in the employee's gross income shall be computed without regard to the exclusions allowed by section 105(d) (relating to wage continuation plans) and section 911 (relating to earned income from sources without the United States). Therefore, although amounts received by the employee from the employer while he is absent from work on account of personal injuries or sickness may be excludable from his gross income under section 105(d), such amounts are, nevertheless, considered as includible in his gross income for purposes of computing his includible compensation. On the other hand, in computing the amount which is includible in the gross income of the employee for purposes of subparagraph (1) of this paragraph, there shall not be included any amount which is contributed by the employer for an annuity contract to which paragraph (b) of this section applies. Thus, although the amount of any employer contributions for an annuity contract to which paragraph (b) of this section applies is, to the extent it exceeds in any taxable year the employee's exclusion allowance for such year, includible in the employee's gross income for that year, such amount is not considered as includible in the employee's gross income for purposes of computing his includible compensation for that year.

(3) **Period during which compensation must be earned.** For purposes of computing an employee's exclusion allowance for a taxable year, there may not be taken into account, as includible compensation, any compensation which was earned by the employee during a taxable year ending after the taxable year for which the exclusion allowance is being determined. On the other hand, an employee's includible compensation may include all or part of his compensation earned during a taxable year prior to the taxable year for which the exclusion allowance is being determined. Such a situation can occur, for example, when an employer purchases an annuity contract for a retired employee, or when an employer purchases an annuity contract for a part-time employee whose most recent one-year period of service (within the meaning of paragraph (f) of this section) extends over more than one taxable year of such employee. For purposes of this subparagraph, it is immaterial when the compensation is actually received by the employee or for what taxable year it is includible in his gross income.

(4) **Status of employer.** In computing an employee's exclusion allowance for a taxable year, there is not taken into account, as includible compensation, any compensation which was earned during a period when the employer was not an employer described in paragraph (b)(1)(i) or (ii) of this section since under paragraph (f)(2) of this section an employee is not considered to be in the service of the employer for any such period. On the other hand, it is immaterial whether the employer is an employer described in paragraph (b)(1)(i) or (ii) of this section at the time the compensation is actually received by the employee. Thus, if an employee receives compensation during his 1961 taxable year for services performed during his 1960 taxable year, such compensation can qualify as includible compensation if his employer was an employer described in paragraph (b)(1)(i) or (ii) of this section during 1960, even though such employer was not such an employer during 1961. See, also, paragraph (b) of this section which provides that the exclusion allowance is only applicable with respect to contributions which are made by an employer at a time when such employer is an employer described in paragraph (b)(1)(i) or (ii) of this section.

(f) **Years of service—(1) In general.** In computing an employee's exclusion allowance for a taxable year, it is necessary to determine such employee's number of years of service for the employer as of the close of such taxable year. For this purpose, the number of years of service of an employee for an employer shall be determined in accordance with the rules set forth in this paragraph. In addition, such rules are applicable in determining, for purposes of paragraph (e) of this section, an employee's most recent one-year period of service.

(2) **Exempt status requirement.** For purposes of determining an employee's number of years of service for an employer and his most recent one-year period of service for such employer, an employee shall not be considered to be employed by the employer, or to be in the service of the employer, during any period that the employer is not an employer described in paragraph (b)(1)(i) or (ii) of this section, or, in the case of an employee of an employer described in paragraph (b)(1)(ii) of this section, during any period when the employee is not performing services for an educational institution (as defined in section 151(e)(4)). The rule in this subparagraph may be illustrated by the following example: A was employed on a full-time basis by the X scientific organization during the whole of 1959 and 1960 and during half of 1961. Both A and the X Organization use the calendar year as their taxable year. The X Organization was an organization described in section 501(c)(3) and exempt from tax under section 501(a) during the

years 1959 and 1961, but not during the year 1960. For purposes of determining A's exclusion allowance for 1961, he is considered to have 1 ½ years of service (his service during 1959 and 1961) and his most recent one-year period of service ending not later than the close of 1961 consists of his service during 1961 (which is equal to ½ year of service) and his service during the last half of 1959 (which is equal to another ½ year of service).

(3) Service included. For purposes of computing an employee's exclusion allowance for a taxable year, there may be taken into account, in determining his number of years of service, all service performed by him as of the close of such taxable year. Therefore, whenever possible, service performed during each of the employee's taxable years should be considered separately in arriving at his total number of years of service. For example, if an employee who reports his income on a calendar year basis is employed on a full-time basis on July 1, 1959, and continues on a full-time basis through December 31, 1960, his number of years of service as of the close of his 1960 taxable year should, if possible, be computed as follows:

(a) Number of years of service performed during 1959 taxable year	½
(b) Number of years of service performed during 1960 taxable year	1
(c) Total number of years of service as of close of 1960 taxable year ((*a*) + (*b*))	1½

However, in determining what constitutes a full year of service, the employer's annual work period, and not the employee's taxable year, is the standard of measurement. For example, in determining whether a professor is employed full time, the number of months in the school's academic year shall be the standard of measurement.

(4) Full-time employee for full year. (i) Each full year during which an individual was employed full time shall be considered as one year of service. In determining whether an individual is employed full-time, the amount of work which he is required to perform shall be compared with the amount of work which is normally required of individuals holding the same position with the same employer and who generally derive the major portion of their personal service income from such position.

(ii)(a) In measuring the amount of work required of individuals holding a particular position, any method that reasonably and accurately reflects such amount may be used. For example, the number of hours of classroom instruction is only an indication of the amount of work required, but it may be used as a measure.

(b) In determining whether positions with the same employer are the same, all of the facts and circumstances concerning the positions shall be considered, including the work performed, the methods by which compensation is computed, and the descriptions (or titles) of the positions. For example, an assistant professor employed in the English department of a university will be considered a full-time employee if the amount of work that he is required to perform is the same as the amount of work normally required of assistant professors of English at that university who derive the main portion of their personal service income from such position.

(c) In case an individual's position is not the same as another with his employer, the rules of this paragraph shall be applied by considering the same position with similar employers or similar positions with the same employer.

(iii) A full year of service for a particular position means the usual annual work period of individuals employed full-time in that general type of employment at the place of employment. For example, if a doctor employed by a hospital works throughout the 12 months of a year except for a one-month vacation, such doctor will be considered as being employed for a full year, if the other doctors at that hospital work 11 months of the year with a one-month vacation. Similarly, if the usual annual work period at a university consists of the fall and spring semesters, an instructor at that university who teaches those semesters will be considered as working a full year.

(5) Other employees. (i) An individual shall be treated as having a fraction of a year of service for each year during which he was a full-time employee for part of the year or for each year during which he was a part-time employee for the entire year or for a part of the year.

(ii) In determining the fraction which represents the fractional year of service for an individual employed full time for part of a year, the numerator shall be the number of weeks (or months) during which the individual was a full-time employee in a position during that year, and the denominator shall be the number of weeks (or months) which is considered under subparagraph (4)(iii) of this paragraph as the usual annual work period for that position. For example, if an instructor is employed full time by a university for the 1959 spring semester (which lasts from February 1959 through May 1959), and the academic year of the university is 8 months long, beginning in October 1958, and ending in May 1959, then he

is considered as having completed 4/8 of a year of service.

(iii) In determining the fraction which represents the fractional year of service of an individual who is employed part time for a full year, the numerator shall be the amount of work required to be performed by the individual, and the denominator shall be the amount of work normally required of individuals who hold the same position. The amount of work required to be performed by the individual and the amount of work normally required of individuals holding the same position shall be determined in accordance with the principles of subparagraph (4) of this paragraph. Thus, if a practicing physician teaches one course at a local medical school 3 hours per week for two semesters and other faculty members at that medical school teach 9 hours per week for two semesters, then the practicing physician is considered as having completed 3/9 of a year of service.

(iv) In determining the fraction representing the fractional year of service of an individual who is employed part time for part of a year, it is necessary to compute the fractional year of service if the individual were a part-time employee for a full year, and the fractional year of service if the individual were a full-time employee for the part of a year. The two fractions shall be multiplied and the product is the fractional year of service of such individual who is employed part time for part of a year. For example, if an attorney who is a specialist in a subject teaches a course in that subject for 3 hours per week for one semester at a nearby law school, and the full-time instructors at that law school teach 12 hours per week for two semesters, then the fractional part of a year of service for such part-time instructor is computed as follows: The fractional year of service if the instructor were a part-time employee for a full year is 3/12 (number of hours employed divided by the usual number of hours of work required for that position); the fractional year of service if the instructor were a full-time employee for part of a year is 1/2 (period worked or one semester, divided by usual work period, or 2 semesters). These fractions are multiplied to obtain the fractional year of service: 3/12 times 1/2, or 3/24 (1/8).

(6) **Less than one year of service considered as one year.** If, at the close of a taxable year, an employee has, under the rules in this paragraph, a period of service of less than one year, such employee shall, nevertheless, be considered to have one year of service for purposes of computing his exclusion allowance for that taxable year. Such period of service of less than one year shall also be considered to be such employee's most recent one-year period of service for purposes of determining his includible compensation.

(7) **Most recent one-year period of service.** (i) In determining, for purposes of paragraph (e) of this section (relating to includible compensation), an employee's most recent one-year period of service, there is first taken into account all service performed by the employee during the taxable year for which the exclusion allowance is being determined. For this purpose, therefore, an employee's most recent one-year period of service may not be the same as his employer's most recent annual work period. The rule in this subdivision may be illustrated by the following example: A, a professor who reports his income on a calendar year basis, is employed by a university on a full-time basis during the university's 1959–1960 and 1960–1961 academic years (October through May). For purposes of computing A's exclusion allowance for his 1960 taxable year, his most recent one-year period of service consists of his service performed during January through May, 1960 (which is part of the 1959–1960 academic year) and his service performed during October through December 1960 (which is part of the 1960–1961 academic year).

(ii) In the case of a part-time employee or a full-time employee who is employed for only part of a year, it will be necessary to aggregate his most recent periods of service to determine his most recent one-year period of service. In such a case, there is first taken into account his service during the taxable year for which the exclusion allowance is being determined; then there is taken into account his service during his next preceding taxable year and so forth until his service equals, in the aggregate, one year of service. For example, if an employee, who reports his income on the calendar year basis, is employed on a full-time basis during the months July through December 1959 (1/2 year of service), July through December 1960 (1/2 year of service), and October through December 1961 (1/4 year of service), his most recent one-year period of service for purposes of computing his exclusion allowance for 1961 consists of his service during 1961 (1/4 year of service), his service during 1960 (1/2 year of service), and his service during the months October through December 1959 (1/4 year of service).

(g) **Illustration of computation of exclusion allowance.** The exclusion provided under paragraph (b) of this section may be illustrated by the following example: A, a professor who reports his income on the calendar year basis, became a full-

time employee of X University on October 1, 1958 (beginning of X University's 1958–1959 academic year) and continued as a full-time employee for the academic years 1958–1959, 1959–1960, and 1960–1961. X University was, during all such academic years, an organization described in section 501(c)(3) and exempt from tax under section 501(a). X University's academic year runs for a period of 8 months: October through May. A received an annual salary, all of which was includible in his gross income, of $8,000 for the 1958–1959 academic year, $8,800 for the 1959–1960 academic year, and $9,600 for the 1960–1961 academic year. Starting in 1958, X University contributed amounts toward the purchase of annuity contracts for A and such purchase was not part of a qualified annuity plan. X University paid, as premiums for such contracts, $1,000 in 1958, $2,000 in 1959, $2,400 in 1960, and $1,400 in 1961. The amount of such premiums which is excludable from A's gross income for the year in which paid is computed as follows:

1958

(1) Amount contributed by employer for annuity contracts in 1958	$1,000.00
(2) Includible compensation for most recent one-year period of service (since A was employed for only 3/8 of a year at the close of 1958, this period is counted as most recent one-year period of service) 3/8 × $8,000	$3,000.00
(3) 20% × includible compensation	$600.00
(4) Number of years of service (although A was employed for less than a year, he is considered to have one-year of service)	1
(5) Item (4) × item (3)	$600.00
(6) Contributions excludable in prior taxable years of A	None
(7) Amount excludable from A's gross income for 1958 ((5)–(6))	$600.00
(8) Amount includible in A's gross income for 1958 ((1)–(7))	$400.00

1959

(9) Amount contributed by employer for annuity contracts in 1959	$2,000.00
(10) Includible compensation for most recent one-year period of service. (3/8 × $8,800 + 5/8 × $8,000)	$8,800.00
(11) 20% × includible compensation	$1,660.00
(12) Number of years of service	1 3/8
(13) Item (12) × item (11)	$2,282.50
(14) Contributions excludable in prior taxable years of A (item (7))	$600.00
(15) Amount excludable from A's gross income for 1959 ((13)–(14))	$1,682.50
(16) Amount includible in A's gross income for 1959 ((9)–(15))	$317.50

1960

(17) Amount contributed by employer for annuity contracts in 1960	$2,400.00
(18) Includible compensation for most recent one-year period of service (3/8 × $9,600 + 5/8 × $8,800)	$9,100.00
(19) 20% × includible compensation	$1,820.00
(20) Number of years of service	2 3/8
(21) Item (20) × item (19)	$4,322.50
(22) Contributions excludable in prior taxable years ((7) + (15))	$2,282.50
(23) Amount excludable from A's gross income for 1960 ((21)–(22))	$2,040.00
(24) Amount includible in A's gross income for 1960 ((17)–(23))	$360.00

1961

(25) Amount contributed by employer for annuity contracts in 1961	$1,400.00
(26) Includible compensation for most recent one-year period of service (5/8 × $9,600 + 3/8 × $9,600)	$9,600.00
(27) 20% × includible compensation	$1,920.00
(28) Number of years of service	3
(29) Item (28) × item (27)	$5,760.00
(30) Contributions excludable in prior taxable years ((7) + (15) + (23))	$4,322.50
(31) Amount excludable from A's gross income for 1961 (item (25) since it is less than (29)–(30))	$1,400.00
(32) Amount includible in A's gross income for 1961 ((25)–(31))	None

[T.D. 6783, 29 FR 18360, Dec. 24, 1964, as amended by T.D. 6885, 31 FR 7802, June 2, 1966; T.D. 7748, 46 FR 1696, Jan. 7, 1981; T.D. 7836, 47 FR 42337, Sept. 27, 1982; T.D. 8115, 51 FR 45736, Dec. 19, 1986]

§ 1.403(c)–1 Taxability of beneficiary under a nonqualified annuity.

(a) Taxability of vested interest in premiums. If after August 1, 1969, an employer (whether or not exempt under section 501(a)) pays premiums for an annuity contract for the benefit of an employee, the amount of such premiums shall be included as compensation in the gross income of the employee for the taxable year during which such premiums are paid, but only to the extent that the employee's rights in such premiums are substantially vested (as defined in § 1.83–3(b)) at the time such premiums are paid. The preceding sentence shall not apply to contracts referred to in the transitional rule of paragraph (d)(1), (ii), or (iii) of this section, or to premiums subject to § 1.403(a)–1(a) or excludible under § 1.403(b)–1(b). If any employer has purchased annuity contracts and transferred them to a trust (other than one described in section 401(a)) that is to provide annuity contracts or benefits for his employees, the amounts so paid shall be treated as contributions to a trust described in section 402(b). For the rules relating to the taxation of the cost of life insurance protection when rights in a life insurance contract are substantially nonvested, see § 1.83–1(a)(2).

(b) Taxability of employee when rights under annuity contract change from nonvested to vested—(1) In general. If, during a taxable year of an employee ending after August 1, 1969, the rights of such employee under an annuity contract purchased for him by an employer (whether or not exempt under section 501(a) or 521(a)) become substantially vested, the value of the annuity contract on the date of such change shall be included in the employee's gross income for such year, to the extent provided in paragraph (b)(2) of this section. The preceding sentence shall not apply, however, to an annuity contract purchased and held as part of a plan which met at the time of such purchase, and continues to meet, the requirements of section 404(a)(2) or an annuity contract referred to in paragraph (d)(ii) or (iii) of this section. For purposes of this section, the value of an annuity contract on the date the employee's rights become substantially vested means the cash surrender value of such contract on such date.

(2) Extent to which value of annuity contract is includible in employee's gross income. For purposes of paragraph (b)(1) of this section, the only amount includible in the gross income of the employee is that the portion of the value of the contract on the date of the change that is attributable to premiums which were paid by the employer after August 1, 1969, and which were not excludible from the employer's gross income under § 1.403(b)–1(b). However, the includible portion does not include—

(i) The value attributable to a premium paid on the date of such change, and

(ii) The value attributable to premiums described in the transitional rule of paragraph (d)(1)(ii) or (iii) of this section.

See § 1.403(b)–1(b)(2) for the treatment of an amount otherwise includible in gross income under section 403(c) as an employer contribution for purposes of the exclusion under section 403(b).

(3) Partial vesting. If, during any taxable year of an employee, only part of his beneficial interest in an annuity contract becomes substantially vested, then only the corresponding part of the value of the annuity contract on the date of such change is includible in the employee's gross income for such taxable year. In such a case, it is first necessary to compute, under the rules in paragraphs (b)(1) and (2) of this section but without regard to any exclusion allowable under § 1.403(b)–1(b), the amount which would be includible in the employee's gross income for the taxable year if his entire beneficial interest in the annuity contract had changed to a substantially vested interest during such year. The amount that is includible under this (3)(without regard to the section 403(b) exclusion) is equal to the amount determined under the preceding sentence multiplied by the percent of the employee's beneficial interest which became substantially vested during the taxable year.

(c) Amounts paid or made available under an annuity contract. The amounts paid or made available to the employee under an annuity contract subject to this section shall be included in the gross income of the employee for the taxable year in which paid or made available, as provided in section 72 (relating to annuities). Such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(d) Taxability of beneficiary under a nonqualified annuity on or before August 1, 1969. (1) Except as provided in section 402(d) (relating to taxable years beginning before January 1, 1977), if an employer purchases an annuity contract and if the amounts paid for the contract.

(i) On or before August 1, 1969, or

(ii) After such date, if pursuant to a binding written contract (as defined in § 1.83–8(b)(2)) entered into before April 22, 1969, or

(iii) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969 and under which the obligation of the employer is essentially the same as under a binding written contract, are not subject to paragraph (a) of § 1.403(a)–1 or paragraph (a) of § 1.403–1, the amount of such contribution shall, to the extent it is not excludible under paragraph (b) of § 1.403(b)–1, be included in the income of the employee for the taxable year during which such contribution is made if, at the time the contribution is made, the employee's rights under the annuity contract are nonforfeitable, except for failure to pay future premiums. If the annuity contract was purchased by an employer which is not exempt from tax under section 501(a) or section 521(a), and if the employee's rights under the annuity contract in such a case were forfeitable at the time the employer's contribution was made for the annuity contract, even though they become nonforfeitable later the amount of such contribu-

tion is not required to be included in the income of the employee at the time his rights under the contract become nonforfeitable. On the other hand, if the annuity contract is purchased by an employer which is exempt from tax under section 501(a) or section 521(a), all or part of the value of the contract may be includible in the employee's gross income at the time his rights under the contract become nonforfeitable (see section 403(d) prior to the repeal thereof by the Tax Reform Act of 1969 and the regulations thereunder). As to what constitutes nonforfeitable rights of an employee, see § 1.402(b)–1(d)(2). The amounts received by or made available to the employee under the annuity contract shall be included in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, sections 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to such amounts. For taxable years beginning after December 31, 1963, such amounts may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). For rules relating to the treatment of employer contributions as part of the consideration paid by the employee, see section 72(f). See also section 101(b)(2)(D) for rules relating to the treatment of the limited exclusion provided thereunder as part of the consideration paid by the employee.

(2) If an employer has purchased annuity contracts and transferred them to a trust, or if an employer has made contributions to a trust for the purpose of providing annuity contracts for his employees as provided in section 402(d) (see paragraph (a) of § 1.402(D)–1), the amount so paid or contributed is not required to be included in the income of the employee. but any amount received by or made available to the employee under the annuity contract shall be includible in the gross income of the employee for the taxable year in which received or made available, as provided in section 72 (relating to annuities). For taxable years beginning before January 1, 1964, section 72(e)(3) (relating to the treatment of certain lump sums), as in effect before such date, shall not apply to any amount received by or made available to the employee under the annuity contract. For taxable years beginning after December 31, 1963, amounts received by or made available to the employee under the annuity contract may be taken into account in computations under sections 1301 through 1305 (relating to income averaging). In such case the amount paid or contributed by the employer shall not constitute consideration paid by the employee for such annuity contract in determining the amount of annuity payments required to be included in his gross income under section 72 unless the employee has paid income tax for any taxable year beginning before January 1, 1949, with respect to such payment or contribution by the employer for such year and such tax is not credited or refunded to the employee. In the event such tax has been paid and not credited or refunded the amount paid or contributed by the employer for such year shall constitute consideration paid by the employee for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under section 72.

(3) For taxable years beginning before January 1, 1958, the provisions contained in section 403(c) prior to the amendment made thereto by the Tax Reform Act of 1969 were included in section 403(b) of the Internal Revenue Code of 1954. Therefore, the regulations contained in this paragraph shall, for such taxable years, be considered as the regulations under section 403(b) as in effect for such taxable years. For the rules with respect to contributions paid after August 1, 1969, see paragraphs (a), (b), and (c) of this section.

[T.D. 6783, 29 FR 18365, Dec. 24, 1964, as amended by T.D. 6885, 31 FR 7802, June 2, 1966; T.D. 7554, 43 FR 31924, July 24, 1978]

§ 1.403(d)–1 Taxability of employee when rights under contracts purchased by exempt organizations change from forfeitable to nonforfeitable.

(a) **In general.** The provisions of section 403(d), repealed by section 321(b) of the Tax Reform Act of 1969 (83 Stat. 571), applied for taxable years beginning after December 31, 1957, only with respect to amounts paid for an annuity contract—

(1) On or before August 1, 1969, or

(2) After such date, if pursuant to a binding written contract (as defined in § 1.83–8(b)(2)) entered into before April 22, 1969, or

(3) After August 1, 1969, pursuant to a written plan in which the employee participated on April 22, 1969, and under which the obligation of the employer is essentially the same as under a binding written contract.

If, during a taxable year of an employee beginning after December 31, 1957, the rights of such employee under an annuity contract purchased for him by an employer which is exempt from tax

under section 501(a) or 521(a) change from forfeitable to nonforfeitable rights, then (except in the case of contracts to which § 1.403(c)–1(b) applies for taxable years ending after August 1, 1969) the value of such annuity contract on the date of such change shall be included in the employee's gross income for such taxable year, to the extent provided in paragraph (b) of this section. However, the preceding sentence does not apply to an annuity contract purchased and held as part of a plan that at the time of such purchase and at all times thereafter meets the requirements of section 404(a)(2). For purposes of this section, the value of an annuity contract on the date the employee's rights change from forfeitable to nonforfeitable rights means the cash surrender value of such contract on such date. As to what constitutes nonforfeitable rights of an employee, see § 1.402(b)–1(d)(2). For the rules with respect to amounts paid after August 1, 1969, under an annuity contract purchased for an employee by an employer which is exempt from tax under section 501(a) or 521(a), see generally section 403(c) and the regulations thereunder.

(b) **Extent to which value of annuity contract is includible in employee's gross income.** For purposes of paragraph (a) of this section, there shall be included in the gross income of an employee for his taxable year in which his rights under an annuity contract change from forfeitable to nonforfeitable rights only an amount equal to the portion of the value of such contract on the date of such change (1) that is attributable to contributions:

(i) Which were made by the employer while it was exempt from tax under section 501(a) or 521(a);

(ii) Which were made after December 31, 1957; and

(iii) Which were not, at the time they were made, excludable from the employee's gross income under paragraph (a) of § 1.403(b)–1;

and (2) that is not excludable from the employee's gross income under paragraph (b) of § 1.403(b)–1. Thus, although amounts are contributed by an employer after December 31, 1957, toward the purchase for an employee of an annuity contract and, at the time of the contribution, such employer is an organization described in section 501(c)(3) and exempt from tax under section 501(a), the value of such annuity contract attributable to such contributions would not be includible in the employee's gross income for the taxable year in which his rights under the contract change to nonforfeitable rights if such amounts were contributed during a taxable year of the employee beginning before January 1, 1958, and were, therefore, excludable from the employee's gross income under paragraph (a) of § 1.403(b)–1. Similarly, the value of such an annuity contract is not includible in the gross income of the employee for the year in which the change occurs to the extent that it is excludable under paragraph (b) of § 1.403(b)–1. See paragraph (b)(2) of § 1.403(b)–1 which provides that the amount otherwise includible in gross income under section 403(d) is considered to be a contribution by the employer for purposes of the exclusion provided in paragraph (b) of § 1.403(b)–1. In addition, the portion of the value of an annuity contract attributable to contributions made by the employer while it was not exempt from tax under either section 501(a) or 521(a) is not includible in the gross income of the employee at the time his rights under the contract change to nonforfeitable rights even though the employer is exempt from tax under section 501(a) or 521(a) at the time of such change. On the other hand, the value of the annuity contract purchased by an organization exempt from tax under section 501(a) or 521(a) may be includible in the gross income of an employee for the year during which his rights under the contract change to nonforfeitable rights even though such organization is not exempt on the date of such change.

(c) **Partial vesting—(1) General rule.** If, during any taxable year of an employee, only part of his beneficial interest in an annuity contract changes from a forfeitable to a nonforfeitable interest, then only the corresponding part of the value of the annuity contract on the date of such change is includible in the employee's gross income for such taxable year. In such a case, it is first necessary to compute, under the rules in paragraphs (a) and (b) of this section but without regard to any exclusion allowable under paragraph (b) of § 1.403(b)–1, the amount which would be includible in the employee's gross income for the taxable year if his entire beneficial interest in the annuity contract had changed to a nonforfeitable interest during such year. The amount that is includible (without regard to any exclusion allowed by paragraph (b) of § 1.403(b)–1) in the gross income of the employee for the taxable year in which the change occurs is an amount equal to the amount determined under the preceding sentence multiplied by the percent of the employee's beneficial interest which changed to a nonforfeitable interest during the taxable year. If at the time the employee's interest changes to a nonforfeitable interest, the employer is an organization described in section

501(a)(3) and exempt from tax under section 501(a), then the amount that is includible in the employee's gross income under this subparagraph is considered as an employer contribution to which the exclusion provided in paragraph (b) of § 1.403(b)–1 applies (see paragraph (b)(2) of § 1.403(b)–1).

(2) Example. The provisions in paragraph (c)(1) of this section may be illustrated by the following example:

Example. X organization purchased an annuity contract for A, one of its employees who reports his income on a calendar year basis. X contributed ⅓ of the amount necessary to purchase the contract before January 1, 1958, and the remaining ⅔ after December 31, 1957. At the time of the contributions, X was an organization exempt from tax under section 501(a) and A's rights under the contract were forfeitable. The annuity contract was not purchased as part of a qualified plan and A made no contributions toward the purchase of the contract. On December 31, 1965, 50 percent of A's interest in the contract changed from a forfeitable to a nonforfeitable interest, and on December 31, 1968, the remaining 50 percent of A's interest in the contract changed to a nonforfeitable interest. The cash surrender value of the contract was $9,900 on December 31, 1965, and $12,000 on December 31, 1968. The amount includible in A's gross income for 1965 and 1968 is computed as follows—

1965

(i) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value of contract on December 31, 1965, attributable to contributions made after December 31, 1957), ⅔ × $9,900, $6,600.

(ii) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1965, 50 percent.

(iii) Amount includible in A's gross income for 1965 ((ii) × (i)), $3,300.

1968

(iv) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value of contract on December 31, 1968, attributable to contributions made after December 31, 1957), ⅔ × $12,000, $8,000.

(v) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1968, 50 percent.

(vi) Amount includible in A's gross income for 1968 ((v) × (iv)), $4,500.

If, on December 31, 1965, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the $3,300 as is not excludable under paragraph (b) of § 1.403(b)–1 is includible in A's gross income for 1965. Similarly, if, on December 31, 1968, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the $4,000 as is not excludable under paragraph (b) of § 1.403(b)–1 is includible in A's gross income for 1968.

[T.D. 6783, 29 FR 18365, Dec. 24, 1964, as amended by T.D. 7554, 43 FR 31925, July 24, 1978]

§ 1.404(a)–1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

(a)(1) Section 404(a) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 404(a) also governs the deductibility of unfunded pensions and death benefits paid directly to former employees or their beneficiaries (see § 1.404(a)–12). For taxable years beginning after 1962, certain self-employed individuals may be covered by pension, annuity, or profit-sharing plans. For the rules relating to the deduction of contributions on behalf of such individuals, see paragraph (a)(2) of § 1.404(a)–8 and § 1.404(e)–1.

(2) Section 404(a) does not apply to a plan which does not defer the receipt of compensation. Furthermore, section 404(a) does not apply to deductions for contributions under a plan which is solely a dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare, or similar benefit plan, or a combination thereof. For example, if under a plan an employer contributes 5 percent of each employee's compensation per month to a fund out of which employees who are laid off will be paid benefits for temporary periods, but employees who are not laid off have no rights to the funds, such a plan is an unemployment benefit plan, and the deductibility of the contributions to it is determined under section 162. As to the deductibility of such contributions, see § 1.162–9.

(3) If, however, the contributions to a pension, profit-sharing, stock bonus, or other plan of deferred compensation can be used to provide any of the benefits referred to in subparagraph (2) of this paragraph, then, except as provided in section 404(c), section 404(a) applies to the entire contribution to the plan. Thus, if in the example described in subparagraph (2) of this paragraph, the employer's contribution on behalf of each employee is set up as a separate account, and if any amount which remains in an employee's account at the time of retirement is paid to him at such time, the deductibility of the contributions to the plan is determined under section 404(a). For the regulations for determining whether the benefits referred to in subparagraph (2) of this paragraph can be included in a qualified pension or profit-sharing plan, see § 1.401–1(b).

(4) As to inclusion of full-time life insurance salesmen within the class of persons considered to be employees, see section 7701(a)(20).

(b) In order to be deductible under section 404(a), contributions must be expenses which would be deductible under section 162 (relating to trade or business expenses) or 212 (relating to expenses for production of income) if it were not for the provision in section 404(a) that they are deductible, if at all, only under section 404(a). Contributions may therefore be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year in carrying on the trade or business or for the production of income and are compensation for personal services actually rendered. In no case is a deduction allowable under section 404(a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year. A contribution under a plan which is primarily for the benefit of shareholders of the employer is not deductible. Such a contribution may constitute a dividend within the meaning of section 316. See also §§ 1.162–6 and 1.162–8. In addition to the limitations referred to above, deductions under section 404(a) are also subject to further conditions and limitations particularly provided therein.

(c) Deductions under section 404(a) are generally allowable only for the year in which the contribution or compensation is paid, regardless of the fact that the taxpayer may make his returns on the accrual method of accounting. Exceptions are made in the case of overpayments as provided in paragraphs (1), (3), and (7) of section 404(a), and, as provided by section 404(a)(6), in the case of payments made by a taxpayer on the accrual method of accounting not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof). This latter provision is intended to permit a taxpayer on the accrual method to deduct such accrued contribution or compensation in the year of accrual, provided payment is actually made not later than the time prescribed by law for filing the return for the taxable year of accrual (including extensions thereof), but this provision is not applicable unless, during the taxable year on account of which the contribution is made, the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year. See section 461 and the regulations thereunder. There is another exception in the case of certain taxpayers who are required to make additional contributions as a result of the Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 134), and the regulations thereunder.

[T.D. 6500, 25 FR 11682, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10144, Sept. 17, 1963]

§ 1.404(a)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for employees (temporary).

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of contributions or compensation under section 404(a)?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(a) shall govern the deduction of contributions paid and compensation paid or incurred by the employer under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits to employees, their spouses, or their dependents. See section 404(b) and § 1.404(b)-1T. Section 404(a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a "welfare benefit fund" (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected the application of such section. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, § 1.419-1T and § 1.419A-2T. For rules relating to the deduction of vacation pay for which

an election is made under section 463, see § 10.2 of this chapter and § 1.463-1T.

[T.D. 8073, 51 FR 4320, Feb. 4, 1986]

§ 1.404(a)–2 Information to be furnished by employer claiming deductions; taxable years ending before December 31, 1971.

(a) For the first taxable year for which a deduction from gross income is claimed under section 404(a)(1), (2), (3), or (7), the employer must file the following information (unless such information has been previously filed in accordance with the regulations under section 23(p) of the Internal Revenue Code of 1939) for each plan involved to establish that it meets the requirements of section 401(a) or 404(a)(2), and that deductions claimed do not exceed the amount allowable under paragraphs (1), (2), (3), and (7) of section 404(a), as the case may be:

(1) Verified copies of all the instruments constituting or evidencing the plan, including trust indentures, group annuity contracts, specimen copy of each type of individual contract, and specimen copy of formal announcement and comprehensive detailed description to employees, with all amendments to any such instruments.

(2) A statement describing the plan which identifies it and which sets forth the name or names of the employers, the effective date of the plan and of any amendments thereto, the method of distribution or of disbursing benefits (whether by trustee, insurance company, or otherwise), the dates when the instruments or amendments were executed, the date of formal announcement and the dates when comprehensive detailed description of the plan and of each amendment thereto were made available to employees generally, the dates when the plan and when the trust or the contract evidencing the plan and of any amendments thereto were put into effect so that contributions thereunder were irrevocable and a summary of the provisions and rules relating to—

(i) Employee eligibility requirements for participation in the plan,

(ii) Employee contributions,

(iii) Employer contributions,

(iv) The basis or formula for determining the amount of each type of benefit and the requirements for obtaining such benefits and the vesting conditions,

(v) The medium of funding (*e.g.*, self-insured, unit purchase group annuity contract, individual level annual premium retirement endowment insurance contracts, etc.) and, if not wholly insured, the medium of contributions and the kind of investments, and

(vi) The discontinuance or modification of the plan and distributions or benefit payments upon liquidation or termination.

(3) A tabulation in columnar form showing the information specified below with respect to each of the 25 highest paid employees covered by the plan in the taxable year, listed in order of their nondeferred compensation (where there are several plans of deferred compensation, the information for each of the plans may be shown on a single tabulation without repetition of the information common to the several plans):

(i) Name.

(ii) Whether an officer.

(iii) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.

(iv) Whether the principal duties consist in supervising the work of other employees.

(v) Year of birth.

(vi) Length of service for employer to the close of the year.

(vii) Total nondeferred compensation paid or accrued during the taxable year with a breakdown of such compensation into the following components:

(a) Basic compensation and overtime pay,

(b) Other direct payments, such as bonuses and commissions,

(c) Compensation paid other than in cash, such as goods, services, insurance not directly related to the benefits or provided from funds under the plan, etc.

(viii) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions during the year, under each other plan of deferred compensation.

(ix) Amount allocated during the year for the benefit of the employee or his beneficiary (including any insurance provided thereby or directly related thereto), less the employee's contributions

during the year, under the plan. If a profit-sharing or stock bonus plan, also a breakdown of such amounts into the following components:

(a) Amounts originally allocated in the year, and

(b) Amounts reallocated in the year.

(x) Amounts of employee contributions during the year under the plan,

(xi) If a pension or annuity plan,

(a) The retirement age and date and the form of the retirement benefit,

(b) The annual rate or amount of the retirement benefit, and

(c) The aggregate of all of the employee's contributions under the plan,

all based, in the case of an employee who is not on retirement benefit under the plan, upon the assumption of his continued employment at his current rate of compensation until his normal retirement age (or the end of the current year if later) and retirement on such date with the normal form of retirement benefit under the plan.

(4) The following totals:

(i) Total nondeferred compensation paid or accrued during the taxable year for all employees covered under the plan and also for all employees of the employer.

(ii) Total amount allocated during the year for the benefit of employees, former or retired employees, or their beneficiaries (including any insurance provided thereby or directly related thereto), less employee contributions during the year under the plan and, if a profit-sharing or stock bonus plan, also a breakdown of such total into the following components:

(a) Amount originally allocated in the year, and

(b) Amount reallocated in the year.

(5) A schedule showing the total number of employees as of the close of the year for each of the following groups, based on reasonable estimates:

(i) All employees ineligible for coverage under the plan because of requirements as to employment classification, specifying the reasons applicable to the group (as, for example, temporary, seasonal, part time, hourly pay basis, etc.).

(ii) All employees ineligible for coverage under the plan because of requirements as to length of service and not included in subdivision (i) of this subparagraph.

(iii) All employees ineligible for coverage under the plan because of requirements as to minimum age and not included in subdivision (i) or (ii) of this subparagraph.

(iv) All employees ineligible for coverage under the plan solely because of requirements as to minimum rate of compensation.

(v) All employees ineligible for coverage under the plan other than those employees included in subdivision (i), (ii), (iii), or (iv) of this subparagraph, specifying the reason applicable to the group.

(vi) All employees ineligible for coverage under the plan for any reasons, which should be the sum of subdivisions (i) to (v), inclusive, of this subparagraph.

(vii) All employees eligible for coverage but not covered under the plan.

(viii) All employees covered under the plan.

(ix) All employees of the employer, which should be the sum of subdivisions (vi), (vii), and (viii) of this subparagraph.

If it is claimed that the requirements of section 401(a)(3)(A) are satisfied, also the data and computations necessary to show that such requirements are satisfied.

(6) In the case of a trust, a detailed balance sheet and a detailed statement of receipts and disbursements during the year; in the case of a nontrusteed annuity plan, a detailed statement of the names of the insurers, the contributions paid by the employer and by the employees, and a statement as to the amounts and kinds of premium refunds or similar credits made available and the disposition of such credits in the year.

(7) If a pension or annuity plan, a detailed description of all the methods, factors, and assumptions used in determining costs and in adjusting the costs for actual experience under the plan (including any loadings, contingency reserves, or special factors and the basis of any insured costs or liabilities involved therein) explaining their source and application in sufficient detail to permit ready analysis and verification thereof, and, in the case of a trust, a detailed description of the basis used in valuing the investments held.

(8) A statement of the applicable limitations under section 404(a)(1), (2), (3), or (7) and an explanation of the method of determining such

limitations, a summary of the data, and a statement of computations necessary to determine the allowable deductions for the taxable year. Also, in the case of a pension or annuity plan, a summary of the costs or liabilities and adjustments for the year under the plan based on the application of the methods, factors, and assumptions used under the plan, in sufficient detail to permit ready verification of the reasonableness thereof.

(9) A statement of the contributions paid under the plan for the taxable year showing the date and amount of each payment. Also, a summary of the deductions claimed for the taxable year for the plan with a breakdown of the deductions claimed into the following components:

(i) For contributions paid in the taxable year before giving effect to the provisions of paragraph (7) of section 404(a).

(ii) For contributions paid in prior taxable years beginning after December 31, 1941, in accordance with the carryover provisions of paragraphs (1) and (3) of section 404(a), before giving effect to the provisions of paragraph (7) thereof, and in accordance with the carryover provisions of section 404(d).

(iii) Any reductions or increases in the deductions in accordance with the provisions of paragraph (7) of section 404(a). However, if the information in this subdivision is filed prior to the filing of the information required by subparagraph (8) of this paragraph, then, in determining the limit of deduction under paragraph (7) of section 404(a), the applicable percentage of the compensation otherwise paid or accrued during the year may be used.

(b) For taxable years subsequent to the year for which all of the applicable information under paragraph (a) of this section (or corresponding provisions of prior regulations) has been filed, information is to be filed only to the following extent:

(1) If there is any change in the plan, instruments, methods, factors, or assumptions upon which the data and information specified in paragraph (a)(1), (2), or (7) of this section are based, a detailed statement explaining the change and its effect is to be filed only for the taxable year in which the change is put into effect. However, if there is no such change, unless otherwise requested by the district director, merely a statement that there is no such change is to be filed.

(2) The information specified in paragraph (a)(3) of this section which has been filed for a taxable year, unless otherwise requested by the district director and so long as the plan and the method and basis of allocations are not changed, is to be filed for subsequent years only to the extent of showing in the tabulation such information with respect to employees who, at any time in the taxable year, own, directly or indirectly, more than 5 percent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendant as owned by the individual for this purpose.

(3) The information specified in paragraph (a)(4), (5), (6), (8), and (9) of this section.

In the case of corporate employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1961. In the case of other employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1962.

(c) If a deduction is claimed under section 404(a)(5) for the taxable year, the taxpayer shall furnish such information as is necessary to show that the deduction is not allowable under the other paragraphs of section 404(a), that the amount paid is an ordinary and necessary expense or an expense for the production of income, and that the employees' rights to, or derived from, such employer's contribution or such compensation were nonforfeitable at the time the contribution or compensation was paid. In the case of corporate employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1961. In the case of other employers, the information required to be submitted by this paragraph shall, except as otherwise provided by the Commissioner, be filed on Form 2950 for taxable years ending on or after December 31, 1962.

(d) For the purpose of the information required by this section, contributions paid in a taxable year shall include those deemed to be so paid in accordance with the provisions of section 404(a)(6) and shall exclude those deemed to be paid in the prior taxable year in accordance with such provisions. As used in this section, "taxable year" refers to the taxable year of the employer and, unless otherwise requested by the district director, a "year" which is not specified as a "taxable year" may be taken as the taxable year of the employer or as the plan, trust, valuation, or group contract year with re-

spect to which deductions are being claimed provided the same rule is followed consistently so that there is no gap or overlap in the information furnished for each item. In any case the date or period to which each item of information furnished relates should be clearly shown. All the information required by this section should be filed with the tax return for the taxable year in which the deduction is claimed, except that, unless sooner requested by the district director, such information, other than that specified in paragraph (a)(4)(i) and (9) of this section, may be filed within 12 months after the close of the taxable year provided there is filed with the tax return a statement that the information cannot reasonably be filed therewith, setting forth the reasons therefor.

(e) In any case all the information and data required by this section must be filed in the office of the district director in which the employer files his tax returns and must be filed independently of any information and data otherwise submitted in connection with a determination of the qualification of the trust or plan under section 401(a). The district director may, in addition, require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401. For taxable years ending on or before December 31, 1961, the district director may waive the filing of such information required by this section which he finds unnecessary in a particular case. For taxable years ending after December 31, 1961, the Commissioner may waive the filing of such information.

(f) Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

(g) In the case of a plan which covers employees, some or all of whom are self-employed individuals and with respect to which a deduction is claimed under section 404(a)(1), (2), (3), or (7), paragraphs (a) and (b) of this section, and the provision of paragraph (d) of this section relating to the time for filing the information required by this section, shall not apply, but in lieu of the information required to be submitted by paragraphs (a) and (b) of this section, the employer shall, with the return for the taxable year in which the deduction is claimed, submit the information required by the form provided by the Internal Revenue Service for such purpose.

(h) When a custodial account forms a part of a plan for which a deduction is claimed under section 404(a)(1), (2), (3), or (7), the information which under this section is to be submitted with respect to a qualified trust must be submitted with respect to such custodial account. Thus, for purposes of this section—

(1) The term "trust" includes custodial account,

(2) The term "trustee" includes custodian, and

(3) The term "trust indenture" includes custodial agreement.

(i) Except as provided under § 1.503(d)–1(a) and § 601.201 of this chapter (Statement of Procedural Rules) in the case of a request for the determination of qualification of a trust under section 401 and exemption under section 501, paragraphs (a) through (h) of this section shall not apply for taxable years ending on or after December 31, 1971. For information to be furnished for taxable years ending on or after December 31, 1971, see § 1.404(a)–2A.

[T.D. 6500, 25 FR 11683, Nov. 26, 1960, as amended by T.D. 6599, 27 FR 4475, May 10, 1962; T.D. 6676, 28 FR 10144, Sept. 17, 1963; T.D. 7165, 37 FR 5025, 5491, March 9, 1972; T.D. 7168, 37 FR 5491, March 16, 1972]

§ 1.404(a)–2A Information to be furnished by employer; taxable years ending on or after December 31, 1971, and before December 31, 1975.

(a) In general. For any taxable year ending on or after December 31, 1971, any employer who maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation shall file the forms prescribed by this section. An employer (including a self-employed individual) maintaining such a plan shall furnish such information as is required by the forms and the instructions relating thereto. The forms shall be filed in the manner and at the time prescribed under paragraph (c) of this section. See § 1.404(a)–2 with respect to information to be furnished for taxable years ending before December 31, 1971. For purposes of this section, in the case of a plan of several employers described in § 1.401–1(d), each employer shall be deemed to be maintaining a separate plan corresponding to the plan of which the trust is a part. For information required to be furnished with respect to a funded deferred compensation plan maintained by an employer who is exempt from tax under section 501(a), see § 1.6033–2(a)(2)(ii)(i).

(b) Forms. The forms prescribed by this section are:

(1) Form 4848, generally relating to information concerning the qualification of the plan, and deductions for contributions made on behalf of employees or self-employed individuals,

(2) Form 4849, generally relating to the financial position of the trust, fund, or custodial or fiduciary account which is a part of the plan, and

(3) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Forms 2950 and 2950SE, relating to the identification of plans to which an employer has made a contribution and information with respect to a deduction for a contribution made on behalf of a self-employed individual, respectively.

(c) Filing requirements. (1) Form 4848 shall be filed by the employer for each taxable year during which he maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation. Such form shall be filed on or before the 15th day of the 5th month following the close of the employer's taxable year. For rules relating to the extension of time for filing, see section 6081 and the regulations thereunder and the instructions for Form 4848.

(2) Form 4849 shall be filed by the employer as an attachment to Form 4848 for each taxable year during which he maintains a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation unless the employer (i) has been notified in writing that Form 4849 will be filed by the fiduciary for such plan as an attachment to Form 990-P or (ii) is not required to file Form 4849 under the instructions relating thereto.

(3) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Form 2950 shall be filed with the employer's tax return for any such taxable year during which a pension, annuity, stock bonus, profit-sharing, or other funded plan of deferred compensation is maintained.

(4) For any taxable year ending on or after December 31, 1971, and before December 31, 1972, Form 2950SE shall be filed by each self-employed individual with his income tax return for any such taxable year in which he claims a deduction for contributions made on his behalf.

(d) Additional information. In addition to the information otherwise required to be furnished by this section, the district director may require any further information that he considers necessary to determine allowable deductions under section 404 or qualification under section 401.

(e) Records. Records substantiating all data and information required by this section to be filed must be kept at all times available for inspection by internal revenue officers at the main office or place of business of the employer.

[T.D. 7165, 37 FR 5025, March 9, 1972, as amended by T.D. 7223, 37 FR 24748, Nov. 21, 1972; T.D. 7551, 43 FR 29292, July 7, 1978]

§ 1.404(a)–3 Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 401(a); application of section 404(a)(1).

(a) If contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(1) or (2) if the further conditions provided therein are also satisfied. As used in this section, a "pension trust" means a trust forming part of a pension plan and an "annuity plan" means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. This section is also applicable to contributions to a foreign situs pension trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States. For the meaning of "pension plan" as used in this section, see paragraph (b)(1)(i) of § 1.401–1. Where disability pensions, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 404(a)(1) or (2). See paragraph (b)(2) of § 1.72–16 as to taxability to employees of cost of incidental life insurance protection. Similarly, where medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14 are provided for retired employees, their spouses, or their dependents under the plan, deductions on account of such subordinate benefits are also covered under section 404(a)(1) or (2). In order to be deductible under section 404(a)(1), contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 501(a). Contributions paid in such a taxable year of the employer may be

carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). See § 1.404(a)–7 for rules relating to the limitation on the amount deductible in such a succeeding taxable year of the employer. See § 1.404(a)–8 as to conditions for deductions under section 404(a)(2) in the case of an annuity plan. In either case, the deductions are also subject to further limitations provided in section 404(a)(1). The limitations provided in section 404(a)(1) are, with an exception provided for certain years under subparagraph (A) thereof (see § 1.404(a)–4), based on the actuarial costs of the plan.

(b) In determining costs for the purpose of limitations under section 404(a)(1), the effects of expected mortality and interest must be discounted and the effects of expected withdrawals, changes in compensation, retirements at various ages, and other pertinent factors may be discounted or otherwise reasonably recognized. A properly weighted retirement age based on adequate analyses of representative experience may be used as an assumed retirement age. Different basic assumptions or rates may be used for different classes of risks or different groups where justified by conditions or required by contract. In no event shall costs for the purpose of section 404(a)(1) exceed costs based on assumptions and methods which are reasonable in view of the provisions and coverage of the plan, the funding medium, reasonable expectations as to the effects of mortality and interest, reasonable and adequate regard for other factors such as withdrawal and deferred retirement (whether or not discounted) which can be expected to reduce costs materially, reasonable expenses of operation, and all other relevant conditions and circumstances. In any case, in determining the costs and limitations, an adjustment shall be made on account of any experience more favorable than that assumed in the basis of limitations for prior years. Unless such adjustments are consistently made every year by reducing the limitations otherwise determined by any decrease in liability or cost arising from experience in the next preceding taxable year which was more favorable than the assumptions on which the costs and limitations were based, the adjustment shall be made by some other method approved by the Commissioner.

(c) The amount of a contribution to a pension or annuity plan that is deductible under section 404(a)(1) or (2) depends upon the methods, factors, and assumptions which are used to compute the costs of the plan and the limitation of section 404(a)(1) which is applied. Since the amount that is deductible for one taxable year may affect the amount that is deductible for other taxable years, the methods, factors, and assumptions used in determining costs and the method of determining the limitation which have been used for determining the deduction for a taxable year for which the return has been filed shall not be changed for such taxable year, except when the Commissioner determines that the methods, factors, assumptions, or limitations were not proper, or except when a change is necessitated by reason of the use of different methods, factors, assumptions, or limitations for another taxable year. However, different methods, factors, and assumptions, or a different method of determining the limitation, if they are proper, may be used in determining the deduction for a subsequent taxable year.

(d) Any expenses incurred by the employer in connection with the plan, such as trustee's and actuary's fees, which are not provided for by contributions under the plan are deductible by the employer under section 162 (relating to trade or business expenses), or 212 (relating to expenses for production of income) to the extent that they are ordinary and necessary.

(e) In case deductions are allowable under section 404(a)(3), as well as under section 404(a)(1) or (2), the limitations under section 404(a)(1) and (3) are determined and applied without giving effect to the provisions of section 404(a)(7) but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See § 1.404(a)–13.

(f)(1) Amounts contributed by an employer under the plan for the funding of medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401–14 must satisfy the general requirements which are applicable to deductions allowable under section 404 and which are set forth in § 1.404(a)–1 including, for example, the requirements described in paragraph (b) of such section. Accordingly, such amounts must constitute an ordinary and necessary expense relating to either the trade or business or the production of income and must not, when added to all other compensation paid by the employer to the employee on whose behalf such a contribution is made, constitute more than reasonable compensation. However, in determining the amount which is deductible with respect to contributions to provide retirement benefits under the plan, amounts contributed for the funding of medical benefits described in

section 401(h) shall not be taken into consideration.

(2) The amounts deductible with respect to employer contributions to fund medical benefits described in section 401(h) shall not exceed the total cost of providing such benefits. The total cost of providing such benefits shall be determined in accordance with any generally accepted actuarial method which is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The amount deductible for any taxable year with respect to such cost shall not exceed the greater of—

(i) An amount determined by distributing the remaining unfunded costs of past and current service credits as a level amount, or as a level percentage of compensation, over the remaining future service of each employee, or

(ii) 10 percent of the cost which would be required to completely fund or purchase such medical benefits.

In determining the amount deductible, an employer must apply either subdivision (i) of this subparagraph for all employees or subdivision (ii) of this subparagraph for all employees. If contributions paid by an employer in a taxable year to fund such medical benefits under a pension or annuity plan exceed the limitations of this subparagraph but otherwise satisfy the conditions for deduction under section 404, then the excess contributions are carried over and are deductible in succeeding taxable years of the employer which end with or within taxable years of the trust for which it is exempt under section 501(a) in order of time to the extent of the difference between the amount paid and deductible in each succeeding year and the limitation applicable to such year under this subparagraph. For purposes of subdivision (i) of this subparagraph, if the remaining future service of an employee is one year or less, it shall be treated as one year.

[T.D. 6500, 25 FR 11685, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 514, Jan. 20, 1961; 6722, 29 FR 5073, April 14, 1964; T.D. 7165, 37 FR 5025, March 9, 1972]

§ 1.404(a)–4 Pension and annuity plans; limitations under section 404(a)(1)(A).

(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), the initial limitation under section 404(a)(1)(A) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5-percent limitation applies to the first taxable year for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year (other than one described in paragraph (d) of this section) for which the 5-percent figure is not reduced as provided in this section. For years to which the initial 5-percent limitation applies, no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5-percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5-percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return an actuarial certification of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year. Such costs shall be determined by methods, factors, and assumptions appropriate as a basis of limitations under section 404(a)(1)(C). Whenever requested by the district director, a similar certification and statement shall be submitted for the year or years specified in such request. The district director will make periodical examinations of such data at not less than 5-year intervals. Based upon such examinations the Commissioner will reduce the limitation under section 404(a)(1)(A) below the 5-percent limitation for the years with respect to which he finds that the 5-percent limitation exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the district director with a request for a change in the limitation. See, however, paragraph (d) of this section with respect to taxable years to which the limitation under section 404(a)(1)(A) does not apply.

(c) For the purpose of limitations under section 404(a)(1)(A), "compensation otherwise paid or accrued" means all of the compensation paid or

accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). Where two or more pension or annuity plans cover the same employee, under section 404(a)(1)(A) the deductions with respect to each such plan are subject to the limitations applicable to the particular plan and the total deductions for all such plans are also subject to the limitations which would be applicable thereto if they constituted a single plan. Where, because of the particular provisions applicable to a large class of employees under a plan, the costs with respect to such employees are nominal in comparison with their compensation, after the first year to which the initial 5-percent limitation applies, deductions under section 404(a)(1)(A) are subject to limitations determined by considering the plan applicable to such class as if it were a separate plan. Deductions are allowable to the extent of the applicable limitations under section 404(a)(1)(A) even where these are greater than the applicable limitations under section 404(a)(1)(B) or section 404(a)(1)(C).

(d) The limitation under section 404(a)(1)(A) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See § 1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

[T.D. 6500, 25 FR 11685, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–5 Pension and annuity plans; limitations under section 404(a)(1)(B).

(a) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), under section 404(a)(1)(B), deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost attributable to such individuals shall be distributed evenly over a period of at least five taxable years. See, however, paragraph (e) of this section with respect to taxable years to which the limitation under section 404(a)(1)(B) does not apply.

(b) The statutory limitation for any taxable year under section 404(a)(1)(B) is any excess of the amount of the costs described in paragraph (a) of this section for the year over the amount allowable as a deduction under section 404(a)(1)(A).

(c) For this purpose, such excess, adjusted for prior experience, may be computed for each year as follows, all determinations being made as of the beginning of the year:

(1) Determine the value of all benefits expected to be paid, after the beginning of the year for all employees, any former employees, and any other beneficiaries, then covered under the plan.

(2) If employees contribute under the plan, determine the value of all contributions expected to be made after the beginning of the year by employees then covered under the plan.

(3) Determine the value of all funds of the plan as of the beginning of the year.

(4) Determine the amount remaining to be distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee by subtracting from subparagraph (1) of this paragraph the sum of subparagraphs (2) and (3) of this paragraph.

(5) Determine the value of all compensation expected to be paid after the beginning of the year to all employees then covered under the plan.

(6) Determine an accrual rate for each employee by dividing subparagraph (5) of this paragraph into subparagraph (4) of this paragraph.

(7) Compute the excess under section 404(a)(1)(B) for the year by multiplying the compensation paid to all employees covered under the plan during the year by any excess of subparagraph (6) of this paragraph over 5 percent. In general, where this method is used, the limitation under section 404(a)(1)(B) will be equal to the excess so computed without further adjustment on account of prior favorable experience, provided all the factors and assumptions used are reasonable in view of all applicable considerations (see § 1.404(a)–3) and provided subparagraph (5) of this paragraph is not less than five times the annual rate of compensation in effect at the beginning of the year.

(d) Instead of determining the excess deductible under section 404(a)(1)(B) by the method shown

in paragraph (c), such excess may be based upon cost determined by some other method which is reasonable and appropriate under the circumstances. Thus, such excess may be based on the amounts necessary with respect to each individual covered employee to provide the remaining unfunded cost of all his benefits under the plan distributed as a level amount over the period remaining until the normal commencement of his retirement benefits, in accordance with other generally accepted actuarial methods which are reasonable and appropriate in view of the provisions of the plan, the funding medium, and other applicable considerations.

(e) The limitation under section 404(a)(1)(B) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See § 1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

[T.D. 6500, 25 FR 11686, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–6 Pension and annuity plans; limitations under section 404(a)(1)(C).

(a) Application to a taxable year of the employer which ends with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2). (1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust for which it is exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2). See paragraph (b) of this section for rules relating to the limitation under section 404(a)(1)(C) for other taxable years of the employer.

(2) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), in lieu of amounts deductible under the limitations of section 404(a)(1)(A) and section 404(a)(1)(B), deductions may be allowed under section 404(a)(1)(C) to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. "Normal cost" for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. For this purpose, the normal cost may be determined by any generally accepted actuarial method and may be expressed either as (i) the aggregate of level amounts with respect to each employee covered under the plan, (ii) a level percentage of payroll with respect to each employee covered under the plan, or (iii) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but it is subject to adjustments for prior favorable experience. See § 1.404(a)–3. In any case, past service or supplementary costs shall not be included in the limitation for any year in which the amount required to fund fully or to purchase such past service or supplementary credits has been deducted, since no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

(b) Application to a taxable year of the employer which does not end with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2). (1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of

an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which end after the trust or plan has terminated. Since contributions paid in such taxable years of the employer are not deductible under section 404(a)(1) or (2) (except as provided in section 404(a)(6)), the limitation under section 404(a)(1)(C) for such taxable years relates only to the amount of any excess contributions that may be carried over to such taxable years under section 404(a)(1)(D).

(2) Subject to the applicable general conditions and limitations (see § 1.404(a)–3), deductions may be allowed under section 404(a)(1)(C) for taxable years of the employer to which this paragraph applies to the extent of limitations based on past service or supplementary costs of providing benefits under the plan. For definition of the "past service or supplementary cost at any time", see paragraph (a)(2) of this section.

(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. The limitation under section 404(a)(1)(C) is subject, however, to adjustments for prior favorable experience. In any case, no amounts are deductible under section 404(a)(1)(C) for any year to which this paragraph applies if the amount required to fund fully or to purchase the past service or supplementary credits has been deducted in prior taxable years of the employer.

[T.D. 6534, 26 FR 515, Jan. 20, 1961]

§ 1.404(a)–7 Pension and annuity plans; contributions in excess of limitations under section 404(a)(1); application of section 404(a)(1)(D).

When contributions paid by an employer in a taxable year to or under a pension or annuity plan exceed the limitations applicable under section 404(a)(1) but otherwise satisfy the conditions for deduction under section 404(a)(1) or (2), then in accordance with section 404(a)(1)(D), the excess contributions are carried over and are deductible in succeeding taxable years of the employer in order of time pursuant to the following rules:

(a) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2), such excess contributions are deductible to the extent of the difference between the amount paid and deductible in such succeeding taxable year and the limitation applicable to such year under section 404(a)(1)(A), (B), or (C).

(b) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated, such excess contributions are deductible to the extent of the limitation applicable to such year under section 404(a)(1)(C) (see paragraph (b) of § 1.404(a)–6).

The provisions of section 404(a)(1)(D) are to be applied before giving effect to the provisions of section 404(a)(7) for any year. The carryover provisions of section 404(a)(1)(D), before effect has been given to section 404(a)(7), may be illustrated by the following example for a plan put into effect in a taxable year ending December 31, 1954:

Taxable Year Ending Dec. 31, 1954	
Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	40,000
Taxable Year Ending Dec. 31, 1955	
Amount of contributions paid in year	$25,000
Carried over from previous years	40,000
Total deductible subject to limitation	65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	15,000
Taxable Year Ending Dec. 31, 1956	
Amount of contributions paid in year	$10,000
Carried over from previous years	15,000
Total deductible subject to limitation	25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

[T.D. 6534, 26 FR 516, Jan. 20, 1961]

§ 1.404(a)–8 Contributions of an employer under an employees' annuity plan which meets the requirements of section 401(a); application of section 404(a)(2).

(a) If contributions are paid by an employer under an annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(2) if the further conditions provided therein are satisfied. For the meaning of

"annuity plan" as used here, see § 1.404(a)–3. In order that contributions by the employer may be deducted under section 404(a)(2), all of the following conditions must be satisfied:

(1) The contributions must be paid toward the purchase of retirement annuities (or for disability, severance, insurance, survivorship benefits incidental and directly related to such annuities, or medical benefits described in section 401(h) as defined in paragraph (a) of § 1.404(h)–1) under an annuity plan for the exclusive benefit of the employer's employees or their beneficiaries.

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements set forth in section 401(a)(3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), and (19). In the case of a plan which covers a self-employed individual, the contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it also meets the requirements of section 401(a), (9), (10), (17), and (18) and of section 401(d) (other than paragraph (1)). In the case of a plan which covers a shareholder-employee within the meaning of section 1379(d), the contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it also meets the requirements of section 401(a)(17) and (18). See section 401(a) and the regulations thereunder for the requirements and the applicable effective dates of the respective paragraphs set forth in section 401(a). Any contributions of an employer which are paid in a taxable year of the employer ending with or within a year of the plan for which it meets the applicable requirements of section 401 may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the plan for which it meets the requirements set out in section 401(a) and (d). See section 401(b) and the regulations thereunder for special rules allowing certain plan amendments to be given retroactive effect. See section 404(a)(6) for a special rule for determining the time when a contribution is deemed to have been made.

(3) There must be a definite written arrangement between the employer and the insurer that refunds of premiums, if any, shall be applied within the taxable year of the employer in which received or within the next succeeding taxable year toward the purchase of retirement annuities (or for disability, severance, insurance, survivorship benefits incidental and directly related to such annuities, or medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401(h)–1 under the plan. For the purpose of this condition, "refunds of premiums" means payments by the insurer on account of credits such as dividends, experience rating credits, or surrender or cancellation credits. The arrangement may be in the form of contract provisions or written directions of the employer or partly in one form and partly in another. This condition will be considered satisfied where—

(i) All credits are applied regularly, as they are determined, toward the premiums next due under the contracts before any further employer contributions are so applied, and

(ii) Under the arrangement,

(A) No refund of premiums may be made during continuance of the plan unless applied as aforesaid, and

(B) If refunds of premiums may be made after discontinuance or termination, whichever is applicable, of the plan on account of surrenders or cancellations before all retirement annuities provided under the plan with respect to service before its discontinuance or termination have been purchased, such refunds will be applied in the taxable year of the employer in which received, or in the next succeeding taxable year, to purchase retirement annuities for employees by a procedure which does not contravene the conditions of section 401(a)(4). If the plan also includes medical benefits described in section 401(h) as defined in paragraph (a) of § 1.401(h)–1, any refund of premiums attributable to such benefits must, in accordance with these rules, be applied toward the purchase of medical benefits described in section 401(h).

(4) Any amounts described in subparagraph (3) of this paragraph which are attributable to contributions on behalf of a self-employed individual must be applied toward the purchase of retirement benefits. Amounts which are so applied are not contributions and thus are not taken into consideration in determining—

(i) The amount deductible with respect to contributions on his behalf, nor

(ii) In the case of an owner-employee, the maximum amount of contributions that may be made on his behalf.

(b) Where the above conditions are satisfied, the amounts deductible under section 404(a)(2) are governed by the limitations provided in section

404(a)(1). See §§ 1.404(a)–3 to 1.404(a)–7, inclusive.

[T.D. 6500, 25 FR 11687, Nov. 26, 1960, as amended by T.D. 6676, 28 FR 10144, Sept. 17, 1963, T.D. 6722, 29 FR 5074, Apr. 14, 1964; T.D. 7501, 42 FR 42321, Aug. 23, 1977]

§ 1.404(a)(8)–1T Deductions for plan contributions on behalf of self-employed individuals (temporary).

Q: How does the amendment to section 404(a)(8)(D), made by section 713(d)(6) of the Tax Reform Act of 1984 (TRA of 1984), affect section 404(a)(8)(C)?

A: In applying the rules of section 404(a)(8)(C), the Service will treat the amendment to section 404(a)(8)(D) as also having been made to section 404(a)(8)(C), pending enactment of technical corrections to TRA of 1984. The effect of treating the amendment as having also been made to section 404(a)(8)(C) is to increase the amount of contributions on behalf of a self-employed individual that will be treated as satisfying section 162 or 212. Generally, therefore, a contribution on behalf of a self-employed individual is treated as satisfying section 162 or 212 if it is not in excess of the individual's earned income for the year, determined without regard to the deduction allowed by section 404 for the self-employed individual's contribution.

[T.D. 8073, 51 FR 4321, Feb. 4, 1986]

§ 1.404(a)–9 Contributions of an employer in an employees' profit-sharing or stock bonus trust that meets the requirements of section 401(a); application of section 404(a)(3)(A).

(a) If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(3)(A) if the further conditions provided therein are also satisfied. In order to be deductible under the first, second, or third sentence of section 404(a)(3)(A), the contributions must be paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. Excess contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 404(a)(3)(A), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). This section is also applicable to contributions to a foreign situs profit-sharing or stock bonus trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States.

(b) The amount of deductions under section 404(a)(3)(A) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued by the employer during such taxable year to employees who are beneficiaries under the plan. For purposes of computing this limitation, the following rules are applicable:

(1) In the case of a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, in such taxable year of the employer, are beneficiaries of the trust funds accumulated under the plan.

(2) In the case of a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated, the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), were beneficiaries of the trust funds accumulated under the plan.

For purposes of this paragraph, "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). The limitations under section 404(a)(3)(A) apply to the total amount deductible for contributions to the trust regardless of the manner in which the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under sec-

tion 404(a)(3)(A), such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or accrued by the employer during such taxable year to the employees who are beneficiaries under the plan. See paragraph (b) of this section for rules for determining who are the beneficiaries under the plan.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years, where contributions in some taxable year are less than the primary limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years over (ii) the aggregate of the deductions allowed or allowable under the limitations provided in section 404(a)(3)(A) for all prior years. Since contributions paid into a profit-sharing or stock bonus trust are deductible under section 404(a)(3)(A) only if they are paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the secondary limitation described in this paragraph is not applicable with respect to determining amounts deductible for a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated. See paragraph (e) of this section for rules relating to amounts which are deductible in such a taxable year.

(e) In any case when the contributions in a taxable year exceed the amount allowable as a deduction for the year under section 404(a)(3)(A), the excess is deductible in succeeding taxable years, in order of time, in accordance with the following limitations:

(1) If the succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a), such excess is deductible in any such succeeding taxable year in which the contributions are less than the primary limitation for that year; but the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such year, or (ii) the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

(2) If the succeeding taxable year ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or if such succeeding taxable year ends after the trust has terminated, the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such succeeding taxable year, or (ii) the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

In no case, however, are excess contributions deductible in a succeeding taxable year if such contributions were not paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a).

(f) In case deductions are allowable under section 404(a)(1) or (2), as well as under section 404(a)(3)(A), the limitations under section 404(a)(1) and (3)(A) are determined and applied without giving effect to the provisions of section 404(a)(7), but the amounts allowable as deductions are subject to the further limitations provided in section 404(a)(7). See § 1.404(a)–13.

(g) The provisions of section 404(a)(3)(A) before giving effect to section 404(a)(7), may be illustrated as follows:

ILLUSTRATION OF PROVISIONS OF SECTION 404(a)(3)(A) FOR A PLAN PUT INTO EFFECT IN THE TAXABLE (CALENDAR) YEAR 1954, BEFORE GIVING EFFECT TO SECTION 404(a)(7) (ALL FIGURES REPRESENT THOUSANDS OF DOLLARS AND ALL TAXABLE (CALENDAR) YEARS ARE YEARS WHICH END WITH OR WITHIN A TAXABLE YEAR OF THE TRUST FOR WHICH IT IS EXEMPT UNDER SECTION 501(a))

	Taxable (calendar) years						
	1954	1955	1956	1957	1958	1959	1960
1. Amount of contributions:							
(i) In taxable year	$65	$10	$15	$100	$70	$40	$30
(ii) Carried over from prior taxable years	0	8	0	0	4	5	3
2. Primary limitation applicable to year:							
15 percent of covered compensation in year [1]	57	54	51	48	45	42	39
3. Secondary limitation applicable to year:							

	Taxable (calendar) years						
	1954	1955	1956	1957	1958	1959	1960
(i) Twice primary limitation	......	....	....	96	90	84	....
(ii) (a) Aggregate primary limitations (see item 2)	......	....	....	210	255	297	....
(b) Aggregate prior deductions (see item 4 (iii)	......	....	....	90	186	255	....
(c) Excess of (a) over (b)	......	....	....	120	69	42	....
(iii) Lesser of (i) or (ii)	......	....	....	96	69	42	....
4. Amount deductible for year on account of:							
(i) Contributions in year	57	10	15	96	69	40	30
(ii) Contributions carried over	0	8	0	0	0	2	3
(iii) Total	57	18	15	96	69	42	33
5. Excess contributions carried over to succeeding years	8	0	0	4	5	3	0

[1] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries of trust funds accumulated under the plan in the year.

[T.D. 6500, 25 FR 11687, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 516, Jan. 20, 1961]

§ 1.404(a)–10 Profit-sharing plan of an affiliated group; application of section 404(a)(3)(B).

(a) Section 404(a)(3)(B) allows a corporation a deduction to the extent provided in paragraphs (b) and (c) of this section for a contribution which it makes for another corporation to a profit-sharing plan or a stock bonus plan under which contributions are determined by reference to profits, provided the following tests are met:

(1) The corporation for which the contribution is made and the contributing corporation are members of an affiliated group of corporations as defined in section 1504, relating to the filing of consolidated returns, and both such corporations participate in the plan. However, it is immaterial whether all the members of such group participate in the plan.

(2) The corporation for which the contribution is made is required under the plan to make the contribution, but such corporation is prevented from making such contribution because it has neither current nor accumulated earnings or profits, or because its current and accumulated earnings or profits are insufficient to make the required contribution. To the extent that such a corporation has any current or accumulated earnings or profits, it is not considered to be prevented from making its required contribution to the plan.

(3) The contribution is made out of the current or accumulated earnings or profits of the contributing corporation.

(b) The amount that is deductible under section 404(a)(3)(B) is determined by applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 as if the contribution were made by the corporation for which it is made. For example, the primary limitation described in paragraph (e) of § 1.404(a)–9 is determined by reference to the compensation otherwise paid or accrued to the employees of the corporation for which the contribution is made, and the secondary limitation described in paragraph (d) of § 1.404(a)–9 and the contribution carryover described in paragraph (c) of § 1.404(a)–9 are determined by reference to the prior contributions and deductions of such corporation. The contributing corporation may deduct the amount so determined subject to the limitations contained in paragraph (c) of this section. The contributing corporation shall not treat such amount as a contribution made by it in applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 either for the taxable year for which the contribution is made or for succeeding taxable years. The corporation for which the contribution is made shall treat the contribution as having been made by it in applying the rules of section 404(a)(3)(A) and § 1.404(a)–9 for succeeding taxable years.

(c) The allowance of the deduction under section 404(a)(3)(B) does not depend upon whether the affiliated group does or does not file a consolidated return. If a consolidated return is filed, it is immaterial which of the participating corporations makes the contribution and takes the deduction or how the contribution or the deduction is allocated among them. However, if a consolidated return is not filed, the contribution which is deductible under section 404(a)(3)(B) by each contributing corporation shall be limited to that portion of its total current and accumulated earnings or profits (adjusted for its contribution deductible without regard to section 404(a)(3)(B)) which the prevented contribution bears to the total current and accumulated earnings or profits of all the participating members of the group having such earnings or profits (adjusted for all contributions deductible without regard to section 404(a)(3)(B)).

For the purpose of this section, current earnings or profits shall be computed as of the close of the taxable year without diminution by reason of any dividends during the taxable year, and accumulated earnings or profits shall be computed as of the beginning of the taxable year.

(d) The application of section 404(a)(3)(B) may be illustrated by the following example in which the affiliated group does not file a consolidated return:

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
A	($10,000)	($140,000)	($150,000)	$200,000	1/5	$6,000	....	....	....	....
B...........	(5,000)	105,000	100,000	300,000	3/10	9,000	$9,000	$91,000	6/326 × 91,000	$1,674.85
C...........	75,000	175,000	250,000	500,000	1/2	15,000	15,000	235,000	6/326 × 235,000	4,325.15
Total.......	60,000	140,000	200,000	1,000,000	....	30,000	24,000	326,000	....	6,000.00

Column:
(1) Member.
(2) Earnings and profits of the taxable year.
(3) Accumulated earnings and profits at beginning of taxable year.
(4) Total current and accumulated earnings and profits (column 2 plus column 3).
(5) Compensation of participating employees.
(6) Contribution formula: 50 percent of consolidated earnings and profits, allocated among participating member in proportion of covered payroll of each to covered payroll of consolidated group.
(7) Individual contribution had it not been prevented.
(8) Individual contribution made by each employer for its own employees.
(9) Balance of accumulated earnings and profits (column 4 minus column 8).
(10) Proportion of make-up contribution.
(11) Make-up contribution.

[T.D. 6500, 25 FR 11688, Nov. 26, 1960]

§ 1.404(a)–11 Trusts created or organized outside the United States; application of section 404(a)(4).

In order that a trust may constitute a qualified trust under section 401(a) and be exempt under section 501(a), it must be created or organized in the United States and maintained at all times as a domestic trust. See paragraph (a) of § 1.401–1. Paragraph (4) of section 404(a) provides, however, that an employer which is a resident, a corporation, or other entity of the United States, making contributions to a foreign stock bonus, pension, or profit-sharing trust, shall be allowed deductions for such contributions, under the applicable conditions and within the prescribed limits of section 404(a), if such foreign trust would qualify for exemption under section 501(a) except for the fact that it is a trust created, organized, or maintained outside the United States. Moreover, if a nonresident alien individual, foreign corporation, or other entity is engaged in trade or business within the United States and makes contributions to a foreign stock bonus, pension, or profit-sharing trust, which would qualify under section 401(a) and be exempt under section 501(a) except that it is created, organized, or maintained outside the United States, such contributions are deductible subject to the conditions and limitations of section 404(a) and to the extent allowed by section 873 or 882(c).

[T.D. 6500, 25 FR 11689, Nov. 26, 1960]

§ 1.404(a)–12 Contributions of an employer under a plan that does not meet the requirements of section 401(a); application of section 404(a)(5).

(a) **In general.** Section 404(a)(5) covers all cases for which deductions are allowable under section 404(a) (for contributions paid by an employer under a stock bonus, pension, profit sharing, or annuity plan or for any compensation paid on account of any employee under a plan deferring the receipt of such compensation) but not allowable under paragraph (1), (2), (3), (4), or (7) of such section. For the rules with respect to the taxability of an employee when rights under a nonexempt trust become substantially vested, see section 402(b) and the regulations thereunder.

(b) **Contributions made after August 1, 1969—(1) In general.** A deduction is allowable for a contribution paid after August 1, 1969, under section 404(a)(5) only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in his gross income as compensation, and then only to the extent allowable under section 404(a). See § 1.404(a)–1. For example, if an employer A contributes $1,000 to the account of its employee E for its taxable (calendar) year 1977, but the amount in the account attributable to that contribution is not includible in E's gross income until his taxable (calendar) year 1980 (at which time the includible amount is $1,150), A's deduction for that contribution is $1,000 in 1980 (if allowable

under section 404(a)). For purposes of this (1), a contribution is considered to be so includible where the employee or his beneficiary excludes it from his gross income under section 101(b) or subchapter N. To the extent that property of the employer is transferred in connection with such a contribution, such transfer will constitute a disposition of such property by the employer upon which gain or loss is recognized, except as provided in section 1032 and the regulations thereunder. The amount of gain or loss recognized from such disposition shall be the difference between the value of such property used to measure the deduction allowable under this section and the employer's adjusted basis in such property.

(2) Special rule for unfunded pensions and certain death benefits. If unfunded pensions are paid directly to former employees, such payments are includible in their gross income when paid, and accordingly, such amounts are deductible under section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404(a)(5) in any case when they are not includible under the other paragraphs of section 404(a).

(3) Separate accounts for funded plans with more than one employee. In the case of a funded plan under which more than one employee participates, no deduction is allowable under section 404(a)(5) for any contribution unless separate accounts are maintained for each employee. The requirement of separate accounts does not require that a separate trust be maintained for each employee. However, a separate account must be maintained for each employee to which employer contributions under the plan are allocated, along with any income earned thereon. In addition, such accounts must be sufficiently separate and independent to qualify as separate shares under section 663(c). Nothing shall preclude a trust which loses its exemption under section 501(a) from setting up such accounts and meeting the separate account requirement of section 404(a)(5) with respect to the taxable years in which such accounts are set up and maintained.

(c) Contributions paid on or before August 1, 1969. No deduction is allowable under section 404(a)(5) for any contribution paid on or before August 1, 1969, by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid on account of any employee under plan deferring the receipt of such compensation, except in the year when paid, and then only to the extent allowable under section 404(a). See § 1.404(a)–1. If payments are made under such a plan and the amounts are not deductible under the other paragraphs of section 404(a), they are deductible under section 404(a)(5) to the extent that the rights of individual employees to, or derived from, such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. If unfunded pensions are paid directly to former employees, their rights to such payments are nonforfeitable, and accordingly, such amounts are deductible under section 404(a)(5) when paid. Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period), and if such amounts meet the requirements of section 162 or 212, such amounts are deductible under section 404(a)(5) in any case where they are not deductible under the other paragraphs of section 404(a). As to what constitutes nonforfeitable rights of an employee in other cases, see § 1.402(b)–1(d)(2). If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amount are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

[T.D. 6500, 25 FR 11689, Nov. 26, 1960; T.D. 7554, 43 FR 31926, July 24, 1978]

§ 1.404(a)–13 Contributions of an employer where deductions are allowable under section 404(a)(1) or (2) and also under section 404(a)(3); application of section 404(a)(7).

(a) Where deductions are allowable under section 404(a)(1) or (2) on account of contributions under a pension or annuity plan and deductions are also allowable under section 404(a)(3) for the same taxable year on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 404(a)(7) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 404(a)(1) or (2) is also a beneficiary under the trusts for which deductions are allowable under section 404(a)(3). The provisions of section 404(a)(7) apply only to deductions for overlapping trusts or plans, *i.e.*, for all trusts or plans for which deductions are allowable under section

404(a)(1), (2), or (3) except (1) any trust or plan for which deductions are allowable under section 404(a)(1) or (2) and which does not cover any employee who is also covered under a trust for which deductions are allowable under section 404(a)(3), and (2) any trust for which deductions are allowable under section 404(a)(3) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 404(a)(1) or (2). The limitations under section 404(a)(7) for any taxable year of the employer are based on the compensation otherwise paid or accrued during the year by the employer to all employees who, in such year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans. For purposes of the preceding sentence, if the taxable year of the employer with respect to which the limitation is being computed ends with or within a taxable year of any of the overlapping trusts or plans during which any such trust is not exempt under section 501(a) or, in the case of a plan, during which it does not meet the requirements of section 404(a)(2), or if such taxable year of the employer ends after any such trust or plan has terminated, then, with respect to such trust or plan, those employees, and only those employees, who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), or the plan met the requirements of section 404(a)(2), were beneficiaries of the funds accumulated under such trust or plan shall be considered the beneficiaries of such trust or plan in the taxable year of the employer with respect to which the limitation is being computed. For purposes of this paragraph, "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2).

(b) Under section 404(a)(7), any excess of the total amount otherwise deductible for the taxable year under section 404(a)(1), (2), or (3) as contributions to overlapping trusts or plans over 25 percent of the compensation otherwise paid or accrued during the year to all the employees who are beneficiaries under such trusts or plans, is not deductible for such year but is deductible for succeeding taxable years, in order of time, so that the total deduction for contributions to such trusts or plans for a succeeding taxable year is equal to the lesser of—

(1) 30 percent of the compensation otherwise paid or accrued during the taxable year to all the employees who are beneficiaries under such trusts or plans in the year, or

(2) The sum of (i) the smaller of (a) 25 percent of the compensation otherwise paid or accrued during the taxable year to all employees who are beneficiaries under such trusts or plans in the year, or (b) the total of the amounts otherwise deductible under section 404(a)(1), (2), or (3) for the year for such trusts or plans and (ii) any carryover to the year from prior years under section 404(a)(7), *i.e.*, any excess otherwise deductible under section 404(a)(1), (2), or (3), but not deducted for a prior taxable year because of the limitations under section 404(a)(7).

(c) The limitations under section 404(a)(7) are determined and applied after all the limitations, deductions otherwise allowable, and carryovers under section 404(a)(1), (2), and (3) have been determined and applied, and, in particular, after effect has been given to the carryover provision in section 404(a)(1)(D) and in the second and third sentences of section 404(a)(3)(A). Where the limitations under section 404(a)(7) reduce the total amount deductible, the excess deductible in succeeding years is treated as a carryover which is distinct from, and additional to, any excess contributions carried over and deductible in succeeding years under the provisions in section 404(a)(1)(D) or in the third sentence of section 404(a)(3)(A). The application of the provisions of section 404(a)(7) and the treatment of carryovers for a case where the taxable years are calendar years and the overlapping trusts or plans consist of a pension trust and a profit-sharing trust put into effect in 1954 and covering the same employees may be illustrated as follows:

ILLUSTRATION OF APPLICATION OF PROVISIONS OF SECTION 404(a)(7) AND OF TREATMENT OF CARRYOVERS FOR OVERLAPPING PENSION AND PROFIT-SHARING TRUSTS PUT INTO EFFECT IN 1954 AND COVERING THE SAME EMPLOYEES (ALL FIGURES REPRESENT THOUSANDS OF DOLLARS AND ALL TAXABLE (CALENDAR) YEARS OF THE EMPLOYER ARE YEARS WHICH END WITH OR WITHIN A TAXABLE YEAR OF THE TRUST FOR WHICH IT IS EXEMPT UNDER SECTION 501(a))

	Taxable calendar years			
	1954	1955	1956	1957
BEFORE GIVING EFFECT TO SECTION 404(a)(7)				
Pension trust contributions and limitations, deductions, and carryovers under section 404(a)(1):				

	Taxable calendar years			
	1954	1955	1956	1957
1. Contributions paid in year	$215	$85	$140	$60
2. Contributions carried over from prior years	0	5	0	20
3. Total deductible for year subject to limitation	215	90	140	80
4. Limitation applicable to year	210	175	120	85
5. Amount deductible for year	210	90	120	80
6. Contributions carried over to succeeding years	5	0	20	0
Profit-sharing trust contributions and limitations, deductions, and carryovers under section 404(a)(3):				
7. Contributions paid in year	200	125	105	65
8. Contributions carried over from prior years	0	35	10	0
9. Total deductible for year subject to limitation	200	160	115	65
10. Limitation applicable to year	165	150	135	[1] 110
11. Amount deductible for year	165	150	115	65
12. Contributions carried over to succeeding years	35	10	0	0
APPLICATION OF SECTION 404(a)(7)				
Totals for pension and profit-sharing trust:				
13. Amount deductible for year under section 404(a)(7):				
(1) 30 percent of compensation covered in year [2]	([3])	300	270	180
(2)(i)(a) 25 percent of compensation covered in year [2]	275	250	225	150
(b) Total amount otherwise deductible for year: item 5 plus item 11	375	240	235	145
(c) Smaller of (a) or (b)	275	240	225	145
(ii) Carryover from prior years under section 404(a)(7)	0	100	40	10
(iii) Sum of (i)(c) and (ii)	275	340	265	155
(3) Amount deductible: Lesser of (1) or (2)(iii)	275	300	265	155
14. Carryover to succeeding years under section 404(a)(7): item 13(2)(ii) plus item 3(2)(i)(b) minus item 13(3)	100	40	10	0

[1] Includes carryover of 20 from 1956.
[2] Compensation otherwise paid or accrued during the year to the employees who are beneficiaries under the trusts in the year.
[3] 30 percent limitation not applicable to first year of plan.

[T.D. 6500, 25 FR 11689, Nov. 26, 1960, as amended by T.D. 6534, 26 FR 517, Jan. 20, 1961]

§ 1.404(a)–14 Special rules in connection with the Employee Retirement Income Security Act of 1974.

(a) Purpose of this section. This section provides rules for determining the deductible limit under section 404(a)(1)(A) of the Internal Revenue Code of 1954 for defined benefit plans.

(b) Definitions. For purposes of this section—

(1) Section 404(a). The term "old section 404(a)" means section 404(a) as in effect on September 1, 1974. Any reference to section 404 without the designation "old" is a reference to section 404 as amended by the Employee Retirement Income Security Act of 1974.

(2) Ten-year amortization base. The term "10-year amortization base" means either the past service and other supplementary pension and annuity credits described in section 404(a)(1)(A)(iii) or any base established in accordance with paragraph (g) of this section. A plan may have several 10-year amortization bases to reflect different plan amendments, changes in actuarial assumptions, changes in funding method, and experience gains and losses of previous years.

(3) Limit adjustment. The term "limit adjustment" with respect to any 10-year amortization base is the lesser of—

(i) The level annual amount necessary to amortize the base over 10 years using the valuation rate, or

(ii) The unamortized balance of the base,

in each case using absolute values (solely for the purpose of determining which is the lesser). To compute the level amortization amount, the base may be divided by the present value of an annuity of one dollar, obtained from standard annuity tables on the basis of a given interest rate (the valuation rate) and a known period (the amortization period).

(4) Absolute value. The term "absolute value" for any number is the value of that number, treating negative numbers as if they were positive numbers. For example, the absolute value of 5 is 5 and the absolute value of minus 3 is 3. On the other hand, the true value of minus 3 is minus 3. This term is relevant to the computation of the limit adjustment described in paragraph (b)(3) and the remaining amortization period of combined bases described in paragraph (i)(3) of this section.

(5) Valuation rate. The term "valuation rate" means the assumed interest rate used to value plan liabilities.

(c) Use of plan in determining deductible limit for employer's taxable year. Although the deductible limit applies for an employer's taxable year, the deductible limit is determined on the basis of a plan year. If the employer's taxable year coincides with the plan year, the deductible limit for the taxable year is the deductible limit for the plan year that coincides with that year. If the employer's taxable year does not coincide with the plan year, the deductible limit under section 404(a)(1)(A)(i), (ii), or (iii) for a given taxable year of the employer is one of the following alternatives:

(1) The deductible limit determined for the plan year commencing within the taxable year.

(2) The deductible limit determined for the plan year ending within the taxable year, or

(3) A weighted average of alternatives (1) and (2). Such an average may be based, for example, upon the number of months of each plan year falling within the taxable year.

The employer must use the same alternative for each taxable year unless consent to change is obtained from the Commissioner under section 446(e).

(d) Computation of deductible limit for a plan year—(1) General rules. The computation of the deductible limit for a plan year is based on the funding methods, actuarial assumptions, and benefit structure used for purposes of section 412, determined without regard to section 412(g) (relating to the alternative minimum funding standard), for the plan year. The method of valuing assets for purposes of section 404 must be the same method of valuing assets used for purposes of section 412.

(2) Special adjustments of computations under section 412. To apply the rules of this section (*i.e.*, rules regarding the computation of normal cost with aggregate type funding methods, unfunded liabilities, and the full funding limitation described in paragraph (k) of the section, where applicable) with respect to a given plan year in computing deductible limits under section 404(a)(1)(A), the following adjustments must be made:

(i) There must be excluded from the total assets of the plan the amount of any plan contribution for a plan year for which the plan was qualified under section 401(a), 403(a) or 405(a) that has not been previously deducted, even though that amount may have been credited to the funding standard account under section 412(b)(3). In the case of a plan using a spread gain funding method which maintains an unfunded liability (*e.g.*, the frozen initial liability method, but not the aggregate method), the amount described in the preceding sentence must be included in the unfunded liability of the plan.

(ii) There must be included in the total assets of the plan for a plan year the amount of any plan contribution that has been deducted with respect to a prior plan year, even though that amount is considered under section 412 to be contributed in a plan year subsequent to that prior plan year. In the case of a plan using a spread gain funding method which does not maintain an unfunded liability, the amount described in the preceding sentence must be excluded from the unfunded liability of the plan.

The special adjustments described in paragraph (d)(2)(i) and (ii) of this section apply on a year-by-year basis for purposes of section 404(a)(1)(A) only. Thus, the adjustments have no effect on the computation of the minimum funding requirement under section 412.

(e) Special computation rules under section 404(a)(1)(A)(i)—(1) In general. For purposes of determining the deductible limit under section 404(a)(1)(A)(i), the deductible limit with respect to a plan year is the sum of—

(i) The amount required to satisfy the minimum funding standard of section 412(a) (determined without regard to section 412(g)) for the plan year and

(ii) An amount equal to the includible employer contributions. The term "includible employer contributions" means employer contributions which were required by section 412 for the plan year immediately preceding such plan year, and which were not deductible under section 404(a) for the prior taxable year of the employer solely because they were not contributed during the prior

taxable year (determine with regard to section 404(a)(6)).

(2) **Rule for an employer using alternative minimum funding standard account and computing its deduction under section 404(a)(1)(A)(i).** This paragraph (e)(2) applies if the minimum funding requirements for the plan are determined under the alternative minimum funding standard described in section 412(g) for both the current plan year and the immediately preceding plan year. In that case, the deductible limit under section 404(a)(1)(A)(i) (regarding the minimum funding requirement of section 412) for the current year is the sum of the amount determined under the rules of paragraph (e)(1) of this section.

(i) Plus the charge under section 412(b)(2)(D), and

(ii) Less the credit under section 412(b)(3)(D),

that would be required if in the current plan year the use of the alternative method were discontinued.

(f) **Special computation rules under section 404(a)(1)(A)(ii) and (iii)—(1) In general.** Subject to the full funding limitation described in paragraph (k) of this section, the deductible limit under section 404(a)(1)(A)(ii) and (iii) is the normal cost of the plan (determined in accordance with paragraph (d) of this section).

(2) **Adjustments in calculating limit under section 404(a)(1)(A)(iii).** In calculating the deductible limit under section 404(a)(1)(A)(iii), the normal cost of the plan is—

(i) Decreased by the limit adjustments to any unamortized bases required by paragraph (g) of this section, for example, bases that are due to a net experience gain, a change in actuarial assumptions, a change in funding method, or a plan provision or amendment which decreases the accrued liability of the plan, and

(ii) Increased by the limit adjustments of any unamortized 10-year amortization bases required by paragraph (g) or (j) of this section, for example, bases that are due to a net experience loss, a change in actuarial assumptions, a change in funding method, or a plan provision or amendment which increases the accrued liability.

(3) **Timing for computations and interest adjustments under section 404(a)(1)(A)(ii) and (iii).** Regardless of the actual time when contributions are made to a plan, in computing the deductible limit under section 404(a)(1)(A)(ii) and (iii) the normal cost and limit adjustments shall be computed as of the date when contributions are assumed to be made ("the computation date") and adjusted for interest at the valuation rate from the computation date to the earlier of—

(i) The last day of the plan year used to compute the deductible limit for the taxable year, or

(ii) The last day of that taxable year. For additional provisions relating to the timing of computations and interest adjustments, see paragraph (h)(6) of this section (relating to the timing of computations and interest adjustments in the maintenance of 10-year amortization bases). For taxable years beginning before April 22, 1981, computations under the preceding sentence may, as an alternative, be based on prior published positions of the Internal Revenue Service under section 404(a).

(4) **Special limit under section 404(a)(1)(A)(ii).** If the deduction for the plan year is determined solely on the basis of section 404(a)(1)(A)(ii) (that is, without regard to clauses (i) or (iii)), the special limitation contained in section 404(a)(1)(A)(ii), regarding the unfunded cost with respect to any three individuals, applies, notwithstanding the rules contained in paragraphs (d)(2) and (f)(1) of this section.

(g) **Establishment of a 10-year amortization base—(1) Experience gains and losses.** In the case of a plan valued by the use of a funding method which is an immediate gain type of funding method (and therefore separately amortizes rather than includes experience gains and losses as a part of the normal cost of the plan), a 10-year amortization base must be established in any plan year equal to the net experience gain or loss required under section 412 to be determined with respect to that plan year. The base is to be maintained in accordance with paragraph (h) of this section. Such a base must not be established if the deductible limit is determined by use of a funding method which is a spread gain type of funding method (under which experience gains and losses are spread over future periods as a part of the plan's normal cost). Examples of the immediate gain type of funding method are the unit credit method, entry age normal cost method, and the individual level premium cost method. Examples of the spread gain type of funding method are the aggregate cost method, frozen initial liability cost method, and the attained age normal cost method.

(2) **Change in actuarial assumptions.** (i) If the creation of an amortization base is required under the rules of section 412(b)(2)(B)(v) or (3)(B)(iii)

(as applied to the funding method used by the plan), a 10-year amortization base must be established at the time of a change in actuarial assumptions used to value plan liabilities. The amount of the base is the difference between the accrued liability calculated on the basis of the new assumptions and the accrued liability calculated on the basis of the old assumptions. Both computations of accrued liability are made as of the date of the change in assumptions.

(ii) A plan using a funding method of the spread gain type does not directly determine an accrued liability. If a plan using such a method is required under section 412(b)(2)(B)(v) or (3)(B)(iii) to create an amortization base, it must establish a base as described in paragraph (g)(2)(i) of this section for a change in actuarial assumptions by determining an accrued liability on the basis of another funding method (of the immediate gain type) that does determine an accrued liability. (The aggregate method is an example of a funding method that is not required under section 412(b)(2)(B)(v) or (3)(B)(iii) to create an amortization base.) The funding method chosen to determine the accrued liability of the plan in these cases must be the same method used to establish all other 10-year amortization bases maintained by the plan, if any. These bases must be maintained in accordance with paragraph (h) of this section.

(3) Past service or supplemental credits. A 10-year base must be established when a plan is established or amended, if the creation of an amortizable base is required under the rules of section 412(b)(2)(B)(ii) or (iii), or (b)(3)(B)(i) (as applied to the funding method used by the plan). The amount of the base is the accrued liability arising from, or the decrease in accrued liability resulting from, the establishment or amendment of the plan. The base must be maintained in accordance with paragraph (h) of this section.

(4) Change in funding method. If a change in funding method results in an increase or decrease in an unfunded liability required to be amortized under section 412, a 10-year base must be established equal to the increase or decrease in unfunded liability resulting from the change in funding method. The base must be maintained in accordance with paragraph (h) of this section.

(h) Maintenance of 10-year amortization base—(1) In general. Each time a 10-year amortization base is established, whether by a change in funding method, by plan amendment, by change in actuarial assumptions, or by experience gains and losses, the base must, except as provided in paragraph (i) of this section, be separately maintained in order to determine when the unamortized amount of the base is zero. The sum of the unamortized balances of all of the 10-year bases must equal the plan's unfunded liability with the adjustments described in paragraph (d) of this section, if applicable. When the unamortized amount of a base is zero, the deductible limit is no longer adjusted to reflect the amortization of the base.

(2) First year's base. See either paragraph (g) or paragraph (i) of this section for rules applicable with respect to the first year of a base.

(3) Succeeding year's base. For any plan year after the first year of a base, the unamortized amount of the base is equal to—

(i) The unamortized amount of the base as of the valuation date in the prior plan year, plus

(ii) Interest at the valuation rate from the valuation date in the prior plan year to the valuation date in the current plan year on the amount described in subdivision (i), minus

(iii) The contribution described in paragraph (h)(4) of this section with respect to the base for the prior plan year.

The valuation date is the date as of which plan liabilities are valued under section 412(c)(9). If such a valuation is performed less often than annually for purposes of section 412, bases must be adjusted for purposes of section 404 each year as of the date on which a section 412 valuation would be performed were it required on an annual basis. See paragraph (b)(3) of this section for the definition of valuation rate.

(4) Contribution allocation with respect to each base. A portion of the total contribution for the prior plan year is allocated to each base. Generally, this portion equals the product of—

(i) The total contribution described in paragraph (h)(6) of this section with respect to all bases, and

(ii) The ratio of the amount described in paragraph (b)(3)(i) of this section with respect to the base to the sum (using true rather than absolute values) of such amounts with respect to all remaining bases.

However, if the result of this computation with respect to a particular base exceeds the amount necessary to amortize such base fully, the smaller amount shall be deemed the contribution made with respect to such base. The unallocated excess with respect to a now fully amortized base shall be

allocated among the other bases as indicated above.

(5) Other allocation methods. The Commissioner may authorize the use of methods other than the method described in paragraph (h)(4) of this section for allocating contributions to bases.

(6) Total contribution for all bases. The contribution with respect to all bases for the prior plan year (see paragraph (h)(3)(iii) of this section) is the difference between—

(i) The sum of (A) the total deduction (including a carryover deduction) for the prior year, (B) interest on the actual contributions for the prior year (whether or not deductible) at the valuation rate for the period between the dates as of which the contributions are credited under section 412 and the valuation date in the current plan year, and (C) interest on the carryover described in section 404(a)(1)(D) that is available at the beginning of the prior taxable year at the valuation rate for the period between the current and prior valuation dates, and

(ii) The normal cost for the prior plan year and interest on it at the valuation rate from the date as of which the normal cost is calculated to the current valuation date.

(7) Effect of failure to contribute normal cost plus interest on unamortized amounts. The failure to make a contribution at least equal to the sum of the normal cost plus interest on the unamortized amounts has the following effects under the preceding rules of this section—

(i) It does not create a new base.

(ii) It results in an increase in the unamortized amount of each base and consequently extends the time before the base is fully amortized.

(iii) The limit adjustment for any base is not increased (in absolute terms) even if the unamortized amount computed under paragraph (h) of this section exceeds the initial 10-year amortization base. Thus, if the total unamortized amount of the plan's bases at the beginning of the plan year is $100,000 (which is also the unfunded liability of the plan), and a required $50,000 normal cost contribution is not made for the plan year, the following effects occur. The total unamortized balance of the plan's bases increases by the $50,000 normal cost for the year (adjusted for interest), plus interest on the $100,000 balance of the bases; and, because of that increase, it will take a longer period to amortize the remaining balance of the bases. (The annual amortization amount does not change.)

(8) Required adjustment to a 10-year base limit adjustment if valuation rate changed. If there is a change in the valuation rate, the limit adjustment for all unamortized 10-year amortization bases must be changed, in addition to establishing a new base as provided in paragraph (g)(2) of this section. The new limit adjustment for any base is the level amount necessary to amortize the unamortized amount of the base over the remaining amortization period using the new valuation rate. The remaining amortization period of the base is the number of years at the end of which the unamortized amount of the base would be zero if the contribution made with respect to that base equaled the limit adjustment each year. This calculation of the remaining period is made on the basis of the valuation rate used before the change. Both the remaining amortization period and the revised limit adjustment may be determined through the use of standard annuity tables. The remaining period may be computed in terms of fractional years, or it may be rounded off to a full year. The unamortized amount of the base as of the valuation date and the remaining amortization period of that base shall not be changed by any change in the valuation rate.

(i) **Combining bases—(1) General method.** For purposes of section 404 only, and not for purposes of section 412, different 10-year amortization bases may be combined into a single 10-year amortization base if such single base satisfies all of the requirements of paragraph (i)(2), (3), and (4) of this section at the time of the combining of the different bases.

(2) Unamortized amount. The unamortized amount of the single base equals the sum, as of the date the combination is made, of the unamortized amount of the bases being combined (treating negative bases as having negative unamortized amounts).

(3) Remaining amortization period. The remaining amortization period of the single base is equal to (i) the sum of the separate products of (A) the unamortized amount of each of these bases (using absolute values) and (B) its remaining amortization period, divided by (ii) the sum of the unamortized amounts of each of the bases (using absolute values). For purposes of this paragraph (i)(3), the remaining amortization period of each base being combined is that number of years at the end of which the unamortized amount of the base would be zero if the contribution made with re-

spect to that base equaled the limit adjustment of that base in each year. This number may be determined through the use of standard annuity tables. The remaining amortization period described in this paragraph may be computed in terms of fractional years, or it may be rounded off to a whole year.

(4) Limit adjustment. The limit adjustment for the single base is the level amount necessary to amortize the unamortized amount of the combined base over the remaining amortization period described in paragraph (i)(3) of this section, using the valuation rate. This amount may be determined through the use of standard annuity tables.

(5) Fresh start alternative. In lieu of combining different 10-year amortization bases, a plan may replace all existing bases with one new 10-year amortization base equal to the unfunded liability of the plan as of the time the new base is being established. This unfunded liability must be determined in accordance with the general rules of paragraphs (d) and (f) of this section. The unamortized amount of the base and the limit adjustment for the base will be determined as though the base were newly established.

(j) Initial 10-year amortization base for existing plan—(1) In general. In the case of a plan in existence before the effective date of section 404(a), the 10-year amortization base on the effective date of section 404(a) is the sum of all 10 percent bases existing immediately before section 404(a) became effective for the plan, determined under the rules of old section 404(a).

(2) Limit adjustment. The limit adjustment for the initial base is the lesser of the unamortized amount of such base or the sum of the amounts determined under paragraph (b)(3) of this section using the original balances of the remaining bases (under old section 404(a) rules) as the amount to be amortized.

(3) Unamortized amount. The employer may choose either to establish a single initial base reflecting both all prior 10-percent bases and the experience gain or loss for the immediately preceding actuarial period, or to establish a separate base for the prior 10-percent bases and another for the experience gain or loss for the immediately preceding period. If the initial 10-year amortization base reflects the net experience gain or loss from the immediately preceding actuarial period, the unamortized amount of the initial base shall equal the total unfunded liability on the effective date of section 404(a) determined in accordance with the general rules of paragraphs (d) and (f) of this section. If, however, a separate base will be used to reflect that gain or loss, the unamortized amount of the initial base shall equal such unfunded liability on the effective date of section 404(a), reduced by the net experience loss or increase by the net experience gain for the immediately preceding actuarial period. In this case, a separate 10-year amortization base must be established on the effective date equal to the net experience gain or loss. Thus, if the effective date unfunded liability is $100,000 and an experience loss of $15,000 is recognized on that date, and if the loss is to be treated as a separate base, the unamortized balances of the two bases would be $85,000 and $15,000. If the unfunded liability were the same $100,000, but a gain of $15,000 instead of a loss were recognized on that date, the unamortized balances of the two bases would be $115,000 and a credit base of $15,000. In both cases, if only one 10-year base is to be established on the effective date, its unamortized balance would be $100,000 (the unfunded liability of the plan). See paragraphs (d) and (f) for rules for determining the unfunded liability of the plan.

(k) Effect of full funding limit on 10-year amortization bases. The amount deductible under section 404(a)(1)(A)(i), (ii), or (iii) for a plan year may not exceed the full funding limitation for that year. See section 412 and paragraphs (d), (e), and (f) of this section for rules to be used in the computation of the full funding limitation. If the total deductible contribution (including carryover) for a plan year equals or exceeds the full funding limitation for the year, all 10-year amortization bases maintained by the plan will be considered fully amortized, and the deductible limit for subsequent plan years will not be adjusted to reflect the amortization of these bases.

(*l*) Transitional rules—(1) Plan years beginning before April 22, 1981. In determining the deductible limit for plan years beginning before April 22, 1981, a contribution will be deductible under section 404(a)(1)(A) if the computation of the deductible limit is based on an interpretation of section 404(a)(1)(A) that is reasonable when considered with prior published positions of the Internal Revenue Service. A computation of the deductible limit may satisfy the preceding sentence even if it does not satisfy the rules contained in paragraphs (c) through (i) of this section.

(2) Transitional approaches. The deductible limit determined for the first plan year with respect to which a plan applies the rules contained in

paragraphs (c) through (i) of this section must be computed using one of the following approaches—

(i) The plan (whether or not in existence before the effective date of section 404(a)) may apply the rules of paragraph (j) for establishing the initial base for an existing plan, treating 10-year bases (if any) as 10 percent bases in adding bases.

(ii) The plan may apply the fresh start alternative for combining bases under paragraph (i)(5).

(iii) The plan may retroactively establish 10-year amortization bases for years with respect to which section 404(a)(1)(A) and the rules of this section would have applied but for the transition rule contained in paragraph (*l*)(1) of this section. Contributions actually deducted are used in retroactively establishing and maintaining these bases under paragraph (h). However, a deduction already taken shall not be recomputed because of the retroactive establishment of a base.

(m) Effective date of section 404(a). In the case of a plan which was in existence on January 1, 1974, section 404(a) generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after December 31, 1974. In the case of a plan not in existence on January 1, 1974, section 404(a) generally applies for contributions on account of taxable years of an employer ending with or within plan years beginning after September 4, 1974. See § 1.410(a)–2(c) for rules concerning the time of plan existence. See also § 1.410(a)–2(d), which provides that a plan in existence on January 1, 1974, may elect to have certain provisions, including the amendments to section 404(a) contained in section 1013 of the Employee Retirement Income Security Act of 1974, apply to a plan year beginning after September 2, 1974, and before the otherwise applicable effective date contained in that section.

[T.D. 7760, 46 FR 6914, Jan. 22, 1981; 45 FR 15685, March 9, 1981]

§ 1.404(b)–1 Method of contribution, etc., having the effect of a plan; effect of section 404(b).

Section 404(a) is not confined to formal stock bonus, pension, profit-sharing, and annuity plans, or deferred compensation plans, but it includes any method of contributions or compensation having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation. Thus, where a corporation pays pensions to a retired employee or employees or to their beneficiaries in such amounts as may be determined from time to time by the board of directors or responsible officers of the company, or where a corporation is under an obligation, whether funded or unfunded, to pay a pension or other deferred compensation to an employee or his beneficiaries, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 404(a). If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision is not intended to cover the case where an employer on the accrual basis defers payment of compensation after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

[T.D. 6500, 25 FR 11690, Nov. 26, 1960]

§ 1.404(b)–1T Method or arrangement of contributions, etc., deferring the receipt of compensation or providing for deferred benefits (temporary).

Q–1: As amended by the Tax Reform Act of 1984, what does section 404(b) of the Internal Revenue Code provide?

A–1: As amended, section 404(b) clarifies that any plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits (other than compensation) is to be treated as a plan deferring the receipt of compensation for purposes of section 404(a) and (d). Accordingly, section 404(a) and (d) (in the case of employees and nonemployees; respectively) shall govern the deduction of contributions paid or compensation paid or incurred with respect to such a plan, or method or arrangement. Section 404(a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. Thus, for example, under section 404(a)(5) and (b), if otherwise deductible under section 162 or 212, a contribution paid or incurred with respect to a nonqualified plan, or method or arrangement, providing for deferred benefits is deductible in the taxable year

of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee (without regard to any applicable exclusion under Chapter 1, Subtitle A, of the Internal Revenue Code). Section 404(a) and (d) applies to all compensation and benefit plans, or methods or arrangements, however denominated, which defer the receipt of any amount of compensation or benefit, including fees or other payments. Thus, a limited partnership (using the accrual method of accounting) may not accrue deductions for a fee owed to an unrelated person (using the cash method of accounting) who performs services for the partnership until the partnership taxable year in which or with which ends the taxable year of the service provider in which the fee is included in income. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a "welfare benefit fund" (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected the application of such section. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, § 1.419-1T and § 1.419A-2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see § 10.2 of this chapter and § 1.463-1T.

Q–2: When does a plan, or method or arrangement, defer the receipt of compensation or benefits for purposes of section 404(a), (b), and (d)?

A–2: (a) For purposes of section 404(a), (b), and (d), a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. The determination of whether a plan, or method or arrangement, defers the receipts of compensation or benefits is made separately with respect to each employee and each amount of compensation or benefit. Compensation or benefits received by an employee's spouse or dependent or any other person, but taxable to the employee, are treated as received by the employee for purposes of section 404. An employee is determined to receive compensation or benefits within or beyond a brief period of time after the end of the employer's taxable year under the rules provided in this Q&A. For the treatment of expenses with respect to transactions between related taxpayers, see section 267.

(b)(1) A plan, or method or arrangement, shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered ("the 2½ month period"). Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is presumed to be paid under a plan, or method or arrangement, deferring the receipt of compensation, to the extent that the salary or bonus is received beyond the applicable 2½ month period. Further, salary or a year-end bonus received beyond the applicable 2½ month period by one employee shall be presumed to constitute payment under a plan, or method or arrangement, deferring the receipt of compensation for such employee even though salary or bonus payments to all other employees are not similarly treated because they are received within the 2½ month period. Benefits are "deferred benefits" if, assuming the benefits were cash compensation, such benefits would be considered deferred compensation. Thus, a plan, or method or arrangement, shall be presumed to be one providing for deferred benefits to the extent benefits for services are received by an employee after the 2½ month period following the end of the employer's taxable year in which the related services are rendered.

(2) The taxpayer may rebut the presumption established under the previous subparagraph with respect to an amount of compensation or benefits only by setting forth facts and circumstances the preponderance of which demonstrates that it was impracticable, either administratively or economically, to avoid the deferral of the receipt by an employee of the amount of compensation or benefits beyond the applicable 2½ month period and that, as of the end of the employer's taxable year such impracticability was unforeseeable. For example, the presumption may be rebutted with respect to an amount of compensation to the extent that receipt of such amount is deferred beyond the applicable 2½ month period (i) either because the funds of the employer were not sufficient to make the payment within the 2½ month period without jeopardizing the solvency of the employer or because it was not reasonably possible to determine within the 2½ month period whether payment of such amount was to be made, and (ii) the circumstance causing the deferral described in

(i) was unforeseeable as of the close of the employer's taxable year. Thus, the presumption with respect to the receipt of an amount of compensation or benefit is not rebutted to the extent it was foreseeable, as of the end of the employer's taxable year, that the amount would be received after the applicable 2½ month period. For example, if, as of the end of the employer's taxable year, it is foreseeable that calculation of a year-end bonus to be paid to an employee under a given formula will not be completed and thus the bonus will not be received (and is in fact not received) by the end of the applicable 2½ month period, the presumption that the bonus is deferred compensation is not rebutted.

(c) A plan, or method or arrangement, shall not be considered as deferring the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of the applicable 2½ month period. Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is not considered paid under a plan, or method or arrangement, deferring the receipt of compensation to the extent that such salary or bonus is received by the employee on or before the end of the applicable 2½ month period.

(d) Solely for purposes of applying the rules of paragraphs (b) and (c) of this Q&A, in the case of an employer's taxable year ending on or after July 18, 1984, and on or before March 21, 1986, compensation or benefits that relate to services rendered in such taxable year shall be deemed to have been received within the applicable 2½ month period if such receipt actually occurs after such 2½ month period but on or before March 21, 1986.

Q–3: When does section 404(b), as amended by the Tax Reform Act of 1984, become effective?

A–3: With the exceptions discussed below, section 404(b), as amended, and the rules under Q&A-2 are effective with respect to amounts paid or incurred after July 18, 1984, in taxable years of employers (and payors) ending after that date. In the case of an extended vacation pay plan maintained pursuant to a collective bargaining agreement (a) between employee representatives and one or more employers, and (b) in effect on June 22, 1984, section 404(b) is not effective before the date on which such collective bargaining agreement terminates (determined without regard to any extension thereof agreed to after June 22, 1984). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 512 of the Tax Reform Act of 1984 shall not be treated as a termination of such collective bargaining agreement. For purposes of this section, an "extended vacation pay plan" is one under which covered employees gradually over a specified period of years earn the right to additional vacation benefits, no part of which, under the terms of the plan, can be taken until the end of the specified period.

[T.D. 8073, 51 FR 4321, Feb. 4, 1986; 51 FR 7262, March 3, 1986; T.D. 8073, 51 FR 11303, April 2, 1986]

§ 1.404(c)–1 Certain negotiated plans; effect of section 404(c).

(a) Section 404(a) does not apply to deductions for contributions paid by an employer under a negotiated plan which meets the following conditions:

(1) The contributions under the plan are held in trust for the purpose of paying, either from principal or income or both, for the benefit of employees and their families, at least medical or hospital care, and pensions on retirement or death of employees; and

(2) Such plan was established before January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which such employer is engaged.

If these conditions are met, such contributions shall be deductible under section 162, to the extent that they constitute ordinary and necessary business expenses.

(b) The term "as a result of an agreement" is intended primarily to cover a trust established under the terms of an agreement referred to in paragraph (a)(2) of this section. It will also include a trust established under a plan of an employer, or group of employers, who are in competition with the employers whose facilities were seized by reason of producing the same commodity, and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. Thus, for example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established about the same time in the anthracite coal industry would be covered by this provision.

(c) If any such trust becomes qualified for exemption under section 501(a), the deductibility of

contributions by an employer to such trust on or after the date of such qualification would no longer be governed by section 404(c), even though the trust may later lose its exemption under section 501(a).

[T.D. 6500, 25 FR 11690, Nov. 26, 1960]

§ 1.404(d)–1T Questions and answers relating to deductibility of deferred compensation and deferred benefits for independent contractors (temporary).

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of contributions or compensation under section 404(d)?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(d) shall govern the deduction of contributions paid and compensation paid or incurred by a payor under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits for service providers with respect to which there is no employer-employee relationship. In such a case, section 404(a) and (b) and the regulations thereunder apply as if the person providing the services were the employee and the person to whom the services are provided were the employer. Section 404(a) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a "welfare benefit fund" (as defined in section 419(e)) after June 18, 1984, in taxable years of employers (and payors) ending after that date. Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected under such section. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419, § 1.419-1T and § 1.419A-2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see § 10.2 of this chapter and § 1.463-1T.

[T.D. 8073, 51 FR 4322, Feb. 4, 1986]

§ 1.404(e)–1 Contributions on behalf of a self-employed individual to or under a pension, annuity, or profit-sharing plan meeting the requirements of section 401; application of section 404(a)(8), (9), and (10) and section 404(e) and (f).

(a) In general. **(1)** The Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809) permits certain self-employed individuals to be treated as employees for purposes of pension, annuity, and profit-sharing plans included in paragraph (1), (2), or (3) of section 404(a). Therefore, for taxable years of an employer beginning after December 31, 1962, employer contributions to qualified plans on behalf of self-employed individuals are deductible under section 404 subject to the limitations of paragraphs (b) and (c) of this section.

(2) In the case of contributions to qualified plans on behalf of self-employed individuals, the amount deductible differs from the amount allowed as a deduction. In general, the amount deductible is 10 percent of the earned income derived by the self-employed individual from the trade or business with respect to which the plan is established, or $2,500, whichever is the lesser. This is the amount referred to in section 401 when reference is made to the amounts which may be deducted under section 404 or the amount of contributions deductible under section 404. Thus, this is the amount taken into consideration in determining whether contributions under the plan are discriminatory. The amount allowed as a deduction with respect to contributions on behalf of a self-employed individual is one-half of the amount deductible. The amount allowed as a deduction is relevant only for purposes of determining the amount an employer may deduct from gross income.

(b) Determination of the amount deductible. **(1)** If a plan covers employees, some of whom are self-employed individuals, the determination of the amount deductible is made on the basis of independent consideration of the common-law employees and of the self-employed individuals. See subparagraphs (2) and (3) of this paragraph. For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, such contributions shall be considered to satisfy the conditions of section 162 (relating to trade or business expenses) or 212 (relating to expenses for the production of income), but only to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which the plan is established. However, the portion of such contribution, if any, attributable to the purchase of life, accident, health, or other insurance protection shall be considered payment of a personal expense which does not satisfy the requirements of section 162 or 212. See para-

graph (f) of this section. For the additional rules applicable where contributions are made by more than one employer on behalf of a self-employed individual, see paragraph (d) of this section.

(2) If contributions are made to a plan included in section 404(a)(1), (2), or (3) on behalf of employees, some of whom are self-employed individuals, the amount deductible with respect to contributions on behalf of the common-law employees covered under the plan shall be determined as if such employees were the only employees for whom contributions and benefits are provided under the plan. Accordingly, for purposes of such determination, the percentage of compensation limitations of section 404(a)(1), (3), and (7) are applicable only with respect to the compensation otherwise paid or accrued during the taxable year by the employer to the common-law employees. Similarly, the costs referred to in section 404(a)(1)(B) and (C) shall be the costs of funding the benefits of the common-law employees. Also, the provisions of section 404(a)(1)(D), (3), and (7), relating to certain carryover deductions, shall be applicable only to amounts contributed, or to the amounts deductible, on behalf of such employees.

(3) If contributions are made to a plan included in section 404(a)(1), (2), or (3) on behalf of individuals some or all of whom are self-employed individuals, the amount deductible in any taxable year with respect to contributions on behalf of such individuals shall be determined as follows:

(i) The provisions of section 404(a)(1), (2), (3), and (7) shall be applied as if such individuals were the only participants for whom contributions and benefits are provided under the plan. Thus, the costs referred to in such provisions shall be the costs of funding the benefits of the self-employed individuals. If such costs are less than an amount equal to the amount determined under subdivision (iii) of this subparagraph, the maximum amount deductible with respect to such individuals shall be the costs of their benefits.

(ii) The provisions of section 404(a)(1)(D), the second and third sentences of section 404(a)(3)(A), and the second sentence of section 404(a)(7), relating to certain carryover deductions, are not applicable to contributions on behalf of self-employed individuals. Contributions on behalf of self-employed individuals are deductible, if at all, only in the taxable year in which the contribution is paid or deemed paid under section 404(a)(6).

(iii) The amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not exceed the lesser of $2,500 or 10 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established.

(iv) If a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. See paragraph (d) of this section.

(c) Special limitation on the amount allowed as a deduction for self-employed individuals. The amount allowed as a deduction under section 404(a)(1), (2), (3), and (7) in any taxable year with respect to contributions made on behalf of a self-employed individual shall be an amount equal to one-half of the amount deductible with respect to such contributions under paragraph (b)(3) of this section. However, for purposes of section 401, the amount which may be deducted, or the amount deductible, under section 404 with respect to contributions made on behalf of self-employed individuals shall be determined without regard to the special limitation of this paragraph.

(d) Rules applicable where contributions are made by more than one employer on behalf of a self-employed individual. (1) Under paragraph (b)(3)(iv) of this section, if a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, the aggregate amounts deductible shall not exceed the lesser of $2,500 or 10 percent of such earned income. This limitation does not apply to contributions made under a plan on behalf of an employee who is not self-employed in the trade or business with respect to which the plan is established, even though such employee may be covered as a self-employed individual under a plan or plans established by other trades or businesses.

(2) In any case in which the application of subparagraph (1) of this paragraph reduces the amount otherwise deductible, the amount deductible by each employer shall be that amount which bears the same ratio to the aggregate amount deductible with respect to all trades or businesses (as determined in subparagraph (1) of this paragraph) as the earned income derived from that employer bears to the aggregate of the earned income derived from all of the trades or businesses with respect to which plans are established. The amount allowed as a deduction to each employer is one-half of the amount determined (in accordance

with the preceding sentence) to be deductible by such employer.

(e) **Partner's distributive share of contributions and deductions.** For purposes of sections 702(a)(8) and 704, a partner's distributive share of contributions on behalf of self-employed individuals under a qualified pension, annuity, or profit-sharing plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of self-employed individuals is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership's taxable year ends, as an item described in section 702(a)(8).

(f) **Contributions allocable to insurance protection.** For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. Such amounts are neither deductible nor considered as contributions for purposes of determining the maximum amount of contributions that may be made on behalf of an owner-employee. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period. See paragraph (b)(5) of § 1.72–16.

(g) **Rules applicable to loans.** For purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received from a qualified trust or plan shall be treated as a contribution to such trust or under such plan on behalf of such owner-employee.

(h) **Definitions.** For purposes of section 404 and the regulations thereunder—

(1) The term "employee" includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4);

(2) The term "owner-employee" means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term "earned income" means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term "compensation" when used with respect to an individual who is an employee described in subparagraph (1) of this paragraph shall be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

(i) **Years to which this section applies.** This section applies to taxable years of employers beginning before January 1, 1974. For taxable years beginning after December 31, 1973, see § 1.404(e)–1A.

[T.D. 6673, 28 FR 10145, Sept. 17, 1963; as amended by T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.404(e)–1A Contributions on behalf of a self-employed individual to or under a qualified pension, annuity, or profit-sharing plan.

(a) **In general.** This section provides rules relating to employer contributions to qualified plans on behalf of self-employed individuals described in subsections (a)(8) and (9), (e), and (f) of section 404. Unless otherwise specifically provided, this section applies to taxable years of an employer beginning after December 31, 1973. See section 1.404(e)–1 for rules relating to plans for self-employed individuals for taxable years beginning before January 1, 1974. Paragraph (b) of this section provides general rules of deductibility, paragraph (c) provides rules relating to defined contribution plans, paragraph (d) provides rules relating to defined benefit plans, paragraph (e) provides rules relating to combinations of plans, paragraph (f) provides rules for partnerships, paragraph (g) provides rules for insurance, paragraph (h) provides rules for loans, and paragraph (i) provides definitions.

(b) **Determination of the amount deductible.** (1) If a defined contribution plan covers employees, some of whom are self-employed individuals, the determination of the amount deductible is made on the basis of independent consideration of the common-law employees and of the self-employed individuals. See subparagraphs (2) and (3) of this paragraph. For purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, such contributions shall be considered to satisfy the conditions of section 162 (relating to trade or business expenses) or 212 (relating to expenses for

the production of income), but only to the extent that such contributions do not exceed the earned income of such individual derived from the trade or business with respect to which the plan is established. However, the portion of such contribution, if any, attributable to the purchase of life, accident, health, or other insurance protection shall be considered payment of a personal expense which does not satisfy the requirements of section 162 or 212. See paragraph (g) of this section.

(2)(i) If contributions are made on behalf of employees, some of whom are self-employed individuals, to a defined contribution plan described in section 414(i) and included in section 404(a)(1), (2), or (3), the amount deductible with respect to contributions on behalf of the common-law employees covered under the plan shall be determined as if such employees were the only employees for whom contributions and benefits are provided under the plan. Accordingly, for purposes of such determination, the percentage of compensation limitations of section 404(a)(3) and (7) are applicable only with respect to the compensation otherwise paid or accrued during the taxable year by the employer with respect to the common-law employees. Similarly, the costs referred to in section 404(a)(1)(A) and (B) shall be the costs of funding the benefits of the common-law employees. Also, the provisions of section 404(a)(1)(D), (3), and (7), relating to certain carryover deductions, shall be applicable only to amounts contributed or to the amounts deductible on behalf of such employees.

(ii) The amount deductible, by reason of contributions on behalf of employees to a defined benefit plan, shall be determined without regard to the self-employed or common law status of each employee.

(3)(i) If contributions are made on behalf of individuals, some or all of whom are self-employed individuals, to a defined contribution plan described in section 414(i) and included in section 404(a)(1), (2), or (3), the amount deductible in any taxable year with respect to contributions on behalf of such individuals shall be determined as follows:

(A) The provisions of section 404(a)(1), (2), (3), and (7) shall be applied as if such individuals were the only participants for whom contributions and benefits are provided under the plan. Thus, the costs referred to in such provisions shall be the costs of funding the benefits of the self-employed individuals. If such costs are less than an amount equal to the amount determined under paragraph (c) of this section, the maximum amount deductible with respect to such individuals shall be the cost of their benefits.

(B) The provisions of section 404(a)(1), (D), the third sentence of section 404(a)(3), (A), and the second sentence of section 404(a)(7), relating to certain carryover deductions are applicable to contributions on behalf of self-employed individuals made in taxable years of an employer beginning after December 31, 1975.

(C) For any employer taxable year in applying the 15 percent limit on deductible contributions set forth in section 404(a)(3) and the 25 percent limit in section 404(a)(7) for any taxable year of the employer, the amount deductible under section 404(e)(4) and paragraph (c)(4) of this section (relating to the minimum deduction of $750 or 100 percent of earned income) shall be substituted for such limits with respect to the self-employed individuals on whose behalf contributions are deductible under section 404(e)(4) for the taxable year of the employer. In addition, although the limitations of section 415 are applicable to the plan for plan years beginning after December 31, 1975, the defined contribution compensation limitation described in section 415(c)(1)(B) shall not be less than the amount deductible under section 404(e)(4) and paragraph (c)(4) of this section with respect to any self-employed individual for the taxable year of the employer ending with or within the limitation year. The special rule in the second sentence of paragraph (3)(A) of section 404(a) is not applicable in determining the amounts deductible on behalf of self-employed individuals.

(ii) The limitations of this subparagraph are not applicable to a defined benefit plan for self-employed individuals.

(c) Defined contribution plans. **(1)** Under section 404(e)(1) in the case of a defined contribution plan, as defined in section 414(i), the amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not exceed the lesser of $7,500 or 15 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established.

(2) Under section 404(e)(2)(A) if a self-employed individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers under two or more defined contribution plans the aggregate amounts deductible shall not exceed the lesser of $7,500 or 15 percent of such earned income. This

limitation does not apply to contributions made under a plan on behalf of an employee who is not self-employed in the trade or business with respect to which the plan is established.

(3) Under section 404(e)(2)(B) in any case in which the applicable limitation of subparagraph (2) of this paragraph reduces the amount otherwise deductible with respect to contributions on behalf of any employee within the meaning of section 401(c)(1), the amount deductible by each employer for such employee shall be that amount which bears the same ratio to the aggregate amount deductible for such employee with respect to all trades or businesses (as determined in subparagraph (1) of this paragraph) as his earned income derived from the employer bears to the aggregate of his earned income derived from all of the trades or businesses with respect to which plans are established.

Under section 404(e)(4), notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, the limitations on the amount deductible for the taxable year of the employer with respect to contributions on behalf of a self-employed individual shall not be less than the lesser of $750 or 100 percent of the earned income derived by such individual for such taxable year from the trade or business with respect to which the plan is established. If such individual receives in any taxable year earned income with respect to which deductions are allowable to two or more employers, 100 percent of such earned income shall be taken into account for purposes of the limitations determined under this subparagraph. This subparagraph does not apply to any taxable year beginning after December 31, 1975, to any employee whose adjusted gross income for that taxable year is greater than $15,000. In applying the preceding sentence, the adjusted gross income of an employee for a taxable year is determined separately for each individual, without regard to any community property laws, and without regard to the deduction allowable under section 404(a).

(d) Defined benefit plans. In the case of a defined benefit plan, as defined in section 401(j), the special limitations provided by section 404(e) and paragraph (c) of this section do not apply. See section 401(j) for requirements applicable to defined benefit plans.

(e) Combination of plans. For special rules applied if a self-employed individual in any taxable year is a participant in both a defined benefit plan and a defined contribution plan, see section 401(j) and the regulations thereunder.

(f) Partner's distributive share of contributions and deductions. (1) For purposes of sections 702(a)(8) and 704 in the case of a defined contribution plan, a partner's distributive share of contributions on behalf of self-employed individuals under such a plan is the contribution made on his behalf, and his distributive share of deductions allowed the partnership under section 404 for contributions on behalf of a self-employed individual is that portion of the deduction which is attributable to contributions made on his behalf under the plan. The contribution on behalf of a partner and the deduction with respect thereto must be accounted for separately by such partner, for his taxable year with or within which the partnership's taxable year ends, as an item described in section 702(a)(8).

(2) In the case of a defined benefit plan, a partner's distributive share of contributions on behalf of self-employed individuals and his distributive share of deductions allowed the partnership under section 404 for such contributions is determined in the same manner as his distributive share of partnership taxable income. See section 704, relating to the determination of the distributive share and the regulations thereunder.

(g) Contributions allocable to insurance protection. Under section 404(e)(3), for purposes of determining the amount deductible with respect to contributions on behalf of a self-employed individual, amounts allocable to the purchase of life, accident, health, or other insurance protection shall not be taken into account. Such amounts are neither deductible nor considered as contributions for purposes of determining the maximum amount of contributions that may be made on behalf of an owner-employee. The amount of a contribution allocable to insurance shall be an amount equal to a reasonable net premium cost, as determined by the Commissioner, for such amount of insurance for the appropriate period. See paragraph (b)(5) of § 1.72–16.

(h) Rules applicable to loans. Under section 404(f), for purposes of section 404, any amount paid, directly or indirectly, by an owner-employee in repayment of any loan which under section 72(m)(4)(B) was treated as an amount received from a qualified trust or plan shall be treated as a contribution to such trust or under such plan on behalf of such owner-employee.

(i) Definitions. Under section 404(a)(8), for purposes of section 404 and the regulations thereunder—

(1) The term "employee" includes an employee as defined in section 401(c)(1) and the term "employer" means the person treated as the employer of such individual under section 401(c)(4);

(2) The term "owner-employee" means an owner-employee as defined in section 401(c)(3);

(3) The term "earned income" means earned income as defined in section 401(c)(2); and

(4) The term "compensation" when used with respect to an individual who is an employee described in subparagraph (1) of this paragraph shall be considered to be a reference to the earned income of such individual derived from the trade or business with respect to which the plan is established.

[T.D. 7636, 44 FR 47056, Aug. 10, 1979]

§ 1.404(g)–1 Deduction of employer liability payments.

(a) General rule. Employer liability payments shall be treated as contributions to a stock bonus, pension, profit-sharing, or annuity plan to which section 404 applies. Such payments that satisfy the limitations of this section shall be deductible under section 404 when paid without regard to any other limitations in section 404.

(b) Employer liability payments. For purposes of this section, employer liability payments mean:

(1) Any payment to the Pension Benefit Guaranty Corporation (PBGC) for termination or withdrawal liability imposed under section 4062 (without regard to section 4062(b)(2)), 4063, or 4064 of the Employee Retirement Insurance Security Act of 1974 (ERISA). Any bond or escrow payment furnished under section 4063 of ERISA shall not be considered as a payment of liability until applied against the liability of the employer.

(2) Any payment to a non-multiemployer plan pursuant to a commitment to the PBGC made in accordance with PBGC Determination of Plan Sufficiency and Termination of Sufficient Plans. See PBGC regulations, 29 CFR 2617.13(b) for rules concerning these commitments. Such payments shall not exceed an amount necessary to provide for, and used to fund, the benefits guaranteed under section 4022 of ERISA.

(3) Any payment to a multiemployer plan for withdrawal liability imposed under part 1 of subtitle E of title IV of ERISA. Any bond or escrow payment furnished under such part shall not be considered as a payment of liability until applied against the liability of the employer.

(c) Limitations, etc.—(1) Permissible expenses. A payment shall be deductible under section 404(g) and this section only if the payment satisfies the conditions of section 162 or section 212. Payments made by an entity which is liable for such payments because it is a member of a commonly controlled group of corporations, or trades or businesses, within the meaning of section 414 (b) or (c), shall not fail to satisfy such conditions merely because the entity did not directly employ participants in the plan with respect to which the liability payments were made.

(2) Qualified plan. A payment shall be deductible under section 404(g) and this section only if the payment is made in a taxable year of the employer ending within or with a taxable year of the trust for which the trust is exempt under section 501(a). For purposes of this paragraph, the payment timing rules of section 404(a)(6) shall apply.

(3) Full funding limitation. (i) If the employer liability payment is to a plan, the total amount deductible for such payment and for other plan contributions may not exceed an amount equal to the full funding limitation as defined in section 412(c)(7) for the taxable year with respect to which the contributions are deemed made under section 404.

(ii) If the total contributions to the plan for the taxable year including the employer liability payment exceed the amount equal to this full funding limitation, the employer liability payment shall be deductible first.

(iii) Any amount paid in a taxable year in excess of the amount deductible in such year under the full funding limitation shall be treated as a liability payment and be deductible in the succeeding taxable years in order of time to the extent of the difference between the employer liability payments made in each succeeding year and the maximum amount deductible for such year under the full funding limitation.

(4) Maximum deduction allowable under section 404. The amount deductible under section 404 is limited to the higher of the maximum amount deductible by the employer under section 404(a) or the amount otherwise deductible under section 404(g). If the contributions are to a plan to which more than one employer contributes, this limit shall apply to each employer separately rather than all employers in the aggregate. Thus, each employer may deduct the greater of its allocable share of the deduction determined under sections

404(a) and 413(b)(7) or 413(c)(6) or its allocable share of the amount deductible under section 404(g).

However, pursuant to the rule in subdivision (ii) of subparagraph (3), in determining each employer's allocable share under section 404(a), the total amount deductible under section 404(a) by all employers shall not exceed the difference between the full funding limitation and the total amount deductible by all employers under section 404(g).

(5) Example. The provisions of this paragraph may be illustrated by the following example:

Example. In the 1983 taxable year, Employer A makes a withdrawal liability payment of $700,000 to multiemployer Plan X to which Employer A and Employer B are required to contribute. Employer A's allocable share of the deduction allowable under sections 404(a) and 413(b)(7) in the 1983 taxable year is $600,000. Employer B's allocable share of the deduction allowable under section 404(a) and 413(b)(7) in the 1983 taxable year is $400,000.

The full funding limitation for the 1983 taxable year is $1,000,000. Based on paragraph (c)(4) of this section, Employer A may deduct $700,000, the amount of the withdrawal liability payment. However, the deduction of Employer B is limited to $300,000, the difference between the full funding limitation and the amount deductible under section 404(g).

(d) Effective date etc.—(1) General rule. This section is effective for employer payments made after September 25, 1980.

(2) Transitional rule. For employer payments made before September 26, 1980, for purposes of section 404, any amount paid by an employer under section 4062, 4063, or 4064 of the Employee Retirement Income Security Act of 1974 shall be treated as a contribution to which section 404 applies by such employer to or under a stock bonus, pension, profit-sharing, or annuity plan.

[T.D. 8085, 51 FR 16297, May 2, 1986]

§ 1.404(k)–1T Questions and answers relating to the deductibility of certain dividend distributions (temporary).

Q–1: What does section 404(k) provide?

A–1: Section 404(k) allows a corporation a deduction for dividends actually paid in accordance with section 404(k)(2) with respect to stock of such corporation held by an employee stock ownership plan (as defined in section 4975(e)(7)) maintained by the corporation (or by any other corporation that is a member of a "controlled group of corporations" within the meaning of section 409(*l*)(4) that includes the corporation), but only if such dividends may be immediately distributed under the terms of the plan and all of the applicable qualification and distribution rules. The deduction is allowed under section 404(k) for the taxable year of the corporation during which the dividends are received by the participants.

Q–2: Is the deductibility of dividends paid to plan participants under section 404(k) affected by a plan provision which permits participants to elect to receive or not receive payment of dividends?

A–2: No. Dividends actually paid in cash to plan participants in accordance with section 404(k) are deductible under section 404(k) despite such an election provision.

Q–3: Are dividends paid in cash directly to plan participants by the corporation and dividends paid to the plan and then distributed in cash to plan participants under section 404(k) treated as distributions under the plan holding stock to which the dividends relate for purposes of sections 72, 401 and 402?

A–3: Generally, yes. However, a deductible dividend under section 404(k) is treated for purposes of section 72 as paid under a contract separate from any other contract that is part of the plan. Thus, a deductible dividend is treated as a plan distribution and as paid under a separate contract providing only for payment of deductible dividends. Therefore, a deductible dividend under section 404(k) is a taxable plan distribution even though an employee has unrecovered employee contributions or basis in the plan.

[T.D. 8073, 51 FR 4322, Feb. 4, 1986]

§ 1.405–1 Qualified bond purchase plans.

(a) Introduction. Section 405 relates to the requirements for qualification of, and the tax treatment of funds contributed to, retirement plans of an employer for the benefit of his employees which are funded through the purchase of United States retirement plan bonds. Such bonds may be purchased under a qualified bond purchase plan described in section 405(a) and paragraph (b) of this section. The qualified bond purchase plan is an alternative method of providing some of the deferred compensation benefits provided by plans described in section 401. In addition, retirement bonds may be purchased under a qualified pension or profit-sharing plan described in section 401. A qualified bond purchase plan or a qualified pension or profit-sharing plan under which retirement bonds are purchased may cover only common-law employees, self-employed individuals, or both. A qualified bond purchase plan may be established after December 31, 1962, and retirement bonds may be purchased by a qualified pension or profit-sharing plan after December 31, 1962. For the

terms and conditions of the retirement bonds, see section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

(b) Qualified bond purchase plans. (1) A qualified bond purchase plan is a definite written program and arrangement which is communicated to the employees and established and maintained by an employer solely to purchase for and distribute to his employees or their beneficiaries retirement bonds. These bonds must be purchased in the name of the employee on whose behalf the contributions are made. The plan must be a permanent plan which meets the requirements of section 401(a)(3), (4), (5), (6), (7), (8), (16), and (19), and, if applicable, the requirements of section 401(a)(9) and (10) and of section 401(d) (other than paragraphs (1), (5)(B), (8), (16), and (19)). The rules set forth in the regulations relating to those provisions shall be applicable to qualified bond purchase plans.

(2) A qualified bond purchase plan must provide that an employee's right to the proceeds of a bond purchased in his name are nonforfeitable and will in no event inure to the benefit of the employer or be reallocated in any manner.

(c) Benefits under a qualified bond purchase plan. (1) Except as provided in subparagraph (2) of this paragraph, a qualified bond purchase plan must conform to the definition of a pension plan in paragraph (b)(1)(i) of § 1.401–1, or the definition of a profit-sharing plan in paragraph (b)(1)(ii) of § 1.401–1. For example, if the qualified bond purchase plan is a profit-sharing plan, the plan must include the definite allocation formula described in paragraph (b)(1)(ii) of § 1.401–1. In addition, if such a profit-sharing plan covers any owner-employee, the plan must also include the definite contribution formula described in section 401(d)(2)(B).

(2)(i) Under a qualified bond purchase plan, the bonds may be distributed to the employees at any time, and the plan need not prohibit the distribution or redemption of the bonds until the retirement of the employee. Accordingly, even though a qualified bond purchase plan is designed as a pension plan, it need not provide systematically for the payment of definitely determinable benefits. However, provisions for distribution must apply in a nondiscriminatory manner.

(ii) A qualified bond purchase plan which is designed as a pension plan may not contain a formula for contributions or benefits which might require the reallocation of amounts to an employee's credit or which might provide for the reversion of any amounts to the employer.

(d) Contributions under a qualified bond purchase plan. (1) The retirement bonds will be issued in the denominations of $50, $100, $500, and $1,000. Therefore, the contribution otherwise called for under the plan may not coincide with an amount that can be invested in retirement bonds. Accordingly, the plan must provide that the contributions on behalf of an individual employee for any year shall be rounded to the nearest multiple of $50.

(2) Since the employee's rights to any bonds purchased for him under a qualified bond purchase plan must be nonforfeitable, a qualified bond purchase plan must, in order to conform to the requirements of section 401(a)(4) with respect to the early termination of the plan, restrict the contributions on behalf of any employee to the amount which could be allocated to him under paragraph (c) of § 1.401–4.

(e) Definitions. For purposes of this section and §§ 1.405–2 and 1.405–3—

(1) The term "employee" includes an employee as defined in section 401(c)(1) and paragraph (b) of § 1.401–10, and the term "employer" means the person treated as the employer of such individual under section 401(c)(4);

(2) The term "owner-employee" means an owner-employee as defined in section 401(c)(3) and paragraph (d) of § 1.401–10;

(3) The term "earned income" means earned income as defined in section 401(c)(2) and paragraph (c) of § 1.401–10; and

(4) The term "retirement bond" means a United States Retirement Plan Bond, as described in section 405(b) and Treasury Department Circular, Public Debt Series—No. 1–63.

[T.D. 6675, 28 FR 10131, Sept. 17, 1963, as amended by T.D. 7748, 46 FR 1697, Jan. 7, 1981]

§ 1.405–2 Deduction of contributions to qualified bond purchase plans.

(a) In general. An employer shall be allowed a deduction for contributions paid to or under a qualified bond purchase plan in the same manner and to the same extent as if such contributions were made to a trust described in section 401(a) which is exempt from tax under section 501(a). A deduction will be allowed only for the taxable year in which the contributions are paid, or treated as paid, except as provided by section 404(a)(1), (3),

and (7). For purposes of the deduction, a contribution is paid at the time the application for the bond is made and the full purchase price paid.

(b) Rules for applying section 404. If a qualified bond purchase plan is designed as a pension plan as defined in paragraph (b)(1)(i) of § 1.401–1, the limitations of section 404 applicable to qualified pension trusts shall apply. See §§ 1.404(a)–3 through 1.404(a)–7. Similarly, if a qualified bond purchase plan is designed as a profit-sharing plan as defined in paragraph (b)(1)(ii) of § 1.401–1, the limitations of section 404 applicable to qualified profit-sharing trusts shall apply. See §§ 1.404(a)–9 and 1.404(a)–10. In addition, if a qualified bond purchase plan designed as a pension plan covers some or all of the employees who are covered by a qualified profit-sharing plan established and maintained by the same employer, or if a qualified bond purchase plan which is designed as a profit-sharing plan covers some or all the employees who are also covered by a qualified pension or annuity plan established and maintained by the same employer, section 404(a)(7) is applicable. See § 1.404(a)–(13). Furthermore, if a qualified bond purchase plan covers employees some or all of whom are employees within the meaning of section 401(c)(1), the provisions of section 404(a)(8), (9), and (10) and 404(e) shall also apply.

(c) Accrual method taxpayers. In the case of a taxpayer using the accrual method of accounting, a contribution to a qualified bond purchase plan will be deemed paid on the last day of the year of accrual if—

(1) During the taxable year of accrual the taxpayer incurs a liability to make the contribution, the amount of which is accruable under section 461 for such taxable year, and

(2) Payment is in fact made no later than the time prescribed by the law for filing the return for the taxable year of accrual (including extensions thereof).

[T.D. 6675, 28 FR 10131, Sept. 17, 1963]

§ 1.405–3 Taxation of retirement bonds.

(a) In general. (1) As in the case of employer contributions under a qualified pension, annuity, profit-sharing, or stock bonus plan, employer contributions on behalf of his common-law employees under a qualified bond purchase plan are not includible in the gross income of the employees when made, and employer contributions on behalf of self-employed individuals are deductible as provided in section 405(c) and § 1.405–2. Further, an employee or his beneficiary does not realize gross income upon the receipt of a retirement bond pursuant to a qualified bond purchase plan or from a trust described in section 401(a) which is exempt from tax under section 501(a). Upon redemption of such a bond, ordinary income will be realized to the extent the proceeds thereof exceed the basis (determined in accordance with paragraph (b) of this section) of the bond. The proceeds of a retirement bond are not entitled to the special tax treatment of section 72(n) and § 1.72–18.

(2) In the event a retirement bond is surrendered for partial redemption and reissuance of the remainder, the person surrendering the bond shall be taxable on the proceeds received to the extent such proceeds exceed the basis in the portion redeemed. In such case, the basis shall be determined (in accordance with paragraph (b) of this section) as if the portion redeemed and the portion reissued had been issued as separate bonds.

(3) In the event a retirement bond is redeemed after the death of the registered owner, the amount taxable (as determined in accordance with subparagraph (1) of this paragraph) is income in respect of a decedent under section 691.

(4) The provisions of section 402(a)(2) are not applicable to a retirement bond. In general, section 402(a)(2) provides for capital gains treatment of certain distributions from a qualified trust which constitute the total distributions payable with respect to any employee. The proceeds of a retirement bond received upon redemption will not be entitled to such capital gain treatment even though the bond is received as a part of, or as the whole of, such a total distribution. Nor will such a bond be taken into consideration in determining whether the distribution represents the total amount payable by the trust with respect to an employee. Thus, a distribution by a qualified trust may constitute a total distribution payable with respect to an employee for purposes of section 402(a)(2) even though the trust retains retirement bonds registered in the name of such employee.

(b) Basis. (1) This paragraph is applicable in determining the basis of any retirement bond distributed pursuant to a qualified bond purchase plan or distributed by a trust qualifying under section 401. In the case of such a bond purchased for an individual at the time he is a common-law employee, the basis is that portion of the purchase price attributable to employee contributions. In the case of such a bond purchased for an individu-

al at the time he is a self-employed individual, the basis shall be determined under subparagraph (3) of this paragraph.

(2) At the time a retirement bond is purchased, there shall be indicated on the application for the retirement bond whether the individual for whom the retirement bond is purchased is a common-law employee or a self-employed individual, and in the case of common-law employees the amount of the purchase price, if any, attributable to the employee's contribution. The answers to these questions will appear on the retirement bond, and when the retirement bond is purchased for a common-law employee, the basis for the retirement bond is presumed to be the amount of the purchase price which the retirement bond indicates was contributed by the employee.

(3)(i) Except as provided in subdivision (ii) of this subparagraph, for purposes of determining the basis of retirement bonds purchased for an individual while he was a self-employed individual, all such bonds redeemed during a taxable year shall be considered in the aggregate as a single retirement bond. The basis of such retirement bonds shall be the difference between the aggregate of their face amounts and the lesser of:

(a) One-half the aggregate of their face amounts, or

(b) The aggregate of the unused amounts allowed as a deduction at the end of the taxable year (as determined in subparagraph (4) of this paragraph).

(ii) The basis of a retirement bond purchased for a self-employed individual which is redeemed after his death is the amount determined by multiplying the face amount of such retirement bond by a fraction—

(a) The numerator of which is the aggregate of the face amounts of all the bonds registered in the individual's name at his death which were purchased while he was a self-employed individual reduced by the aggregate of the unused amounts allowed as a deduction at his death (as determined in subparagraph (4) of this paragraph), and

(b) The denominator of which is the aggregate of the face amounts of all such bonds.

(4)(i) In the case of retirement bonds purchased under a qualified bond purchase plan, the aggregate of the unused amounts allowed as a deduction at the end of any taxable year shall be an amount equal to the total of the amounts allowable for such taxable year, and the amounts allowed in all prior taxable years, as a deduction under section 405(c) for contributions used to purchase retirement bonds for the registered owner while he was a self-employed individual, reduced by an amount equal to the portion of the face amounts of such retirement bonds redeemed in prior taxable years which were included in the registered owner's gross income.

(ii) In the case of retirement bonds purchased by a trust described in section 401(a) and exempt under section 501(a), there shall be allocated to the retirement bond the deduction under section 404 attributable to the contributions used to purchase the retirement bond. The amount so allocated shall be treated in the same manner as the deduction allowed under section 405(c) for purposes of computing the unused amounts allowed as a deduction under subdivision (i) of this subparagraph. Further, the amount so allocated shall not be included in the investment in the contract for purposes of section 72 in determining the portion of the other assets distributed by the trust included in gross income.

(5) The application of the rule of subparagraphs (3) and (4) of this paragraph may be illustrated by the following examples:

Example (1). B, a self-employed individual, adopts a qualified bond purchase plan in 1963. During 1963 the plan purchased $2,000 worth of retirement bonds in his name. As a result of overestimating his income for 1963, only $400 was allowed B as a deduction pursuant to section 405(c). In 1964, prior to B's retirement in June of that year, the plan purchased a $500 retirement bond in B's name for which a deduction was allowable pursuant to section 405(c) in the amount of $250. B redeemed a retirement bond with a face amount of $500 in September of 1964 and another with a face amount of $500 in October of 1964. Of the proceeds received in 1964 from the redemption of the bonds, $1,000 plus interest, B shall exclude from his gross income $500 (face amount of the retirement bonds, $1,000, less $500, one-half of the face amount, the latter being less than the aggregate of the unused amounts allowed as a deduction, $250 allowable for the taxable year in which the bonds were redeemed plus $400, the unused amounts allowed in prior taxable years, or $650). The aggregate of the unused amounts allowed as a deduction shall be reduced by the amount so excluded ($650–$500=$150). During the following year, B redeems another retirement bond with a face amount of $500. Of the proceeds received from the redemption of such retirement bond, $500 plus interest, B shall exclude from his gross income $350 (face amount of the retirement bonds, $500, less $150, the aggregate of the unused amounts allowed as a deduction, the latter being less than one-half of the face amount of the bond, $250). The aggregate of the unused amounts allowed as a deduction is reduced to zero ($150–$150=0). Upon redemption of the remaining retirement bonds registered in B's name, B shall exclude from his gross income with respect to such proceeds an amount equal to the face amounts of the bonds redeemed.

Example (2). C, a self-employed individual, participated in a qualified bond purchase plan during the years 1963 through 1966. The plan purchased in his name retirement bonds in the

aggregate of $10,000. C deducted $4,000 from his gross income for the four years ($1,000 for each year) with respect to the purchase of such retirement bonds. C retired in December of 1966 and during the following year redeemed one retirement bond with a face amount of $1,000. C excluded from his gross income $500 of the proceeds of the bond. C died without redeeming any of the remaining retirement bonds registered in his name. The basis of each remaining retirement bond shall be determined by multiplying the face amount of each retirement bond by $5,500 ÷ $9,000. The numerator is the aggregate of the face amounts registered in C's name (as a self-employed individual) at his death, $9,000, reduced by the aggregate of the unused amounts allowed as a deduction at his death, $3,500 (amounts allowed as a deduction under section 405(c), $4,000, reduced by the portion of the face amount of the retirement bond redeemed by C which was included in C's gross income, $500), or $5,500. The denominator is the face amount of the retirement bonds registered in his name as a self-employed individual at his death, $9,000.

[T.D. 6675, 28 FR 10131, Sept. 17, 1963]

§ 1.406–1 Treatment of certain employees of foreign subsidiaries as employees of the domestic corporation.

(a) Scope—(1) General rule. For purposes of applying the rules in part 1 of subchapter D of chapter 1 of subtitle A of the Code and the regulations thereunder with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), of a domestic corporation, an individual who is a citizen of the United States and who is an employee of a foreign subsidiary (as defined in section 3121(*l*)(8) and the regulations thereunder) of such domestic corporation shall be treated as an employee of such domestic corporation if the requirements of paragraph (b) of this section are satisfied.

(2) Cross-references. For rules relating to nondiscrimination requirements and the determination of compensation, see paragraph (c) of this section. For rules under which termination of the status of an individual as an employee of the domestic corporation in certain instances will not be considered as separation from service for certain purposes, see paragraph (d) of this section. For rules regarding deductibility of contribution, see paragraph (e) of this section. For rules regarding treatment of such individual as an employee of the domestic corporation under related provisions, see paragraph (f) of this section.

(b) Application of this section—(1) Requirements. This section shall apply and the employee of the foreign subsidiary shall be treated as an employee of domestic corporation for the purposes set forth in paragraph (a)(1) of this section only if each of the following requirements is satisfied:

(i) The domestic corporation must have entered into an agreement under section 3121(*l*) to provide social security coverage which applies to the foreign subsidiary of which such individual is an employee and which has not been terminated under section 3121(*l*)(3) or (4).

(ii) The plan, referred to in paragraph (a)(1) of this section, must expressly provide for contributions or benefits for individuals who are citizens of the United States and who are employees of one or more of its foreign subsidiaries to which an agreement entered into by such domestic corporation under section 3121(*l*) applies. The plan must apply to all of the foreign subsidiaries to which such agreement applies.

(iii) Contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) must not be provided by any other person with respect to the remuneration paid to such individual by the foreign subsidiary.

(2) Supplementary rules. Subparagraph (1)(ii) of this paragraph does not modify the requirements for qualification of a plan described in section 401(a), 403(a), or 405(a) and the regulations thereunder. It is not necessary that the plan provide benefits or contributions for all United States citizens who are employees of such foreign subsidiaries. If the plan is amended to cover individuals who are employees by reason of paragraph (a)(1) of this section, the plan will not qualify unless it meets the coverage requirements of section 410(b)(1) (section 401(a)(3), as in effect on September 1, 1974, for plan years to which section 410 does not apply; see § 1.410(a)–2 for the effective dates of section 401) and the nondiscrimination requirements of section 401(a)(4). In addition, the administrative rules contained in § 1.401(a)–3(e) (relating to the determination of the contributions or benefits provided by the employer under the Social Security Act) will also apply for purposes of determining whether the plan meets the requirements of section 401. For purposes of subparagraph (1)(iii) of this paragraph, contributions will not be considered as provided under a funded plan merely because the foreign subsidiary is required under the laws of the foreign jurisdiction to pay social insurance taxes or to make similar payments with respect to the wages paid to the employee.

(c) Special rules—(1) Nondiscrimination requirements. For purposes of applying sections 401(a)(4) and 410(b)(1)(B) (section 401(a)(3)(B), as in effect on September 1, 1974, for plan years to

which section 410 does not apply) and the regulations thereunder (relating to nondiscrimination concerning benefits and contributions and coverage of employees) with respect to an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) If the employee is an officer, shareholder, or (with respect to plan years to which section 410 does not apply) person whose principal duties consist in supervising the work of other employees of the foreign subsidiary of the domestic corporation, he shall be treated as having such capacity with respect to the domestic corporation; and

(ii) The determination as to whether the employee is a highly compensated employee shall be made by comparing his total compensation (determined under subparagraph (2) of this paragraph) with the compensation of all the employees of the domestic corporation (including individuals treated as employees of the domestic corporation pursuant to section 406 and this section).

(2) Determination of compensation. For purposes of applying section 401(a)(5) and the regulations thereunder, relating to classifications that will not be considered discriminatory, with respect to an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) The total compensation of the employee shall be the remuneration of the employee from the foreign subsidiary (including any allowances that are paid to the employee because of his employment in a foreign country) which would constitute his total compensation if his services had been performed for the domestic corporation;

(ii) The basic or regular rate of compensation of the employee shall be determined for the employee in the same manner as it is determined under section 401 for other employees of the domestic corporation; and

(iii) The amount paid by the domestic corporation which is equivalent to the tax imposed with respect to the employee by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act) shall be treated as having been paid by the employee and shall be included in his compensation.

(d) Termination of status as deemed employee not to be treated as separation from service for purposes of capital gain provisions and limitation of tax. For purposes of applying the rules, relating to the treatment of certain distributions which are made after an employee's separation from service, set forth in section 72(n) as in effect on September 1, 1974 (with respect to taxable years ending after December 31, 1969, and to which section 402(e) does not apply), and in sections 402(a)(2) and (e) and 403(a)(2) (with respect to distributions or payments made after December 31, 1973, and in taxable years beginning after December 31, 1973) with respect to an employee of a foreign subsidiary who is treated as an employee of a domestic corporation under paragraph (a)(1) of this section, the employee shall not be considered as separated from the service of the domestic corporation solely by reason of the occurrence of any one or more of the following events:

(1) The termination, under the provisions of section 3121(*l*), of the agreement entered into by the domestic corporation under that section which covers the employment of the employee;

(2) The employee's becoming an employee of another foreign subsidiary of the domestic corporation with respect to which such agreement does not apply;

(3) The employee's ceasing to be an employee of the foreign subsidiary by reason of which employment he was treated as an employee of such domestic corporation, if he becomes an employee of another corporation controlled by such domestic corporation; or

(4) The termination of the provision of the plan described in paragraph (b)(1)(ii) of this section, for coverage of United States citizens who are employees of foreign subsidiaries covered by an agreement under section 3121(*l*).

For purposes of subparagraph (3) of this paragraph, a corporation is considered to be controlled by a domestic corporation if such domestic corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(e) **Deductibility of contributions—(1) In general.** For purposes of applying sections 404 and 405(c) with respect to the deduction for contributions made to or under a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), by a domestic corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an employee of a foreign subsidiary treated as an employee of the domestic corporation under paragraph (a)(1) of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, no deduction shall be allowed to such domestic corporation or to any other corporation which would otherwise be entitled to deduct its contributions on behalf of such employee under one of such sections;

(ii) There shall be allowed as a deduction from the gross income of the foreign subsidiary which is effectively connected with the conduct of a trade or business within the United States (within the meaning of section 882 and the regulations thereunder) an amount which is allocable and apportionable to such gross income under the rules of § 1.861–8 and which in no event may exceed the amount which (but for subdivision (i) of this subparagraph) would be deductible under section 404 or section 405(c) by the domestic corporation if the individual were an employee of the domestic corporation and if his compensation were paid by the domestic corporation; and

(iii) Any reference to compensation shall be considered to be a reference to the total compensation of such individual (determined by applying paragraph (c)(2) of this section).

(2) Year of deduction. Any amount deductible by the foreign subsidiary under section 406(d) and this paragraph shall be deductible for its taxable year with or within which ends the taxable year of the domestic corporation for which the contribution was made.

(3) Special rules. Whether contributions to a plan on behalf of an employee of the foreign subsidiary who is treated as an employee of the domestic corporation under paragraph (a)(1) of this section, or whether forfeitures with regard to such employee, will require an inclusion in the income of the domestic corporation or an adjustment in the basis of its stock in the foreign subsidiary, shall be determined in accordance with the rules of general application of subtitle A of chapter 1 of the Code (relating to income taxes). For example, an unreimbursed contribution by the domestic corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the foreign subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.

(f) Treatment as an employee of the domestic corporation under related provisions. An individual who is treated as an employee of a domestic corporation under paragraph (a)(1) of this section shall also be treated as an employee of such domestic corporation, with respect to the plan having the provision described in paragraph (b)(1)(ii) of this section, for purposes of applying section 72(d) (relating to employees' annuities), section 72(f) (relating to special rules for computing employees' contributions), section 101(b) (relating to employees' death benefits), section 2039 (relating to annuities), and section 2517 (relating to certain annuities under qualified plans) and the regulations thereunder.

(g) Nonexempt trust. If the plan of the domestic corporation is a qualified plan described under section 401(a), the fact that a trust which forms a part of such plan is not exempt from tax under section 501(a) shall not affect the treatment of an employee of a foreign subsidiary as an employee of a domestic corporation under section 406(a) and paragraph (a)(1) of this section.

[T.D. 7501, 42 FR 42321, Aug. 23, 1978]

§ 1.407–1 Treatment of certain employees of domestic subsidiaries engaged in business outside the United States as employees of the domestic parent corporation.

(a) Scope—(1) General rule. For purposes of applying the rules in part 1 of subchapter D of chapter 1 of subtitle A of the Code and the regulations thereunder with respect to a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a),. or a bond purchase plan described in section 405(a), of a domestic parent corporation (as defined in paragraph (b)(3)(ii) of this section), an individual who is a citizen of the United States and who is an employee of a domestic subsidiary (as defined in paragraph (b)(3)(i) of this section) of such domestic parent corporation shall be treated as an employee of such domestic parent corporation if the requirements of paragraph (b) of this section are satisfied.

(2) Cross-references. For rules relating to nondiscrimination requirements and the determination of compensation, see paragraph (c) of this section. For rules under which termination of the status of an individual as an employee of the domestic parent corporation in certain instances will not be considered as separation from service for certain purposes, see paragraph (d) of this section. For rules regarding deductibility of contributions, see paragraph (e) of this section. For rules regarding treatment of such individual as an employee of the domestic parent corporation under related provisions, see paragraph (f) of this section.

(b) Application of this section—(1) Requirements. This section shall apply and the employee of the domestic subsidiary shall be treated as an employee of the domestic parent corporation for the purposes set forth in paragraph (a)(1) of this section only if each of the following requirements is satisfied:

(i) The plan, referred to in paragraph (a)(1) of this section, must expressly provide for contributions of benefits for individuals who are citizens of the United States and who are employees of one or more of the domestic subsidiaries of the domestic parent corporation. The plan must apply to every domestic subsidiary.

(ii) Contributions under a funded plan of deferred compensation (whether or not a plan described in section 401(a), 403(a), or 405(a)) must not be provided by any other person with respect to the remuneration paid to such individual by the domestic subsidiary.

(2) Supplementary rules. Subparagraph (1)(i) of this paragraph does not modify the requirements for qualification of a plan described in section 401(a), 403(a), or 405(a) and the regulations thereunder. It is not necessary that the plan provide benefits or contributions for all United States citizens who are employees of such domestic subsidiaries. If the plan is amended to cover individuals who are employees by reason of paragraph (a)(1) of this section, the plan will not qualify unless it meets the coverage requirements of section 410(b)(1) (section 401(a)(3), as in effect on September 1, 1974, for plan years to which section 410 does not apply; see § 1.410(a)-2 for the effective dates of section 401) and the nondiscrimination requirements of section 410(a)(4). The administrative rules contained in § 1.401(a)-3(e) (relating to the determination of the contributions or benefits provided by the employer under the Social Security Act) will also apply for purposes of determining whether the plan meets the requirements of section 401. For purposes of subparagraph (1)(ii) of this paragraph, contributions will not be considered as provided under a funded plan merely because the domestic subsidiary employer pays the tax imposed by section 3111 (relating to tax on employers under the Federal Insurance Contributions Act) with respect to such employee or is required under the laws of a foreign jurisdiction to pay social insurance taxes or to make similar payments with respect to the wages paid to the employee.

(3) Definitions—(i) Domestic subsidiary. For purposes of this section, a corporation shall be treated as a domestic subsidiary for any taxable year only if each of the following requirements is satisfied:

(A) It is a domestic corporation 80 percent or more of the outstanding voting stock of which is owned by another domestic corporation;

(B) 95 percent or more of its gross income for the three-year period immediately preceding the close of its taxable year which ends on or before the close of the taxable year of such other domestic corporation (or for such part of such period during which it was in existence) was derived from sources without the United States, determined pursuant to sections 861 through 864 and the regulations thereunder; and

(C) 90 percent or more of its gross income for such period (or such part) was derived from the active conduct of a trade or business.

If for the period (or part thereof) referred to in (B) and (C) of this subdivision such corporation has no gross income, the provisions of (B) and (C) shall be treated as satisfied if it is reasonable to anticipate that, with respect to the first taxable year thereafter for which such corporation has gross income, such provisions will be satisfied.

(ii) Domestic parent corporation. The domestic parent corporation of any domestic subsidiary is the domestic corporation which owns 80 percent or more of the outstanding voting stock of such domestic subsidiary.

(c) Special rules—(1) Nondiscrimination requirements. For purposes of applying sections 401(a)(4) and 410(b)(1)(B) (section 401(a)(3)(B), as in effect on September 1, 1974, for plan years to which section 410 does not apply) and the regulation thereunder (relating to nondiscrimination concerning benefits and contributions and coverage of employees) with respect to an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) If the employee is an officer, shareholder, or (with respect to plan years to which section 410 does not apply) a person whose principal duties consist in supervising the work of other employees of the domestic subsidiary of the domestic parent corporation, he shall be treated as having such capacity with respect to the domestic parent corporation; and

(ii) The determination as to whether the employee is a highly compensated employee shall be made by comparing his total compensation (determined under subparagraph (2) of this paragraph)

with the compensation of all the employees of the domestic parent corporation (including individuals treated as employees of the domestic parent corporation pursuant to section 407 and this section).

(2) Determination of compensation. For purposes of applying section 401(a)(5) and the regulations thereunder, relating to classifications that will not be considered discriminatory, with respect to an employee of the domestic subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) The total compensation of the employee shall be the remuneration of the employee from the domestic subsidiary (including any allowances that are paid to the employee because of his employment in a foreign country) which would constitute his total compensation if his services had been performed for such domestic parent corporation; and

(ii) The basic or regular rate of compensation of the employee shall be determined for the employee in the same manner as it is determined under section 401 for other employees of the domestic parent corporation.

(d) Termination of status as deemed employee not to be treated as separation from service for purposes of capital gain provisions and limitation of tax. For purposes of applying the rules, relating to treatment of certain distributions which are made after an employee's separation from service, set forth in section 72(n) as in effect on September 1, 1974 (with respect to taxable years ending after December 31, 1969, and to which section 402(e) does not apply), and in sections 402(a)(2) and (e) and 403(a)(2) (with respect to distributions or payments made after December 31, 1973, and in taxable years beginning after December 31, 1973) with respect to an employee of a domestic subsidiary who is treated as an employee of a domestic parent corporation under paragraph (a)(1) of this section, the employee shall not be considered as separated from the service of the domestic parent corporation solely by reason of the occurrence of any one or more of the following events:

(1) The fact that the corporation of which such individual is an employee ceases, for any taxable year, to be a domestic subsidiary within the meaning of paragraph (b)(3)(i) of this section;

(2) The employee ceasing to be an employee of the domestic subsidiary of such domestic parent corporation, if he becomes an employee of another corporation controlled by such domestic parent corporation; or

(3) The termination of the provision of the plan described in paragraph (b)(1)(i) of this section, requiring coverage of the United States citizens who are employees of domestic subsidiaries of the domestic parent corporation.

For purposes of subparagraph (2) of this paragraph, a corporation is considered to be controlled by a domestic parent corporation if the domestic parent corporation owns directly or indirectly more than 50 percent of the voting stock of the corporation.

(e) Deductibility of contributions—(1) In general. For purposes of applying sections 404 and 405(c) with respect to the deduction for contributions made to or under a pension, profit-sharing, or stock bonus plan described in section 401(a), an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a), by a domestic parent corporation, or by another corporation which is entitled to deduct its contributions under section 404(a)(3)(B), on behalf of an employee of a domestic subsidiary treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section—

(i) Except as provided in subdivision (ii) of this subparagraph, no deduction shall be allowed to the domestic parent corporation which would otherwise be entitled to deduct its contributions on behalf of such employee under one of such sections;

(ii) There shall be allowed as a deduction to the domestic subsidiary of which such individual is an employee an amount equal to the amount which (but for subdivision (i) of this subparagraph) would be deductible under section 404 or section 405(c) by the domestic parent corporation if the individual were an employee of the domestic parent corporation and if his compensation were paid by the domestic corporation; and

(iii) Any reference to compensation shall be considered to be a reference to the total compensation (of such individual determined by applying paragraph (c)(2) of this section).

(2) Year of deduction. Any amount deductible by the domestic subsidiary under section 407(d) and this paragraph shall be deductible for its taxable year with or within which ends the taxable year of the domestic parent corporation for which the contribution was made.

(3) Special rules. Whether contributions to a plan on behalf of an employee of the domestic

subsidiary who is treated as an employee of the domestic parent corporation under paragraph (a)(1) of this section, or whether forfeitures with regard to such employee, will require an inclusion in the income of the domestic parent corporation or an adjustment in the basis of its stock in the domestic subsidiary, shall be determined in accordance with the rules of general application of subtitle A of chapter 1 of the Code (relating to income taxes). For an example, an unreimbursed contribution by the domestic parent corporation to a plan which meets the requirements of section 401(a) will be treated, to the extent each employee's rights to the contribution are nonforfeitable, as a contribution of capital to the domestic subsidiary to the extent that such contributions are made on behalf of the employees of such subsidiary.

(f) Treatment as an employee of the domestic parent corporation under related provisions. An individual who is treated as an employee of a domestic parent corporation under paragraph (a)(1) of this section shall also be treated as an employee of such domestic corporation, with respect to the plan having the provision described in paragraph (b)(1)(i) of this section, for purposes of applying section 72(d) (relating to special rules for computing employees' contributions), section 72(f) (relating to special rules for computing employees' contributions), section 101(b) (relating to employees' death benefits), section 2039 (relating to annuities), and section 2517 (relating to certain annuities under qualified plans) and the regulations thereunder.

(g) Nonexempt trust. If the plan of the domestic parent corporation is a qualified plan described under section 401(a), the fact that a trust which forms a part of such plan is not exempt from tax under section 501(a) shall not affect the treatment of an employee of a domestic subsidiary as an employee of a domestic parent corporation under section 407(a) and paragraph (a)(1) of this section. [T.D. 7501, 42 FR 42323, Aug. 23, 1977]

§ 1.408–1 General rules.

(a) In general. Section 408 prescribes rules relating to individual retirement accounts and individual retirement annuities. In addition to the rules set forth in §§ 1.408–2 and 1.408–3, relating respectively to individual retirement accounts and individual retirement annuities, the rules set forth in this section shall also apply.

(b) Exemption from tax. The individual retirement account or individual retirement annuity is exempt from all taxes under subtitle A of the Code other than the taxes imposed under section 511, relating to tax on unrelated business income of charitable, etc., organizations.

(c) Sanctions—(1) Excess contributions. If an individual retirement account or individual retirement annuity accepts and retains excess contributions, the individual on whose behalf the account is established or who is the owner of the annuity will be subject to the excise tax imposed by section 4973.

(2) Prohibited transactions by owner or beneficiary of individual retirement account. (i) Under section 408(e)(2), if, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year. In any case in which any individual retirement account ceases to be an individual retirement account by reason of the preceding sentence as of the first day of any taxable year, section 408(d)(1) applies as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day). The preceding sentence applies even though part of the fair market value of the individual retirement account as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(ii) If the trust with which the individual engages in any transaction described in subdivision (i) of this subparagraph is established by an employer or employee association under section 408(c), only the employee who engages in the prohibited transaction is subject to disqualification of his separate account.

(3) Prohibited transaction by person other than owner or beneficiary of account. If any person other than the individual on whose behalf an individual retirement account is established or the individual's beneficiary engages in any transaction prohibited by section 4975 with respect to such account, such person shall be subject to the taxes imposed by section 4975.

(4) Pledging account as security. Under section 408(e)(4), if, during any taxable year of the individual for whose benefit an individual retirement account is established, that individual uses the account or any portion thereof as security for a loan, the portion so used is treated as distributed to that individual.

(5) Borrowing on annuity contract. Under section 408(e)(3), if during any taxable year the owner of an individual retirement annuity borrows any money under or by use of such contract, the contract ceases to be an individual retirement annuity as of the first day of such taxable year. See § 1.408–3(c).

(6) Premature distributions. If a distribution (whether a deemed distribution or an actual distribution) is made from an individual retirement account, or individual retirement annuity, to the individual for whose benefit the account was established, or who is the owner of the annuity, before the individual attains age 59½ (unless the individual has become disabled within the meaning of section 72(m)(7)), the tax under Chapter 1 of the Code for the taxable year in which such distribution is received is increased under section 408(f)(1) or (f)(2). The increase equals 10 percent of the amount of the distribution which is includible in gross income for the taxable year. Except in the case of the credits allowable under section 31, 39, or 42, no credit can be used to offset the increased tax described in this subparagraph. See, however, § 1.408–4(c)(3).

(d) Limitation on contributions and benefits. An individual retirement account or individual retirement annuity is subject to the limitation on contributions and benefits imposed by section 415 for years beginning after December 31, 1975.

(e) Community property laws. Section 408 shall be applied without regard to any community property laws.

[T.D. 7714, 45 FR 52790, Aug. 8, 1980]

§ 1.408–2 Individual retirement accounts.

(a) In general. An individual retirement account must be a trust or a custodial account (see paragraph (d) of this section). It must satisfy the requirements of paragraph (b) of this section in order to qualify as an individual retirement account. It may be established and maintained by an individual, by an employer for the benefit of his employees (see paragraph (c) of this section), or by an employee association for the benefit of its members (see paragraph (c) of this section).

(b) Requirements. An individual retirement account must be a trust created or organized in the United States (as defined in section 7701(a)(9)) for the exclusive benefit of an individual or his beneficiaries. Such trust must be maintained at all times as a domestic trust in the United States. The instrument creating the trust must be in writing and the following requirements must be satisfied.

(1) Amount of acceptable contributions. Except in the case of a contribution to a simplified employee pension described in section 408(k) and a rollover contribution described in section 408(d)(3), 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8) or 409(b)(3)(C), the trust instrument must provide that contributions may not be accepted by the trustee for the taxable year in excess of $1,500 on behalf of any individual for whom the trust is maintained. An individual retirement account maintained as a simplified employee pension may provide for the receipt of up to $7,500 for a calendar year.

(2) Trustee. (i) The trustee must be a bank (as defined in section 401(d)(1) and the regulations thereunder) or another person who demonstrates, in the manner described in paragraph (b)(2)(ii) of this section, to the satisfaction of the Commissioner, that the manner in which the trust will be administered will be consistent with the requirements of section 408 and this section.

(ii) A person may demonstrate to the satisfaction of the Commissioner that the manner in which he will administer the trust will be consistent with the requirements of section 408 only upon the filing of a written application to the Commissioner of Internal Revenue, Attention: E:EP, Internal Revenue Service, Washington, D.C. 20224. Such application must meet the applicable requirements of the regulations under section 401(d)(1), relating to nonbank trustees of pension and profit-sharing trusts benefiting owner-employees.

(iii) Section 11.408(a)(2)–1 of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this subparagraph (2).

(3) Life insurance contracts. No part of the trust funds may be invested in life insurance contracts. An individual retirement account may invest in annuity contracts which provide, in the case of death prior to the time distributions commence, for a payment equal to the sum of the premiums paid or, if greater, the cash value of the contract.

(4) Nonforfeitability. The interest of any individual on whose behalf the trust is maintained in the balance of his account must be nonforfeitable.

(5) Prohibition against commingling. (i) The assets of the trust must not be commingled with other property except in a common trust fund or common investment fund.

(ii) For purposes of this subparagraph, the term "common investment fund" means a group trust created for the purpose of providing a satisfactory diversification of investments or a reduction of administrative expenses for the individual participating trusts, and which group trust satisfies the requirements of section 408(c) (except that it need not be established by an employer or an association of employees) and the requirements of section 401(a) in the case of a group trust in which one of the individual participating trusts is an employees' trust described in section 401(a) which is exempt from tax under section 501(a).

(iii) For purposes of this subparagraph, the term "individual participating trust" means an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or a trust which satisfies the requirements of section 408(a) provided that in the case of such an employees' trust, such trust would be permitted to participate in such a group trust if all the other individual participating trusts were employees' trusts described in section 401(a) which are exempt from tax under section 501(a).

(6) **Distribution of interest.** (i) The trust instrument must provide that the entire interest of the individual for whose benefit the trust is maintained must be distributed to him in accordance with paragraph (b)(6)(ii) or (iii) of this section.

(ii) Unless the provisions of paragraph (b)(6)(iii) of this section apply, the entire interest of the individual must be actually distributed to him not later than the close of his taxable year in which he attains age 70½.

(iii) In lieu of distributing the individual's entire interest as provided in paragraph (b)(6)(ii) of this section, the interest may be distributed commencing not later than the taxable year described in such paragraph (b)(6)(ii). In such case, the trust must expressly provide that the entire interest of the individual will be distributed to the individual and the individual's beneficiaries, in a manner which satisfies the requirements of paragraph (b)(6)(v) of this section, over any of the following periods (or any combination thereof)—

(A) The life of the individual,

(B) The lives of the individual and spouse,

(C) A period certain not extending beyond the life expectancy of the individual, or

(D) A period certain not extending beyond the joint life and last survivor expectancy of the individual and spouse.

(iv) The life expectancy of the individual or the joint life and last survivor expectancy of the individual and spouse cannot exceed the period computed by use of the expected return multiples in § 1.72–9, or, in the case of payments under a contract issued by an insurance company, the period computed by use of the mortality tables of such company.

(v) If an individual's entire interest is to be distributed over a period described in paragraph (b)(6)(iii) of this section, beginning in the year the individual attains 70 ½ the amount to be distributed each year must be not less than the lesser of the balance of the individual's entire interest or an amount equal to the quotient obtained by dividing the entire interest of the individual in the trust at the beginning of such year (including amounts not in the individual retirement account at the beginning of the year because they have been withdrawn for the purpose of making a rollover contribution to another individual retirement plan) by the life expectancy of the individual (or the joint life and last survivor expectancy of the individual and spouse (whichever is applicable)), determined in either case as of the date the individual attains age 70 in accordance with paragraph (b)(6)(iv) of this section, reduced by one for each taxable year commencing after the individual's attainment of age 70 ½. An annuity or endowment contract issued by an insurance company which provides for non-increasing payments over one of the periods described in paragraph (b)(6)(iii) of this section beginning not later than the close of the taxable year in which the individual attains age 70 ½ satisfies this provision. However, no distribution need be made in any year, or a lesser amount may be distributed, if beginning with the year the individual attains age 70 ½ the aggregate amounts distributed by the end of any year are at least equal to the aggregate of the minimum amounts required by this subdivision to have been distributed by the end of such year.

(vi) If an individual's entire interest is distributed in the form of an annuity contract, then the requirements of section 408(a)(6) are satisfied if the distribution of such contract takes place before the close of the taxable year described in subdivision (ii) of this subparagraph, and if the individual's interest will be paid over a period described in subdivision (iii) of this subparagraph and at a rate which satisfies the requirements of subdivision (v) of this subparagraph.

(vii) In determining whether paragraph (b)(6)(v) of this section is satisfied, all individual retirement

plans maintained for an individual's benefit (except those under which he is a beneficiary described in section 408(a)(7)) at the close of the taxable year in which he reaches age 70 ½ must be aggregated. Thus, the total payments which such individual receives in any taxable year must be at least equal to the amount he would have been required to receive had all the plans been one plan at the close of the taxable year in which he attained age 70 ½.

(7) Distribution upon death. (i) The trust instrument must provide that if the individual for whose benefit the trust is maintained dies before the entire interest in the trust has been distributed to him, or if distribution has been commenced as provided in paragraph (b)(6) of this section to the surviving spouse and such spouse dies before the entire interest has been distributed to such spouse, the entire interest (or the remaining part of such interest if distribution thereof has commenced) must, within 5 years after the individual's death (or the death of the surviving spouse) be distributed or applied to the purchase of an immediate annuity for this beneficiary or beneficiaries (or the beneficiary or beneficiaries of the surviving spouse) which will be payable for the life of such beneficiary or beneficiaries (or for a term certain not extending beyond the life expectancy of such beneficiary or beneficiaries) and which annuity contract will be immediately distributed to such beneficiary or beneficiaries. A contract described in the preceding sentence is not includible in gross income upon distribution. Section 1.408–4(e) provides rules applicable to the taxation of such contracts. The first sentence of this paragraph (b)(7) shall have no application if distributions over a term certain commenced before the death of the individual for whose benefit the trust was maintained and the term certain is for a period permitted under paragraph (b)(6)(iii)(C) or (D) of this section.

(ii) Each such beneficiary (or beneficiary of a surviving spouse) may elect to treat the entire interest in the trust (or the remaining part of such interest if distribution thereof has commenced) as an account subject to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section instead of those of section 408(a)(7) and paragraph (b)(7) of this section. Such an election will be deemed to have been made if such beneficiary treats the account in accordance with the requirements of section 408(a)(6) and paragraph (b)(6) of this section. An election will be considered to have been made by such beneficiary if either of the following occurs: (A) any amounts in the account (including any amounts that have been rolled over, in accordance with the requirements of section 408(d)(3)(A)(i), into an individual retirement account, individual retirement annuity, or retirement bond for the benefit of such individual) have not been distributed within the appropriate time period required by section 408(a)(7) and paragraph (b)(7) of this section; or (B) any additional amounts are contributed to the account (or to the account, annuity, or bond to which the beneficiary has rolled such amounts over, as described in (1) above) which are subject, or deemed to be subject, to the distribution requirements of section 408(a)(6) and paragraph (b)(6) of this section.

(8) Definition of beneficiaries. The term "beneficiaries" on whose behalf an individual retirement account is established includes (except where the context indicates otherwise) the estate of the individual, dependents of the individual, and any person designated by the individual to share in the benefits of the account after the death of the individual.

(c) Accounts established by employers and certain association of employees—(1) In general. A trust created or organized in the United States (as defined in section 7701(a)(9)) by an employer for the exclusive benefit of his employees or their beneficiaries, or by an association of employees for the exclusive benefit of its members or their beneficiaries, is treated as an individual retirement account if the requirements of paragraphs (c)(2) and (c)(3) of this section are satisfied under the written governing instrument creating the trust. A trust described in the preceding sentence is for the exclusive benefit of employees or members even though it may maintain an account for former employees or members and employees who are temporarily on leave.

(2) General requirements. The trust must satisfy the requirements of paragraphs (b)(1) through (7) of this section.

(3) Special requirement. There must be a separate accounting for the interest of each employee or member.

(4) Definitions—(i) Separate accounting. For purposes of paragraph (c)(3) of this section, the term "separate accounting" means that separate records must be maintained with respect to the interest of each individual for whose benefit the trust is maintained. The assets of the trust may be held in a common trust fund, common investment fund, or common fund for the account of all individuals who have an interest in the trust.

(ii) **Employee association.** For purposes of this paragraph and section 408(c), the term "employee association" means any organization composed of two or more employees, including but not limited to, an employee association described in section 501(c)(4). Such association may include employees within the meaning of section 401(c)(1). There must be, however, some nexus between the employees (*e.g.*, employees of same employer, employees in the same industry, etc.) in order to qualify as an employee association described in this subdivision (ii).

(d) **Custodial accounts.** For purposes of this section and section 408(a), a custodial account is treated as a trust described in section 408(a) if such account satisfies the requirements of section 408(a) except that it is not a trust and if the assets of such account are held by a bank (as defined in section 401(d)(1) and the regulations thereunder) or such other person who satisfies the requirements of paragraph (b)(2)(ii) of this section. For purposes of this chapter, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account will be treated as the trustee thereof.

[T.D. 7714, 45 FR 52791, Aug. 8, 1980]

§ 1.408–3 Individual retirement annuities.

(a) **In general.** An individual retirement annuity is an annuity contract or endowment contract (described in paragraph (e)(1) of this section) issued by an insurance company which is qualified to do business under the law of the jurisdiction in which the contract is sold and which satisfies the requirements of paragraph (b) of this section. A participation certificate in a group contract issued by an insurance company described in this paragraph will be treated as an individual retirement annuity if the contract satisfies the requirements of paragraph (b) of this section; the certificate of participation sets forth the requirements of paragraphs (1) through (5) of section 408(b); the contract provides for a separate accounting of the benefit allocable to each participant-owner; and the group contract is for the exclusive benefit of the participant owners and their beneficiaries. For purposes of this title, a participant-owner of a group contract described in this paragraph shall be treated as the owner of an individual retirement annuity. A contract will not be treated as other than an individual retirement annuity merely because it provides for waiver of premium on disability. An individual retirement annuity contract which satisfies the requirements of section 408(b) need not be purchased under a trust if the requirements of paragraph (b) of this section are satisfied. An individual retirement endowment contract may not be held under a trust which satisfies the requirements of section 408(a). Distribution of the contract is not a taxable event. Distributions under the contract are includible in gross income in accordance with the provisions of § 1.408–4(e).

(b) **Requirements—(1) Transferability.** The annuity or the endowment contract must not be transferable by the owner. An annuity or endowment contract is transferable if the owner can transfer any portion of his interest in the contract to any person other than the issuer thereof. Accordingly, such a contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose his interest in the contract to any person other than the issuer thereof. On the other hand, a contract is not to be considered transferable merely because the contract contains: a provision permitting the individual to designate a beneficiary to receive the proceeds in the event of his death, a provision permitting the individual to elect a joint and survivor annuity, or other similar provisions.

(2) **Annual premium.** Except in the case of a contribution to a simplified employee pension described in section 408(k), the annual premium on behalf of any individual for the annuity or the endowment contract cannot exceed $1,500. Any refund of premiums must be applied before the close of the calendar year following the year of the refund toward the payment of future premiums or the purchase of additional benefits.

(3) **Distribution.** The entire interest of the owner must be distributed to him in the same manner and over the same period as described in § 1.408–2(b)(6).

(4) **Distribution upon death.** If the owner dies before the entire interest has been distributed to him, or if distribution has commenced to the surviving spouse, the remaining interest must be distributed in the same manner, over the same period, and to the same beneficiaries as described in § 1.408–2(b)(7).

(5) **Nonforfeitability.** The entire interest of the owner in the annuity or endowment contract must be nonforfeitable.

(6) **Flexible premium.** [Reserved]

(c) **Disqualification.** If during any taxable year the owner of an annuity borrows any money under the annuity or endowment contract or by use of

such contract (including, but not limited to, pledging the contract as security for any loan), such contract will cease to be an individual retirement annuity as of the first day of such taxable year, and will not be an individual retirement annuity at any time thereafter. If an annuity or endowment contract which constitutes an individual retirement annuity is disqualified as a result of the preceding sentence, an amount equal to the fair market value of the contract as of the first day of the taxable year of the owner in which such contract is disqualified is deemed to be distributed to the owner. Such owner shall include in gross income for such year an amount equal to the fair market value of such contract as of such first day. The preceding sentence applies even though part of the fair market value of the individual retirement annuity as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

(d) Premature distribution tax on deemed distribution. If the individual has not attained age 59½ before the beginning of the year in which the disqualification described in paragraph (c) of this section occurs, see section 408(f)(2) for additional tax on premature distributions.

(e) Endowment contracts—(1) Additional requirement for endowment contracts. No contract providing life insurance protection issued by a company described in paragraph (a) of this section shall be treated as an endowment contract for purposes of this section if—

(i) Such contract matures later than the taxable year in which the individual in whose name the contract is purchased attains the age of 70½;

(ii) Such contract is not for the exclusive benefit of such individual or his beneficiaries;

(iii) Premiums under the contract may increase over the term of the contract;

(iv) When all premiums are paid when due, the cash value of such contract at maturity is less than the death benefit payable under the contract at any time before maturity;

(v) The death benefit does not, at some time before maturity, exceed the greater of the cash value or the sum of premiums paid under the contract;

(vi) Such contract does not provide for a cash value;

(vii) Such contract provides that the life insurance element of such contract may increase over the term of such contract, unless such increase is merely because such contract provides for the purchase of additional benefits;

(viii) Such contract provides insurance other than life insurance and waiver of premiums upon disability; or

(ix) Such contract is issued after November 6, 1978.

(2) Treatment of proceeds under endowment contract upon death of individual. In the case of the payment of a death benefit under an endowment contract upon the death of the individual in whose name the contract is purchased, the portion of such payment which is equal to the cash value immediately before the death of such individual is not excludable from gross income under section 101(a) and is treated as a distribution from an individual retirement annuity. The remaining portion, if any, of such payment constitutes current life insurance protection and is excludable under section 101(a). If a death benefit is paid under an endowment contract at a date or dates later than the death of the individual, section 101(d) is applicable only to the portion of the benefit which is attributable to the amount excludable under section 101(a).

[T.D. 7714, 45 FR 52792, Aug. 8, 1980]

§ 1.408–4 Treatment of distributions from individual retirement arrangements.

(a) General rule—(1) Inclusion in income. Except as otherwise provided in this section, any amount actually paid or distributed or deemed paid or distributed from an individual retirement account or individual retirement annuity shall be included in the gross income of the payee or distributee for the taxable year in which the payment or distribution is received.

(2) Zero basis. Notwithstanding section 1015(d) or any other provision of the Code, the basis (or investment in the contract) of any person in such an account or annuity is zero. For purposes of this section, an assignment of an individual's rights under an individual retirement account or an individual retirement annuity shall, except as provided in § 1.408–4(g) (relating to transfer incident to divorce), be deemed a distribution to such individual from such account or annuity of the amount assigned.

(b) Rollover contribution—(1) To individual retirement arrangement. Paragraph (a)(1) of this section shall not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual

for whose benefit the account was established or who is the owner of the annuity if the entire amount received (including the same amount of money and any other property) is paid into an individual retirement account, annuity (other than an endowment contract), or bond created for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution.

(2) To qualified plan. Paragraph (a)(1) of this section does not apply to any amount paid or distributed from an individual retirement account or individual retirement annuity to the individual for whose benefit the account was established or who is the owner of the annuity if—

(i) No amount in the account or no part of the value of the annuity is attributable to any source other than a rollover contribution from an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or a rollover contribution from an annuity plan described in section 403(a) and the earnings on such sums, and

(ii) The entire amount received (including the same amount of money and any other property) represents the entire amount in the account and is paid into another such trust or plan (for the benefit of such individual) not later than the 60th day after the day on which the payment or distribution is received.

This subparagraph does not apply if any portion of the rollover contribution described in paragraph (b)(2)(i) of this section is attributable to an employees' trust forming part of a plan or an annuity under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan.

(3) To section 403(b) contract. [Reserved]

(4) Frequency limitation. (i) For taxable years beginning on or before December 31, 1977, paragraph (b)(1) of this section does not apply to any amount received by an individual from an individual retirement account, annuity or bond if at any time during the 3–year period ending on the day of receipt, the individual received any other amount from an individual retirement account, annuity or bond which was not includible in his gross income because of the application of paragraph (b)(1) of this section.

(ii) [Reserved]

(c) Excess contributions returned before due date of return—(1) Excess contribution. For purposes of this paragraph, excess contributions are the excess of the amounts contributed to an individual retirement account or paid for an individual retirement annuity during the taxable year over the amount allowable as a deduction under section 219 or 220 for the taxable year.

(2) General rule. (i) Paragraph (a)(1) of this section does not apply to the distribution of any excess contribution paid during a taxable year to an account or annuity if: the distribution is received on or before the date prescribed by law (including extensions) for filing the individual's return for such taxable year; no deduction is allowed under section 219 or section 220 with respect to the excess contribution; and the distribution is accompanied by the amount of net income attributable to the excess contribution as of the date of the distribution as determined under subdivision (ii).

(ii) The amount of net income attributable to the excess contributions is an amount which bears the same ratio to the net income earned by the account during the computation period as the excess contribution bears to the sum of the balance of the account as of the first day of the taxable year in which the excess contribution is made and the total contribution made for such taxable year. For purposes of this paragraph, the term "computation period" means the period beginning on the first day of the taxable year in which the excess contribution is made and ending on the date of the distribution from the account.

(iii) For purposes of paragraph (c)(2)(ii), the net income earned by the account during the computation period is the fair market value of the balance of the account immediately after the distribution increased by the amount of distributions from the account during the computation period, and reduced (but not below zero) by the sum of: (A) the fair market value of the balance of the account as of the first day of the taxable year in which the excess contribution is made and (B) the contributions to the account made during the computation period.

(3) Time of inclusion. (i) For taxable years beginning before January 1, 1977, the amount of net income determined under subparagraph (2) is includible in the gross income of the individual for the taxable year in which it is received. The amount of net income thus distributed is subject to the tax imposed by section 408(f)(1) for the year includible in gross income.

(ii) [Reserved]

(4) Example. The provisions of this paragraph may be illustrated by the following example:

Example. On January 1, 1975, A, age 55, who is a calendar-year taxpayer, contributes $1,500 to an individual retirement account established for his benefit. For 1975, A is entitled to a deduction of $1,400 under section 219. For 1975, A does not claim as deductions any other items listed in section 62. A's gross income for 1975 is $9,334. On April 1, 1976, $107 is distributed to A from his individual retirement account. As of such date, the balance of the account is $1,498 [$1,605 − $107]. There were no other distributions from the account as of such date. The net amount of income earned by the account is $105 [$1,498 + $107 − (0 + $1,500)]. The net income attributable to the excess contribution is $7. [$105 × ($100/$1,500)]. A's adjusted gross income for 1975 is his gross income for 1975 ($9,334) reduced by the amount allowable to A as a deduction under section 219 ($1,400), or $7,934. A will include the $7 of the $107 distributed on April 1, 1976, in his gross income for 1976. Further, A will pay an additional income tax of $.70 for 1976 under section 408(f)(1).

(d) Deemed distribution—(1) General rule. In any case in which an individual retirement account ceases to be an individual retirement account by reason of the application of section 408(e)(2), paragraph (a)(1) of this section shall apply as if there were a distribution on the first day of the taxable year in which such account ceases to be an individual retirement account of an amount equal to the fair market value on such day of all of the assets in the account on such day. In the case of a deemed distribution from an individual retirement annuity, see § 1.408–3(d).

(2) Using account as security. In any case in which an individual for whose benefit an individual retirement account is established uses, directly or indirectly, all or any portion of the account as security for a loan, paragraph (a)(1) of this section shall apply as if there were distributed on the first day of the taxable year in which the loan was made an amount equal to that portion of the account used as security for such loan.

(e) Distribution of annuity contracts. Paragraph (a)(1) of this section does not apply to any annuity contract which is distributed from an individual retirement account and which satisfies the requirements of paragraphs (b)(1), (3), (4) and (5) of section 408. Amounts distributed under such contracts will be taxable to the distributee under section 72. For purposes of applying section 72 to a distribution from such a contract, the investment in such contract is zero.

(f) Treatment of assets distributed from an individual retirement account for the purchase of an endowment contract. Under section 408(e)(5), if all, or any portion, of the assets of an individual retirement account are used to purchase an endowment contract described in § 1.408–3(e) for the benefit of the individual for whose benefit the account is established—

(1) The excess, if any, of the total amount of assets used to purchase such contract over the portion of the assets attributable to life insurance protection shall be treated as a rollover contribution described in section 408(d)(3), and

(2) The portion of the assets attributable to life insurance protection shall be treated as a distribution described in paragraph (a)(91) of this section, except that the provisions of section 408(f) shall not apply to such amount.

(g) Transfer incident to divorce—(1) General rule. The transfer of an individual's interest, in whole or in part, in an individual retirement account, individual retirement annuity, or a retirement bond, to his former spouse under a valid divorce decree or a written instrument incident to such divorce shall not be considered to be a distribution from such an account or annuity to such individual or his former spouse; nor shall it be considered a taxable transfer by such individual to his former spouse notwithstanding any other provision of Subtitle A of the Code.

(2) Spousal account. The interest described in this paragraph (g) which is transferred to the former spouse shall be treated as an individual retirement account of such spouse if the interest is an individual retirement account; an individual retirement annuity of such spouse if such interest is an individual retirement annuity; and a retirement bond of such spouse if such interest is a retirement bond.

[T.D. 7714, 45 FR 52793, Aug. 8, 1980]

§ 1.408–5 Annual reports by trustees or issuers.

(a) In general. The trustee of an individual retirement account or the issuer of an individual retirement annuity shall make annual calendar year reports concerning the status of the account or annuity. The report shall contain the information required in paragraph (b) and be furnished or filed in the manner and time specified in paragraph (c).

(b) Information required to be included in the annual reports. The annual calendar year report shall contain the following information for transactions occurring during the calendar year—

(1) The amount of contributions;

(2) The amount of distributions;

(3) In the case of an endowment contract, the amount of the premium paid allocable to the cost of life insurance;

(4) The name and address of the trustee or issuer; and

(5) Such other information as the Commissioner may require.

(c) Manner and time for filing. (1) The annual report shall be furnished to the individual on whose behalf the account is established or in whose name the annuity is purchased (or the beneficiary of the individual or owner). The report shall be furnished on or before the 30th day of June following the calendar year for which the report is required.

(2) The Commissioner may require the annual report to be filed with the Service at the time the Commissioner specifies.

(d) Penalties. Section 6693 prescribes penalties for failure to file the annual report.

(e) Effective date. This section shall apply to reports for calendar years after 1978.

(f) Reports for years prior to 1979. For years prior to 1979, a trustee or issuer shall make reports in the time and manner as the Commissioner requires.

[T.D. 7714, 45 FR 52795, Aug. 8, 1980]

§ 1.408–6 Disclosure statements for individual retirement arrangements.

(a) In general—(1) General rule. Trustees and issuers of individual retirement accounts and annuities are, under the authority of section 408(i), required to provide disclosure statements. This section sets forth these requirements.

(2) [Reserved]

(b)–(c) [Reserved]

(d) Requirements. (1)–(3) [Reserved]

(4) Disclosure statements. (i) Under the authority contained in section 408(i), a disclosure statement shall be furnished in accordance with the provisions of this subparagraph by the trustee of an individual retirement account described in section 408(a) or the issuer of an individual retirement annuity described in section 408(b) or of an endowment contract described in section 408(b) to the individual (hereinafter referred to as the "benefited individual") for whom such an account, annuity, or contract is, or is to be, established.

(ii)(A)(*1*) The trustee or issuer shall furnish, or cause to be furnished, to the benefited individual, a disclosure statement satisfying the requirements of subdivisions (iii) through (viii) of this subparagraph, as applicable, and a copy of the governing instrument to be used in establishing the account, annuity, or endowment contract. The copy of such governing instrument need not be filled in with financial and other data pertaining to the benefited individual; however, such copy must be complete in all other respects. The disclosure statement and copy of the governing instrument must be received by the benefited individual at least seven days preceding the earlier of the date of establishment or purchase of the account, annuity, or endowment contract. A disclosure statement or copy of the governing instrument required by this subparagraph may be received by the benefited individual less than seven days preceding, but no later than, the earlier of the date of establishment or purchase, if the benefited individual is permitted to revoke the account, annuity, or endowment contract pursuant to a procedure which satisfies the requirements of subdivision (ii)(A)(*2*) of this subparagraph.

(*2*) A procedure for revocation satisfies the requirements of this subdivision (ii)(A)(*2*) of this subparagraph if the benefited individual is permitted to revoke the account, or endowment contract by mailing or delivering, at his option, a notice of revocation on or before a day not less than seven days after the earlier of the date of establishment or purchase and, upon revocation, is entitled to a return of the entire amount of the consideration paid by him for the account, annuity, or endowment contract without adjustment for such items as sales commissions, administrative expenses or fluctuation in market value. The procedure may require that the notice be in writing or that it be oral, or it may require both a written and an oral notice. If an oral notice is required or permitted, the procedure must permit it to be delivered by telephone call during normal business hours. If a written notice is required or permitted, the procedure must provide that, if mailed, it shall be deemed mailed on the date of the postmark (or if sent by certified or registered mail, the date of certification or registration) if it is deposited in the mail in the United States in an envelope, or other appropriate wrapper, first class postage prepaid, properly addressed.

(B) If after a disclosure statement has been furnished, or caused to be furnished, to the benefited individual pursuant to paragraph (d)(4)(ii)(A) of this section and—

(1) On or before the earlier of the date of establishment or purchase, or

(2) On or before the last day on which the benefited individual is permitted to revoke the account, annuity, or endowment contract (if the benefited individual has a right to revoke the account, annuity, or endowment contract pursuant to the rules of subdivision (ii)(A) of this subparagraph),

there becomes effective a material adverse change in the information set forth in such disclosure statement or a material change in the governing instrument to be used in establishing the account, annuity, or contract, the trustee or issuer shall furnish, or cause to be furnished, to the benefited individual such amendments to any previously furnished disclosure statement or governing instrument as may be necessary to adequately inform the benefited individual of such change. The trustee or issuer shall be treated as satisfying this subdivision (ii)(B) of this subparagraph only if material required to be furnished by this subdivision is received by the benefited individual at least seven days preceding the earlier of the date of establishment or purchase of the account, annuity, or endowment contract or if the benefited individual is permitted to revoke the account, annuity, or endowment contract on or before a date not less than seven days after the date on which such material is received, pursuant to a procedure for revocation otherwise satisfying the provisions of subdivision (ii)(A)(2) of this subparagraph.

(C) If the governing instrument is amended after the account, annuity, or endowment contract is no longer subject to revocation pursuant to subdivision (ii)(A) or (B) of this subparagraph, the trustee or issuer shall not later than the 30th day after the later of the date on which the amendment is adopted or becomes effective, deliver or mail to the last known address of the benefited individual a copy of such amendment and, if such amendment affects a matter described in subdivisions (iii) through (viii) of this subparagraph, a disclosure statement with respect to such matter meeting the requirements of subdivision (iv) of this subparagraph.

(D) For purposes of subdivision (ii)(A) and (B) of this subparagraph, if a disclosure statement, governing instrument, or an amendment to either, is mailed to the benefited individual, it shall be deemed (in the absence of evidence to the contrary) to be received by the benefited individual seven days after the date of mailing.

(E) In the case of a trust described in section 408(c) (relating to certain retirement savings arrangements for employees or members of associations of employees), the following special rules shall be applied:

(1) For purposes of this subparagraph, references to the benefited individual's account, annuity, or endowment contract shall refer to the benefited individual's interest in such trust, and

(2) The provisions of subdivision (ii) of this subparagraph shall be applied by substituting "the date on which the benefited individual's interest in such trust commences" for "the earlier of the date of establishment or purchase" wherever it appears therein.

Thus, for example, if an employer establishes a trust described in section 408(c) for the benefit of employees, and the trustee furnishes an employee with a disclosure statement and a copy of the governing instrument (as required by this subparagraph) on the date such employee's interest in the trust commences, such employee must be given a right to revoke such interest within a period of at least seven days. If any contribution has been made within such period (whether by the employee or by the employer), the full amount of such contribution must be paid to such employee pursuant to subdivision (ii)(A)(2) of this subparagraph.

(iii) The disclosure statement required by this subparagraph shall set forth in nontechnical language the following matters as such matters relate to the account, annuity, or endowment contract (as the case may be);

(A) Concise explanations of—

(1) The statutory requirements prescribed in section 408(a) (relating to an individual retirement account) or section 408(b) (relating to an individual retirement annuity and an endowment contract), and any additional requirements (whether or not required by law) that pertain to the particular retirement savings arrangement.

(2) The income tax consequences of establishing an account, annuity, or endowment contract (as the case may be) which meets the requirements of section 408(a) (relating to an individual retirement account) or section 408(b) (relating to an individual retirement annuity and an endowment contract), including the deductibility of contributions to, the tax treatment of distributions (other than premature distributions) from, the availability of income tax free rollovers to and from, and the tax status of such account, annuity, or endowment contract.

(3) The limitations and restrictions on the deduction for retirement savings under section 219, including the ineligibility of certain individuals who are active participants in a plan described in section 219(b)(2)(A) or for whom amounts are contributed under a contract described in section 219(b)(2)(B) to make deductible contributions to an account or for an annuity or endowment contract.

(4) The circumstances under which the benefited individual may revoke the account, annuity, or endowment contract, and the procedure therefor (including the name, address, and telephone number of the person designated to receive notice of such revocation). Such explanation shall be prominently displayed at the beginning of the disclosure statement.

(B) Statements to the effect that—

(1) If the benefited individual or his beneficiary engages in a prohibited transaction, described in section 4975(c) with respect to an individual retirement account, the account will lose its exemption from tax by reason of section 408(e)(2)(A), and the benefited individual must include in gross income, for the taxable year during which the benefited individual or his beneficiary engages in the prohibited transaction the fair market value of the account.

(2) If the owner of an individual retirement annuity or endowment contract described in section 408(b) borrows any money under, or by use of, such annuity or endowment contract, then, under section 408(e)(3), such annuity or endowment contract loses its section 408(b) classification, and the owner must include in gross income, for the taxable year during which the owner borrows any money under, or by use of, such annuity or endowment contract, the fair market value of the annuity or endowment contract.

(3) If a benefited individual uses all or any portion of an individual retirement account as security for a loan, then, under section 408(e)(4), the portion so used is treated as distributed to such individual and the benefited individual must include such distribution in gross income for the taxable year during which he so uses such account.

(4) An additional tax of 10 percent is imposed by section 408(f) on distributions (including amounts deemed distributed as the result of a prohibited loan or use as security for a loan) made before the benefited individual has attained age 59 ½, unless such distribution is made on account of death or disability, or unless a rollover contribution is made with such distribution.

(5) Sections 2039(e) (relating to exemption from estate tax of annuities under certain trusts and plans) and 2517 (relating to exemption from gift tax of specified transfers of certain annuities under qualified plans) apply (including the manner in which such sections apply) to the account, annuity, or endowment contract.

(6) Section 402(a)(2) and (e) (relating to tax on lump sum distributions) is not applicable to distributions from an account, annuity, or endowment contract.

(7) A minimum distribution is required under section 408(a)(6) or (7) and 408(b)(3) or (4) (including a brief explanation of the amount of minimum distribution) and that if the amount distributed from an account, annuity, or endowment contract during the taxable year of the payee is less than the minimum required during such year, an excise tax, which shall be paid by the payee, is imposed under section 4974, in an amount equal to 50 percent of the excess of the minimum required to be distributed over the amount actually distributed during the year.

(8) An excise tax is imposed under section 4973 on excess contributions (including a brief explanation of an excess contribution).

(9) The benefited individual must file Form 5329 (Return for Individual Retirement Savings Arrangement) with the Internal Revenue for each taxable year during which the account, annuity, or endowment contract is maintained.

(10) The account or contract has or has not (as the case may be) been approved as to form for use as an account, annuity, or endowment contract by the Internal Revenue Service. For purposes of this subdivision, if a favorable opinion or determination letter with respect to the form of a prototype trust, custodial account, annuity, or endowment contract has been issued by the Internal Revenue Service, or the instrument which establishes an individual retirement trust account or an individual retirement custodial account utilizes the precise language of a form currently provided by the Internal Revenue Service (including any additional language permitted by such form), such account or contract may be treated as approved as to form.

(11) The Internal Revenue Service approval is a determination only as to the form of the account, annuity, or endowment contract, and does not

represent a determination of the merits of such account, annuity, or endowment contract.

(12) The proceeds from the account, annuity or endowment contract may be used by the benefited individual as a rollover contribution to another account or annuity or retirement bond in accordance with the provisions of section 408(d)(3).

(13) In the case of an endowment contract described in section 408(b), no deduction is allowed under section 219 for that portion of the amounts paid under the contract for the taxable year properly allocable to the cost of life insurance.

(14) If applicable, in the event that the benefited individual revokes the account, annuity, or endowment contract, pursuant to the procedure described in the disclosure statement (see subdivision (A)(4) of this subdivision (iii)), the benefited individual is entitled to a return of the entire amount of the consideration paid by him for the account, annuity, or endowment contract without adjustment for such items as sales commissions, administrative expenses or fluctuation in market value.

(15) Further information can be obtained from any district office of the Internal Revenue Service.

To the extent that information on the matters described in subdivisions (iii)(A) and (B) of this subparagraph is provided in a publication of the Internal Revenue Service relating to individual retirement savings arrangements, such publication may be furnished by the trustee or issuer in lieu of providing information relating to such matters in a disclosure statement.

(C) The financial disclosure required by paragraph (d)(4)(v), (vi), and (vii) of this section.

(iv) In the case of an amendment to the terms of an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section, the disclosure statement required by this subparagraph need not repeat material contained in the statement furnished pursuant to paragraph (d)(4)(iii) of this section, but it must set forth in nontechnical language those matters described in paragraph (d)(4)(iii) of this section which are affected by such amendment.

(v) With respect to an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section (other than an account or annuity which is to receive only a rollover contribution described in paragraph (d)(4)(vi) of this section and to which no deductible contributions will be made), the disclosure statement must set forth in cases where either an amount is guaranteed over period of time (such as in the case of a nonparticipating endowment or annuity contract), or a projection of growth of the value of the account, annuity, or endowment contract can reasonably be made (such as in the case of a participating endowment or annuity contract (other than a variable annuity) or passbook savings account), the following:

(A) To the extent that an amount is guaranteed,

(1) The amount, determined without regard to any portion of a contribution which is not deductible, that would be guaranteed to be available to the benefited individual if (i) level annual contributions in the amount of $1,000 were to be made on the first day of each year, and (ii) the benefited individual were to withdraw in a single sum the entire amount of such account, annuity, or endowment contract at the end of each of the first five years during which contributions are to be made, at the end of the year in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the guaranteed available amount is less than the increase of the guaranteed available amount during any preceding year for any reason other than decrease or cessation of contributions, and

(2) A statement that the amount described in subdivision (v)(A)(1) of this subparagraph is guaranteed, and the period for which guaranteed;

(B) To the extent a projection of growth of the value of the account, annuity, or endowment contract can reasonably be made but the amounts are not guaranteed.

(1) The amount, determined without regard to any portion of a contribution which is not deductible, and upon the basis of an earnings rate no greater than, and terms no different from, those currently in effect, that would be available to the benefited individual if (i) level annual contributions in the amount of $1,000 were to be made on the first day of each year, and (ii) the benefited individual were to withdraw in a single sum the entire amount of such account, annuity, or endowment contract at the end of each of the first five years during which contributions are to be made, at the end of each of the years in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the available amount is less than the increase of the available amount during any preceding year for any reason other than decrease or cessation of contributions, and

(2) A statement that the amount described in paragraph (d)(4)(v)(B)(1) of this section is a projection and is not guaranteed and a statement of the earnings rate and terms on the basis of which the projection is made;

(C) The portion of each $1,000 contribution attributable to the cost of life insurance, which would not be deductible, for each year during which contributions are to be made; and

(D) The sales commission (including any commission attributable to the sale of life insurance), if any, to be charged in each year, expressed as a percentage of gross annual contributions (including any portion attributable to the cost of life insurance) to be made for each year.

(vi) With respect to an account or annuity described in paragraph (d)(4)(i) of this section to which a rollover contribution described in section 402(a)(5)(A), 403(a)(4)(A), 408(d)(3)(A) or 409(b)(3)(C) will be made, the disclosure statement must set forth, in cases where an amount is guaranteed over a period of time (such as in the case of a non-participating annuity contract, or a projection of growth of the value of the account or annuity can reasonably be made (such as in the case of a participating annuity contract (other than a variable annuity) or a passbook savings account), the following:

(A) To the extent guaranteed,

(1) The amount that would be guaranteed to be available to the benefited individual if (i) Such a rollover contribution in the amount of $1,000 were to be made on the first day of the year, (ii) No other contribution were to be made, and (iii) The benefited individual were to withdraw in a single sum the entire amount of such account or annuity at the end of each of the first five years after the contribution is made, at the end of the year in which the benefited individual attains the ages of 60, 65, and 70, and at the end of any other year during which the increase of the guaranteed available amount is less than the increase of the guaranteed available amount during any preceding year, and

(2) A statement that the amount described in paragraph (d)(vi)(A)(1) of this section is guaranteed;

(B) To the extent that a projection of growth of the value of the account or annuity can reasonably be made but the amounts are not guaranteed,

(1) The amount, determined upon the basis of an earnings rate no greater than, and terms no different from, those currently in effect, that would be available to the benefited individual if (i) such a rollover contribution in the amount of $1,000 were to be made on the first day of the year, (ii) no other contribution were to be made, and (iii) the benefited individual were to withdraw in a single sum the entire amount of such account or annuity at the end of each of the first five years after the contribution is made, at the end of each of the years in which the benefited individual attains the ages of 60, 65, 70, and at the end of any other year during which the increase of the available amount is less than the increase of the available amount during any preceding year, and

(2) A statement that the amount described in paragraph (d)(4)(vi)(B)(1) of this section is a projection and is not guaranteed and a statement of the earnings rate and terms on the basis of which the projection is made; and

(C) The sales commission, if any, to be charged in each year, expressed as a percentage of the assumed $1,000 contribution.

(vii) With respect to an account, annuity, or endowment contract described in paragraph (d)(4)(i) of this section, in all cases not subject to paragraph (d)(4)(v) or (vi) of this section (such as in the case of a mutual fund or variable annuity), the disclosure statement must set forth information described in subdivisions (A) through (C) of this subdivision (vii) based (as applicable with respect to the type or types of contributions to be received by the account, annuity, or endowment contract) upon the assumption of (1) level annual contributions of $1,000 on the first day of each year, (2) a rollover contribution of $1,000 on the first day of the year and no other contributions, or (3) a rollover contribution of $1,000 on the first day of the year plus level annual contributions of $1,000 on the first day of each year.

(A) A description (in nontechnical language) with respect to the benefited individual's interest in the account, annuity, or endowment contract, of:

(1) Each type of charge, and the amount thereof, which may be made against a contribution,

(2) The method for computing and allocating annual earnings, and

(3) Each charge (other than those described in complying with paragraph (d)(4)(vii)(A)(1) of this section) which may be applied to such interest in determining the net amount of money available to the benefited individual and the method of computing each such charge;

(B) A statement that growth in value of the account, annuity, or endowment contract is neither guaranteed nor projected; and

(C) The portion of each $1,000 contribution attributable to the cost of life insurance, which would not be deductible, for every year during which contributions are to be made.

(viii) A disclosure statement, or an amendment thereto, furnished pursuant to the provisions of this subparagraph may contain information in addition to that required by paragraph (d)(4)(iii) through (vii) of this section. However, such disclosure statement will not be considered to comply with the provisions of this subparagraph if the substance of such additional material or the form in which it is presented causes such disclosure statement to be false or misleading with respect to the information required to be disclosed by this paragraph.

(ix) The provisions of section 6693, relating to failure to provide reports on individual retirement accounts or annuities, shall apply to any trustee or issuer who fails to furnish, or cause to be furnished, a disclosure statement, a copy of the governing instrument, or an amendment to either, as required by this paragraph.

(x) This section shall be effective for disclosure statements and copies of governing instruments mailed, or delivered without mailing, after February 14, 1977.

(xi) This section does not reflect the amendments made by section 1501 of the Tax Reform Act of 1976 (90 Stat. 1734) relating to retirement savings for certain married individuals.

[T.D. 7714, 45 FR 52795, Aug. 8, 1980, 45 FR 56802, Aug. 26, 1980]

§ 1.408–7 Reports on distributions from individual retirement plans.

(a) Requirement of report. The trustee of an individual retirement account or the issuer of an individual retirement annuity who makes a distribution during any calendar year to an individual from such account or under such annuity shall make a report on Form W–2P (in the case of distributions that are not total distributions) or Form 1099R (in the case of total distributions), and their related transmittal forms, for such year. The return must show the name and address of the person to whom the distribution was made, the aggregate amount of such distribution, and such other information as is required by the forms.

(b) Amounts subject to this section. The amounts subject to reporting under paragraph (a) include all amounts distributed or made available to which section 408(d) applies.

(c) Time and place for filing. The report required under this section for any calendar year shall be filed after the close of that year and on or before February 28 of the following year with the appropriate Internal Revenue Service Center.

(d) Statement to recipients. (1) Each trustee or issuer required to file Form 1099R or Form W–2P under this section shall furnish to the person whose identifying number is (or should be) shown on the forms a copy of the form.

(2) Each statement required by this paragraph to be furnished to recipients shall be furnished to such person after November 30 of the year of the distribution and on or before January 31 of the following year.

(e) Effective date. This section is effective for calendar years beginning after December 31, 1977.

[T.D. 7714, 45 FR 52798, Aug. 8, 1980]

§ 1.409–1 Retirement bonds.

(a) In general. Section 409 authorizes the issuance of bonds under the Second Liberty Bond Act the purchase price of which would be deductible under section 219. Section 409 also prescribes the tax treatment of such bonds. See paragraph (b) of this section.

(b) Income tax treatment of bonds—(1) General rule. Except as provided in paragraph (b)(2) of this section, the entire proceeds upon redemption of a retirement bond described in section 409(a) shall be included in the gross income of the taxpayer entitled to such proceeds. If a bond has not been tendered for redemption by the registered owner before the close of the taxable year in which he attains age 70½, he must include in his gross income for such taxable year the amount of the proceeds he would have received if the bond had been redeemed at age 70½. The provisions of sections 72 and 1232 do not apply to a retirement bond.

(2) Exceptions. (i) If a retirement bond is redeemed within 12 months after the issue date, the proceeds are excluded from gross income if no deduction is allowed under section 219 on account of the purchase of such bond. For definition of issue date, see 31 CFR 346.1(c).

(ii) If a retirement bond is redeemed after the close of the taxable year in which the registered

owner attains age 70 ½ the proceeds from the redemption of the bond are excludable from the gross income of the registered owner or his beneficiary to the extent that such proceeds were includible in the gross income of the registered owner for such taxable year.

(iii) If a retirement bond is surrendered for reissuance in the same or lesser face amount, the difference between current redemption value of the bond surrendered for reissuance and the current surrender value of the bond reissued is includible in the gross income of the registered owner.

(3) **Basis.** The basis of a retirement bond is zero.

(c) **Rollover.** The first sentence of paragraph (b)(1) of this section shall not apply in any case in which a retirement bond is redeemed by the registered owner before the close of the taxable year in which he attains the age of 70½ if he transfers the entire amount of the proceeds of such redemption to—

(1) An individual retirement account described in section 408(a) or an individual retirement annuity described in section 408(b) (other than an endowment contract described in § 1.408–3(e)), or

(2) An employees' trust which is described in section 401(a) which is exempt from tax under section 501(a), or an annuity plan described in section 403(a), for the benefit of the registered owner, on or before the 60th day after the day on which he received the proceeds of such redemption. This subparagraph shall not apply in the case of a transfer to a trust or plan described in (c)(2) of this section unless no part of the purchase price of the retirement bond redeemed is attributable to any source other than a rollover contribution from such an employees' trust or annuity plan (other than an annuity plan or employees' trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under the plan).

(d) **Additional tax—(1) Early redemption.** Except as provided in paragraph (d)(2) of this section, under section 409(c) if a retirement bond is redeemed by the registered owner before he attains age 59½, his tax under chapter 1 of the Code is increased by an amount equal to 10 percent of the proceeds of the redemption includible in his gross income for the taxable year. Except in the case of the credits allowable under sections 31, 39, or 42, no credit can be used to offset the tax described in the preceding sentence.

(2) **Limitations.** Paragraph (d)(1) of this section shall not apply if—

(i) During the taxable year of the registered owner in which a retirement bond is redeemed, the registered owner becomes disabled within the meaning of section 72(m)(7), or

(ii) A retirement bond is tendered for redemption in accordance with paragraph (b)(2)(i) of this section.

[T.D. 7714, 45 FR 52799, Aug. 8, 1980]

§ 1.410(a)–1 Minimum participation standards; general rules.

(a) **In general.** A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies—

(1) The minimum age and service requirements of section 410(a)(1) and § 1.410(a)–3,

(2) The maximum age requirements of section 410(a)(2) and § 1.410(a)–4, and

(3) The minimum coverage requirements of section 410(b)(1) and § 1.410(b)–1.

(b) **Organization of regulations relating to minimum participation standards—(1) General rules.** This section prescribes general rules relating to the minimum participation standards provided by section 410.

(2) **Effective dates.** Section 1.410(a)–2 provides rules under section 1017 of the Employee Retirement Income Security Act of 1974 relating to effective dates under section 410.

(3) **Age and service conditions.** Section 1.410(a)–3 provides rules under section 410(a)(1) relating to minimum age and service conditions.

(4) **Maximum age and time of participation.** Section 1.410(a)–4 provides rules under section 410(a)(2) and (4) relating to maximum age and time of participation.

(5) **Year of service; breaks in service.** For rules relating to years of service and breaks in service, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans). See § 1.410(a)–5 for rules under section 410(a)(3)(B) relating to seasonal industries and for certain rules under section 410(a)(5) relating to breaks in service.

(6) **Breaks in service.** Section 1.410(a)–6 provides special rules under section 1017(f) of the

Employee Retirement Income Security Act of 1974 relating to amendment of break in service rules.

(7) Elapsed time. Section 1.410(a)–7 provides rules under sections 410 and 411 relating to the elapsed time method of crediting years of service.

(8) Coverage. Section 1.410(b)–1 provides rules relating to the minimum coverage requirements provided by section 410(b)(1).

(9) Church election. Section 1.410(d)–1 provides rules relating to the election by a church to have participation, vesting, funding, etc., provisions apply.

(c) Application of participation standards to certain plans—(1) General rule. Except as provided in subparagraph (2) of this paragraph, section 410 does not apply to—

(i) A governmental plan (within the meaning of section 414(d) and the regulations thereunder),

(ii) A church plan (within the meaning of section 414(e) and the regulations thereunder) which has not made the election provided by section 410(d) and the regulations thereunder,

(iii) A plan which has not provided for employer contributions at any time after September 2, 1974, and

(iv) A plan established and maintained by a society, order, or association described in section 501(c)(8) or (9), if no part of the contributions to or under such plan are made by employers of participants in such plan.

(2) Participation requirements. A plan described in subparagraph (1) of this paragraph shall, for purposes of section 401(a), be treated as meeting the requirements of section 410 if such plan meets the coverage requirements resulting from the application of section 401(a)(3) as in effect on September 1, 1974. Such coverage requirements include the rules in § 1.410(b)–1(d) (special rules relating to minimum coverage requirements), that interpret statutory provisions substantially identical to section 401(a)(3) as in effect on September 1, 1974. In applying the rules of that paragraph (d) to plans described in this paragraph (c) employees whose principal duties consist in supervising the work of other employees shall be treated as officers, shareholders, and highly compensated employees.

(d) Supersession. Sections 11.410(a)–1 through 11.410(d)–1 inclusive, of the Temporary Income Tax Regulation under the Employee Retirement Income Security Act of 1974 are superseded by this section and §§ 1.410(a)–2 through 1.410(d)–1.

[T.D. 7508, 42 FR 47193, Sept. 20, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980; T.D. 7735, 45 FR 74722, Nov. 12, 1980]

§ 1.410(a)–2 Effective dates.

(a) Plans not in existence on January 1, 1974. Under section 1017(a) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was not in existence on January 1, 1974, section 410 and the regulations thereunder apply for plan years beginning after September 2, 1974. See paragraph (c) of this section for time plan considered to be in existence.

(b) Plans in existence on January 1, 1974. Under section 1017(b) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was in existence on January 1, 1974, section 410 and the regulations thereunder apply for plan years beginning after December 31, 1975. See paragraph (c) of this section for time plan considered to be in existence.

(c) Time of plan existence—(1) General rule. For purposes of this section, a plan is considered to be in existence on a particular day if—

(i) The plan on or before that day was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholder), even though no amounts had been contributed under the plan as of such day, and

(ii) The plan was not terminated on or before that day.

(2) Collectively bargained plan. Notwithstanding subparagraph (1) of this paragraph, a plan described in section 413(a), relating to a plan maintained pursuant to a collective bargaining agreement, is considered to be in existence on a particular day if—

(i) On or before that day there is a legally enforceable agreement to establish such a plan signed by the employer, and

(ii) The employer contributions to be made to the plan are set forth in the agreement.

(3) Special rule. If a plan is considered to be in existence on January 1, 1974, under subparagraph (1) of this paragraph, any other plan with which such existing plan is merged or consolidated shall also be considered to be in existence on such date.

(d) Certain existing plans may elect new provisions—(1) In general. The plan administrator (as defined in section 414(g)) of a plan that was in existence on January 1, 1974, may elect to have the provisions of the Code relating to participation, vesting, funding, and form of benefit (as in effect from time to time) apply to a plan year selected by the plan administrator which begins after September 2, 1974, but before the otherwise applicable effective dates determined under section 1017(b) or (c), 1021, or 1024 of the Employee Retirement Income Security Act of 1974, and to all subsequent plan years. The provisions referred to are the amendments to the Code made by sections 1011, 1012, 1013, 1015, 1016(a)(1) through (11) and (13) through (27), 1021, and 1022(b) of the Employee Retirement Income Security Act of 1974.

(2) Election is irrevocable. Any election made under this paragraph, once made shall be irrevocable.

(3) Procedure and time for making election. An election under this paragraph shall be made by attaching a statement to either the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective or to a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and, if trusteed, the exempt status under section 501(a) of the Code of a trust constituting a part of the plan. If the election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter. The statement shall indicate that the election is made under section 1017(d) of the Employee Retirement Income Security Act of 1974 and the first plan year for which the election is effective.

(e) Examples. The rules of this section are illustrated by the following examples:

Example (1). A plan is adopted on January 2, 1974, effective as of January 1, 1974. The plan is not considered to have been in existence on January 1, 1974.

Example (2). A plan was in existence on January 1, 1974, and was amended on November 1, 1974, to increase benefits. The fact that the plan was amended is not relevant and the amended plan is considered to be in existence on January 1, 1974.

Example (3). (i) A subsidiary business corporation is a member of a controlled group of corporations within the meaning of IRC section 1563(a). On November 1, 1974, the plan of the parent corporation is amended to provide coverage for employees of the subsidiary corporation. This amendment of the parent corporation's plan does not affect the effective date of section 410 with respect to the parent corporation's plan. No distinction is made for this purpose between employees of the parent corporation and employees of the subsidiary corporation.

(ii) If the subsidiary adopted a separate plan on November 1, 1974, under paragraph (a) of this section, section 410 would apply to that plan for its first plan year beginning after September 2, 1974. However, the adoption of a different plan by the subsidiary would not affect the time section 410 applies to the plan of the parent corporation. If, instead of adopting its own separate plan, the subsidiary merely executed an adoption agreement under the terms of the parent plan providing that a subsidiary, upon the execution of an adoption agreement, will become part of the parent plan, the effective date of section 410 with respect to such plan will not be affected by the adoption of the plan by the subsidiary.

[T.D. 7508, 42 FR 47194, Sept. 20, 1977]

§ 1.410(a)–3 Minimum age and service conditions.

(a) General rule. Except as provided by paragraph (b) or (c) of this section, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the plan requires, as a condition of participation in the plan, that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of—

(1) Age 25. The date on which the employee attains the age of 25; or

(2) One year of service. The date on which the employee completes 1 year of service.

(b) Special rule for plan with 3-year 100 percent vesting. A plan which provides that after not more than 3 years of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) Age 25. The date on which the employee attains the age of 25; or

(2) Three years of service. The date on which the employee completes 3 years of service.

(c) Special rule for employees of certain educational institutions. A plan maintained exclusively for employees of an educational institution (as defined in section 170(b)(1)(A)(ii)) by an employer exempt from tax under section 501(a) which provides that after 1 year of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder)

at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) Age 30. The date on which the employee attains the age of 30; or

(2) One year of service. The date on which the employee completes 1 year of service.

(d) Other conditions. Section 410(a), § 1.410(a)–4, and this section relate solely to age and service conditions and do not preclude a plan from establishing conditions, other than conditions relating to age or service, which must be satisfied by plan participants. For example, such provisions would not preclude a qualified plan from requiring, as a condition of participation, that an employee be employed within a specified job classification. See section 410(b) and the regulations thereunder for rules with respect to coverage of employees under qualified plans.

(e) Age and service requirements—(1) General rule. For purposes of applying the rules of this section, plan provisions may be treated as imposing age or service requirements even though the provisions do not specifically refer to age or service. Plan provisions which have the effect of requiring an age or service requirement with the employer or employers maintaining the plan will be treated as if they imposed an age or service requirement. In general, a plan under which an employee cannot participate unless he retires will impose an age and service requirement. However, a plan may provide benefits which supplement benefits provided for employees covered under a pension plan, as defined in section 3(2) of the Employee Retirement Income Security Act of 1974, satisfying the requirements of section 410(a)(1) without violating the age and service rules.

(2) Examples. The rules of this paragraph are illustrated by the following examples:

Example (1). Corporation A is divided into two divisions. In order to work in division 2 an employee must first have been employed in division 1 for 5 years. A plan provision which required division 2 employment for participation will be treated as a service requirement because such a provision has the effect of requiring 5 years of service.

Example (2). Plan B requires as a condition of participation that each employee have had a driver's license for 15 years or more. This provision will be treated as an age requirement because such a provision has the effect of requiring an employee to attain a specified age.

Example (3). A plan which requires 1 year of service as a condition of participation also excludes a part-time or seasonal employee if his customary employment is for not more than 20 hours per week or 5 months in any plan year. The plan does not qualify because the provision could result in the exclusion by reason of a minimum service requirement of an employee who has completed a year of service. The plan would not qualify even though after excluding all such employees, the plan satisfied the coverage requirements of section 410(b).

Example (4). Employer A establishes a plan which covers employees after they retire and does not cover current employees unless they retire. Any employee who works past age 60 is treated as retired. The plan fails to satisfy the requirements of section 410(a) because the plan imposes a minimum age and service requirement in excess of that allowed by this section.

Example (5). Employer B establishes plan X, which provides that employees covered by qualified plan Y will receive benefits supplementing their benefits under plan Y to take into account cost of living increases after retirement. Plan X is not treated as imposing an age of service requirement.

Example (6). Employer C establishes a qualified plan satisfying the minimum age and service requirements. At a later time, entry into the plan is frozen so that employees not covered at that time cannot participate in the plan. The limitation on new participants is not treated as imposing a minimum age and service requirement.

[T.D. 7508, 42 FR 47194, Sept. 20, 1977]

§ 1.410(a)–3T Minimum age and service conditions (temporary).

(a) [Reserved]

(b) Special rule for plan with 2-year 100 percent vesting. A plan which provides that after not more than 2 years of service each participant's right to his or her accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues satisfies the requirements of paragraph (a) of this section if the period of service required by the plan as a condition of participation does not extend beyond the later of—

(1) [Reserved]

(2) Two years of service. The date on which the employee competes 2 years of service. For employees not described in § 1.411(a)-3T(e)(1), which describes employees with one hour of service in any plan year beginning after December 31, 1988, or later in the case of certain collectively bargained plans, the preceding sentence shall be applied by substituting "3 years of service" for "2 years of service".

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(a)–4 Maximum age conditions and time of participation.

(a) Maximum age conditions—(1) General rule. A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the plan excludes from participation (on the basis of

age) an employee who has attained an age specified by the plan unless—

(i) The plan is a defined benefit plan or a target benefit plan, and

(ii) The employee begins employment with the employer after the employee has attained an age specified by the plan, which age is not more than 5 years before normal retirement age (within the meaning of section 411(a)(8) and § 1.411(a)–7).

For purposes of this paragraph, a target benefit plan is a defined contribution plan under which the amount of employer contributions allocated to each participant is determined under a plan formula which does not allow employer discretion and on the basis of the amount necessary to provide a target benefit specified by the plan for such participant. Such target benefit must be the type of benefit which is provided by a defined benefit plan and the targeted benefit must not discriminate in favor of employees who are officers, shareholders, or highly compensated. For purposes of this paragraph, in the determination of the time an employee begins employment, any such time which is included in a period of service which may be disregarded under the break in service rules need not be taken into account.

(2) **Examples.** The rules provided by this paragraph are illustrated by the following examples:

Example (1). A defined benefit plan provides that an employee will become a participant upon completion of 3 years of service if at such time the employee is less than age 60. The normal retirement age under the plan is age 65. The plan also provides full and immediate vesting for each of the plan's participants. Under the plan, an employee hired at age 58 would be denied participation on account of service for the first 3 years and on account of maximum age for the remaining years even though the employee was hired more than 5 years prior to the normal retirement date. The plan therefore does not satisfy section 410(a)(2).

Example (2). A defined benefit plan provides a normal retirement age of the later of age 65 or completion of 10 years of service. Because no employee could ever be hired within 5 years of his normal retirement age, the plan could not exclude employees for being over a specified age.

Example (3). Prior to the effective date of section 410, a defined benefit plan with a normal retirement age of 65 contained a maximum age 55 requirement for participation. Because of the maximum age requirement, an employee hired at age 58 was excluded from the plan. This employee is age 61 at the time that section 410 first applies to the plan. The employee cannot be excluded from participation because of age. The exclusion under section 410(a)(2) is not applicable in this instance because the employee's age at the time of hire, 58, was not within 5 years of the normal retirement age specified in the plan.

Example (4). Employee A was hired at age 50 and participated in a defined benefit plan until separating from service at age 55 with 5 years of service and with no vested benefit. At age 61, employee A was rehired within 5 years of the normal retirement age of 65 after he incurred 6 consecutive breaks in service. Because A's consecutive number of 1-year breaks (6) exceeds his years of service prior to such breaks (5), his service before the breaks may be disregarded. Consequently, A's initial employment date falling within such period may be disregarded and the plan could exclude A on account of his age because his employment commenced within 5 years of normal retirement age.

(b) **Time of participation—(1) General rule.** A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless under the plan any employee who has satisfied the applicable minimum age and service requirements specified in § 1.410(a)–3, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(i) The first day of the first plan year beginning after the date on which such employee first satisfied such requirements, or

(ii) The date 6 months after the date on which he first satisfied such requirements,

unless such employee was separated from service and has not returned before the date referred to in subdivision (i) or (ii), whichever is applicable. If such separated employee returns to service after either of such dates without incurring a 1–year break in service, the employee must commence participation immediately upon his return. In the case of a plan using the elapsed time method described in § 1.410(a)–7, such an employee who has a period of absence commencing before the date referred to in subdivision (i) or (ii) (whichever is applicable) must commence participation as of such applicable date no later than the date such absence ended. However, if an employee's prior service is disregarded on account of the plan's break–in–service rules then, for purposes of this subparagraph, such service is also disregarded for purposes of determining the date on which such employee first satisfied the minimum age and service requirements.

(2) **Examples.** The rules provided by this paragraph are illustrated by the following examples:

Example (1). A calendar year plan provides that an employee may enter the plan only on the first semi-annual entry date, January 1 or July 1, after he has satisfied the applicable minimum age and service requirements specified in section 410(a)(1). The plan satisfies the requirements of this paragraph because an employee is eligible to participate no later than the earlier of (1) the first day of the first plan year beginning after he satisfied the applicable minimum age and service requirements, or (2) the date 6 months after he satisfied such requirements.

Example (2). A plan provides that an employee is not eligible to participate until the first day of the first plan year beginning after he has satisfied the minimum age and service requirements of section 410(a)(1). In this case, an employee

who satisfies the "6 month" rule described in subparagraph (1) of this paragraph will not be eligible to participate in the plan. Therefore, the plan does not satisfy the requirements of this paragraph.

Example (3). A calendar year plan provides that an employee may enter the plan only on the first semi-annual entry date, January 1 or July 1, after he has satisfied the applicable minimum age and service requirements specified in section 410(a)(1). Employee A after 10 years of service separated from service in 1976 with a vested benefit. On February 1, 1990, A returns to employment covered by the plan. Assuming A completes a year of service after his return, A must participate immediately on his return, February 1. A's prior service cannot be disregarded, because he had a vested benefit when he separated from service. Therefore, the plan may not postpone his participation until July 1.

Example (4). Assume the same facts as in example (3). The plan has the break-in-service rule described in section 410(a)(5)(D) and § 1.410(a)–5(c)(4). Employee B, after he had 5 years of service but no vested benefit incurs 5 consecutive 1-year breaks. Because B's prior service can be disregarded, the plan may postpone B's participation in the plan under the rule described in section 410(a)(4) and this paragraph.

[T.D. 7508, 42 FR 47195, Sept. 20, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980]

§ 1.410(a)–5 Year of service; break in service.

(a) Year of service. For the rules relating to years of service under subparagraphs (A), (C), and (D) of section 410(a)(3), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

Rules relating to a general rule for a year of service, hours of service, and maritime industries apply for purposes of section 410(a) and the regulations thereunder.

(b) Seasonal industries. For rules which relate to seasonal industries under section 410(a)(3)(B), see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefits plans.

(c) Breaks in service—(1) General rule. This paragraph provides rules with respect to breaks in service under section 410(a)(5). Except as provided in subparagraphs (2), (3), (4), and (5) of this paragraph, all of an employee's years of service with the employer or employers maintaining a plan are taken into account in computing his period of service under the plan for purposes of section 410(a)(1) and § 1.410(a)–3.

(2) Employees under 3-year 100 percent vesting schedule—(i) General rule. In the case of an employee who incurs a 1-year break in service under a plan which provides that after not more than 3 years of service, each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues, the employee's service before the break in service is not required to be taken into account after the break in service in determining the employee's years of service under section 410(a)(1) and § 1.410(a)–3 if such employee has not satisfied such service requirement.

(ii) Example. The rules of this subparagraph are illustrated by the following example.

Example. A qualified plan computing service by the actual counting of hours provides full and immediate vesting. The plan can not require as a condition of participation that an employee complete 3 consecutive years of service with the employer because the requirement as to consecutive years is not permitted under section 410(a)(5). However, such a plan can require 3 years without a break in service, *i.e.*, 3 years with no intervening years in which the employee fails to complete more than 500 hours of service. Under a plan containing such a participation requirement, the following example illustrates when employees would become eligible to participate.

Year	Hours of service completed: Employee A	Employee B	Employee C
1	1,000	1,000	1,000
2	1,000	1,000	500
3	1,000	700	1,000
4	1,000	1,000	700
5	1,000	1,000	1,000
6	1,000	1,000	1,000

Note.—Employee A will have satisfied the plan's service requirement at the end of year 3. Employee B at the end of year 4, and Employee C at the end of year 6.

(3) One-year break in service—(i) In general. In computing the period of service of an employee who has incurred a 1-year break in service, for purposes of section 410(a)(1) and § 1.410(a)–3, a plan may disregard the employee's service before the break until the employee completes a year of service after such break in service.

(ii) Examples. The rules provided by this subparagraph are illustrated by the following examples.

Example (1). Employee A completes a year of service under a plan computing service by the actual counting of hours for the 12-month period ending December 31, 1980, and incurs a 1-year break in service for the 12-month period ending December 31, 1981. The plan does not contain the provisions permitted by section 410(a)(5)(B) (relating to 3-year 100 percent vesting) and section 410(a)(5)(D) (relating to nonvested participants). Thereafter, he does not complete a year of service. As of January 1, 1982, in computing his period of service under the plan his service prior to December 31, 1981, is not required to be taken into account for purposes of section 410(a)(1) and § 1.410(a)–3.

Example (2). The employee in example (1) completes a year of service for the 12-month period ending December 31, 1982. Prior to December 31, 1982, in computing the employee's period of service as of any date occurring in 1982, the employ-

ee's service before December 31, 1981, is not required to be taken into account for purposes of section 410(a)(1) and § 1.410(a)-3. Because the employee completed a year of service for the 12-month period ending December 31, 1982, however, his period of service is redetermined as of January 1, 1982. Upon completion of a year of service for 1982, the employee's period of service, determined as of any date occurring in 1982, includes service prior to December 31, 1981.

(4) Nonvested participants—(i) General rule. In the case of a participant in a plan who does not have any nonforfeitable right under the plan to his employer-derived accrued benefit and who incurs a 1-year break in service, for purposes of section 410(a)(1) and § 1.410(a)-3 the plan may disregard his years of service prior to such break if the number of his consecutive 1-year breaks in service equals or exceeds his aggregate number of years of service prior to such break. In the case of a plan using the elapsed time method described in Department of Labor regulations, the plan may disregard such years of service prior to such break if the period of severance is at least 1 year and the period of severance equals or exceeds the prior period of service, whether or not consecutive, completed before such period of severance. The plan may in computing such aggregate number of years of service prior to such break disregard any years of service which could have been disregarded under this subparagraph by reason of any prior break in service.

(ii) Examples. The rules of this subparagraph are illustrated by the following example:

Example. In 1980, A, who was hired at age 35, separates from the service of X Corporation after completing 4 years of service. At this time A had no vested benefits. In 1985, after incurring 5 consecutive one-year breaks in service, A was reemployed. Under section 410(a)(5)(D), A's 4 years of service may be disregarded because they are exceeded by the number of years of consecutive one-year breaks (5) after such service.

(d) Special continuity rule for certain plans. For special rules for computing years of service in the case of a plan maintained by more than one employer, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

[T.D. 7508, 42 FR 47196, Sept. 20, 1977; T.D. 7508, 42 FR 57123, Nov. 1, 1977, as amended by T.D. 7703, 45 FR 40980, June 17, 1980]

§ 1.410(a)-6 Amendment of break in service rules; transition period.

(a) In general. Under section 1017(f)(1) of the Employee Retirement Income Security Act of 1974, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the rules of the plan relating to breaks in service are amended, and—

(1) Such amendment is effective after January 1, 1974, and before the date on which section 410 becomes applicable to the plan, and

(2) Under such amendment, any employee's participation in the plan commences at any date later than the later of—

(i) The date on which his participation would commence under the break in service rules of section 410(a)(5), or

(ii) The earliest date on which his participation would commence under the plan as in effect on or after January 1, 1974.

(b) Break in service rules. For purposes of paragraph (a), the term "break in service rules" means the rules provided by a plan relating to circumstances under which a period of an employee's service or plan participation is disregarded for purposes of determining his rights to participate in the plan, if under such rules such service is disregarded by reason of the employee's failure to complete a required period of service within a specified period of time.

[T.D. 7508, 42 FR 47197, Sept. 20, 1977; 43 FR 2721, Jan. 19, 1978]

§ 1.410(a)-7 Elapsed time.

(a) In general—(1) Introduction to elapsed time method of crediting service. (i) 29 CFR 2530.-200b-2 sets forth the general method of crediting service for an employee. The general method is based upon the actual counting of hours of service during the applicable 12-consecutive-month computation period. The equivalencies set forth in 29 CFR 2530.200b-3 are also methods for crediting hours of service during computation periods. Under the general method and the equivalencies an employee receives a year's credit (in units of years of service or years of participation) for a computation period during which the employee is credited with a specified number of hours of service. In general, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is determined by totalling the number of years' credit to which an employee is entitled.

(ii) Under the alternative method set forth in this section, by contrast, an employee's statutory entitlement with respect to eligibility to participate, vesting and benefit accrual is not based upon the actual completion of a specified number of hours of service during a 12-consecutive-month

period. Instead, such entitlement is determined generally with reference to the total period of time which elapses while the employee is employed (*i.e.*, while the employment relationship exists) with the employer or employers maintaining the plan. The alternative method set forth in this section is designed to enable a plan to lessen the administrative burdens associated with the maintenance of records of an employee's hours of service by permitting each employee to be credited with his or her total period of service with the employer or employers maintaining the plan, irrespective of the actual hours of service completed in any 12-consecutive-month period.

(2) **Overview of the operation of the elapsed time method.** (i) Under the elapsed time method of crediting service, a plan is generally required to take into account the period of time which elapses while the employee is employed (*i.e.*, while the employment relationship exists) with the employer or employers maintaining the plan, regardless of the actual number of hours he or she completes during such period. Under this alternative method of crediting service, an employee's service is required to be taken into account for purposes of eligibility to participate and vesting as of the date he or she first performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan. Service is required to be taken into account for the period of time from the date the employee first performs such an hour of service until the date he or she severs from service with the employer or employers maintaining the plan.

(ii) The date the employee severs from service is the earlier of the date the employee quits, is discharged, retires or dies, or the first anniversary of the date the employee is absent from service for any other reason (*e.g.*, disability, vacation, leave of absence, layoff, etc.). Thus, for example, if an employee quits, the severance from service date is the date the employee quits. On the other hand, if an employee is granted a leave of absence (and if no intervening event occurs), the severance from service date will occur one year after the date the employee was first absent on leave, and this one year of absence is required to be taken into account as service for the employer or employers maintaining the plan. Because the severance from service date occurs on the earlier of two possible dates (*i.e.*, quit, discharge, retirement or death *or* the first anniversary of an absence from service for any other reason), a quit, discharge, retirement or death within the year after the beginning of an absence for any other reason results in an immediate severance from service. Thus, for example, if an employee dies at the end of a four-week absence resulting from illness, the severance from service date is the date of death, rather than the first anniversary date of the first day of absence for illness.

(iii) In addition, for purposes of eligibility to participate and vesting under the elapsed time method of crediting service, an employee who has severed from service by reason of a quit, discharge or retirement may be entitled to have a period of time of 12 months or less taken into account by the employer or employers maintaining the plan if the employee returns to service within a certain period of time and performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1). In general, the period of time during which the employee must return to service begins on the date the employee severs from service as a result of a quit, discharge or retirement and ends on the first anniversary of such date. However, if the employee is absent for any other reason (*e.g.*, layoff) and then quits, is discharged or retires, the period of time during which the employee may return and receive credit begins on the severance from service date and ends one year after the first day of absence (*e.g.*, first day of layoff). As a result of the operation of these rules, a severance from service (*e.g.*, a quit), or an absence (*e.g.*, layoff) followed by a severance from service, never results in a period of time of more than one year being required to be taken into account after an employee severs from service or is absent from service.

(iv) For purposes of benefit accrual under the elapsed time method of crediting service, an employee is entitled to have his or her service taken into account from the date he or she begins to participate in the plan until the severance from service date. Periods of severance under any circumstances are not required to be taken into account. For example, a participant who is discharged on December 14, 1980 and rehired on October 14, 1981 is not required to be credited with the 10 month period of severance for benefit accrual purposes.

(3) **Overview of certain concepts relating to the elapsed time method—(i) In general.** The rules with respect to the elapsed time method of crediting service are based on certain concepts which are defined in paragraph (b) of this section. These concepts are applied in the substantive rules contained in paragraphs (c), (d), (e), (f) and (g) of this section. The purpose of this subparagraph is to summarize these concepts.

(ii) Employment commencement date. (A) A concept which is necessary in order to credit service accurately under any service crediting method is the establishment of a starting point for crediting service. The employment commencement date, which is the date on which an employee first performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan, is used to establish the date upon which an employee must begin to receive credit for certain purposes (*e.g.*, eligibility to participate and vesting).

(B) In order to credit accurately an employee's total service with an employer or employers maintaining the plan, a plan also may provide for an "adjusted" employment commencement date (*i.e.*, a recalculation of the employment commencement date to reflect noncreditable periods of severance) or a reemployment commencement date as defined in paragraph (b)(3) of this section. Fundamentally, all three concepts rely upon the performance of an hour of service to provide a starting point for crediting service. One purpose of these three concepts is to enable plans to satisfy the requirements of this section in a variety of ways.

(C) The fundamental rule with respect to these concepts is that any plan provision is permissible so long as it satisfies the minimum standards. Thus, for example, although the rules of this section provide that credit must begin on the employment commencement date, a plan is permitted to "adjust" the employment commencement date to reflect periods of time for which service is not required to be credited. Similarly, a plan may wish to credit service under the elapsed time method as discrete periods of service and provide for a reemployment commencement date. Certain plans may wish to provide for both concepts, although it is not a requirement of this section that plans so provide.

(iii) Severance from service date. Another fundamental concept of the elapsed time method of crediting service is the severance from service date, which is defined as the earlier of the date on which an employee quits, retires, is discharged or dies, or the first anniversary of the first date of absence for any other reason. One purpose of the severance from service date is to provide the endpoint for crediting service under the elapsed time method. As a general proposition, service is credited from the employment commencement date (*i.e.*, the starting point) until the severance from service date (*i.e.*, the endpoint). A complementary purpose of the severance from service date is to establish the starting point for measuring a period of severance from service in order to determine a "break in service" (see paragraph (a)(3)(v) of this section). A third purpose of such date is to establish the starting point for measuring the period of time which may be required to be taken into account under the service spanning rules (see paragraph (a)(3)(vi) of this section).

(iv) Period of service. A third elapsed time concept is the use of the "period of service" rather than the "year of service" in determining service to be taken into account for purposes of eligibility to participate, vesting and benefit accrual. For purposes of eligibility to participate and vesting, the period of service runs from the employment commencement date or reemployment commencement date until the severance from service date. For purposes of benefit accrual, a period of service runs from the date that a participant commences participation under the plan until the severance from service date. Because the endpoint of the period of service is marked by the severance from service date, an employee is credited with the period of time which runs during any absence from service (other than for reason of a quit, retirement, discharge or death) which is 12 months or less. Thus, for example, a three week absence for vacation is taken into account as part of a period of service and does not trigger a severance from service date.

(v) Period of severance. A period of severance begins on the severance from service date and ends when an employee returns to service with the employer or employers maintaining the plan. The purpose of the period of severance is to apply the statutory "break in service" rules to an elapsed time method of crediting service.

(vi) Service spanning. Under the elapsed time method of crediting service, a plan is required to credit periods of service and, under the service spanning rules, certain periods of severance of 12 months or less for purposes of eligibility to participate and vesting. Under the first service spanning rule, if an employee severs from service as a result of quit, discharge or retirement and then returns to service within 12 months, the period of severance is required to be taken into account. Also, a situation may arise in which an employee is absent from service for any reason other than quit, discharge, retirement or death and during the absence a quit, discharge or retirement occurs. The second service spanning rule provides in that set of circumstances that a plan is required to take into account the period of time between the severance from service date (*i.e.*, the date of quit, discharge or retirement) and the first anniversary

of the date on which the employee was first absent, if the employee returns to service on or before such first anniversary date.

(4) Organization and applicability. (i) The substantive rules for crediting service under the elapsed time method with respect to eligibility to participate are contained in paragraph (c), the rules with respect to vesting are contained in subparagraph (d), and the rules with respect to benefit accrual are contained in paragraph (e). The format of the rules is designed to enable a plan to use the elapsed time method of crediting service either for all purposes or for any one or combination of purposes under sections 410 and 411. Thus, for example, a plan may credit service for eligibility to participate purposes by the use of the general method of crediting service set forth in 29 CFR 2530.200b–2 or by the use of any of the equivalencies set forth in 29 CFR 2530.200b–3, while the plan may credit service for vesting and benefit accrual purposes by the use of the elapsed time method of crediting service.

(ii) A plan using the elapsed time method of crediting service for one or more classifications of employees covered under the plan may use the general method of crediting service set forth in 29 CFR 2530.200b–2 or any of the equivalencies set forth in 29 CFR 2530.200b–3 for other classifications of employees, provided that such classifications are reasonable and are consistently applied. Thus, for example, a plan may provide that part-time employees are credited under the general method of crediting service set forth in 29 CFR 2530.200b–2 and full-time employees are credited under the elapsed time method. A classification, however, will not be deemed to be reasonable or consistently applied if such classification is designed with an intent to preclude an employee or employees from attaining his or her statutory entitlement with respect to eligibility to participate, vesting or benefit accrual. For example, a classification applied so that any full-time employee credited with less than 1,000 hours of service during a given 12-consecutive-month period would be considered part-time and subject to the general method of crediting service rather than the elapsed time method would not be reasonable.

(iii) Notwithstanding paragraph (a)(4)(i) and (ii) of this section, the use of the elapsed time method for some purposes or the use of the elapsed time method for some employees may, under certain circumstances, result in discrimination prohibited under section 401(a)(4), even though the use of the elapsed time method for such purposes, and for such employees, is permitted under this section.

(5) More than one employer plans. For special rules for computing years of service in the case of a plan maintained by more than one employer, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(b) Definitions—(1) Employment commencement date. For purposes of this section, the term "employment commencement date" shall mean the date on which the employee first performs an hour of service within the meaning of 29 CFR 2530.-200b–2(a)(1) for the employer or employers maintaining the plan.

(2) Severance from service date. For purposes of this section, a "severance from service" shall occur on the earlier of—

(i) The date on which an employee quits, retires, is discharged or dies; or

(ii) The first anniversary of the first date of a period in which an employee remains absent from service (with or without pay) with the employer or employers maintaining the plan for any reason other than a quit, retirement, discharge or death, such as vacation, holiday, sickness, disability, leave of absence or layoff.

(3) Reemployment commencement date. For purposes of this section, the term "reemployment commencement date" shall mean the first date, following a period of severance from service which is not required to be taken into account under the service spanning rules in paragraphs (c)(2)(iii) and (d)(1)(iii) of this section, on which the employee performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan.

(4) Participation commencement date. For purposes of this section, the term "participation commencement date" shall mean the date a participant first commences participation under the plan.

(5) Period of severance. For purposes of this section, the term "period of severance" shall mean the period of time commencing on the severance from service date and ending on the date on which the employee again performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for an employer or employers maintaining the plan.

(6) Period of service—(i) General rule. For purposes of this section, the term "period of ser-

vice" shall mean a period of service commencing on the employee's employment commencement date or reemployment commencement date, whichever is applicable, and ending on the severance from service date.

(ii) **Aggregation rule.** Unless a plan provides in some manner for an "adjusted" employment commencement date or similar method of consolidating periods of service, periods of service shall be aggregated unless such periods may be disregarded under section 410(a)(5) or 411(a)(4).

(iii) **Other federal law.** Nothing in this section shall be construed to alter, amend, modify, invalidate, impair or supersede any law of the United States or any rule or regulation issued under such law. Thus, for example, nothing in this section shall be construed as denying an employee credit for a "period of service" if credit is required by a separate federal law. Furthermore, the nature and extent of such credit shall be determined under such law.

(c) **Eligibility to participate—(1) General rule.** For purposes of section 410(a)(1)(A), a plan generally may not require as a condition of participation in the plan that an employee complete a period of service with the employer or employers maintaining the plan extending beyond the later of—

(i) The date on which the employee attains the age of 25; or

(ii) The date on which the employee completes a one–year period of service. See the regulations under section 410(a) (relating to eligibility to participate).

(2) **Determination of one-year period of service.** (i) For purposes of determining the date on which an employee satisfies the service requirement for initial eligibility to participate under the plan, a plan using the elapsed time method of crediting service shall provide that an employee who completes the 1-year period of service requirement on the first anniversary of his employment commencement date satisfies the minimum service requirement as of such date. In the case of an employee who fails to complete a one-year period of service on the first anniversary of his employment commencement date, a plan which does not contain a provision permitted by section 410(a)(5)(D) (rule of parity) shall provide for the aggregation of periods of service so that a one-year period of service shall be completed as of the date the employee completes 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service.

(ii) For purposes of section 410(a)(1)(B)(i), a "3-year period of service" shall be deemed to be "3 years of service."

(iii) **Service spanning rules.** In determining a 1-year period of service for purposes of initial eligibility to participate and a period of service for purposes of retention of eligibility to participate, in addition to taking into account an employee's period of service, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Notwithstanding paragraph (c)(2)(iii)(A) of this section, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit, discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's retention of eligibility to participate in the plan, a plan shall take into account an employee's entire period of service unless certain periods of service may be disregarded under section 410(a)(5) of the Code.

(v) **Example.** Employee W, age 31, completed 6 months of service and was laid off. After 2 months of layoff, W quit. Five months later, W returned to service. For purposes of eligibility to participate, W was required to be credited with 13 months of service (8 months of service and 5 months of severance). If, on the other hand, W had not returned to service within the first 10 months of severance (*i.e.*, within 12 months after the first day of layoff), W would be required to be credited with only 8 months of service.

(3) **Entry date requirements—(i) General rule.** For purposes of section 410(a)(4), it is necessary for a plan to provide that any employee who has satisfied the minimum age and service requirements, and who is otherwise entitled to participate in the plan, commences participation in the plan no later than the earlier of—

(A) The first day of the first plan year beginning after the date on which such employee satisfied such requirements, or

(B) The date six months after the date on which he satisfied such requirements, unless such employee was separated from service before the date referred to in subdivision (i)(A) or (B), whichever is applicable. See the regulations under section 410(a) (relating to eligibility to participate).

(ii) Separation from service—(A) Definition. For purposes of this section, the term "separated from service" includes a severance from service or an absence from service for any reason other than a quit, discharge, retirement or death, regardless of the duration of such absence. Accordingly, if an employee is laid off for a period of six weeks, the employee shall be deemed to be "separated from service" during such period for purposes of the entry date requirements.

(B) Application. A period of severance which is taken into account under the service spanning rules in paragraph (c)(2)(iii) of this section or an absence of 12 months or less may result in an employee satisfying the plan's minimum service requirement during such period of time. In addition, once an employee satisfies the plan's minimum service requirement, either before or during such period of time, such period of time may contain an entry date applicable to such employee. In the case of an employee whose period of severance is taken into account and such period contains an entry date applicable to the employee, he or she shall be made a participant in the plan (if otherwise eligible) no later than the date on which he or she ended the period of severance. In the case of an employee whose period of absence contains an entry date applicable to such employee, he or she, no later than the date such absence ended, shall be made a participant in the plan (if otherwise eligible) as of the first applicable entry date which occurred during such absence from service.

(iii) Examples. For purposes of the following examples, assume that the plan provides for a minimum age requirement of 25 and a minimum service requirement of one year, and provides for semi-annual entry dates.

(A) Employee A, age 35, worked for 10 months in a job classification covered under the plan, became disabled for nine consecutive months and then returned to service. During the period of absence, A completed a 1-year period of service and passed a semi-annual entry date after satisfying the minimum service requirement. Accordingly, the plan is required to make A a participant no later than his return to service effective as of the applicable entry date.

(B) Employee B, after satisfying the minimum age and service requirements, quit work before the next semi-annual entry date, and then returned to service before incurring a 1-year period of severance, but after such semi-annual entry date. Employee B is entitled to become a participant immediately upon his return to service effective as of the date of his return.

(4) Break in service. For purposes of applying the break in service rules under section 410(a)(5)(B) and (C), the term "1-year period of severance" shall be substituted for the term "1-year break in service". A 1-year period of severance shall be determined on the basis of a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period does not perform an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for the employer or employers maintaining the plan.

(5) One-year hold-out—(i) General rule. (A) For purposes of section 410(a)(5)(C), in determining the period of service of an employee who has incurred a 1-year period of severance, a plan may disregard the employee's period of service before such period of severance until the employee completes a 1-year period of service after such period of severance.

(B) Example. Assume that a plan provides for a minimum service requirement of 1-year and provides for semi-annual entry dates, but does not contain the provisions permitted by section 410(a)(5)(D) (relating to the rule of parity). Employee G, age 40, completed a seven-month period of service, quit and then returned to service 15 months later, thereby incurring a 1-year period of severance. After working four months, G was laid off for nine months and then returned to work again. Although the plan may hold employee G out from participation in the plan until the completion of a 1-year period of service after the 1-year (or greater) period of severance, once the 1-year hold-out is completed, the plan is required to provide the employee with such statutory entitlement as arose during the 1-year hold-out. Accordingly, employee G satisfied the 1-year hold-out requirement as of the eighth month of layoff, and G is entitled to become a participant in the plan immediately upon his return to service after the nine-month layoff effective as of the first appli-

cable entry date occurring after the date on which he satisfied the 1-year of service requirement (*i.e.*, the first applicable entry date after the first month of layoff). See the regulations under section 410(a) (relating to eligibility to participate).

(6) Rule of parity—(i) General rule. For purposes of section 410(a)(5)(D), in the case of a participant who does not have any nonforfeitable right under the plan to his accrued benefit derived from employer contributions and who incurs a 1-year period of severance, a plan, in determining an employee's period of service for purposes of section 410(a)(1), may disregard his period of service if his latest period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 410(a) (relating to eligibility to participate).

(ii) In determining whether a completely nonvested employee's service may be disregarded under the rule of parity, a plan is not permitted to apply the rule until the employee incurs a 1-year period of severance. Accordingly, a plan may not disregard a period of service of less than one year until an employee has incurred a period of severance of at least one year.

(iii) **Example.** Assume that a plan provides for a minimum service requirement of one year and provides for the rule of parity. An employee works for three months, quits and then is rehired 10 months later. Such employee is entitled to receive 13 months of credit for purposes of eligibility to participate and vesting (see the service spanning rules). Although the period of severance exceeded the period of service, the three months of service may not be disregarded because no 1-year period of severance occurred.

(d) Vesting—(1) General rule. (i) For purposes of section 411(a)(2), relating to vesting in accrued benefits derived from employer contributions, a plan which determines service to be taken in account on the basis of elapsed time shall provide that an employee is credited with a number of years of service equal to at least the number of whole years of the employee's period of service, whether or not such periods of service were completed consecutively.

(ii) In order to determine the number of whole years of an employee's period of service, a plan shall provide that non-successive periods of service must be aggregated and that less than whole year periods of service (whether or not consecutive) must be aggregated on the basis that 12 months of service (30 days are deemed to be a month in the case of the aggregation of fractional months) or 365 days of service equal a whole year of service.

(iii) **Service spanning rules.** In determining a participant's period of service for vesting purposes, a plan shall take into account the following periods of severance—

(A) If an employee severs from service by reason of a quit, discharge or retirement and the employee then performs an hour of service within the meaning of 29 CFR 2530.200b-2(a)(1) within 12 months of the severance from service date, the plan is required to take into account the period of severance; and

(B) Notwithstanding paragraph (d)(1)(iii)(A) of this section, if an employee severs from service by reason of a quit, discharge or retirement during an absence from service of 12 months or less for any reason other than a quit, discharge, retirement or death, and then performs an hour of service within the meaning of 29 CFR 2530.200b-2(a)(1) within 12 months of the date on which the employee was first absent from service, the plan is required to take into account the period of severance.

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory five to fifteen year graded vesting, an employee with a period (or periods) of service which yield 5 whole year periods of service and an additional 321-day period of service is twenty-five percent vested in his or her employer-derived accrued benefits (based solely on the 5 whole year periods of service).

(2) Service which may be disregarded. (i) For purposes of section 411(a)(4), in determining the nonforfeitable percentage of an employee's right to his or her accrued benefits derived from employer contributions, all of an employee's period or periods of service with an employer or employers maintaining the plan shall be taken into account unless such service may be disregarded under paragraph (d)(2)(ii) of this section.

(ii) For purposes of paragraph (d)(2)(i) of this section, the following periods of service may be disregarded—

(A) The period of service completed by an employee before the date on which he attains age 22;

(B) In the case of a plan which requires mandatory employee contributions, the period of service which falls within the period of time to which a particular employee contribution relates, if the employee had the opportunity to make a contribution for such period of time and failed to do so;

(C) The period of service during any period for which the employer did not maintain the plan or a predecessor plan;

(D) The period of service which is not required to be taken into account by reason of a period of severance which constitutes a break in service within the meaning of paragraph (d)(4) of this section;

(E) The period of service completed by an employee prior to January 1, 1971, unless the employee completes a period of service of at least 3 years at any time after December 31, 1970; and

(F) The period of service completed before the first plan year for which this section applies to the plan, if such service would have been disregarded under the plan rules relating to breaks in service in effect at that time. See the regulations under section 411(a) (relating to vesting).

(3) Seasonal industry. [Reserved.]

(4) Break in service. For purposes of applying the break in service rules, the term "1-year period of severance" shall be substituted for the term "1-year break in service". A 1-year period of severance shall be a 12-consecutive-month period beginning on the severance from service date and ending on the first anniversary of such date, provided that the employee during such 12-consecutive-month period fails to perform an hour of service within the meaning of 29 CFR 2530.200b–2(a)(1) for an employer or employers maintaining the plan.

(5) One-year hold-out. For purposes of section 411(a)(6)(B), in determining the nonforfeitable percentage of the right to accrued benefits derived from employer contributions of an employee who has incurred a 1-year period of severance, the period of service completed before such period of severance is not required to be taken into account until the employee has completed a 1-year period of service after his return to service. See the regulations under section 411(a) (relating to vesting).

(6) Vesting in pre-break accruals. For purposes of section 411(a)(6)(C), a "1-year period of severance" shall be deemed to constitute a "1-year break in service." See the regulations under section 411(a) (relating to vesting).

(7) Rule of parity—(i) General rule. For purposes of section 411(a)(6)(D), in the case of an employee who is a nonvested participant in employer-derived benefits at the time he incurs a 1-year period of severance, the period of service completed by such participant before such period of severance is not required to be taken into account for purposes of determining the vested percentage of his or her right to employer-derived benefits if at such time the consecutive period of severance equals or exceeds his prior periods of service, whether or not consecutive, completed before such period of severance. See the regulations under section 411(a) (relating to vesting).

(e) Benefit accrual. (1) For purposes of section 411(b), a plan may provide that a participant's service with an employer or employers maintaining the plan shall be determined on the basis of the participant's total period of service beginning on the participation commencement date and ending on the severance from service date.

(2) Under section 411(b)(3)(A), a defined benefit pension plan may determine an employee's service for purposes of benefit accrual on any basis which is reasonable and consistent and which takes into account all service during the employee's participation in the plan which is included in a period of service required to be taken into account under section 410(a)(5) (relating to service which must be taken into account for purposes of determining an employee's eligibility to participate). A plan which provides for the determination of an employee's service with an employer or employers maintaining the plan on the basis permitted under paragraph (e)(1) of this section will be deemed to meet the requirements of section 411(b)(3)(A), provided that the plan meets the requirements of 29 CFR 2530.204–3, relating to plans which determine an employee's service for purposes of benefit accrual on a basis other than computation periods. Specifically, under 29 CFR 2530.204–3, it must be possible to prove that, despite the fact that benefit accrual under such a plan is not based on computation periods, the plan's provisions meet at least one of the three benefit accrual rules of section 411(b)(1) under all circumstances. Further, 29 CFR 2530.204–3 prohibits such a plan from disregarding service under section 411(b)(3)(C) (which would otherwise permit a plan to disregard service performed by an employee during a computation period in which the employee is credited with less than 1,000 hours). See the regulations under section 411(b) (relating to benefit accrual).

(f) Transfers between methods of crediting service—(1) Single plan. A plan may provide that an employee's service for purposes of eligibility to participate, vesting or benefit accrual shall be determined on the basis of computation periods under the general method set forth in 29 CFR 2530.200b–2 for certain classes of employees but under the alternative method permitted under this section for other classes of employees if the plan provides as follows—

(i) In the case of an employee who transfers from a class of employees whose service is determined on the basis of computation periods to a class of employees whose service is determined on the alternative basis permitted under this section, the employee shall receive credit for a period of service consisting of—

(A) A number of years equal to the number of years of service credited to the employee before the computation period during which the transfer occurs; and

(B) The greater of (1) the period of service that would be credited to the employee under the elapsed time method for his service during the entire computation period in which the transfer occurs or (2) the service taken into account under the computation periods method as of the date of the transfer.

In addition, the employee shall receive credit for service subsequent to the transfer commencing on the day after the last day of the computation period in which the transfer occurs.

(ii) In the case of an employee who transfers from a class of employees whose service is determined on the alternative basis permitted under this section to a class of employees whose service is determined on the basis of computation periods—

(A) The employee shall receive credit, as of the date of the transfer, for a number of years of service equal to the number of 1-year periods of service credited to the employee as of the date of the transfer, and

(B) The employee shall receive credit, in the computation period which includes the date of the transfer, for a number of hours of service determined by applying one of the equivalencies set forth in 29 CFR 2530.200b–3(e)(1) to any fractional part of a year credited to the employee under this section as of the date of the transfer. Such equivalency shall be set forth in the plan and shall apply to all similarly situated employees.

(2) More than one plan. In the case of an employee who transfers from a plan using either the general method of determining service on the basis of computation periods set forth in 29 CFR 2530.200b–2 or the method of determining service permitted under this section to a plan using the other method of determining service, all service required to be credited under the plan to which the employee transfers shall be determined by applying the rules of paragraph (f)(1) of this section.

(g) Amendments to change method of crediting service. A plan may be amended to change the method of crediting service for any purpose or for any class of employees between the general method set forth in 29 CFR 2530.200–2 and the method permitted under this section, if such amendment contains provisions under which each employee with respect to whom the method of crediting service is changed is treated in the same manner as an employee who transfers from one class of employees to another under paragraph (f)(1) of this section.

(h) Transitional rule. For plans in existence on [insert the date of the publication of this document], the provisions of paragraph (f) of this section are effective for plan years beginning after December 31, 1983.

[T.D. 7703, 45 FR 40980, June 17, 1980]

§ 1.410(a)–8 Five consecutive 1-year breaks in service, transitional rules under the Retirement Equity Act of 1984.

Sections 410(a)(5)(D) and 411(a)(6)(D), as amended by the Retirement Equity Act of 1984 (REA 1984), permit a plan to disregard years of service that were disregarded under the plan provisions satisfying those sections (as in effect on August 22, 1984) as of the day before the REA amendments apply to the plan. Under section 302(a) of REA 1984, the new break-in-service rules generally apply to plan years beginning after December 31, 1984. Thus, for example, assume a plan has a calendar plan year and disregarded years of service as permitted by sections 410(a)(5)(D) and 411(a)(6)(D) as in effect on August 22, 1984. An employee completed two years of service in 1981 and 1982, and then incurred two consecutive 1-year breaks in service in 1983 and 1984. The plans may disregard the prior years of service even though the employee did not incur five consecutive 1-year breaks in service. On the other hand, assume the employee completed three consecutive years of service beginning in 1980, and incurred two 1-year breaks in service in 1983 and 1984. Because, as of December 31, 1984, the

years of service credited before 1983 could not be disregarded, whether the plan may subsequently disregard those years of service would be governed by the rules enacted by REA 1984.

[T.D. 8219, 53 FR 31851, Aug. 22, 1988]

§ 1.410(a)–9 Maternity and paternity absence.

(a) Elapsed time—(1) Rule. For purposes of applying the rules of § 1.410(a)-7 (relating to the elapsed time method of crediting service) to absences described in sections 410(a)(5)(E) and 411(a)(6)(E) (relating to maternity or paternity absence), the severance from service date of an employee who is absent from service beyond the first anniversary of the first day of absence by reason of a maternity or paternity absence described in section 410(a)(5)(i)(E) or 411(a)(6)(i)(E) is the second anniversary of the first day of such absence. The period between the first and second anniversaries of the first day of absence from work is neither a period of service nor a period of severance. This rule applies to maternity and paternity absences beginning on or after the first day of the first plan year in which the plan is required to credit service under sections 410(a)(5)(E) and 411(a)(6)(E).

(2) Example. The rules of this section are illustrated by the following example:

Assume an individual works until June 30, 1986; is first absent from employment on July 1, 1986, on account of maternity or paternity absence; and on July 1, 1989, performs an hour of service. The period of service must include the period from employment commencement date until June 30, 1987 (one year after the date of separation for any reason other than a quit, discharge, retirement, or death). The period from July 1, 1987, to June 30, 1988, is neither a period of service nor a period of severance. The period of severance would be from July 1, 1988, to June 30, 1989.

(b) Other methods. This paragraph provides a safe harbor for plans that compute years of service under the hours of service methods or permitted equivalencies. Such a plan will be treated as satisfying the requirements of sections 410(a)(5)(E) and 411(a)(6)(E) if the plan increases the minimum period of consecutive 1-year breaks required to disregard any service (or deprive any employee of any right) by one. Thus, a plan will satisfy sections 410(a)(5)(E) and 411(a)(6)(E) without having to compute service for maternity or paternity and sections 410(a)(5)(D) and 411 (a)(4)(D) and (a)(6)(C), by increasing the period of consecutive breaks in service from 5 to 6.

[T.D. 8219, 53 FR 31852, Aug. 22, 1988]

§ 1.410(a)–8T Year of service; break in service (temporary).

(a) [Reserved]

(b) [Reserved]

(c) **Breaks in service—**

(1) [Reserved]

(2) Employees under 2-year 100 percent vesting schedule—(i) General rule. In the case of an employee who incurs a 1-year break in service under a plan which provides that after not more than 2 years of service each participant's right to his accrued benefit under the plan is completely nonforfeitable (within the meaning of section 411 and the regulations thereunder) at the time such benefit accrues, the employee's service before the break in service is not required to be taken into account after the break in service in determining the employee's years of service under section 410(a)(1) and § 1.410(a)-3 if such employee has not satisfied such service requirement.

(ii) Example. The rules of this subparagraph are illustrated by the following example:

Example. A qualified plan computing service by the actual counting of hours provides full and immediate vesting. The plan can not require as a condition of participation that an employee complete 2 consecutive years of service with the employer because the requirement as to consecutive years is not permitted under section 410(a)(5). However, such a plan can require 2 years without a break in service, i.e., 2 years with no intervening years in which the employee fails to complete more than 500 hours of service. Under a plan containing such a participation requirement, the following example illustrates when employees would become eligible to participate.

Year	Hours of service completed		
	Employee A	Employee B	Employee C
1	1,000	1,000	1,000
2	1,000	700	500
3	1,000	1,000	1,000
4	1,000	1,000	700
5	1,000	1,000	1,000

Note.—Employee A will have satisfied the plan's service requirement at the end of year 2, Employee B at the end of year 3, and Employee C at the end of year 5.

(3) One-year break in service—

(i) [Reserved]

(ii) Examples. The rules provided by this subparagraph are illustrated by the following examples:

Example (1). Employee A completes a year of service under a plan computing service by the actual counting of hours for the 12-month period ending December 31, 1989, and incurs a 1-year break in service for the 12-month period ending December 31, 1990. The plan does not contain the provisions

permitted by section 410(a)(5)(B) (relating to 2-year 100 percent vesting) and section 410(a)(5)(D) (relating to nonvested participants). Thereafter, he does not complete a year of service. As of January 1, 1991, in computing his period of service under the plan his service prior to December 31, 1990, is not required to be taken into account for purposes of section 410(a)(1) and § 1.410(a)-3.

Example (2). [Reserved]

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(a)–9T Elapsed time (temporary).

(a) [Reserved]

(b) [Reserved]

(c) **Eligibility to participate—**

(1) [Reserved]

(2) **Determination of one-year period of service.**

(i) [Reserved]

(ii) For purposes of section 410(a)(1)(B)(i), a "2-year period of service" shall be deemed to be "2 years of service."

(d) **Vesting—(1) General rule.**

(i) [Reserved]

(ii) [Reserved]

(iii) [Reserved]

(iv) For purposes of determining an employee's nonforfeitable percentage of accrued benefits derived from employer contributions, a plan, after calculating an employee's period of service in the manner prescribed in this paragraph, may disregard any remaining less than whole year, 12-month or 365-day period of service. Thus, for example, if a plan provides for the statutory three to seven year graded vesting, an employee with a period (or periods) of service which yields 3 whole year periods of service and an additional 321-day period of service is twenty percent vested in his or her employer-derived accrued benefits (based solely on the 3 whole year periods of service).

(2) [Reserved]

[T.D. 8170, 53 FR 239, Jan. 6, 1988]

§ 1.410(b)–1 Minimum coverage requirements.

(a) **In general.** A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies the requirements of section 410(b)(1). A plan satisfies the requirements of section 410(b)(1) if it satisfies the requirements of paragraph (9)(1) or (2) of this section. This section does not apply in the case of a plan which provides contributions or benefits for any individual who is an owner-employee (as defined in section 401(c)(3) and the regulations thereunder).

(b) **Coverage tests—(1) Percentage test.** A plan satisfies the requirements of this subparagraph if it benefits—

(i) Seventy percent or more of all employees, or

(ii) Eighty percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan,

excluding in each case employees who have not satisfied the minimum age and service requirements (if any) prescribed by the plan, as of the date coverage is tested, as a condition of participation and employees permitted to be excluded under paragraph (c) of this section. The percentage requirements of this subparagraph refer to a percentage of active employees, including employees temporarily on leave, such as those in the Armed Forces of the United States, if such employees are eligible under the plan.

(2) **Classification test.** A plan satisfies the requirements of section 410(b)(1) and this subparagraph if it benefits such employees as qualify under a classification of employees set up by the employer, which classification is found by the Internal Revenue Service not to be discriminatory in favor of employees who are officers, shareholders, or highly compensated. For purposes of this subparagraph, except as provided by paragraph (c) of this section, all active employees (including employees who do not satisfy the minimum age or service requirements of the plan) are taken into account.

(c) **Exclusion of certain employees.** Under section 410(b)(2), for purposes of section 410(b)(1) and paragraph (b) of this section, there shall be excluded from consideration employees described in subparagraphs (1), (2), and (3) of this paragraph.

(1) **Bargaining unit.** Under section 410(b)(2)(A) and this paragraph, there may be excluded from consideration employees not included in the plan who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if the Internal Revenue Service finds that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or

employers. For purposes of determining whether such bargaining occurred, it is not material that such employees are not covered by another plan or that the plan was not considered in such bargaining.

(2) Air pilots. Under section 410(b)(2)(B) and this paragraph there may be excluded from consideration, in the case of a plan established or maintained pursuant to an agreement which the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with title II of the Railway Labor Act and one or more employers all employees not covered by such agreement. Section 410(b)(2)(B) and this subparagraph do not apply to a plan if the plan provides contributions or benefits for employees whose principal duties are not customarily performed aboard aircraft in flight.

(3) Nonresident aliens. Under section 410(b)(2)(C) and this paragraph, there may be excluded from consideration employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(b) and the regulations thereunder) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3) and the regulations thereunder).

(d) Special rules—(1) Highly compensated. The classification of an employee as highly compensated for purposes of section 410(b)(1)(B) and § 1.410(b)-1(b)(2) is made on the basis of the facts and circumstances of each case, taking into account the level of the employee's compensation and the level of compensation paid by the employer to other employees, whether or not covered by the plan. Average compensation levels determined on a local, regional, or national basis, are not relevant for this purpose. Further, the classification of an employee as highly compensated is not made solely on the basis of the number or percentage of employees whose compensation exceeds, or is exceeded by, the employee's.

(2) Discrimination. The determination as to whether a plan discriminates in favor of employees who are officers, shareholders, or highly compensated is made on the basis of the facts and circumstances of each case, allowing a reasonable difference between the ratio of such employees benefited by the plan to all such employees of the employer and the ratio of the employees (other than officers, shareholders, or highly compensated) of the employer benefited by the plan to all employees (other than officers, shareholders, or highly compensated). A showing that a specified percentage of employees covered by a plan are not officers, shareholders, or highly compensated, is not in itself sufficient to establish that the plan does not discriminate in favor of employees who are officers, shareholders, or highly compensated.

(3) Multiple plans. (i) An employer may designate two or more plans as constituting a single plan which is intended to qualify for purposes of section 410(b)(1) and this section, in which case all plans so designated shall be considered as a single plan in determining whether the requirements of such section are satisfied by each of the separate plans. A determination that the combination of plans so designated does not satisfy such requirements does not preclude a determination that one or more of such plans, considered separately, satisfies such requirements.

(ii) Notwithstanding subdivision (i) of this subparagraph, a plan which is subject to the limitations of section 401(a)(17) of the Code or section 301(d)(3) of the Tax Reduction Act of 1975 cannot be considered with any other plan which covers any employee covered by such plan.

(4) Profit-sharing plans. Employees under a profit-sharing plan who receive the amounts allocated to their accounts before the expiration of a period of time or the occurrence of a contingency specified in the plan shall not be considered covered by the plan. Thus, in case a plan permits employees to receive immediately the amounts allocated to their accounts, or to have such amounts paid to a profit-sharing plan for them, the employees who receive the shares immediately shall not be considered covered by the plan.

(5) Certain classifications. See section 401(a)(5) and the regulations thereunder for rules relating to classifications of employees which are not considered to be discriminatory per se for purposes of section 410(b)(1)(B) and § 1.410(b)-1(b)(2).

(6) Integration with Social Security Act. See section 401(a)(5) and the regulations thereunder for rules relating to integration of plans with the Social Security Act.

(7) Different age and service requirements—(i) Application. The rules of this subparagraph (7) apply to a plan which must satisfy the minimum age and service requirements of section 410(a)(1)(A) in order to be a qualified plan. Accordingly, the rules are inapplicable to plans described in section 410(c)(1) (see § 1.410(a)-1(c)(1)); plans satisfying the alternative minimum age and service requirements of

section 410(a)(1)(B) but not satisfying the requirements of section 410(a)(1)(A); and plans which provide contributions or benefits for employees, some or all of whom are owner-employees (see section 401(a)(10)).

(ii) **General rules.** A provision for different age and service requirements for present and future employees either upon establishment or subsequent amendment is not, of itself, discriminatory under section 410(b)(1)(B) even though present employees who are officers, shareholders, or highly compensated cannot meet the age and service requirements for future employees at the time the plan is established or amended and even though present participants who are officers, shareholders, or highly compensated would not have satisfied the age and service requirements for future employees at the time they became participants in the plan. Furthermore, prohibited discrimination will be deemed not to arise in operation, solely because of such different requirements, when future employees are added to the employer's work force.

(8) **Certain controlled groups.** In applying the percentage test and classification test described in paragraph (b)(1) and (2) of this section for a year, all the employees of corporations or trades and businesses whose employees are treated as employed by a single employer by reason of section 414(b) or (c) must be taken into account. The preceding sentence shall apply for a plan year if, on 1 day in each quarter of such plan year, such corporations are members of a controlled group of corporations (within the meaning of section 414(b)) of such trades or businesses are under common control (within the meaning of section 414(c)).

(9) **Transitional rule.** In the case of a cash and deferred profit-sharing plan, in existence on June 27, 1974, the requirements of paragraph (b)(2) of this section are satisfied if over one-half of the participants in the plan are among the lowest paid two-thirds of all eligible employees. This subparagraph shall not apply after December 31, 1977.

(e) **Example.** The rules provided by this section are illustrated by the following example:

Example. An employer established a non-contributory defined benefit plan covering all employees of its ABC Division who are hired prior to age 60 and who are at least 25 years old. The normal retirement age under the plan is age 65. The employer has 100 employees including 20 employees who are under age 25 and 10 employees who were hired over age 60. The plan does not cover 15 employees who are over age 25 and were hired before age 60 because they are not in the ABC Division. Of these 15 excluded employees, 3 have less than 1 year of service. In addition, 12 of the 55 employees covered have less than one year of service. The plan can be shown not to satisfy the requirements of IRC section 410(b)(1)(A) as follows:

(i) Number of employees	100
(ii) Number of employees excluded on account of minimum age and service	20
(iii) (i)–(ii)	80
(iv) Number of employees who must be covered if plan is to satisfy IRC section 410(b)(1)(A), 70% of (iii)	56
(v) Number of employees actually covered	55

Because the number of employees covered is less than the number of employees who must be covered, the plan does not satisfy the percentage coverage requirements of IRC section 410(b)(1)(A).

[T.D. 7508, 42 FR 47197, Sept. 20, 1977, as amended by T.D. 7735, 45 FR 74722, Nov. 12, 1980]

§ 1.410(d)–1 Election by church to have participation, vesting, funding, etc., provisions apply.

(a) **In general.** If a church or convention or association of churches which maintains any church plan, as defined in section 414(e), makes an election under this section, certain provisions of the Code and Title I of the Employee Retirement Income Security Act of 1974 (the "Act") shall apply to such church plan as if such plan were not a church plan. The provisions of the Code referred to are section 410 (relating to minimum participation standards), section 411 (relating to minimum vesting standards), section 412 (relating to minimum funding standards), section 4975 (relating to prohibited transactions), and paragraphs (11), (12), (13), (14), (15), and (19) of section 401(a) (relating to joint and survivor annuities, mergers and consolidations, assignment or alienation of benefits, time of benefit commencement, certain social security increases, and withdrawals of employee contributions, respectively).

(b) **Election is irrevocable.** An election under this section with respect to any church plan shall be binding with respect to such plan and, once made, shall be irrevocable.

(c) **Procedure for making election—(1) Time of election.** An election under this section may be made for plan years for which the provisions of section 410(d) of the Code apply to the church plan. By reason of section 1017(b) of the Act section 410(d) does not apply to a plan in existence on January 1, 1974, for plan years beginning before January 1, 1976. Section 1017(d) of the Act permits a plan administrator to elect to have certain provisions of the Code (including section 410(d)) apply to a plan before the otherwise applicable effective dates of such provisions. See § 1.410(a)–2(d). Therefore, for a plan in exist-

ence on January 1, 1974, an election under section 410(d) of the Code may be made for a plan year beginning before January 1, 1976, only if an election has been made under section 1017(d) of the Act with respect to that plan year.

(2) By whom election is to be made. The election provided by this section may be made only by the plan administrator of the church plan.

(3) Manner of making election. The plan administrator may elect to have the provisions of the Code described in paragraph (a) of this section apply to the church plan as it is were not a church plan by attaching the statement described in subparagraph (5) of this paragraph to either (i) the annual return required under section 6058(a) (or an amended return) with respect to the plan which is filed for the first plan year for which the election is effective or (ii) a written request for a determination letter relating to the qualification of the plan under section 401(a), 403(a), or 405(a) of the Code and if trusteed, the exempt status under section 501(a) of the Code of a trust constituting a part of the plan.

(4) Conditional election. If an election is made with a written request for a determination letter, the election may be conditioned upon issuance of a favorable determination letter and will become irrevocable upon issuance of such letter.

(5) Statement. The statement described in subparagraph (3) of this paragraph shall indicate (i) that the election is made under section 410(d) of the Code and (ii) the first plan year for which it is effective.

[T.D. 7508, 42 FR 47198, Sept. 20, 1977]

§ 1.411(a)–1 Minimum vesting standards; general rules.

(a) In general. A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless—

(1) The plan provides that an employee's right to his normal retirement benefit (see § 1.411(a)–7(c)) is nonforfeitable (see § 1.411(a)–4) upon and after the attainment of normal retirement age (see § 1.411(a)–7(b)),

(2) The plan provides that an employee's rights in his accrued benefit derived from his own contributions (see § 1.411(c)–1) are nonforfeitable at all times, and

(3) The plan satisfies the requirements of—

(A) Section 411(a)(2) and § 1.411(a)–3 (relating to vesting in accrued benefit derived from employer contributions), and

(B) In the case of a defined benefit plan, section 411(b)(1) and § 1.411(b)–1 (relating to accrued benefit).

(b) Organization of regulations relating to minimum vesting standards—(1) General rules. This section prescribes general rules relating to the minimum vesting standards provided by section 411.

(2) Effective dates. Section 1.411(a)–2 provides rules under section 1017 of the Employee Retirement Income Security Act of 1974 relating to effective dates under section 411.

(3) Employer contributions. Section 1.411(a)–3 provides rules under section 411(a)(2) relating to vesting in employer-derived accrued benefits.

(4) Certain forfeitures. Section 1.411(a)–4 provides rules under section 411(a)(3) relating to certain permitted forfeitures, suspensions, etc. under qualified plans.

(5) Nonforfeitable percentage. Section 1.411(a)–5 provides rules under section 411(a)(4) relating to service included in the determination of an employee's nonforfeitable percentage under section 411(a)(2) and § 1.411(a)–3.

(6) Years of service; break in service. Section 1.411(a)–6 provides rules under section 411(a)(5) and (6) of the Internal Revenue Code of 1954 relating to years of service and breaks in service. Rules prescribed by the Secretary of Labor, relating to years of service and breaks in service under part 2 of subtitle B of title I of the Employee Retirement Income Security Act of 1974 are provided under 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(7) Definitions and special rules. Section 1.411(a)–7 provides definitions and special rules under section 411(a)(7), (8), and (9), for purposes of section 411 and the regulations thereunder.

(8) Changes in vesting schedule. Section 1.411(a)–8 provides rules under section 411(a)(10) relating to changes in the vesting schedule of a plan.

(9) Breaks in service. Section 1.411(a)–9 provides special rules relating to breaks in service.

(10) Accrued benefits. See § 1.411(b)–1 for rules under section 411(b) relating to accrued benefit requirements under defined benefit plans.

(11) Allocation of accrued benefits. See § 1.411(c)–1 for rules under section 411(c) relating to allocation of accrued benefits between employer and employee contributions.

(12) Discrimination, etc. See § 1.411(d)–1 for rules relating to the coordination of section 411 with section 401(a)(4) (relating to discrimination) and other rules under section 411(d).

(c) Application of standards to certain plans—(1) General rule. Except as provided in subparagraph (2) of this paragraph, section 411 does not apply to—

(i) A governmental plan (within the meaning of section 414(d) and the regulations thereunder),

(ii) A church plan (within the meaning of section 414(e) and the regulations thereunder) which has not made the election provided by section 410(d) and the regulations thereunder,

(iii) A plan which has not provided for employer contributions at any time after September 2, 1974, and

(iv) A plan established and maintained by a society, order, or association described in section 501(c)(8) or (9), if no part of the contributions to or under such plan are made by employers of participants in such plan.

(2) Vesting requirements. A plan described in subparagraph (1) of this paragraph shall, for purposes of section 401(a), be treated as meeting the requirements of section 411 if such plan meets the vesting requirements resulting from the application of section 401(a)(4) and section 401(a)(7) as in effect on September 1, 1974.

(d) Supersession. Sections 11.411(a)–1 through 11.411(d)–3, inclusive, of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 are superseded by this section and §§ 1.411(a)–2 through 1.411(d)–3.
[T.D. 7501, 42 FR 42324, Aug. 23, 1977]

§ 1.411(a)–2 Effective dates.

(a) Plan not in existence on January 1, 1974. Under section 1017(a) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was not in existence on January 1, 1974, section 411 and the regulations thereunder apply for plan years beginning after September 2, 1974. See paragraph (c) of this section for time plan is considered in existence.

(b) Plans in existence on January 1, 1974. Under section 1017(b) of the Employee Retirement Income Security Act of 1974, in the case of a plan which was in existence on January 1, 1974, section 411 and the regulations thereunder apply for plan years beginning after December 31, 1975. See paragraph (c) of this section for time plan is considered to be in existence.

(c) Time of plan existence—(1) General rule. For purposes of this section, a plan is considered to be in existence on a particular day if—

(i) The plan on or before that day was reduced to writing and adopted by the employer (including, in the case of a corporate employer, formal approval by the employer's board of directors and, if required, shareholders), even though no amounts had been contributed under the plan as of such day, and

(ii) The plan was not terminated on or before that day.

For example, if a plan was adopted on January 2, 1974, effective as of January 1, 1974, the plan is not considered to have been in existence on January 1, 1974, because it was not both adopted and in writing on January 1, 1974.

(2) Collectively-bargained plan. Notwithstanding paragraph (c)(1) of this section, a plan described in section 413(a), relating to a plan maintained pursuant to a collective-bargaining agreement, is considered to be in existence on a particular day if—

(i) On or before that day there is a legally enforceable agreement to establish such a plan signed by the employer, and

(ii) The employer contributions to be made to the plan are set forth in the agreement.

(3) Special rule. If a plan is considered to be in existence under subparagraph (1) of this paragraph, any other plan with which such existing plan is merged or consolidated shall also be considered to be in existence on such date.

(d) Existing plans under collective-bargaining agreements. For a special effective date rule for certain plans maintained pursuant to a collective bargaining agreement, see section 1017(c)(1) of the Employee Retirement Income Security Act of 1974 (88 Stat. 932).

(e) Certain existing plans may elect new provisions. The plan administrator may elect to have the provisions of the Code relating to participation, vesting, funding, and form of benefit apply to a selected plan year. See § 1.410(a)–2(d) for rules relating to such an election.

(f) Application of rules. The requirements of section 411 do not apply to employees who separate from service with the employer prior to the first plan year to which such requirements apply and who never return to service with the employer in a plan year to which section 411 applies.

[T.D. 7501, 42 FR 42325, Aug. 23, 1977]

§ 1.411(a)–3 Vesting in employer-derived benefits.

(a) In general—(1) Alternative requirements. A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan satisfies the requirements of section 411(a)(2) and this section. A plan satisfies the requirements of this section if is satisfies the requirements of paragraph (b), (c), or (d) of this section.

(2) Composite arrangements. A plan will not be considered to satisfy the requirements of paragraph (b), (c), or (d) of this section unless it satisfies all requirements of a particular one of such paragraphs with respect to all of an employee's years of service. A plan which, for example, satisfies the requirements of paragraph (b) (but not (c) or (d)) for an employee's first 9 years of service and satisfies the requirements of paragraph (c) (but not (b)) for all of his remaining years of service, does not satisfy the requirements of this section. A plan is not precluded from satisfying the requirement of one such paragraph with respect to one group of employees and another such paragraph with respect to another group provided that the groups are not so structured as to evade the requirements of this paragraph. For example, if plan A provides that employees who commence participation before age 30 are subject to the "rule of 45" vesting schedule and employees who commence participation after age 30 are subject to the full vesting after 10 years schedule, plan A would be so structured as to evade the requirements of this paragraph.

(3) Plan amendments. A plan which satisfies the requirements of a particular one of such paragraphs for each of an employee's years of service and which is amended so that, as amended, it satisfies the requirements of another such paragraph for all such years of service, satisfies the requirements of this section even though, as amended, it does not satisfy the requirements of the paragraph which were satisfied prior to the amendment. See § 1.411(a)–8 for rules relating to employee election where the vesting schedule is amended.

(b) 10-year vesting. A plan satisfies the requirements of section 411(a)(2)(A) and this paragraph if an employee who has completed 10 years of service has a nonforfeitable right to 100 percent of his accrued benefit derived from employer contributions.

(c) 5- to 15-year vesting. A plan satisfies the requirements of section 411(a)(2)(B) and this paragraph if an employee who has completed at least 5 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contribution which percentage is not less than the nonforfeitable percentage determined under the following table:

Completed years of service	Nonforfeitable percentage
5	25
6	30
7	35
8	40
9	45
10	50
11	60
12	70
13	80
14	90
15 or more	100

(d) Rule of 45. A plan satisfies the requirements of section 411(a)(2)(C) and this paragraph if an employee is entitled to the greater of the two percentages determined under paragraph (d)(1) or (2) of this section.

(1) Age and service test. An employee who is not separated from the service, who has completed at least 5 years of service, and with respect to whom the sum of his age and years of service equals or exceeds 45, has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions which is not less than the nonforfeitable percentage corresponding to his number of completed years of service to the sum of his age and completed years of service (whichever percentage is the lesser) determined under the following table:

Completed years of service	Sum of age and service	Nonforfeitable percentage
5	45 or 46	50
6	47 or 48	60
7	49 or 50	70
8	51 or 52	80
9	53 or 54	90
10 or more	55 or more	100

(2) Service test. An employee who has completed at least 10 years of service has a nonforfeitable right to a percentage of his accrued benefit

derived from employer contributions determined under the following table:

Completed years of service	Nonforfeitable percentage
10	50
11	60
12	70
13	80
14	90
15	100

(3) Computation of age. For purposes of subparagraph (1) of this paragraph, the age of an employee is his age on his last birthday.

(e) Examples. The rules provided by this section are illustrated by the following examples:

Example (1). Plan B provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable as follows:

Completed years of service	Nonforfeitable percentage
2 or less	0
3	30
4	35
5	40
6	45
7	50
8	55
9	60
10	65
11	70
12	75
13	80
14	85
15	100

Plan B does not satisfy the requirements of paragraph (c) of this section (relating to 5–15-year vesting) because the nonforfeitable percentage provided by the plan after completion of 14 years of service (85 percent) is less than the percentage required by paragraph (c) of this section at that time (90 percent). The fact that the nonforfeitable percentage provided by the plan for years prior to the 13th year of service is greater than the percentage required under paragraph (c) of this section is immaterial. The plan fails to satisfy the requirements of paragraph (c) of this section even if it is demonstrated that the value of the vesting provided by the plan to the employee is at least equal to the value of the vesting rate required by that paragraph.

Example (2). Plan C provides for plan participation after the completion of 1 year of service. The plan provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable after 10 years of plan participation rather than service. The plan does not satisfy the requirements of paragraph (b) of this section because, under the plan, an employee obtains a 100 percent nonforfeitable right to his employer-derived accrued benefit only after completion of more than 10 years of service.

Example (3). Plan D provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable in accordance with the following schedule:

Completed years of service	Nonforfeitable percentage
0–9	0
10	50
11	60
12	70
13	80
14	90
15	100

The plan does not satisfy the requirements of paragraph (b) of this section after the 9th year of service. It does not satisfy the requirements of paragraph (c) of this section for years prior to the 10th year of service. It does not satisfy the requirements of paragraph (d)(1) of this section for any year of service prior to the 10th year. The plan does not satisfy the requirements of this section because it does not satisfy the requirements of a particular one of the three paragraphs for each of an employee's years of service.

Example (4). Plan G provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable upon completion of 5 years of service. The plan satisfies the requirements of paragraphs (b), (c), and (d) of this section and, because it satisfies the requirements of at least one of such paragraphs for all of an employee's years of service, it satisfies the requirements of this section.

[T.D. 7501, 42 FR 42325, Aug. 23, 1977]

§ 1.411(a)-3T Vesting in employer-derived benefits (temporary).

(a) In general.

(1) [Reserved]

(2) Composite arrangements. A plan will not be considered to satisfy the requirements of paragraph (b), (c), or (d) of this section unless it satisfies all requirements of a particular one of such paragraphs with respect to all of an employee's years of service. A plan which, for example, satisfies the requirements of paragraph (b) (but not (c) or (d)) for an employee's first 4 years of service and satisfies the requirements of paragraph (c) (but not (b)) for all of his remaining years of service does not satisfy the requirements of this section. A plan is not precluded from satisfying the requirements of one such paragraph with respect to one group of employees and another such paragraph with respect to another group provided that the groups are not so structured as to evade the requirements of this paragraph.

(3) [Reserved]

(b) 5-year vesting. A plan satisfies the requirements of section 411(a)(2)(A) and this paragraph if an employee who has completed 5 years of service has a nonforfeitable right to 100 percent of his or her accrued benefits derived from employer contributions.

(c) 3- to 7-year vesting. A plan satisfies the requirements of section 411(a)(2)(B) and this paragraph if an employee who has completed at least 3 years of service has a nonforfeitable right to a percentage of his accrued benefit derived from employer contributions, which percentage is not less than the nonforfeitable percentage determined under the following table:

Completed years of service	Nonforfeitable percentage
3	20
4	40
5	60
6	80
7 or more	100

(d) Multiemployer plans. A plan satisfies the requirements of section 411(a)(2)(C) and this paragraph if—

(1) The plan is a multiemployer plan (within the meaning of section 414(f)), and

(2) Under the plan—

(i) An employee who is covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B) has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions not later than upon completion of 10 years of service, and

(ii) The requirements of paragraph (b) or (c) of this section are met with respect to employees who are not covered pursuant to a collective bargaining agreement described in section 414(f)(1)(B).

(iii) For purposes of this provision, an employee is not covered pursuant to a collective bargaining agreement unless the employee is represented by a bona fide employee representative that is a party to the collective bargaining agreement pursuant to which the multiemployer plan is maintained. Thus, for example, an employee of either the multiemployer plan or the employee representative is not covered pursuant to the collective bargaining agreement under which the plan is maintained even if the employee is covered pursuant to an agreement entered into by the multiemployer plan or employee representative on behalf of the employee and even if all such employees covered under the plan constitute only a de minimis percentage of the total employees covered under the plan.

(e) Effective date. (1) The provisions of this section apply to all employees who have one hour of service in any plan year beginning after—

(i) December 31, 1988, or

(ii) In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before March 1, 1986, for employees covered by any such agreement, the earlier of—

(A) The later of—

(1) January 1, 1989, or

(2) The date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after February 28, 1986), or

(B) January 1, 1991.

(2) For employees not described in paragraph (e)(1), above, the regulations in effect prior to January 1, 1989, shall be applied to determine the requirements of this section.

(f) Examples. The rules provided by this section are illustrated by the following examples:

Example (1). Plan B provides that each employee's rights to his employer-derived accrued benefit are nonforfeitable as follows:

Completed years of service	Nonforfeitable percentage
1	0
2	10
3	25
4	45
5	65
6	75
7	100

Plan B does not satisfy the requirements of paragraph (c) of this section (relating to 3- to 7-year vesting) because the nonforfeitable percentage provided by the plan after completion of 6 years of service (75 percent) is less than the percentage required by paragraph (c) of this section at that time (80 percent). The fact that the nonforfeitable percentage provided by the plan for years prior to the 6th year of service is greater than the percentage required under paragraph (c) of this section is immaterial. The plan fails to satisfy the requirements of paragraph (c) of this section even if it is demonstrated that the value of the vesting provided by the plan to the employees is at least equal to the value of the vesting rate required by this paragraph.

Example (2). Plan C provides for plan participation after the completion of 1 year of service. The plan provides that each employee's rights to his employer-derived accrued benefits are 100 percent nonforfeitable after 5 years of plan participation rather than service. The plan does not satisfy the requirements of paragraph (b) of this section because, under the plan, an employee obtains a 100 percent nonforfeitable right to his or her employer-derived accrued benefit only after completion of more than 5 years of service.

Example (3). Plan D provides that each employee's rights to his employer-derived accrued benefits are nonforfeitable in accordance with the following schedule:

Completed years of service	Nonforfeitable percentage
0 to 4	0
5	60
6	80
7	100

The plan does not satisfy the requirements of paragraph (b) of this section after the 4th year of service. It does not satisfy the requirements of paragraph (c) of this section for years prior to the 5th year of service. The plan does not satisfy the requirements of this section because it does not satisfy the requirements of a particular one of the two paragraphs for each of an employee's years of service.

Example (4). Plan G provides that each employee's rights to his employer-derived accrued benefit are 100 percent nonforfeitable upon completion of 3 years of service. The plan satisfies the requirements of paragraphs (b) and (c) of this section and, because it satisfies the requirements of at least one of such paragraphs for all of an employee's years of service, it satisfies the requirements of this section.

[T.D. 8170, 53 FR 240, Jan. 6, 1988]

§ 1.411(a)-4 Forfeitures, suspensions, etc.

(a) Nonforfeitability. Certain rights in an accrued benefit must be nonforfeitable to satisfy the requirements of section 411(a). This section defines the term "nonforfeitable" for purposes of these requirements. For purposes of section 411 and the regulations thereunder, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. Except as provided by paragraph (b) of this section, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time. Certain adjustments to plan benefits such as adjustments in excess of reasonable actuarial reductions, can result in rights being forfeitable. Rights which are conditioned upon a sufficiency of plan assets in the event of a termination or partial termination are considered to be forfeitable because of such condition. However, a plan does not violate the nonforfeitability requirements merely because in the event of a termination an employee does not have any recourse toward satisfaction of his nonforfeitable benefits from other than the plan assets or the Pension Benefit Guaranty Corporation. Furthermore, nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced to take into account benefits which are provided under the Social Security Act or under any other Federal or State law and which are taken into account in determining plan benefits. To the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards, or the nondiscrimination requirements of section 401(a)(4), they may be forfeited without regard to the limitations on forfeitability required by this section. The right of an employee to repurchase his accrued benefit for example under section 411(a)(3)(D), is an example of a right which is required to satisfy such standards. Accordingly, such a right is subject to the limitations on forfeitability. Rights which are required to be prospectively nonforfeitable under the vesting standards are nonforfeitable and may not be forfeited until it is determined that such rights are, in fact, in excess of the vesting standards. Thus, employees have a right to vest in the accrued benefits if they continue in employment of employers maintaining the plan unless a forfeitable event recognized by section 411 occurs. For example, if a plan covered employees in Division A of Corporation X under a plan utilizing a 10-year 100 percent vesting schedule, the plan could not forfeit employees' rights on account of their moving to service in Division B of Corporation X prior to completion of 10 years of service even though employees are not vested at that time.

(b) Special rules. For purposes of paragraph (a) of this section a right is not treated as forfeitable—

(1) Death—(i) General rule. In the case of a participant's right to his employer-derived accrued benefit, merely because such accrued benefit is forfeitable by the participant to the extent it has not been paid or distributed to him prior to his death. This subparagraph shall not apply to a benefit which must be paid to a survivor in order to satisfy the requirements of section 401(a)(11).

(ii) Employee contributions. A participant's right in his accrued benefit derived from his own contributions must be nonforfeitable at all times. Such a right is not treated as forfeitable merely because, after commencement of annuity or pension payments in a benefit form provided under the plan, the participant dies without receiving payments equal in amount to his nonforfeitable accrued benefit derived from his contributions determined at the time of commencement.

(2) Suspension of benefits upon reemployment of retiree. In the case of certain suspensions of benefits under section 411(a)(3)(B), see regulations

prescribed by the Secretary of Labor under 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(3) Retroactive plan amendment. In the case of a participant's right to his employer-derived accrued benefit, merely because such benefit is subject to reduction to the extent provided by a plan amendment described in section 412(c)(8) and the regulations thereunder, which amendment is given retroactive effect in accordance with such section.

(4) Other forfeiture rules—(i) Withdrawal of mandatory contributions. For rules allowing forfeitures on account of the withdrawal of mandatory contributions, see § 1.411(a)–7(d)(2) and (3).

(ii) Class year plans. For forfeiture rules pertaining to class year plans, see § 1.411(d)–3(b).

(iii) Additional requirements. For additional requirements relating to nonforfeitability of benefits in the event of a withdrawal by the employee, see section 401(a)(19) and § 1.401(a)–19.

(5) Multiemployer plan. In the case of a multiemployer plan described in section 414(f), merely because an employee's accrued benefit which results from service with an employer before such employer was required to contribute to the plan is forfeitable on account of the cessation of contributions by the employer of the employee. This subparagraph shall not apply to an employee's accrued benefit with respect to an employer which accrued under a plan maintained by that employer prior to the adoption by that employer of the multiemployer plan.

(6) Lost beneficiary; escheat. In the case of a benefit which is payable, merely because the benefit is forfeitable on account of the inability to find the participant or beneficiary to whom payment is due, provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit. In addition, a benefit which is lost by reason of escheat under applicable state law is not treated as a forfeiture.

(c) Examples. The rules of this section are illustrated by the following examples:

Example (1). Corporation A's plan provides that an employee is fully vested in his employer-derived accrued benefit after completion of 5 years of service. The plan also provides that, if an employee works for a competitor he forfeits his rights in the plan. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and therefore the plan would not satisfy the requirements of section 411. If the plan limited the forfeiture to employees who completed less than 10 years of service, the plan would not fail to satisfy the requirements of section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A).

Example (2). Plan B provides that if an employee does not apply for benefits within 5 years after the attainment of normal retirement age, the employee loses his plan benefits. Such a plan provision could result in forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and, therefore, the plan would not satisfy the requirements of section 411.

[T.D. 7501, 42 FR 42326, Aug. 23, 1977]

§ 1.411(a)–4T Forfeitures, suspensions, etc. (temporary).

(a) Nonforfeitability. Certain rights in an accrued benefit must be nonforfeitable to satisfy the requirements of section 411(a). This section defines the term "nonforfeitable" for purposes of these requirements. For purposes of section 411 and the regulations thereunder, a right to an accrued benefit is considered to be nonforfeitable at a particular time if, at that time and thereafter, it is an unconditional right. Except as provided by paragraph (b) of this section, a right which, at a particular time, is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which will cause the loss of such right is a forfeitable right at that time. Certain adjustments to plan benefits, such as adjustments in excess of reasonable actuarial reductions, can result in rights being forfeitable. Rights which are conditioned upon a sufficiency of plan assets in the event of a termination or partial termination are considered to be forfeitable because of such condition. However, a plan does not violate the nonforfeitability requirements merely because in the event of a termination an employee does not have any recourse toward satisfaction of his nonforfeitable benefits from other than the plan assets, the Pension Benefit Guaranty Corporation, or a trust established and maintained pursuant to sections 4041(c)(3)(B) (ii) or (iii) and section 4049 of ERISA with respect to the plan. Furthermore, nonforfeitable rights are not considered to be forfeitable by reason of the fact that they may be reduced as allowed under sections 401(a)(5) and 401(*l*). To the extent that rights are not required to be nonforfeitable to satisfy the minimum vesting standards, or the nondiscrimination requirements of section 401(a)(4), they may be forfeited without regard to the limitations on forfeitability required by this section. The right of an employee to repurchase his accrued benefit for example under section 411(a)(3)(D), is an example of a right which is required to satisfy such standards. Accordingly, such a right is subject to the

limitations on forfeitability. Rights which are required to be prospectively nonforfeitable under the vesting standards are nonforfeitable and may not be forfeited until it is determined that such rights are, in fact, in excess of the vesting standards. Thus, employees have a right to vest in the accrued benefits if they continue in employment of employers maintaining the plan unless a forfeitable event recognized by section 411 occurs. For example, if a plan covered employees in Division A of Corporation X under a plan utilizing a 5-year 100 percent vesting schedule, the plan could not forfeit employees' rights on account of their moving to service in Division B of Corporation X prior to completion of 5 years of service even though employees are not vested at that time.

(b) [Reserved]

(c) **Examples.** The rules of this section are illustrated by the following examples:

Example (1). Corporation A's plan provides that an employee is fully vested in his employer-derived accrued benefit after completion of 3 years of service. The plan also provides that if the employee works for a competitor he forfeits his rights in the plan. Such provision could result in the forfeiture of an employee's rights which are required to be nonforfeitable under section 411 and therefore the plan would not satisfy the requirements of section 411. If the plan limited the forfeiture to employees who completed less than 5 years of service, the plan would not fail to satisfy the requirements of section 411 because the forfeitures under this provision are limited to rights which are in excess of the minimum required to be nonforfeitable under section 411(a)(2)(A).

Example (2). [Reserved]

[T.D. 8170, 53 FR 241, Jan. 6, 1988]

§ 1.411(a)-5 Service included in determination of nonforfeitable percentage.

(a) **In general.** Under section 411(a)(4), for purposes of determining the nonforfeitable percentage of an employee's right to his employer-derived accrued benefit under section 411(a)(2) and § 1.411(a)-3, all of an employee's years of service with an employer or employers maintaining the plan shall be taken into account except that years of service described in paragraph (b) of this section may be disregarded.

(b) **Certain service.** For purposes of paragraph (a) of this section, the following years of service may be disregarded:

(1) **Service before age 22.** (i) In the case of a plan which satisfies the requirements of section 411(a)(2)(A) or (B) (relating to 10-year vesting and 5-15-year vesting, respectively), a year of service completed by an employee before he attains age 22.

(ii) In the case of a plan which does not satisfy the requirements of section 411(a)(2)(A) or (B), a year of service completed by an employee before he attains age 22 if the employee is not a participant (for purposes of section 410) in the plan at any time during such year.

(iii) For purposes of this subparagraph in the case of a plan utilizing computation periods, service during a computation period described in section 411(a)(5)(A) within which the employee attains age 22 may not be disregarded. In the case of a plan utilizing the elapsed time method described in § 1.410(a)-7, service on or after the date on which the employee attains age 22 may not be disregarded.

(2) **Contributory plans.** In the case of a plan utilizing computation periods, a year of service completed by an employee under a plan which requires mandatory contributions (within the meaning of section 411(c)(2)(C) and § 1.411(c)-1(c)(4)) to be made by the employee for such year, if the employee does not participate for such year solely because of his failure to make all mandatory contributions to the plan for such year. If the employee contributes any part of the mandatory contributions for the year, such year may not be excluded by reason of this subparagraph. In the case of a plan utilizing the elapsed time method described in § 1.410(a)-7, the service which may be disregarded is the period with respect to which the mandatory contribution is not made.

(3) **Plan not maintained**—(i) **In general.** An employee's years of service with an employer during any period for which the employer did not maintain the plan or a predecessor plan may be disregarded for purposes of section 411(a)(2). Paragraph (b)(3)(ii) of this section provides rules regarding the period prior to the adoption of a plan. Paragraph (b)(3)(iii) of this section provides rules regarding the period after the termination of a plan. Paragraph (b)(3)(iv) of this section provides rules regarding employers who have certain relationships with other employers maintaining the plan.

(ii) **Period prior to adoption.** The period for which a plan is not maintained by an employer includes the period before the plan was established. For purposes of this subdivision, a plan is established on the first day of the plan year in which the plan is adopted even though the plan is adopted after such first day. Except as provided in paragraph (b)(3)(iv) of this section if an employer adopts a plan which has previously been established by another employer or group of employers,

the plan is not maintained by the adopting employer prior to the first day of the plan year in which the plan is adopted by the adopting employer. In the case of a transfer of assets or liabilities (including a merger or consolidation) involving two plans maintained by a single employer, the successor (or transferee) plan is treated as if it was established at the same time as the date of the establishment of the earliest component plan. In the case of a plan merger, consolidation, or transfer of plan assets or liabilities involving plans of two or more employers, the successor plan is treated as if it were established on each of the separate dates on which such component plan was established for the employees of each employer. Thus, for example, if employer A establishes a plan January 1, 1970, and employer B establishes a plan January 1, 1980, and the plans were subsequently merged, then the merged plan would be treated as if it were in existence on January 1, 1970, with respect to A's employees and as if it were in existence on January 1, 1980, with respect to B's employees.

(iii) Period after termination or withdrawal. The period for which a plan is not maintained by an employer includes the period after the plan is terminated. For purposes of this section, a plan is terminated at the date there is a termination of the plan within the meaning of section 411(d)(3)(A) and the regulations thereunder. Notwithstanding the preceding sentence, if contributions to or under a plan are made after termination, the plan is treated as being maintained until such contributions cease, whether or not accruals are made after such termination. If, after termination of a plan in circumstances under which the employer may be liable to the Pension Benefit Guaranty Corporation under section 4062 of the Act, employer contributions are made to or under the plan to fund benefits accrued at the time of termination, such contributions shall, for purposes of this paragraph, be deemed to be payments in satisfaction of employer liability to such Corporation rather than contributions to or under the plan. In the case of a plan maintained by more than one employer, the period for which the plan is not maintained by the withdrawing employer includes the period after the withdrawal from the plan.

(iv) Certain employers. For purposes of this subparagraph—

(A) Predecessor employers. Service with a predecessor employer who maintained the plan of the current employer is treated as service with such current employer (see section 414(a)(1) and the regulations thereunder), and certain service with a predecessor employer who did not maintain the plan of the current employer is treated as service with the current employer (see section 414(a)(2) and the regulations thereunder).

(B) Related employers. Service with an employer is treated as service for certain related employers for the period during which the employers are related. These related employers include members of a controlled group of corporations (within the meaning of section 1563(a), determined without regard to subsections (a)(4) and (e)(3)(C) thereof) and trades or businesses (whether or not incorporated) which are under common control (see section 414(b) and (c) and 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefits plans).

(C) Plan maintained by more than one employer. Service with an employer who maintains a plan is treated as service for each other employer who maintains that plan for the period during which the employers are maintaining the plan (see section 413(b)(4) and (c)(3) and 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans).

(v) Predecessor plan—(A) General rule. In the case of an employee who was covered by a predecessor plan, the time the successor of such plan is maintained for such employee includes the time the predecessor plan was maintained if, as of the later of the time the predecessor plan is terminated or the successor plan is established, the employee's years of service under the predecessor plan are not equalled or exceeded by the aggregate number of consecutive 1-year breaks in service occurring after such years of service. Years of service and breaks in service, without regard to whether the employee has nonforfeitable rights under the predecessor plan, are determined under section 411(a)(5) and (6) except that years between the termination date of the predecessor plan and the date of establishment of the successor plan do not count as years of service.

(B) Definition of predecessor plan. For purposes of this section, if—

(*1*) An employer establishes a retirement plan (within the meaning of section 7476(d)) qualified under subchapter D of chapter 1 of the Code within the 5-year period immediately preceding or following the date another such plan terminates, and

(2) The other plan is terminated during a plan year to which this section applies.

The terminated plan is a predecessor plan with respect to such other plan.

(C) *Example.* The rules provided by this subparagraph are illustrated by the following example:

Example. (1) Employer X's qualified plan A terminated on January 1, 1977, Employer X established qualified plan B on January 1, 1981. Under paragraph (b)(3)(v)(B) of this section, plan A is a predecessor plan with respect to plan B because plan B is established within the 5-year period immediately following the date plan A terminated.

(2) Employee C was not covered by the A plan. Under the general rule in subdivision (v)(A) of this subparagraph, plan B is not maintained until January 1, 1981, with respect to Employee C.

(3) Employee D was covered by the A plan. On December 31, 1976, D had 4 years of service. D had 4 consecutive 1-year breaks in service because, during the years between the termination of plan A and the establishment of plan B, he did not have more than 500 hours of service in any applicable computation period. Because D's consecutive 1-year breaks (4) equal his years of service prior to his breaks (4), plan B is not maintained until January 1, 1981, with respect to employee D.

(4) Employee E was covered by the A plan. On December 31, 1975, E had 6 years of service. E had a 1-year break in service in 1976. E also had 4 consecutive 1-year breaks in service for the period between plan A's termination and plan B's establishment. Because E's years of service (6) are not less than his consecutive 1-year breaks (5), plan B is maintained for E as of the establishment date of plan A.

(4) **Break in service.** A year of service which is not required to be taken into account by reason of a break in service (within the meaning of section 411(a)(6) and § 1.411(a)–6)).

(5) **Service before January 1, 1971.** A year of service completed by an employee prior to January 1, 1971, unless the employee completes at least 3 years of service at any time after December 31, 1970. For purposes of determining if an employee completes 3 years of service, whether or not consecutive, the exceptions of section 411(a)(4) are not applicable. For the meaning of the term "year of service", see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(6) **Service before effective date.** A year of service completed before the first plan year for which this section applies to the plan, if such service would have been disregarded under the plan rules relating to breaks in service (whether or not such rules are so designated in the plan) as such rules were in effect from time to time under the plan. For this purpose, plan rules which result in the loss of prior vesting or benefit accruals of an employee, or which deny an employee eligibility to participate, by reason of separation or failure to complete a required period of service within a specified period of time (*e.g.*, 300 hours in one year) will be considered break in service rules. See § 1.411(a)–9 for requirements relating to certain amendments to the break in service rules of a plan.

(ii) **Examples.** The rules of this subparagraph are illustrated by the following examples:

Example 1. The A plan in 1971 provides for immediate participation and vesting at normal retirement age. Employees accrue a unit benefit based on their compensation in each year. The plan provides that if an employee is not employed on the last day of the calendar year, he loses all accrued benefits. The requirement of employment on the last day of the year is a break in service rule because employees can lose benefits by reason of their separation. Accordingly, in the case of employees who separate and do not return by the close of the year, service which is completed prior to separation may be disregarded.

Example 2. The B plan in 1971 excludes from plan participation employees who work less than 1,200 hours per year. Because years of less than 1,200 hours are not taken into account under the B plan for eligibility to participate, such years are excluded under rules relating to breaks in service. Therefore, the years can be disregarded under this subparagraph.

Example 3. The C plan in 1971 provides for immediate participation and provides accruals and vesting credit for 1,200 hours or more in a given year. The plan provides that if a participant works less than 300 hours in a given year, he loses all prior vesting and benefit credits. The 300 hour rule is a break in service rule because the failure to complete 300 hours results in the loss of vesting and prior service credit. The 1,200 hour requirement is not a break in service rule because even though employees do not increase vesting or accrue benefits for service between 300 and 1,200 hours, they cannot lose prior vesting or benefits for such service. Accordingly, the C plan can disregard completed years only on account of less than 300 hours of service by an employee.

(c) **Special continuity rule for certain plans.** For special rules for computing years of service in the case of a plan maintained by more than one employer, see 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

[T.D. 7501, 42 FR 42327, Aug. 23, 1977, as amended by T.D. 7703, 45 FR 40985, June 17, 1980]

§ 1.411(a)–6 Year of service; hours of service; breaks in service.

(a) **Year of service.** Under section 411(a)(5)(A), for purposes of the regulations thereunder, the term "year of service" is defined in regulations prescribed by the Secretary of Labor under section 203(b)(2)(A) of the Employee Retirement Income Security Act of 1974. For special rules applicable to seasonal industries and maritime industries, see regulations prescribed by the Secretary of Labor under subparagraphs (C)

and (D) of section 203(b)(2) of the Employee Retirement Income Security Act of 1974.

(b) Hours of service. Under section 411(a)(5)(B), for purposes of the regulations thereunder, the term "hours of service" has the meaning provided by section 410(a)(3)(C). See regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(c) Breaks in service. Under section 411(a)(6), for purposes of § 1.411(a)–5(b)(4) and of this paragraph—

(1) In general—(i) Year of service after 1-year break in service. In the case of an employee who has incurred a 1-year break in service, years of service completed before such break are not required to be taken into account until the employee has completed one year of service after his return to service.

(ii) Defined contribution plan. In the case of a participant in a defined contribution plan or in an insured defined benefit plan (which plan satisfies the requirements of section 411(b)(1)(F) and § 1.411(b)–1) who has incurred a 1-year break in service, years of service completed after such break are not required to be taken into account for purposes of determining the nonforfeitable percentage of the participant's right to employer-derived benefits which accrued before such break. This subdivision does not permit years of service completed before a 1-year break in service to be disregarded in determining the nonforfeitable percentage of a participant's right to employer-derived benefits which accrue after such break.

(iii) Nonvested participants. In the case of an employee who is a nonvested participant in employer-derived benefits at the time he incurs a 1-year break in service, years of service completed by such participant before such break are not required to be taken into account for purposes of determining the nonforfeitable percentage of his right to employer-derived benefits if at such time the number of consecutive 1-year breaks in service included in his most recent break in service equals or exceeds the aggregate number of his years of service, whether or not consecutive, completed before such break. In the case of a plan utilizing the elapsed time method described in § 1.410(a)–7, the condition in the preceding sentence shall be satisfied if the period of severance is at least one year and the consecutive period of severance equals or exceeds his prior period of service, whether or not consecutive, completed before such period of severance. In computing the aggregate number of years of service prior to such break, years of service which could have been disregarded under this subdivision by reason of any prior break in service may be disregarded.

(2) One-year break in service defined. The term "1-year break in service" means a calendar year, plan year, or other 12-consecutive month period designated by a plan (and not prohibited under regulations prescribed by the Secretary of Labor) during which the participant has not completed more than 500 hours of service. In the case of a plan utilizing the elapsed time method, the term "1-year break in service" means a 12-consecutive month period beginning on the severance from service date or any anniversary thereof and ending on the next succeeding anniversary of such date; provided, however, that the employee during such 12-consecutive month period does not complete any hours of service within the meaning of 29 CFR Part 2530.200b–2(a) for the employer or employers maintaining the plan. See regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(d) Examples. The rules provided by this section are illustrated by the following examples:

Example (1). (i) X Corporation maintains a defined contribution plan to which section 411 applies. The plan uses the calendar year as the vesting computation period. In 1980, Employee A, who was hired at age 35, separates from the service of X Corporation after completing 4 years of service. At the time of his separation, Employee A had a nonforfeitable right to 25 percent of his employer-derived accrued benefit which was not distributed. In 1985, after incurring 5 consecutive one-year breaks in service, Employee A is re-employed by X Corporation and becomes an active participant in the plan. The plan provides that, for 1985 and all subsequent years, Employee A's previous years of service will not be taken into account for purposes of computing the nonforfeitable percentage of his employer-derived accrued benefit, solely because of his break in service.

(ii) The plan fails to satisfy section 411. Section 411(a)(6)(B) would permit the plan to disregard Employee A's prior service for purposes of computing his nonforfeitable percentage in 1985 only, but such service must be taken into account in subsequent years unless there is another break in service. Under section 411(a)(6)(C), the plan is not required to take Employee A's post-break service into account for purposes of computing his nonforfeitable right to his pre-break employer-derived accrued benefits. This provision, however, would not permit the plan to disregard pre-break service in determining his nonforfeitable right to his benefit accrued after the break. The exception provided by section 411(a)(6)(D) does not apply in the case of a participant who has any nonforfeitable right to his accrued benefit derived from employer contributions.

Example (2). (i) X Corporation maintains a qualified plan to which sections 410 and 411 (relating to minimum participation standards and minimum vesting standards, respectively) apply. The plan permits participation upon completion of a

year of service and provides that 100% of an employee's employer-derived accrued benefit vests after 10 years of service. The plan uses the calendar year as the vesting computation period. The plan provides that an employee who completes at least 1,000 hours of service in a 12-month period is credited with a year of service for participation and vesting purposes. The plan also provides that an employee who does not complete more than 500 hours of service in that 12-month period incurs a one-year break in service. The plan includes the rule described in section 411(a)(6)(D) for participation and vesting purposes. Under this rule, an employee's years of service prior to a break in service may be disregarded under certain circumstances if he has no vested right to any employer-derived benefit under the plan. The plan does not contain the rule described in section 411(a)(6)(B) (relating to the requirement of one year of service after a one-year break in service).

(ii) Employee A commences employment with the X Corporation on January 1, 1977. Employee A's employment history for 1977 through 1989 is as follows:

Year ending December 31	Hours of service completed
1977	1,000
1978	800
1979	1,000
1980	400
1981	1,000
1982	0
1983	400
1984	1,000
1985	0
1986	0
1987	500
1988	200
1989	1,000

Employee A's status as a participant during this period is determined as follows:

1978: Employee A was a plan participant on January 1, 1978, because he completed a year of service (1,000 hours) in 1977. He did not complete a year of service in 1978 because he completed fewer than 1,000 hours in that year. Because he completed more than 500 hours of service in 1978, however, Employee A did not incur a one-year break in service that year.

1979: Employee A completes a year of service in 1979. Because he did not incur a one-year break in service in 1978, the plan may not disregard his 1977 service for purposes of determining his years of service as of January 1, 1979.

1980: Employee A incurs a one-year break in service in 1980.

1981: Because Employee A had completed 2 years of service prior to 1981 and had incurred one 1-year break in service prior to 1981, under section 411(a)(6)(D), the plan may not disregard his pre-1980 service in 1981. Employee A completes a year of service in 1981.

1982: Employee A incurs a one-year break in service in 1982.

1983: Employee A incurs a one-year break in service in 1983. As of the end of 1983, he has completed 3 years of service and has incurred 2 consecutive one-year breaks in service.

1984: Employee A completes a year of service in 1984. Under section 411(a)(6)(D), his pre-1982 service may not be disregarded in 1984 because, as of the beginning of 1984, his pre-1984 years of service (3) exceed his consecutive one-year breaks in service (2).

1984–1988: Employee A incurs 4 consecutive one-year breaks in service during the years 1985 through 1988.

1989: Employee A's pre-1989 service is disregarded in 1989 and all subsequent plan years because his years of service as of January 1, 1989, equal the number of consecutive one-year breaks he has incurred as of that date. Therefore, as of the beginning of 1989, Employee A is not a plan participant. Employee A completes a year of service in 1989. (Although section 411(a)(6)(D) does not prohibit the plan provision under which Employee A's pre-1989 service is disregarded, that section does not require such a provision in a qualified plan.)

[T.D. 7501, 42 FR 42329, Aug. 23, 1977, as amended by T.D. 7703, 45 FR 40985, June 17, 1980]

§ 1.411(a)–7 Definitions and special rules.

(a) **Accrued benefit.** For purposes of section 411 and the regulations thereunder, the term "accrued benefit" means—

(1) **Defined benefit plan.** In the case of a defined benefit plan—

(i) If the plan provides an accrued benefit in the form of an annual benefit commencing at normal retirement age, such accrued benefit, or

(ii) If the plan does not provide an accrued benefit in the form described in subdivision (i) of this subparagraph, an annual benefit commencing at normal retirement age which is the actuarial equivalent (determined under section 411(c)(3) and § 1.411(c)–5 of the accrued benefit determined under the plan. In general, the term "accrued benefits" refers only to pension or retirement benefits. Consequently, accrued benefits do not include ancillary benefits not directly related to retirement benefits such as payment of medical expenses (or insurance premiums for such expenses), disability benefits not in excess of the qualified disability benefit (see section 411(a)(9) and paragraph (c)(3) of this section), life insurance benefits payable as a lump sum, incidental death benefits, current life insurance protection, or medical benefits described in section 401(h). For purposes of this paragraph a subsidized early retirement benefit which is provided by a plan is not taken into account, except to the extent of determining the normal retirement benefit under the plan (see section 411(a)(9) and paragraph (c) of this section). The accrued benefit includes any optional settlement at normal retirement age under actuarial assumptions no less favorable than those which would be applied if the employee were terminating his employment at normal retirement age. The accrued benefit does not include any subsidized value in a joint and survivor annuity to the extent

that the annual benefit of the joint and survivor annuity does not exceed the annual benefit of a single life annuity.

(2) Defined contribution plan. In the case of a defined contribution plan, the balance of the employee's account held under the plan.

(b) Normal retirement age—(1) General rule. For the purposes of section 411 and the regulations thereunder, the term "normal retirement age" means the earlier of—

(i) The time specified by a plan at which a plan participant attains normal retirement age, or

(ii) The later of—

(A) The time the plan participant attains age 65, or

(B) The 10th anniversary of the date the plan participant commences participation in the plan.

If a plan, or the employer sponsoring the plan, imposes a requirement that an employee retire upon reaching a certain age, the normal retirement age may not exceed that mandatory retirement age. The preceding sentence will apply if the employer consistently enforces a mandatory retirement age rule, whether or not set forth in the plan or any related document. For purposes of subdivision (i) of this subparagraph, if an age is not specified by a plan as the normal retirement age then the normal retirement age under the plan is the earliest age beyond which the participant's benefits under the plan are not greater solely on account of his age or service. For purposes of paragraph (b)(1)(ii)(B) of this section, participation commences on the first day of the first year in which the participant commenced his participation in the plan, except that years which may be disregarded under section 410(a)(5)(D) may be disregarded in determining when participation commenced.

(2) Examples. The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A defines normal retirement age as age 65. Under the plan, benefits payable to participants who retire at or after age 60 are not reduced on account of early retirement. For purposes of section 411 and the vesting regulations, normal retirement age under Plan A is age 65 (determined under subparagraph (1)(i) of this paragraph). This is true even if in operation all participants retire at age 60.

Example (2). Plan B does not specify any age as the normal retirement age. Under the plan, participants who have attained age 55 are entitled to benefits commencing upon retirement but the benefits of participants who retire before attaining age 70 are subject to reduction on account of early retirement. For purposes of section 411 and the vesting regulations the normal retirement age under Plan B is the later of (i) age 65, or (ii) the 10th anniversary of the date a plan participant commences participation in the plan (assuming such date is prior to age 70).

Example (3). The facts are the same as in example (2). Employee X first became a participant in Plan B on January 1, 1980 at age 53. His participation continued until December 31, 1980, when he separated from the service with no vested benefits. After incurring 5 consecutive 1-year breaks in service, Employee X again becomes an employee and a plan participant on January 1, 1986, at age 59. For purposes of section 411, Employee X's normal retirement age under Plan B is age 69, the 10th anniversary of the date on which his year of plan participation commenced. His participation in 1980 may be disregarded under the last sentence of paragraph (b)(1) of this section.

(c) Normal retirement benefit—(1) In general. For purposes of section 411 and the regulations thereunder, the term "normal retirement benefit" means the periodic benefit under the plan commencing upon early retirement (if any) or at normal retirement age, whichever benefit is greater.

(2) Periodic benefit. For purposes of subparagraph (1) of this paragraph—

(i) In the case of a plan under which a benefit is payable as an annuity in the same form upon early retirement and at normal retirement age, the greater benefit is determined by comparing the amount of such annuity payments.

(ii) In the case of a plan under which an annuity benefit payable upon early retirement is not in the same form as an annuity benefit payable at normal retirement age, the greater benefit is determined by converting the annuity benefit payable upon early retirement age into the same form of annuity benefit as is payable at normal retirement age and by comparing the amount of the converted early retirement benefit payment with the amount of the normal retirement benefit payment.

(iii) In the case of a plan which is integrated with the Social Security Act or any other Federal or State law, the periodic benefit payable upon and after early retirement age is adjusted for any increases in such benefits occurring on or after early retirement age which are taken into account under the plan. See however, section 401(a)(15) and the regulations thereunder.

(3) Benefits included. For purposes of this paragraph, the normal retirement benefit under a plan shall be determined without regard to ancillary benefits not directly related to retirement benefits such as medical benefits or disability benefits not in excess of the qualified disability benefit; see section 411(a)(7) and paragraph (a)(1) of this section. For this purpose, a qualified disability benefit is a disability benefit which is not in excess of the amount of the benefit which would be

payable to the participant if he separated from service at normal retirement age.

(4) **Early retirement benefit; social security supplement.** (i) For purposes of this paragraph, the early retirement benefit under a plan shall be determined without regard to any social security supplement.

(ii) For purposes of this subparagraph, a social security supplement is a benefit for plan participants which—

(A) Commences before the age and terminates before the age when participants are entitled to old-age insurance benefits, unreduced on account of age, under title II of the Social Security Act, as amended (see section 202(a) and (g) of such Act), and

(B) Does not exceed such old-age insurance benefit.

(5) **Special limitation.** If a defined benefit plan bases its normal retirement benefits on employee compensation, the compensation must reflect the compensation which would have been paid for a full year of participation within the meaning of section 411(b)(3). If an employee works less than a full year of participation, the compensation used to determine benefits under the plan for such year of participation must be multiplied by the ratio of the number of hours for a complete year of participation to the number of hours worked in such year. A plan whose benefit formula is computed on a computation base which cannot decrease is not required to adjust employee compensation in the manner described in the previous sentence. Thus, for example, if a plan provided a benefit based on an employee's compensation for his highest five consecutive years or a separate benefit for each year of participation based on the employee's compensation for such year the plan would not have to so adjust compensation. However, if a plan provided a benefit based on an employee's compensation for the employee's last five years or the five highest consecutive years out of the last 10 years, the compensation, would have to be so adjusted. For special rules for applying the limitations on proration of a year of participation for benefit accrual, see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(6) **Examples.** The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A provides for a benefit equal to 1% of high 5 years compensation for each year of service and a normal retirement age of 65. The plan also provides for a full unreduced accrued benefit without any actuarial reduction for any employee at age 55 with 30 years of service. Even though the actuarial value of the early retirement benefit could exceed the value of the benefit at the normal retirement age, the normal retirement benefit would not include the greater value of the early retirement benefit because actuarial subsidies are ignored.

Example (2). Plan B provides the following benefits: (1) at normal retirement age 65, $300/mo. for life and (2) at early retirement age 60, $400/mo. for life. The normal retirement benefit is $400/mo., the greater of the benefit payable at normal retirement age ($300) or early retirement ($400).

Example (3). Assume the same facts as example (2) except that the early retirement benefit of $400 is reduced to $300 upon attainment of age 65. If each employee's social security benefit at age 65 is not less than $100, the $100 would be considered to be a social security supplement and would therefore be ignored. Consequently, the normal retirement benefit would be $300.

Example (4). Plan C provides a benefit at normal retirement age equal to 1% per year of service, multiplied by the participant's compensation averaged over the 5 years immediately prior to retirement. An early retirement benefit is provided upon attainment of age 60 equal to the benefit accrued to date of early retirement reduced by 4 percent for each year by which the early retirement date precedes the normal retirement age of 65. Employee A was hired at age 30, participated immediately, and retired at age 65. Employee A's annual compensation was $50,000 between ages 55–60 and was reduced to $33,000 after age 60. The following table indicates the amount of annual benefit that would have been provided by the plan formula if the employee retired at or after age 60:

Age	Final average computed (1)—	Percent accrued benefit (2)—	Reduction (3)—	Annual benefit (4)—
60	$50,000	30	0.80	$12,000
61	46,600	31	.84	12,135
62	43,200	32	.88	12,165
63	39,800	33	.92	12,083
64	36,400	34	.96	11,881
65	33,000	35	1.00	11,550

Note.—Col. (1) times col. (2) times col. (3) equals col. (4).

The normal retirement benefit is the greater of the benefit payable at normal retirement age or the early retirement benefit. Employee A's normal retirement benefit is $12,165, the greatest annual benefit Employee A would be entitled to.

(d) Rules relating to certain distributions and cash-outs of accrued benefits—(1) In general. This paragraph sets forth vesting rules applicable to certain distributions from qualified plans and their related trusts (other than class year plans). Subparagraphs (2) and (3) set forth the exceptions to nonforfeitability on account of withdrawal of mandatory contributions provided by section 411(a)(3)(D). When a plan utilizes these exceptions with respect to a given participant's accrued benefit, such accrued benefit is not subject to the cash-out rules or vesting rules of subparagraphs (4) or (5), respectively. Section 411 prescribes certain requirements with respect to accrued benefits under a qualified plan. These requirements would generally not be satisfied if the plan disregarded service in computing accrued benefits even though amounts were distributed on account of such service. Subparagraph (4) of this paragraph sets forth rules under section 411(a)(7)(B) which allow a plan to make distributions and compute accrued benefits without regard to the accrued benefit attributable to the distribution. When a defined contribution plan utilizes this exception with respect to an accrued benefit, the plan is not required to satisfy the rules of subparagraph (5) of this paragraph. Subparagraph (5) of this paragraph sets forth a vesting requirement applicable to certain distributions from defined contribution plans. Subparagraph (6) sets forth other rules which pertain to the distribution rules of this paragraph.

(2) Withdrawal of mandatory contribution—(i) General rule. In the case of a participant's right to his employer-derived accrued benefit, a right is not treated as forfeitable merely because all or a portion of such benefit may be forfeited on account of the withdrawal by the participant of any amount attributable to his accrued benefit derived from his mandatory contributions (within the meaning of section 411(c)(2)(C) and § 1.411(c)–1) before he has become a 50 percent vested participant (within the meaning of § 1.401(a)–19(b)(2)). For purposes of determining the vested percentage, the plan may disregard service after the withdrawal. For example, assume that a plan utilizes 1000 hours for computing years of service and that for the computation period employee A had 1000 hours of service. If A was 40 percent vested at the beginning of the period but only had 800 hours at the time of the withdrawal, the plan could treat A as only 40 percent vested because service after the withdrawal can be disregarded. On the other hand, if A had 1000 hours at the time of the withdrawal, he must receive a year of service for the computation period, even though service is not taken into account until the end of such period.

(ii) Plan repayment provision. (A) Subdivision (i) of this subparagraph shall not apply unless, at the time the amount described in such subdivision is withdrawn by the participant, the plan provides the employee with a right to restoration of his employer-derived accrued benefit to the extent forfeited in accordance with such subdivision upon repayment to the plan of the full amount of the withdrawal.

(B) In the case of a defined benefit plan (as defined in section 414(j)) the restoration of the employee's employer-derived accrued benefit may be conditioned upon repayment of interest on the full amount of the distribution. Such interest shall be computed on the amount of the distribution from the date of such distribution to the date of repayment, compounded annually from the date of distribution, at the rate determined under section 411(c)(2)(C) in effect on the date of repayment. A plan may provide for repayment of interest which is less than the amount determined under the preceding sentence.

(C) In the case of both defined benefit plans and defined contribution plans, the plan repayment provision described in this subparagraph may provide that the employee must repay the full amount of the distribution in order to have the forfeited benefit restored. The plan provision may not require that such repayment be made sooner than the time described in paragraph (d)(2)(ii)(D) of this section.

(D)(*1*) If a distribution is on account of separation from service, the time for repayment may not end before the earlier of—

(i) 5 years after the first day the employee is subsequently employed, or

(ii) The close of the first period of consecutive 1-year breaks in service commencing after the distribution.

If the distribution occurs for any other reason, the time for repayment may not end earlier than 5 years after the date of distribution. Nevertheless, a plan provision may provide for a longer period in which the employee may repay. For example, a plan could allow repayments to be made at any time before normal retirement age.

(2) In the case of a plan utilizing the elapsed time method, described in § 1.410(a)-7, the minimum time for repayment shall be determined as in paragraph (d)(2)(ii)(D)(1) of this section except as provided in this subdivision. The 5 consecutive 1-year break periods shall be determined by substituting the term "1-year period of severance" for the term "1-year break in service". Also, the repayment period both commences and closes in a manner determined by the Commissioner that is consistent with the rules in § 1.410(a)-7 and the substitution in section 411(a)(6) (C) and (D) of a 5-year break in service rule for the former 1-year break in service rule.

(E) A defined benefit plan using the break in service rule described in section 410(a)(5)(D) or a defined contribution plan using the break in service rule described in section 411(a)(6)(C) for determining employees' accrued benefits is not required to provide for repayment by an employee whose accrued benefit is disregarded by reason of a plan provision using these rules.

(iii) Computation of benefit. In the case of a defined contribution plan, the employer-derived accrued benefit required to be restored by this subparagraph shall not be less than the amount in the account balance of the employee which was forfeited, unadjusted by any subsequent gains or losses.

(iv) Delayed forfeiture. A defined contribution plan may, in lieu of the forfeiture and restoration described in this subparagraph, provide that the forfeiture does not occur until the expiration of the time for repayment described in subdivision (ii) of this subparagraph provided that the conditions of this subparagraph are satisfied.

(3) Withdrawal of mandatory contributions; accruals before September 2, 1974—(i) General rule. In the case of a participant's right to the portion of the employer-derived benefit which accrued prior to September 2, 1974, a right is not treated as forfeitable merely because all or part of such portion may be forfeited on account of the withdrawal by the participant of an amount attributable to his benefit derived from mandatory contributions (within the meaning of section 411(c)(2)(C) and § 1.411(c)–1(c)(4)) made by the participant before September 2, 1974, if the amount so subject to forfeiture is no more than proportional to such amounts withdrawn. This subparagraph shall not apply to any plan to which any mandatory contribution (within the meaning of section 411(c)(2)(C) and § 1.411(c)–1(c)(4)) is made after September 2, 1974.

(ii) Defined contribution plan. In the case of a defined contribution plan, the portion of a participant's employer-derived benefit which accrued prior to September 2, 1974, shall be determined on the basis of a separate accounting between benefits accruing before and after such date. Gains, losses, withdrawals, forfeitures, and other credits or charges must be separately allocated to such benefits. Any allocation made on a reasonable and consistent basis prior to September 1, 1977, shall satisfy the requirements of this subdivision.

(iii) Defined benefit plan. In the case of a defined benefit plan, the portion of a participant's employer-derived benefit which accrued prior to September 2, 1974, shall be determined in a manner consistent with the determination of an accrued benefit under section 411(b)(1)(D) (see § 1.411(b)–1(c)). Any method of determining such accrued benefit which the Commissioner finds to be reasonable shall satisfy the requirements of this subdivision.

(4) Certain cash-outs of accrued benefits—(i) Involuntary cash-outs. For purposes of determining an employee's right to an accrued benefit derived from employer contributions under a plan, the plan may disregard service performed by the employee with respect to which—

(A) The employee receives a distribution of the present value of his entire nonforfeitable benefit at the time of the distribution,

(B) The requirements of section 411(a)(11) are satisfied at the time of the distribution. See § 1.411(a)(11)-1.

(C) The distribution is made due to the termination of the employee's participation in the plan, and

(D) The plan has a repayment provision which satisfies the requirements of subdivision (iv) of this subparagraph in effect at the time of the distribution.

A distribution shall be deemed to be made due to the termination of an employee's participation in the plan if it is made no later than the close of the second plan year following the plan year in which such termination occurs. For purposes of determining the entire nonforfeitable benefit, the plan may disregard service after the distribution, as illustrated in subparagraph (2)(i) of this paragraph.

(ii) Voluntary cash-outs. For purposes of determining an employee's accrued benefit derived from employer contributions under a plan, the

plan may disregard service performed by the employee with respect to which—

(A) The employee receives a distribution of the present value of his nonforfeitable benefit attributable to such service at the time of such distribution,

(B) The employee voluntarily elects to receive such distribution,

(C) The distribution is made on termination of the employee's participation in the plan, and

(D) The plan has a repayment provision in effect at the time of the distribution which satisfies the requirements of subdivision (iv) of this subparagraph.

A distribution shall be deemed to be made on termination of participation in the plan if it is made not later than the close of the second plan year following the plan year in which such termination occurs. For purposes of determining the nonforfeitable benefit, the plan may disregard service after the distribution as illustrated in subparagraph (2)(i) of this subparagraph.

(iii) Disregard of service. Service of an employee permitted to be disregarded under subdivision (i) or (ii) of the subparagraph is not required to be taken into account in computing the employee's accrued benefit under the plan. In the case of a voluntary distribution described in subdivision (ii) of this subparagraph which is less than the present value of the employee's total nonforfeitable benefit immediately prior to the distribution, the accrued benefit not required to be taken into account is such total accrued benefit multiplied by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the present value of his total nonforfeitable benefit immediately prior to such distribution. For example, A who is 50 percent vested in an account balance of $1,000 receives a voluntary distribution of $250. The accrued benefit which can be disregarded equals $1,000 times $250/$500, or $500. However, such service may not by reason of this paragraph be disregarded for purposes of determining an employee's years of service under sections 410(a)(3) and 411(a)(4).

(iv) Plan repayment provision. (A) A plan repayment provision satisfies the requirements of this subdivision if, under the provision, the accrued benefit of an employee that is disregarded by a plan under this subparagraph is restored upon repayment to the plan by the employee of the full amount of the distribution. An accrued benefit is not restored unless all of the optional forms of benefit and subsidies relating to such benefit are also restored. A plan is not required to provide for repayment of an accrued benefit unless the employee—

(1) Received a distribution that is in a plan year to which section 411 applies (see § 1.411(a)-2), which distribution is less than the amount of his accrued benefit determined under the same optional form of benefit as the distribution was made, and

(2) Resumes employment covered under the plan.

(B) Example.

Plan A provides a single sum distribution equal to the present value of the normal form of the accrued benefit payable at normal retirement age which is a single life annuity. Plan A also provides a subsidized joint and survivor annuity and a subsidized early retirement annuity benefit. A participant who is fully vested and receives a single sum distribution equal to the present value of the single life annuity normal retirement benefit is not required to be provided the right under the plan to repay the distribution upon subsequent reemployment even though the participant received a distribution that did not reflect the value of the subsidy in the joint and survivor annuity or the value of the early retirement annuity subsidy. This is true whether or not the participant had satisfied at the time of the distribution all of the conditions necessary to receive the subsidies. However, if a participant does not receive his total accrued benefit in the optional form of benefit under which his benefit was distributed, the plan must provide for repayment. If the employee repays the distribution in accordance with section 411(a)(7), the plan must restore the employee's accrued benefit which would include the right to receive the subsidized joint and survivor annuity and the subsidized early retirement annuity benefit.

(C) A plan may impose the same conditions on repayments for the restoration of employer-derived accrued benefits that are allowed as conditions for restoration of employer-derived accrued benefits upon repayment of mandatory contributions under paragraphs (d)(2)(ii) (B), (C), (D) and (E) of this section.

(v) In the case of a defined contribution plan, the employer-derived accrued benefit required to be restored by this subparagraph shall not be less than the amount in the account balance of the employee, both the amount distributed and the amount forfeited, unadjusted by any subsequent gains or losses. Thus, for example, if an employee received a distribution of $250 when he was 25 percent vested in an account balance of $1,000, upon repayment of $250 the account balance may not be less than $1,000 even if, because of plan losses, the account balance, if not distributed, would have been reduced to $500.

(5) Vesting requirement for defined contribution plans—(i) Application. The requirements of this

subparagraph apply to a defined contribution plan which makes distributions to employees from their accounts attributable to employer contributions at a time when—

(A) Employees are less than 100 percent vested in such accounts, and

(B) Under the plan, employees can increase their percentage of vesting in such accounts after the distributions.

(ii) Requirements. In order for a plan, to which this subparagraph applies, to satisfy the vesting requirements of section 411, account balances under the plan (with respect to which percentage vesting can increase) must be computed in a manner which satisfies either subdivision (iii)(A) or (B) of this subparagraph.

(iii) Permissible methods. A plan may provide for either of the following methods, but not both, for computing account balances with respect to which percentage vesting can increase and from which distributions are made:

(A)(*1*) A separate account is established for the employee's interest in the plan as of the time of the distribution, and

(*2*) At any relevant time the employee's vested portion of the separate account is not less than an amount ("X") determined by the formula: $X=P(AB+(R\times D))-(R\times D)$. For purposes of applying the formula: P is the vested percentage at the relevant time; AB is the account balance at the relevant time; D is the amount of the distribution; R is the ratio of the account balance at the relevant time to the account balance after distribution; and the relevant time is the time at which, under the plan, the vested percentage in the account cannot increase.

A plan is not required to provide for separate accounts provided that account balances are maintained under a method that has the same effect as under this subdivision.

(B) At any relevant time the employee's vested portion is not less than an amount ("X") determined by the formula: $X=P(AB+D)-D$. For purposes of applying the formula, the terms have the same meaning as under subdivision (iii)(A)(*2*) of this subparagraph.

(C) An application of the methods described in subdivisions (iii)(A) and (B) of this subparagraph is illustrated by the following examples:

Example (1). The X defined contribution plan uses the method described in subdivision (iii)(A) of this subparagraph for computing account balances and the break in service rule described in section 411(a)(6)(C) (service after a 1-year break does not increase the vesting percentage in account balances accrued prior to the break). The plan distributes $250 to A when A's account balance prior to the distribution equals $1,000 and he is 25 percent vested. At the time of the distribution, A has not incurred a 1-year break so that his vesting percentage can increase. Six years later, when A is 60 percent vested, he incurs a 1-year break so that his vesting percentage cannot increase. At this time his separate account balance equals $1,500. R=$1,500/$750 or 2. A's separate account must equal 60 percent ($1,500+(2×$250))–(2×$250) or 60 percent ($1,500+$500)–$500, or $1,200–$500 equals $700.

Example (2). The Y defined contribution plan uses the method described in subdivision (iii)(B) of this subparagraph for computing account balances and the break in service rule described in section 411(a)(6)(C). The plan distributes $250 to B when B's account balance prior to the distribution equals $1,000 and he is 25 percent vested. At the time of the distribution, B has not incurred a 1-year break so that his vesting percentage can increase. Six years later, when A is 60 percent vested, he incurs a 1-year break so that his vesting percentage cannot increase. At this time his account balance equals $1,500. B's separate account must equal 60 percent ($1,500+$250)–$250, 60% of $1,750–$250 equals $800.

(6) Other rules—(i) Distributions on separation or other event. None of the rules of this paragraph preclude distributions to employees upon separation from service or any other event recognized by the plan for commencing distributions. Such a distribution must, of course, satisfy the applicable qualification requirements pertaining to such distributions. For example, a profit-sharing plan could pay the vested portion of an account balance to an employee when he separated from service, but in order to satisfy section 411 the plan might not be able to forfeit the nonvested account balance until the employee has a 1-year break in service. Similarly, the fact that a plan cannot disregard an accrued benefit attributable to service for which an employee has received a distribution because the plan does not satisfy the cash-out requirements of subparagraph (4) of this paragraph does not mean that the employee's accrued benefit (computed by taking into account such service) cannot be offset by the accrued benefit attributable to the distribution.

(ii) Joint and survivor requirements. See § 1.401(a)–11(a)(2) (relating to joint and survivor annuities) for special rules applicable to certain distributions described in this paragraph.

(iii) Plan repayments. (A) Under subparagraphs (2) and (4) of this paragraph, a plan may be required to restore accrued benefits in the event of repayment by an employee.

(B) For purposes of applying the limitations of section 415(c) and (e), in the case of a defined contribution plan, the repayment by the employee

and the restoration by the employer shall not be treated as annual additions.

(C) In the case of a defined contribution plan, the permissible sources for restoration of the accrued benefit are: income or gain to the plan, forfeitures, or employer contributions. Notwithstanding the provisions of § 1.401–1(b)(1)(ii), contributions may be made for such an accrued benefit by a profit-sharing plan even though there are no profits. In order for such a plan to be qualified, account balances (accrued benefits) generally must correspond to assets in the plan. Accordingly, there cannot be an unfunded account balance. However, an account balance will not be deemed to be unfunded in the case of a restoration if assets for the restored benefit are provided by the end of the plan year following the plan year in which the repayment occurs.

[T.D. 7501, 42 FR 42329, Aug. 23, 1977; as amended by T.D. 8038, 50 FR 29374, July 19, 1985; T.D. 8219, 53 F.R. 31852, Aug. 22, 1988]

§ 1.411(a)–8 Changes in vesting schedule.

(a) Requirement of prior schedule. Under section 411(a)(10)(A), for plan years for which section 411 applies, a plan will be treated as not meeting the minimum vesting standards of section 411(a)(2) if the plan does not satisfy the requirements of this paragraph. If the vesting schedule of a plan is amended, then as of the date such amendment is adopted, the plan satisfies the requirements of this paragraph if, under the plan as amended, in the case of an employee who is a participant on—

(1) The date the amendment is adopted, or

(2) The date the amendment is effective, if later.

The nonforfeitable percentage (determined as of such date) of such employee's right to his employer-derived accrued benefit is not less than his percentage computed under the plan without regard to such amendment.

(b) Election of former schedule—(1) In general. Under section 411(a)(10)(B), for plan years for which section 411 applies, if the vesting schedule of a plan is amended, the plan will not be treated as meeting the minimum vesting standards of section 411(a)(2) unless the plan as amended, provides that each participant whose nonforfeitable percentage of his accrued benefit derived from employer contributions is determined under such schedule, and who has completed at least 5 years of service with the employer, may elect, during the election period, to have the nonforfeitable percentage of his accrued benefit derived from employer contributions determined without regard to such amendment. Notwithstanding the preceding sentence, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment.

(2) Election period. For purposes of subparagraph (1) of this paragraph, the election period under the plan must begin no later than the date the plan amendment is adopted and end no earlier than the latest of the following dates:

(i) The date which is 60 days after the day the plan amendment is adopted,

(ii) The date which is 60 days after the day the plan amendment becomes effective, or

(iii) The date which is 60 days after the day the participant is issued written notice of the plan amendment by the employer or plan administrator.

(3) Service requirement. For purposes of subparagraph (1) of this paragraph, a participant shall be considered to have completed 5 years of service if such participant has completed 5 years of service, whether or not consecutive, without regard to the exceptions of section 411(a)(4) prior to the expiration of the election period described in subparagraph (2) of this paragraph. For the meaning of the term "year of service", see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(4) Election only by participant. The election described in subparagraph (1) of this paragraph is available only to an individual who is a participant in the plan at the time such election is made.

(5) Election may be irrevocable. A plan, as amended, shall not fail to meet the minimum vesting standards of section 411(a)(2) by reason of section 411(a)(10)(B) merely because such plan provides that the election described in subparagraph (1) of this paragraph is irrevocable.

(6) Relationship with section 411(a)(2). The election described in subparagraph (1) of this paragraph is available for a vesting schedule which does not satisfy the requirements of section 411(a)(2) only if under such schedule all participants have a 50 percent nonforfeitable right after 10 years of service, and a 100 percent nonforfeitable right after 15 years of service, in their employer-derived accrued benefit. If the vesting

schedule provides less vesting than the percentages required by the preceding sentence, the plan can be amended to provide for such vesting.

(c) Special rules—(1) Amendment of vesting schedule. For purposes of this section, an amendment of a vesting schedule is each plan amendment which directly or indirectly affects the computation of the nonforfeitable percentage of employees' rights to employer-derived accrued benefits. Consequently, such an amendment, for example, includes each change in the plan which affects either the plan's computation of years of service or of vesting percentages for years of service.

(2) Aggregation of amendments. All plan amendments which are: (i) amendments of a vesting schedule within the meaning of subparagraph (1) of this paragraph and (ii) adopted and effective at the same time, shall be deemed to be a single amendment for purposes of applying the rules in paragraphs (a) and (b) of this section.

[T.D. 7501, 42 FR 42333, Aug. 23, 1977]

§ 1.411(a)-8T. Changes in vesting schedule (temporary).

(a) [Reserved]

(b) Election of former schedule—(1) In general. Under section 411(a)(10)(B), for plan years for which section 411 applies, if the vesting schedule of a plan is amended, the plan will not be treated as meeting the minimum vesting standards of section 411(a)(2) unless the plan as amended provides that each participant whose nonforfeitable percentage of his accrued benefit derived from employer contributions is determined under such schedule, and who has completed at least 3 years of service with the employer, may elect, during the election period, to have the nonforfeitable percentage of his accrued benefit derived from employer contributions determined without regard to such amendment. Notwithstanding the preceding sentence, no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment. For employees not described in § 1.411(a)-3T(e)(1), this section shall be applied by substituting "5 years of service" for "3 years of service" where such language appears.

(2) Election period. For purposes of subparagraph (1) of this paragraph, the election period under the plan must begin no later than the date the plan amendment is adopted and end no earlier than the latest of the following dates:

(i) The date which is 60 days after the day the plan amendment is adopted,

(ii) The date which is 60 days after the day the plan amendment becomes effective, or

(iii) The date which is 60 days after the day the participant is issued written notice of the plan amendment by the employer or plan administrator.

(3) Service requirement. For purposes of subparagraph (1) of this paragraph, a participant shall be considered to have completed 3 years of service if such participant has completed 3 years of service, whether or not consecutive, without regard to the exceptions of section 411(a)(4) prior to the expiration of the election period described in subparagraph (2) of this paragraph. For the meaning of the term "year of service", see regulations prescribed by the Secretary of Labor under 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

[T.D. 8170, 53 FR 241, Jan. 6, 1988]

§ 1.411(a)-9 Amendment of break in service rules; transitional period.

(a) In general. Under section 1017(f)(2) of the Employee Retirement Income Security Act of 1974, a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if the rules of the plan relating to breaks in service are amended, and—

(1) Such amendment is effective after January 1, 1974, and before the effective date of section 411, and

(2) Under such amendment, the nonforfeitable percentage of any employee's right to his employer-derived accrued benefit is less than the lesser of the nonforfeitable percentage of such employee's right to such benefit—

(i) Under the break in service rules provided by section 411(a)(6) and § 1.411(a)-6(c), or

(ii) The greatest such percentage under the plan as in effect on or after January 1, 1974 (provided the break in service rules of the plan were not in violation of any law or rule of law on January 1, 1974).

(b) Break in service rules. For purposes of paragraph (a), the term "break in service rules" means the rules provided by a plan relating to circumstances under which a period of an employee's service or plan participation is disregarded, for

purposes of determining the extent to which his rights to his accrued benefit under the plan are unconditional, if under such rules such service is disregarded by reason of the employee's failure to complete a required period of service within a specified period of time. For this purpose, plan rules which result in the loss of prior vesting or benefit accruals of an employee, or which deny an employee eligibility to participate, by reason of separation or failure to complete a required period of service within a specified period of time (*e.g.*, 300 hours in one year) will be considered break in service rules. For purposes of section 411(b)(3), service described under the plan's break in service rules, as in effect before the effective date of section 411, need not be counted.

[T.D. 7501, 42 FR 42333, Aug. 23, 1977]

§ 1.411(a)–11 Restriction and valuation of distributions.

(a) Scope—(1) In general. Section 411(a)(11) restricts the ability of a plan to distribute any portion of a participant's accrued benefit without the participant's consent. Section 411(a)(11) also restricts the ability of defined benefit plans to distribute any portion of a participant's accrued benefit in optional forms of benefit without complying with specified valuation rules for determining the amount of the distribution. If the consent requirements or the valuation rules of this section are not satisfied, the plan fails to satisfy the requirements of section 411(a).

(2) Accrued benefit. For purposes of this section, an accrued benefit is valued taking into consideration the particular optional form in which the benefit is to be distributed. The value of an accrued benefit is the present value of the benefit in the distribution form determined under the plan. For example, a plan that provides a subsidized early retirement annuity benefit may specify that the optional single sum distribution form of benefit available at early retirement age is the present value of the subsidized early retirement annuity benefit. In this case, the subsidized early retirement annuity benefit must be used to apply the valuation requirements of this section and the resulting amount of the single sum distribution. However, if a plan that provides a subsidized early retirement annuity benefit specifies that the single sum distribution benefit available at early retirement age is the present value of the normal retirement annuity benefit, then the normal retirement annuity benefit is used to apply the valuation requirements of this section and the resulting amount of the single sum distribution available at early retirement age.

(b) General consent rules. A plan must satisfy the participant consent requirement with respect to the distribution of a participant's nonforfeitable accrued benefit with a present value in excess of $3,500. See paragraphs (c) (3) and (4) for situations where no consent is required.

(c) Consent, etc. requirements—(1) General rule. If an accrued benefit is immediately distributable, section 411(a)(11) permits plans to provide for the distribution of any portion of a participant's nonforfeitable accrued benefits only if the applicable consent requirements are satisfied.

(2) Consent. (i) No consent is valid unless the participant has received a general description of the material features, and an explanation of the relative values of, the optional forms of benefit available under the plan in a manner that would satisfy the notice requirements of section 417(a)(3). See § 1.401(a)-20 Q&A-36. In addition, so long as a benefit is immediately distributable, a participant must be informed of his right, if any, to defer receipt of the distribution. Furthermore, consent is not valid if a significant detriment is imposed under the plan on any participant who does not consent to a distribution. Whether or not a significant detriment is imposed shall be determined by the Commissioner by examining the particular facts and circumstances.

(ii) A plan must provide participants with notice of their rights specified in this subparagraph no less than 30 days and no more than 90 days before the annuity starting date. Written consent of the participant to the distribution must not be made before the participant receives the notice and must not be made more than 90 days before the annuity starting date. See § 1.401(a)-20 Q&A-10 for the definition of annuity starting date.

(iii) See § 1.401(a)-20 Q&A-24 for a special rule applicable to consents to plan loans.

(3) $3,500. Written consent of the participant is required before the commencement of the distribution of any portion of an accrued benefit if the present value of the nonforfeitable total accrued benefit is greater than $3,500. The consent requirements are deemed satisfied if such value does not exceed $3,500 and the plan may distribute such portion to the participant as a single sum. Present value for this purpose must be determined in the same manner as under section 417(e); see § 1.417(e)-1(d). If the present value determined at the time of a distribution to the participant

exceeds $3,500, then the present value at any subsequent time shall be deemed to exceed $3,500.

(4) **Immediately distributable.** Participant consent is required for any distribution while it is immediately distributable, i.e., prior to the later of the time a participant has attained normal retirement age (as defined in section 411(a)(8)) or age 62. Once a distribution is no longer immediately distributable, a plan may distribute the benefit in the form of a QJSA in the case of a benefit subject to section 417 or in the normal form in other cases without consent.

(5) **Death of participant.** The consent requirements of section 411(a)(11) do not apply after the death of the participant.

(6) **QDROs.** The consent requirements of section 411(a)(11) do not apply to payments to an alternate payee, defined in section 414(p)(8), except as provided in a qualified domestic relations order pursuant to section 414(p).

(7) **Section 401(a)(9), etc.** The consent requirements of section 411(a)(11) do not apply to the extent that a distribution is required to satisfy the requirements of section 401(a)(9) or 415. See section 401(a)(9) and the regulations thereunder and § 1.401(a)-20 Q&A 23 for guidance on these requirements. Notwithstanding any provision to the contrary in section 401(a)(14) or § 1.401(a)-14, a plan may not distribute a participant's nonforfeitable accrued benefit with a present value in excess of $3,500 while the benefit is immediately distributable unless the participant consents to such distribution. The failure of a participant to consent is deemed to be an election to defer commencement of payment of the benefit for purposes of section 401(a)(14) and § 1.401(a)-14.

(d) **Distribution valuation requirements.** In determining the present value of any distribution of any accrued benefit from a defined benefit plan, the plan must take into account specified valuation rules. For this purpose, the valuation rules are the same valuation rules for valuing distributions as set forth in section 417(e); see § 1.417(e)-1(d). This paragraph (d) applies both before and after the participant's death regardless of whether the accrued benefit is immediately distributable. This paragraph also applies whether or not the participant's consent is required under paragraphs (b) and (c) of this section.

(e) **Special rules—(1) Plan termination.** The requirements of this section apply before, on and after a plan termination. If a defined contribution plan terminates and the plan does not offer an annuity option (purchased from a commercial provider), then the plan may distribute a participant's accrued benefit without the participant's consent. The preceding sentence does not apply if the employer or any entity within the same controlled group as the employer maintains another defined contribution plan, other than an employee stock ownership plan (as defined in section 4975(e)(7)). In such a case, the participant's accrued benefit may be transferred without the participant's consent to the other plan if the participant does not consent to an immediate distribution from the terminating plan. See section 411(d)(6) and the regulations thereunder for other rules applicable to transferee plans and plan terminations.

(2) **ESOP dividends.** The requirements of this section do not apply to any distribution of dividends to which section 404(k) applies.

(3) **Other rules.** See § 1.401(a)-20 Q&As 14, 17 and 24 for other rules that apply to the section 411(a)(11) requirements.

[T.D. 8219, 53 FR 31853, Aug. 22, 1988]

§ 1.411(b)–1 Accrued benefit requirements.

(a) **Accrued benefit requirements—(1) In general.** Under section 411(b), for plan years beginning after the applicable effective date of section 411, rules are provided for the determination of the accrued benefit to which a participant is entitled under a plan. Under a defined contribution plan, a participant's accrued benefit is the balance to the credit of the participant's account. Under a defined benefit plan, a participant's accrued benefit is his accrued benefit determined under the plan. A defined benefit plan is not a qualified plan unless the method provided by the plan for determining accrued benefits satisfies at least one of the alternative methods (described in paragraph (b) of this section) for determining accrued benefits with respect to all active participants under the plan. A defined benefit plan may provide that accrued benefits for participants are determined under more than one plan formula. In such a case, the accrued benefits under all such formulas must be aggregated in order to determine whether or not the accrued benefits under the plan for participants satisfy one of the alternative methods. A plan may satisfy different methods with respect to different classifications of employees, or separately satisfy one method with respect to the accrued benefits for each such classification, provided that such classifications are not so structured as to evade the accrued benefit requirements of section

411(b) and this section. (For example, if a plan provides that employees who commence participation at or before age 40 accrue benefits in a manner which satisfies the 133⅓ percent method of determining accrued benefits and employees who commence participation after age 40 accrue benefits in a manner which satisfies the 3 percent method of determining accrued benefits, the plan would be so structured as to evade the requirements of section 411(b).) A defined benefit plan does not satisfy the requirements of section 411(b) and this section merely because the accrued benefit is defined as the "reserve under the plan". Special rules are provided for the first two years of service by a participant, certain insured defined benefit plans, and certain reductions in accrued benefits due to increasing age or service. In addition, a special rule is provided with respect to accruals for service before the effective date of section 411.

(2) Cross references—

(i) 3 percent method. For rules relating to the 3 percent method of determining accrued benefits, see paragraph (b)(1) of this section.

(ii) 133⅓ percent method. For rules relating to the 133⅓ percent method of determining accrued benefits, see paragraph (b)(2) of this section.

(iii) Fractional method. For rules relating to the fractional method of determining accrued benefits, see paragraph (b)(3) of this section.

(iv) Accruals before effective date. For rules relating to accruals for service before the effective date of section 411, see paragraph (c) of this section.

(v) First 2 years of service. For special rules relating to determination of accrued benefit for first 2 continuous years of service, see paragraph (d)(1) of this section.

(vi) Certain insured plans. For special rules relating to determination of accrued benefit under a defined benefit plan funded exclusively by insurance contracts, see paragraph (d)(2) of this section.

(vii) Accruals decreased by increasing age or service. For special rules relating to prohibition of decrease in accrued benefit on account of increasing age or service, see paragraph (d)(3) of this section.

(viii) Separate accounting. For rules relating to requirements for separate accounting, see paragraph (e) of this section.

(ix) Year of participation. For definition of "year of participation", see paragraph (f) of this section.

(b) Defined benefit plans. A defined benefit plan satisfies the requirements of section 411(b)(1) and this paragraph for a plan year to which section 411 and this section apply if it satisfies the requirements of subparagraph (1), (2), or (3) of this paragraph for such year.

(1) 3 percent method—(i) General rule. A defined benefit plan satisfies the requirements of this paragraph for a plan year if, as of the close of the plan year, the accrued benefit to which each participant is entitled, computed as if the participant separated from the service as of the close of such plan year, is not less than 3 percent of the 3 percent method benefit, multiplied by the number of years (not in excess of 33⅓) of his participation in the plan including years after his normal retirement age. For purposes of this subparagraph, the "3 percent method benefit" is the normal retirement benefit to which the participant would be entitled if he commenced participation at the earliest possible entry age for any individual who is or could be a participant under the plan and if he served continuously until the earlier of age 65 or the normal retirement age under the plan.

(ii) Special rules—(A) Compensation. In the case of a plan providing a retirement benefit based upon compensation during any period, the normal retirement benefit to which a participant would be entitled is determined as if he continued to earn annually the average rate of compensation which he earned during consecutive years of service, not in excess of 10, for which his compensation was the highest. For purposes of this subdivision (A), the number of consecutive years of service used in computing average compensation shall be the number of years of service specified under the plan (not in excess of 10) for computing normal retirement benefits.

(B) Social security, etc. For purposes of this subparagraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(C) Computation in certain cases. In the case of any plan to which the provisions of section 411(b)(1)(D) and paragraph (c) of this section are applicable, for any plan year the accrued benefit of any participant shall not be less than the accrued benefit otherwise determined under this subparagraph, reduced by the excess of the accrued benefit

determined under this subparagraph as of the first day of the first plan year to which section 411 applies over the accrued benefit determined under section 411(b)(1)(D) and paragraph (c) of this section and increased by the amount determined under paragraph (c)(2)(v) of this section.

(iii) Examples. The application of this subparagraph is illustrated by the following examples:

Example (1). The M Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 or $4 per month for each year of participation. As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. The plan provides for no limit on the number of years of credited service. A, age 40, is a participant in the M Corporation's plan.

A has completed 12 years of participation in the plan of the M Corporation as of the close of the plan year. Under subdivision (i) of this subparagraph, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $1,920 [40×(12×$4)]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless A has accrued an annual benefit of at least $691 [0.03×($1,920×12)] as of the close of the plan year. Under the M Corporation plan, A is entitled to an accrued benefit of $576 [(12×12)×$4] as of the close of the plan year. Thus, with respect to A, the accrued benefit provided under the M Corporation plan does not satisfy the requirements of this subparagraph.

Example (2). Assume the same facts as in example (1) except that the M Corporation's plan provides that only the first 30 years of participation are taken into account. Under subdivision (i) of this subparagraph, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age under the plan (25) and served continuously until normal retirement age (65) is an annual benefit of $1.440 [30×$48]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless A has accrued an annual benefit of at least $518 [0.03×($1,-440×12)] as of the close of the plan year. Under the M Corporation plan, A is entitled to an accrued benefit of $576 [12×$48]. Thus, with respect to A, the accrued benefit provided under the M Corporation plan satisfies the requirements of this subparagraph.

Example (3). The N Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 50 percent of average compensation for the highest 3 consecutive years of compensation for an employee with 25 years of participation. A participant who separates from service before age 65 is entitled to 2 percent of average compensation for the highest 3 consecutive years of compensation for each year of participation not in excess of 25. The plan has no minimum age or service requirement for participation. The normal retirement age specified under the plan is age 65. On December 31, 1990, B, age 40, is a participant in the N Corporation's plan. B began employment with the N Corporation and became a participant in the N Corporation's plan on January 1, 1980. Under this subparagraph, the normal retirement benefit to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is 50 percent of average compensation for the highest 3 consecutive years of compensation per year commencing at age 65. Under this subparagraph, B must have accrued an annual benefit of at least 16.5 percent of his highest 3 consecutive years of compensation per year commencing at age 65 [0.03×50 percent of average compensation for the highest 3 consecutive years of compensation × 11] as of the close of the plan year. Under the N Corporation plan, B has accrued an annual benefit of 22 percent of average compensation for his highest 3 consecutive years of compensation per year commencing at age 65. Thus, with respect to B, the accrued benefit under the N Corporation plan satisfies the requirements of this subparagraph.

Example (4). The P Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 50 percent of average compensation for the 3 consecutive years of compensation from the P Corporation next preceding normal retirement age. The plan has no minimum age or service requirement for participation. The normal retirement age under the plan is age 65. On December 31, 1990, C, age 55, separates from service with the P Corporation. C began employment with the P Corporation and became a participant in the P Corporation's plan on January 1, 1980. As of December 31, 1990, C's average compensation for the 3 consecutive years preceding his separation from service is $15,000. Under this subparagraph, the normal retirement benefit to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of 50 percent of average compensation for the 3 consecutive years of compensation from the P Corporation next preceding normal retirement age commencing at age 65. C must have accrued an annual benefit of at least $2,475 commencing at age 65 [0.03×(0.050×$15,000)×11] as of his separation from the service with the P Corporation in order for the P Corporation's plan to satisfy the requirements of this subparagraph with respect to C.

Example (5). On December 31, 1985, the R Corporation's defined benefit plan provided an annual retirement benefit commencing at age 65 of $100 for each year of participation, not to exceed 30. As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. The appropriate computation period is the calendar year. On January 1, 1986, the plan is amended to provide an annual retirement benefit commencing at age 65 of $200 for each year of participation (before and after the amendment), not to exceed 30. B, age 40, is a participant in the R Corporation's plan. B has completed 15 years of participation in the plan of the R Corporation as of December 31, 1990. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $6,000 [30×200]. Under subdivision (i) of this subparagraph, the plan does not satisfy the requirements of this subparagraph unless B has accrued an annual benefit of at least $2,700 [0.03×$6,000×15] as of December 31, 1990. Under the R Corporation plan, B is entitled to an accrued benefit of $3,000 [$200×15] as of December 31, 1990. Thus, with respect to B, the accrued benefit provided under the R Corporation plan satisfies the requirements of this subparagraph.

Example (6). On December 31, 1995, the J Corporation's defined benefit plan provided an annual retirement benefit commencing at age 65 of $4,800 after 30 years of participation. The normal retirement age specified under the plan is age 65. The appropriate computation period is the calendar year. On

January 1, 1996, the plan is amended to provide an annual retirement benefit commencing at age 65 of $6,000. A, age 40, is a participant in the J Corporation's plan since its adoption on January 1, 1986. Under paragraph (b)(1)(i) of this section, on December 31, 1995, the normal retirement benefit commencing at age 5 to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of $4,800. Under paragraph (b)(1)(i) of this section, on January 1, 1996, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (0) under the plan and served continuously until normal retirement age (65) is an annual benefit of $6,000. Under subdivision (i) of this subparagraph, the plan does not satisfy the requirements of this subparagraph unless A has an accrued benefit on December 31, 1995 of at least $1,440 [$4,800×0.02×10] and an accrued benefit on January 1, 1996 of at least $1,800 [$6,000×0.03×10].

Example (7). The X Company's defined benefit plan provides an annual retirement benefit commencing at age 65 of $4 per month for each year of participation (not to exceed 30). As a condition of participation, the plan requires that an employee have attained age 25. The normal retirement age specified under the plan is age 65. D, age 68, is a participant in the X Company's plan. D has completed 20 years of participation in the X Company plan as of the close of the plan year. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit, commencing at age 65, of $1,440 [30×$48]. Under paragraph (b)(1)(i) of this section, the plan does not satisfy the requirements of this subparagraph unless D has accrued an annual benefit, commencing at age 65, of $864 [0.03×$1,440×20] as of the close of the plan year. Under the X Company plan, D has accrued an annual benefit, commencing at age 65, of $960 [20×$48]. Thus, with respect to D the accrued benefit provided under the X Company plan satisfies the requirements of this subparagraph.

Example (8). Assume the same facts as in example (7) except that for purposes of determining accrued benefits under the plan the X Company's plan disregards all years of participation after normal retirement age. Under paragraph (b)(1)(i) of this section, the normal retirement benefit commencing at age 65 to which a participant would be entitled if he commenced participation at the earliest possible entry age (25) under the plan and served continuously until normal retirement age (65) is an annual benefit of $1,440 [30×$48]. Under paragraph (b)(1)(i) of this section the plan does not satisfy the requirements of this subparagraph unless D has accrued an annual benefit, commencing at age 65, of $864 [0.03×$1,440×20] as of the close of the plan year. Under the X Company's plan D has accrued an annual benefit commencing at age 65, of $816 [17×$48]. Thus, with respect to D, the accrued benefit provided under the X Company plan does not satisfy the requirements of this subparagraph.

(2) 133⅓ percent rule—(i) General rule. A defined benefit plan satisfies the requirements of this subparagraph for a particular plan year if—

(A) Under the plan the accrued benefit payable at the normal retirement age (determined under the plan) is equal to the normal retirement benefit (determined under the plan), and

(B) The annual rate at which any individual who is or could be a participant can accrue the retirement benefits payable at normal retirement age under the plan for any later plan year cannot be more than 133 ⅓ percent of the annual rate at which he can accrue benefits for any plan year beginning on or after such particular plan year and before such later plan year.

(ii) Special rules. For purposes of this subparagraph—

(A) Plan amendments. Any amendment to the plan which is in effect for the current plan year shall be treated as if it were in effect for all other plan years.

(B) Change in accrual rate. Any change in an accrual rate which change does not apply to any individual who is or could be a participant in the plan year is disregarded. Thus, for example, if for its plan year beginning January 1, 1980, a defined benefit plan provides an accrued benefit in plan year 1980 of 2 percent of a participant's average compensation for his highest 3 years of compensation for each year of service and provides that in plan year 1981 the accrued benefit will be 3 percent of such average compensation, the plan will not be treated as failing to satisfy the requirements of this subparagraph for plan year 1980 because in plan year 1980 the change in the accrual rate does not apply to any individual who is or could be a participant in plan year 1980. However, if, for example, a defined benefit plan provided for an accrued benefit of 1 percent of a participant's average compensation for his highest 3 years of compensation for each of the first 10 years of service and 1.5 percent of such average compensations for each year of service thereafter, the plan will be treated as failing to satisfy the requirements of this subparagraph for the plan year even though no participant is actually accruing at the 1.5 percent rate because an individual who could be a participant and who had over 10 years of service would accrue at the 1.5 percent rate, which rate exceeds 133 ⅓ percent of the 1 percent rate.

(C) Early retirement benefits. The fact that certain benefits under the plan may be payable to certain participants before normal retirement age is disregarded. Thus, the requirements of subdivision (i) of this subparagraph must be satisfied without regard to any benefit payable prior to the normal retirement benefit (such as an early retirement benefit which is not the normal retirement benefit (see § 1.411(a)–7(c)).

(D) Social security, etc. For purposes of this paragraph, for any plan year, social security bene-

fits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(E) Postponed retirement. A plan shall not be treated as failing to satisfy the requirements of this subparagraph for a plan year merely because no benefits under the plan accrue to a participant who continues service with the employer after such participant has attained normal retirement age.

(F) Computation of benefit. A plan shall not satisfy the requirements of this subparagraph if the base for the computation of retirement benefits changes solely by reason of an increase in the number of years of participation. Thus, for example, a plan will not satisfy the requirements of this subparagraph if it provides a benefit, commencing at normal retirement age, of the sum of (1) 1 percent of average compensation for a participant's first 3 years of participation multiplied by his first 10 years of participation (or, if less than 10 his total years of participation) and (2) 1 percent of average compensation for a participant's 3 highest years of participation multiplied by each year of participation subsequent to the 10th year.

(iii) Examples. The application of this subparagraph is illustrated by the following examples:

Example (1). On January 1, 1980, the R Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of 5 consecutive years of participation for which his compensation is the highest. The percentage is 2 percent for each of the first 20 years of participation and 1 percent per year thereafter. The appropriate computation period is the calendar year. The R Corporation's plan satisfies the requirements of this subparagraph because the 133⅓ percent rule does not restrict subsequent accrual rate decreases.

Example (2). On January 1, 1980, the J Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of his final 5 consecutive years of participation. The percentage is 1 percent for each of the first 5 years of participation; 1 ⅓ percent for each of the next 5 years of participation; and 1 ⅞ percent for each year thereafter. The appropriate computation period is the calendar year. Even though no single accrual rate under the J Corporation's plan exceeds 133 ⅓ percent of the immediately preceding accrual rate, the J Corporation's plan does not satisfy the requirements of this subparagraph because the rate of accrual for all years of participation in excess of 10 (1 ⅞ percent) exceeds 133⅓ percent of the rate of accrual for any of the first 5 years of participation (1 percent).

Example (3). On January 1, 1980, the C Corporation's defined benefit plan provides for an annual benefit (commencing at age 65) of a percentage of a participant's average compensation for the period of 3 consecutive years of participation for which his compensation is the highest. The percentage is 2 percent for each of the first 5 years of participation; 1 percent for each of the next 5 years of participation; and 1 ½ percent for each year thereafter. The appropriate computation period is the calendar year. Even though the average rate of accrual under the C Corporation's plan is not less rapidly than ratably, the C Corporation's plan does not satisfy the requirements of this subparagraph because the rate of accrual for all years of participation in excess of 10 (1 ½ percent) for any employee who is actually accruing benefits or who could accrue benefits exceeds 133 ⅓ percent of the rate of accrual for the sixth through tenth years of participation, respectively (1 percent).

(3) Fractional rule—(i) In general. A defined benefit plan satisfies the requirements of this paragraph if the accrued benefit to which any participant is entitled is not less than the fractional rule benefit multiplied by a fraction (not exceeding 1)—

(A) The numerator of which is his total number of years of participation in the plan, and

(B) The denominator of which is the total number of years he would have participated in the plan if he separated from the service at the normal retirement age under the plan.

(ii) Special rules. For purposes of this subparagraph—

(A) Fractional rule benefit. The "fractional rule benefit" is the annual benefit commencing at the normal retirement age under the plan to which a participant would be entitled if he continued to earn annually until such normal retirement age the same rate of compensation upon which his normal retirement benefit would be computed. Such rate of compensation shall be computed on the basis of compensation taken into account under the plan (but taking into account average compensation for no more than the 10 years of service immediately preceding the determination). For purposes of this subdivision (A), the normal retirement benefit shall be determined as if the participant had attained normal retirement age on the date any such determination is made.

(B) Social security, etc. For purposes of this subparagraph, for any plan year, social security benefits and all relevant factors used to compute benefits, *e.g.*, consumer price index, are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years.

(C) Postponed retirement. A plan shall not be treated as failing to satisfy the requirements of this subparagraph merely because no benefits under the plan accrue to a participant who continues service with the employer after such participant has attained normal retirement age under the plan.

(D) Computation in certain cases. In the case of any plan to which the provisions of section 411(b)(1)(D) and paragraph (c) of this section are

applicable, for any plan year the accrued benefit of any participant shall not be less than the accrued benefit otherwise determined under this subparagraph, reduced by the excess of the accrued benefit determined under this subparagraph as of the first day of the first plan year to which section 411 applies over the accrued benefit determined under section 411(b)(1)(D) and paragraph (c) of this section and increased by the amount determined under paragraph (c)(2)(v) of this section.

(iii) Examples. The application of this subparagraph is illustrated by the following examples:

Example (1). The R Corporation's defined benefit plan provides an annual retirement benefit commencing at age 65 of 30 percent of a participant's average compensation for his highest 3 consecutive years of participation. If a participant separates from service prior to normal retirement age, the R Corporation's plan provides a benefit equal to an amount which bears the same ratio to 30 percent of such average compensation as the participant's actual number of years of participation in the plan bears to the number of years the participant would have participated in the plan had he separated from service at age 65. The plan further provides that normal retirement age is age 65. A, age 55, is a participant in the R Corporation's plan for the current year, and A has 15 years of participation in the R Corporation's plan. As of the current year, A's average compensation for his highest 3 years of compensation is $20,000. The R Corporation's plan satisfies the requirements of this subparagraph because if A separates from the service in the current year he will be entitled to an annual benefit of $3,600 commencing at age 65 [$0.3 \times \$20,000 \times {}^{15}/_{25}$].

Example (2). The J Corporation's defined benefit plan provides a normal retirement benefit of 1 percent per year of a participant's average compensation from the employer. In the case of a participant who separates from service prior to normal retirement age (65), the plan provides that the annual benefit is an amount which is equal to 1 percent of such compensation multiplied by the number of years of plan participation actually completed by the participant. The plan year of the J Corporation's plan is the calendar year. B, age 55, is a participant in the J Corporation's plan for the current year. B became a participant in the J Corporation's plan on January 1, 1980. As of December 31, 1990, B's compensation history is as follows:

Year	Compensation
1980	$17,000
1981	18,000
1982	20,000
1983	20,000
1984	21,000
1985	22,000
1986	23,000
1987	25,000
1988	26,000
1989	29,000
1990	32,000

If B separates from service on December 31, 1990, he would be entitled to an annual benefit of $2,530 commencing at age 65. Because the J Corporation's plan does not limit the number of years of compensation to be taken into account in determining the normal retirement benefit, B's rate of compensation for purposes of determining his normal retirement benefit is $23,600 [$18,000 + $20,000 + $20,000 + $21,000 + $22,000 + $23,000 + $25,000 + $26,000 + $29,000 + $32,000]/10. Under this subparagraph, B's accrued benefit under the J Corporation's plan as of December 31, 1990 must be not less than $2,561 per year commencing at age 65 [0.01 × ($17,000 + $18,000 + $20,000 + $20,000 + $21,000 + $22,000 + $23,000 + $25,000 + $26,000 + $29,000 + $32,000 + ($23,600 × 10)) × $^{11}/_{21}$]. Thus, the J Corporation's plan would not satisfy the requirements of this subparagraph.

(c) Accruals for service before effective date—(1) General rule. For a plan year to which section 411 applies, a defined benefit plan does not satisfy the requirements of section 411(b)(1) and this section unless, under the plan, the accrued benefit of each participant for plan years beginning before section 411 applies is not less than the greater of—

(i) Such participant's accrued benefit (as of the day before section 411 applies) determined under the plan as in effect from time to time prior to September 2, 1974 (without regard to any amendment adopted after such date), or

(ii) One-half of the accrued benefit that would be determined with respect to the participant as of the day before section 411 applies if the participant's accrued benefit were computed for such prior plan years under a method which satisfies the requirements of section 411(b)(1)(A), (B), or (C) and paragraph (b)(1), (2), or (3) of this section. See 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans, for time participation deemed to begin.

(2) Special rules. (i) A plan shall not be deemed to fail to satisfy the requirements of section 411(b) and this section merely because the method for computing the accrued benefit of a participant for years of participation prior to the first plan year for which section 411 is effective with respect to the plan is not the same method for computing the accrued benefit of a participant for years of participation subsequent to such plan year.

(ii) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(A) and paragraph (b)(1) of this section shall be applied as if the participant separated from service with the employer on the day before the first day of the first plan year to which section 411 applies.

(iii) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(B) and paragraph (b)(2) of this section shall be applied in the following manner:

(A) Except as provided in (c)(2)(iii)(B) of this section, section 411(b)(1)(B) and paragraph (b)(2) of this section shall be applied as if the participant separated from service with the employer on the

day before the first day of the first plan year to which section 411 applies.

(B) In the case that the plan does not satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section at any time prior to the day specified in (c)(2)(iii)(A) of this section, the plan shall be deemed revised to the extent necessary to satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section for all plan years beginning before the applicable effective date of section 411 and this section. For purposes of the preceding sentence, a plan shall not be deemed revised to the extent necessary to satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section for a plan year if the benefit a participant would receive if he were employed until normal retirement age is reduced by such revision or if the revised rate of accrual with respect to such accrued benefit does not otherwise satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section.

(iv) For purposes of paragraph (c)(1)(ii) of this section, section 411(b)(1)(C) and paragraph (b)(3) of this section shall be applied as if the participant separated from service on the day before the first day of the first plan year to which section 411 applies.

(v) The excess of the accrued benefit payable at normal retirement age of any participant determined under section 411(b)(1)(A), (B), or (C) (without regard to section 411(b)(1)(D)), and paragraph (b)(1), (2), or (3) of this section (without regard to this paragraph) as of the day before the first day of the first plan year to which section 411 and this section applies over the accrued benefit determined under paragraph (c)(1) of this section shall be accrued in accordance with the provisions of the plan as in effect after the applicable effective date of section 411, as if the plan had been initially adopted on such effective date.

(d) Special rules—(1) First 2 years of service. Notwithstanding paragraphs (1), (2), and (3) of paragraph (b) of this section, under section 411(b)(1)(E) and this subparagraph, a plan shall not be treated as failing to satisfy the requirements of paragraph (b) of this section solely because the accrual of benefits under the plan does not become effective until the employee has completed 2 continuous years of service. For purposes of this subparagraph, continuous years of service are years of service (within the meaning of section 410(a)(3)(A)) which are not separated by a break in service (within the meaning of section 410(a)(5)). For years of service beginning after such 2 years of service, the accrued benefit of an employee shall not be less than that to which the employee would be entitled if section 411(b)(1)(E) and this subparagraph did not apply. Thus, for example, a plan which otherwise satisfies the requirements of paragraph (b)(2) of this section provides for a rate of accrual of 1 percent of average compensation for the highest 3 years of compensation beginning with the third year of service of a participant shall not be treated as satisfying paragraph (b)(2) of this section because as of the time the employee completes 3 continuous years of service there is no accrual during the first 2 years of service. In addition, a plan which otherwise satisfies the requirements of paragraph (b)(1) of this section and which requires that an employee must attain age 25 and complete 1 year of service prior to becoming a participant will not satisfy the requirements of paragraph (b)(1) of this section if an employee who completes 2 years of service prior to attaining age 25 does not begin accruals immediately upon commencement of participation in the plan. For rules relating to years of service, see 29 CFR Part 2530, Department of Labor regulations relating to minimum standards for employee pension benefit plans.

(2) Certain insured defined benefit plans. Notwithstanding paragraphs (b)(1), (2), and (3) of this section, a defined benefit plan satisfies the requirements of paragraph (b) of this section if such plan is funded exclusively by the purchase of contracts from a life insurance company and such contracts satisfy the requirements of sections 412(i)(2) and (3) and the regulations thereunder. The preceding sentence is applicable only if an employee's accrued benefit as of any applicable date is not less than the cash surrender value such employee's insurance contracts would have on such applicable date if the requirements of section 412(i)(4), (5), and (6) and the regulations thereunder were satisfied.

(3) Accrued benefit may not decrease on account of increasing age or service. Notwithstanding paragraphs (b)(1), (2), and (3) of this section and paragraphs (d)(1) and (2) of this section, a defined benefit plan shall be treated as not satisfying the requirements of paragraphs (b) and (d) of this section if the participant's accrued benefit is reduced on account of any increase in his age or years of service. The preceding sentence shall not apply to social security supplements described in § 1.411(a)–7(c)(4).

(e) Separate accounting. A plan satisfies the requirements of this paragraph if the requirements

of paragraph (e)(1) or (2) of this paragraph are met.

(1) Defined benefit plan. In the case of a defined benefit plan, the requirements of this paragraph are satisfied if the plan requires separate accounting for the portion of each employee's accrued benefit derived from any voluntary employee contributions permitted under the plan. For purposes of this subparagraph the term "voluntary employee contributions" means all employee contributions which are not mandatory contributions within the meaning of section 411(c)(2)(C) and the regulations thereunder. See § 1.411(c)–1(b)(1) for rules requiring the determination of such an accrued benefit by the use of a separate account.

(2) Defined contribution plan. In the case of a defined contribution plan, the requirements of this paragraph are not satisfied unless the plan requires separate accounting for each employee's accrued benefit. If a plan utilizes the break in service rule of section 411(a)(6)(C), an employee could have different percentages of vesting between pre-break and post-break accrued benefits. In such a case, the requirements of this paragraph are not satisfied unless the plan computes accrued benefits in a manner which takes into account different percentages. A plan which provides separate accounts for pre-break and post-break accrued benefits will be deemed to compute benefits in a reasonable manner.

(f) Year of participation—(1) In general. This paragraph is inapplicable to a defined contribution plan. For purposes of determining an employee's accrued benefit, a "year of participation" is a period of service determined under regulations prescribed by the Secretary of Labor in 29 CFR Part 2530, relating to minimum standards for employee pension benefit plans.

(2) Additional rule relating to year of participation. A trust shall not constitute a qualified trust if the plan of which such trust is a part provides for the crediting of a year of participation, or part thereof, and such credit results in the discrimination prohibited by section 401(a)(4).

(g) Additional illustrations. The application of this section may be illustrated by the following example:

Example. (i) The S Corporation established a defined benefit plan on January 1, 1980. The plan provides a minimum age for participation of age 25. The normal retirement age under the plan is age 65. The appropriate computation periods are the calendar year. The plan provides an annual benefit, commencing at age 65, equal to $96 per year of service for the first 25 years of service, and $48 per year of service for each additional year of service.

(ii) The plan of the S Corporation does not satisfy the requirements of section 411(b)(1)(A) and paragraph (b)(1) of this section because the accrued benefit under the plan at some point will be less than the accrued benefit required under section 411(b)(1)(A) and paragraph (b)(1) of this section (i.e., 3 percent × normal retirement benefit × years of participation).

(iii) The plan of the S Corporation does satisfy the requirements of section 411(b)(1)(B) and paragraph (b)(2) of this section because the rate of benefit accrual is equal in each of the first 25 years of service and the rate decreases thereafter.

(iv) The plan of the S Corporation does satisfy the requirements of section 411(b)(1)(C) and paragraph (b)(3) of this section because the accrued benefit under the plan will equal or exceed the normal retirement benefit multiplied by the fraction described in paragraph (b)(3)(i) of this section.

[T.D. 7501, 42 FR 42334, Aug. 23, 1977]

§ 1.411(c)–1 Allocation of accrued benefits between employer and employee contributions.

(a) Accrued benefit derived from employer contributions. For purposes of section 411 and the regulations thereunder, under section 411(c)(1), an employee's accrued benefit derived from employer contributions under a plan as of any applicable date is the excess, if any, of—

(1) The total accrued benefit under the plan provided for the employee as of such date, over

(2) The accrued benefit provided for the employee, derived from contributions made by the employee under the plan as of such date.

For computation of accrued benefit derived from employee contributions to a defined contribution plan or from voluntary employee contributions to a defined benefit plan, see paragraph (b) of this section. For computation of accrued benefit derived from mandatory employee contributions to a defined benefit plan, see paragraph (c) of this section.

(b) Accrued benefit derived from employee contribution to defined contribution plan, etc. For purposes of section 411 and the regulations thereunder, under section 411(c)(2)(A) the accrued benefit derived from employee contributions to a defined contribution plan is determined under paragraph (b)(1) or (2) of this section, whichever applies. Under section 411(d)(5), the accrued benefit derived from voluntary employee contributions to a defined benefit plan is determined under paragraph (b)(1) of this section.

(1) Separate accounts maintained. If a separate account is maintained with respect to an employee's contributions and all income, expenses, gains, and losses attributable thereto, the accrued benefit

determined under this subparagraph as of any applicable date is the balance of such account as of such date.

(2) **Separate accounts not maintained.** If a separate account is not maintained with respect to an employee's contributions and the income, expenses, gains, and losses attributable thereto, the accrued benefit determined under this subparagraph is the employee's total accrued benefit determined under the plan multiplied by a fraction—

(i) The numerator of which is the total amount of the employee's contributions under the plan less withdrawals, and

(ii) The denominator of which is the sum of (A) the amount described in paragraph (b)(2)(i) of this section, and (B) the total contributions made under the plan by the employer on behalf of the employee less withdrawals.

For purposes of this subparagraph, contributions include all amounts which are contributed to the plan even if such amounts are used to provide ancillary benefits, such as incidental life insurance, health insurance, or death benefits, and withdrawals include only amounts distributed to the employee and do not reflect the cost of any death benefits under the plan.

(c) **Accrued benefit derived from mandatory employee contributions to a defined benefit plan**—(1) **General rule.** In the case of a defined benefit plan (as defined in section 414(j)) the accrued benefit derived from contributions made by an employee under the plan as of any applicable date is an annual benefit, in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, equal to the amount of the employee's accumulated contributions (determined under paragraph (c)(3) of this section) multiplied by the appropriate conversion factor (determined under paragraph (c)(2) of this section). Paragraph (e) of this section provides rules for actuarial adjustments where the benefit is to be determined in a form other than the form described in this paragraph.

(2) **Appropriate conversion factor.** For purposes of this paragraph, the term "appropriate conversion factor" means the factor necessary to convert an amount equal to the accumulated contributions to a single life annuity (without ancillary benefits) commencing at normal retirement age and shall be 10 percent for a normal retirement age of 65 years. For other normal retirement ages the appropriate conversion factor shall be the factor as determined by the Commissioner.

(3) **Accumulated contributions.** For purposes of section 411(c) and this section, the term "accumulated contributions" means the total of—

(i) All mandatory contributions made by the employee (determined under paragraph (c)(4) of this section),

(ii) Interest (if any) on such contributions, computed at the rate provided by the plan to the end of the last plan year to which section 411(a)(2) does not apply (by reason of the applicable effective date), and

(iii) Interest on the sum of the amounts determined under paragraphs (c)(3)(i) and (ii) of this section compounded annually at the rate of 5 percent per annum from the beginning of the first plan year to which section 411(a)(2) applies (by reason of the applicable effective date) to the date on which the employee would attain normal retirement age.

For example, if under section 1017 of the Employee Retirement Income Security Act of 1974, section 411(a)(2) of the Code applies for plan years beginning after December 31, 1975, and for plan years beginning before 1975, the plan provided for 3 percent interest on employee contributions, an employee's accumulated contributions would be computed by crediting interest at the rate provided by the plan (3 percent) for plan years beginning before 1976 and by crediting interest at the rate of 5 percent (or another rate prescribed under section 411(c)(2)(D)) thereafter. Section 1017 of the Employee Retirement Income Security Act of 1974 and § 1.411(a)–2 provide the effective dates for the application of section 411(a)(2).

(4) **Mandatory contributions.** For purposes of section 411(c) and this section the term "mandatory contributions" means amounts contributed to the plan by the employee which are required as a condition of his employment, as a condition of his participation in the plan, or as a condition of obtaining benefits (or additional benefits) under the plan attributable to employer contributions. For example, if the benefit derived from employer contributions depends upon a specified level of employee contributions, employee contributions up to that level would be treated as mandatory contributions. Mandatory contributions, otherwise satisfying the requirements of this subparagraph, include amounts contributed to the plan which are used to provide ancillary benefits such as incidental life insurance, health insurance, or death benefits.

(d) Limitation on accrued benefit. The accrued benefit derived from mandatory employee contributions under a defined benefit plan (determined under paragraph (c) of this section) shall not exceed the greater of—

(1) The accrued benefit of the employee under the plan, or

(2) The accrued benefit derived from employee contributions determined without regard to any interest under section 411(c)(2)(C)(ii) and (iii) and under paragraphs (c)(3)(ii) and (iii) of this section.

(e) Actuarial adjustments for defined benefit plans—(1) Accrued benefit. In the case of a defined benefit plan (as defined in section 414(j)) if an employee's accrued benefit is to be determined as an amount other than an annual benefit commencing at normal retirement age, such benefit (determined under section 411(c)(1) and paragraph (a) of this section) shall be the actuarial equivalent of such benefit, as determined by the Commissioner.

(2) Accrued benefit derived from employee contributions. In the case of a defined benefit plan (as defined in section 414(j)) if the accrued benefit derived from mandatory contributions made by an employee is to be determined with respect to a benefit other than an annual benefit in the form of a single life annuity (without ancillary benefits) commencing at normal retirement age, such benefit shall be the actuarial equivalent of such benefit (determined under section 411(c)(2)(B) and paragraph (c) of this section) as determined by the Commissioner.

(f) Suspension of benefits, etc.—(1) Suspensions. No adjustment to an accrued benefit is required on account of any suspension of benefits if such suspension is permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 855) (Code section 411(a)(3)(B)).

(2) Employment after retirement. No actuarial adjustment to an accrued benefit is required on account of employment after normal retirement age. For example, if a plan with a normal retirement age of 65 provides a benefit of $400 a month payable at age 65 the same $400 benefit (with no upward adjustment) could be paid to an employee who retires at age 68.

[T.D. 7501, 42 FR 42338, Aug. 23, 1977]

§ 1.411(d)–1 Coordination of vesting and discrimination requirements. [Reserved]

§ 1.411(d)–2 Termination or partial termination; discontinuance of contributions.

(a) General rule—(1) Required nonforfeitability. A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan provides that—

(i) Upon the termination or partial termination of the plan, or

(ii) In addition, in the case of a plan to which section 412 (relating to minimum funding standards) does not apply, upon the complete discontinuance of contributions under the plan,

the rights of each affected employee to benefits accrued to the date of such termination or partial termination (or, in the case of a plan to which section 412 does not apply, discontinuance), to the extent funded, or the rights of each employee to the amounts credited to his account at such time, are nonforfeitable (within the meaning of § 1.411(a)–4).

(2) Required allocation. (i) A plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) unless the plan provides for the allocation of any previously unallocated funds to the employes covered by the plan upon the termination or partial termination of the plan (or, in the case of a plan to which section 412 does not apply, upon the complete discontinuance of contributions under the plan). Such provision may be incorporated in the plan at its inception or by an amendment made prior to the termination or partial termination of the plan for the discontinuance of contributions thereunder. In the case of a defined contribution plan under which unallocated forfeitures are held in a suspense account in order to satisfy the requirements of section 415, this subdivision shall not require such plan to provide for allocations from the suspense account to the extent that such allocations would result in annual additions to participants' accounts in excess of amounts permitted under section 415 for the year for which such allocations would be made.

(ii) Any provision for the allocation of unallocated funds which is found by the Secretary of Labor or the Pension Benefit Guaranty Corporation (whichever is appropriate) to satisfy the requirements of section 4044 or section 403(d)(1) of the Employee Retirement Income Security Act of 1974 is acceptable if it specifies the method to be

used and does not conflict with the provisions of section 401(a)(4) of the Internal Revenue Code of 1954 and the regulations thereunder. Any allocation of funds required by paragraph (1), (2), (3), or (4)(A) of section 4044(a) of such Act shall be deemed not to result in discrimination prohibited by section 401(a)(4) of the Code (see, however, paragraph (e) of this section). Notwithstanding the preceding sentence, in the case of a plan which establishes subclasses or categories pursuant to section 4044(b)(6) of such Act, the allocation of funds by the use of such subclasses or categories shall not be deemed not to result in discrimination prohibited by the Code. The allocation of unallocated funds may be in cash or in the form of other benefits provided under the plan. However, the allocation of the funds contributed by the employer among the employees need not necessarily benefit all the employees covered by the plan.

(iii) Paragraphs (a)(2)(i) and (ii) of this section do not require the allocation of amounts to the account of any employee if such amounts are not required to be used to satisfy the liabilities with respect to employees and their beneficiaries under the plan (see section 401(a)(2)).

(b) Partial termination—(1) General rule. Whether or not a partial termination of a qualified plan occurs (and the time of such event) shall be determined by the Commissioner with regard to all the facts and circumstances in a particular case. Such facts and circumstances include: the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan; and plan amendments which adversely affect the rights of employees to vest in benefits under the plan.

(2) Special rule. If a defined benefit plan ceases or decreases future benefit accruals under the plan, a partial termination shall be deemed to occur if, as a result of such cessation or decrease, a potential reversion to the employer, or employers, maintaining the plan (determined as of the date such cessation or decrease is adopted) is created or increased. If no such reversion is created or increased, a partial termination shall be deemed not to occur by reason of such cessation or decrease. However, the Commissioner may determine that a partial termination of such a plan occurs pursuant to subparagraph (1) of this paragraph for reasons other than such cessation or decrease.

(3) Effect of partial termination. If a termination of a qualified plan occurs, the provisions of section 411(d)(3) apply only to the part of the plan that is terminated.

(c) Termination—(1) Application. This paragraph applies to a plan other than a plan described in section 411(e)(1) (relating to governmental, certain church plans, etc.).

(2) Plans subject to termination insurance. For purposes of this section, a plan to which title IV of the Employee Retirement Income Security Act of 1974 applies is considered terminated on a particular date if, as of that date—

(i) The plan is voluntarily terminated by the plan administrator under section 4041 of the Employee Retirement Income Security Act of 1974, or

(ii) The Pension Benefit Guaranty Corporation terminates the plan under section 4042 of the Employee Retirement Income Security Act of 1974.

For purposes of this subparagraph, the particular date of termination shall be the date of termination determined under section 4048 of such Act.

(3) Other plans. In the case of a plan not described in paragraph (c)(2) of this section, a plan is considered terminated on a particular date if, as of that date, the plan is voluntarily terminated by the employer, or employers, maintaining the plan.

(d) Complete discontinuance—(1) General rule. For purposes of this section, a complete discontinuance of contributions under the plan is contrasted with a suspension of contributions under the plan which is merely a temporary cessation of contributions by the employer. A complete discontinuance of contributions may occur although some amounts are contributed by the employer under the plan if such amounts are not substantial enough to reflect the intent on the part of the employer to continue to maintain the plan. The determination of whether a complete discontinuance of contributions under the plan has occurred will be made with regard to all the facts and circumstances in the particular case, and without regard to the amount of any contributions made under the plan by employees. Among the factors to be considered in determining whether a suspension constitutes a discontinuance are:

(i) Whether the employer may merely be calling an actual discontinuance of contributions a suspension of such contributions in order to avoid the requirement of full vesting as in the case of a discontinuance, or for any other reason;

(ii) Whether contributions are recurring and substantial; and

(iii) Whether there is any reasonable probability that the lack of contributions will continue indefinitely.

(2) Time of discontinuance. In any case in which a suspension of a profit-sharing plan maintained by a single employer is considered a discontinuance, the discontinuance becomes effective not later than the last day of the taxable year of the employer following the last taxable year of such employer for which a substantial contribution was made under the profit-sharing plan. In the case of a profit-sharing plan maintained by more than one employer, the discontinuance becomes effective not later than the last day of the plan year following the plan year within which any employer made a substantial contribution under the plan.

(e) Contributions or benefits which remain forfeitable. Under section 411(d)(2) and (3), section 411(a) and this section do not apply to plan benefits which may not be provided for designated employees in the event of early termination of the plan under provisions of the plan adopted pursuant to regulations prescribed by the Secretary or his delegate to preclude the discrimination prohibited by section 401(a)(4). Accordingly, in such a case, plan benefits may be required to be reallocated without regard to this section. See § 1.401–4(c).

[T.D. 7501, 42 FR 42339, Aug. 23, 1977]

§ 1.411(d)–3 Other special rules.

(a) Class year plans—(1) General rule. Under section 411(d)(4), the requirements of section 411(a)(2) for a class year plan shall be deemed to be satisfied if such plan provides that each employee's rights to or derived from employer contributions on his behalf for any plan year are nonforfeitable no later than the end of the 5th plan year following the plan year for which such contributions were made. For purposes of section 411 and the regulations thereunder, the term "class year plan" means a profit-sharing, stock bonus, or money purchase plan which provides that the nonforfeitable rights of employees to or derived from employer contributions are determined separately for each plan year. See § 1.411(d)–4A for rules that apply to class year plans for contributions made for plan years beginning after October 22, 1986.

(2) Other rules—(i) Prohibited forfeiture on withdrawals. In the case of a class year plan, section 401(a)(19) and the regulations thereunder shall be applied separately to each plan year.

(ii) Distribution rules. The rules of § 1.411(a)–7(d) apply to a class year plan. For example, under the rule in § 1.411(a)–7(d)(2)(ii)(D), a class year plan would be permitted to limit the time of repayment to a 5-year period beginning on the date of withdrawal, or under the rule in § 1.411(a)–7(d)(2)(iii), a class year plan would restore the amount of the forfeited account balance in the event of repayment. For purposes of applying subparagraphs (2) and (3) of § 1.411(a)–7(d), relating to withdrawal of mandatory contributions, a withdrawal of employee contributions shall be treated as a withdrawal of such contributions on a plan year by plan year basis in succeeding order of time. Any repayments shall be treated as being on account of plan years in succeeding order of time. For purposes of applying any rule of such paragraph (*e.g.*, paragraph (d)(2)(ii)(C)) the term "one-year break in service" means any plan year in which under subparagraph (1) of this paragraph a class year plan may forfeit an employee's rights.

(iii) Computation of years for withdrawals. In applying the requirement of paragraph (a)(1) of this section that rights must be nonforfeitable no later than the end of the fifth plan year following the plan year for which contributions are made, any plan year for which there has been a withdrawal of contributions and no repayment of such contributions (determined as of the last day of the plan year) is not required to count toward the five years. For example, assume that contributions are made for A in 1981 to a calendar year plan. Under the general rule of paragraph (a)(1) of this section, the contributions must be nonforfeitable on December 31, 1986. If in 1982, A withdraws the contributions for 1981, and repays these contributions in 1984, 1982 and 1983 are not required to be counted toward the five years because at the end of each year there is a withdrawal and no repayment of such withdrawal. Accordingly, the plan must provide that A's interest in the contribution for 1981 will be vested on December 31, 1988.

(b) Prohibition against accrued benefit decrease. Under section 411(d)(6) a plan is not a qualified plan (and a trust forming a part of such plan is not a qualified trust) if a plan amendment decreases the accrued benefit of any plan participant, unless the plan amendment satisfies the requirements of section 412(c)(8) (relating to certain retroactive amendments) and the regulations thereunder. For purposes of determining whether or

not any participant's accrued benefit is decreased, all the provisions of a plan affecting directly or indirectly the computation of accrued benefits which are amended with the same adoption and effective dates shall be treated as one plan amendment. Plan provisions indirectly affecting accrued benefits include, for example, provisions relating to years of service and breaks in service for determining benefit accrual, and to actuarial factors for determining optional or early retirement benefits.

(c) Rules applicable to section 414(k) plan. For special rules applicable to defined benefit plans which provide a benefit derived from employer contributions which is based partly on a participant's separate account, see section 414(k) and the regulations thereunder.

[T.D. 7501, 42 FR 42340, Aug. 23, 1977; as amended by T.D. 8038, 50 FR 29375, July 19, 1985; T.D. 8219, 53 FR 31854, Aug. 22, 1988]

§ 1.411(d)–4 Section 411(d)(6) protected benefits.

Q-1: What are "section 411(d)(6) protected benefits"?

A-1: (a) In general. The term "section 411(d)(6) protected benefit" includes any benefit that is described in one or more of the following categories:

(1) Benefits described in section 411(d)(6)(A),

(2) Early retirement benefits and retirement-type subsidies described in section 411(d)(6)(B)(i), and

(3) Optional forms of benefit described in section 411(d)(6)(B)(ii).

Such benefits, to the extent they have accrued, are subject to the protection of section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a) (including section 401(a)(25)) and cannot, therefore, be reduced, eliminated or made subject to employer discretion except to the extent permitted by regulations.

(b) Optional forms of benefit—(1) In general. An "optional form of benefit" is a distribution form with respect to an employee's benefit (described in paragraph (a)(1) and/or (a)(2) of this Q&A-1) that is available under the plan and is identical with respect to all features relating to the distribution form, including the payment schedule, timing, commencement, medium of distribution (e.g., in cash or in-kind), the portion of the benefit to which such distribution features apply and the election rights with respect to such optional forms. To the extent there are any differences in such features, the plan provides separate optional forms of benefit. Differences in amounts of benefits, methods of calculation, or values of distribution forms do not result in optional forms of benefit for purposes of this rule. However, such amounts, methods of calculation, or values may be protected benefits within section 411(d)(6)(A) and/or section 411(d)(6)(B)(i). See § 1.401(a)-4 for further discussion and examples relating to optional forms of benefits.

(2) Examples. The following examples illustrate the meaning of the term "optional form of benefit." Other issues, such as the requirement that the optional forms satisfy section 401(a)(4), are not addressed in these examples and no inferences are intended with respect to such requirements. Assume that the distribution forms, including those not described in these examples, provided under the plan in each of the following examples are identical in all respects not described.

Example 1. A plan permits each participant to receive his benefit under the plan as a single sum distribution; a level monthly distribution schedule over 15 years; a single life annuity; a joint and 50 percent survivor annuity; a joint and 75 percent survivor annuity; a joint and 50 percent survivor annuity with a benefit increase for the participant if the beneficiary dies before a specified date; and joint and 50 percent survivor annuity with a 10 year certain feature. Each of these benefit distribution options is an optional form of benefit (without regard to whether the values of these options are actuarially equivalent).

Example 2. A plan permits each participant to receive his benefit under the plan as a single life annuity commencing at termination from employment; a joint and 50 percent survivor annuity commencing at termination from employment; a single sum distribution that is actuarially equivalent to the single life annuity determined by using a specified interest rate (X percent) for the employees of division A; and a single sum distributions that is actuarially equivalent to the single life annuity determined by using an interest rate that is 80 percent of X percent for employees of Division B. This plan provides three optional forms of benefit. While the interest rates used to determine the single sum distributions available to the employees of Divisions A and the employees of Division B respectively differ, this difference does not result in two single sum optional forms of benefit.

Example 3. A plan permits each participant who is employed by division A to receive his benefit in a single sum distribution payable upon termination from employment and each participant who is employed by division B in a single sum distribution payable upon termination from employment on or after the attainment of age 50. This plan provides two single sum optional forms of benefit.

Example 4. A plan permits each participant to receive his benefit in a single life annuity that commences in the month after the participant's termination from employment or in a single life annuity that commences upon the completion of five consecutive one year breaks in service. These are two optional forms of benefit.

Example 5. A profit-sharing plan permits each participant who is employed by division A to receive an in-service distribution upon the satisfaction of objective criteria set forth in the plan designed to determine whether the participant has a heavy and immediate financial need, and each participant who is employed by division B to receive an in-service distribution

upon the satisfaction of objective criteria set forth in the plan designed to determine whether the participant has a heavy and immediate financial need attributable to extraordinary medical expenses. These in-service distribution options are two optional forms of benefits.

Example 6. A profit-sharing plan permits each participant who is employed by division A to receive an in-service distribution up to $5,000 and each participant who is employed by division B to receive an in-service distribution of up to his total benefit. These in-service distribution options differ as to the portion of the accrued benefit that may be distributed in a particular form and are, therefore, two optional forms of benefit.

Example 7. A profit-sharing plan provides for a single sum distribution on termination of employment. The plan is amended in 1991 to eliminate the single sum optional form of benefit with respect to benefits accrued after the date of amendment. This single sum optional form of benefit continues to be a single optional form of benefit although, over time, the percentage of various employees' accrued benefits that are potentially payable under this single sum may vary because the form is only available with respect to benefits accrued up to and including the date of the amendment.

Example 8. A profit-sharing plan permits each participant to receive a single sum distribution of his benefit in cash or in the form of a specified class of employer stock. This plan provides two single sum distribution optional forms of benefit.

Example 9. A stock bonus plan permits each participant to receive a single sum distribution of his benefit in cash or in the form of the property in which such participant's benefit was invested prior to the distribution. This plan's single sum distribution option provides two optional forms of benefit.

Example 10. A defined benefit plan provides for an early retirement benefit payable upon termination of employment after attainment of age 55 and either after ten years of service or, if earlier, upon plan termination to employees of Division A and provides for an identical early retirement benefit payable on the same terms with the exception of payment on plan termination to employees of Division B. The plan provides for two optional forms of benefit.

Example 11. A profit-sharing plan provides for loans secured by an employee's account balance. In the event of default on such a loan, there is an execution on such account balances. Such execution is a distribution of the employee's accrued benefits under the plan. A distribution of an accrued benefit contingent on default under a plan loan secured by such accrued benefits is an optional form of benefit under the plan.

(c) Plan terms—(1) General rule. Generally, benefits described in section 411(d)(6)(A), early retirement benefits, retirement-type subsidies, and optional forms of benefit are section 411(d)(6) protected benefits only if they are provided under the terms of a plan. However, if an employer establishes a pattern of repeated plan amendments providing for similar benefits in similar situations for substantially consecutive, limited periods of time, such benefits will be treated as provided under the terms of the plan, without regard to the limited periods of time, to the extent necessary to carry out the purposes of section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a), including section 401(a)(25). A pattern of repeated plan amendments providing that a particular optional form of benefit is available to certain named employees for a limited period of time is within the scope of this rule and may result in such optional form of benefit being treated as provided under the terms of the plan to all employees covered under the plan without regard to the limited period of time and the limited group of named employees.

(2) Effective date. The provisions of paragraph (c)(1)of this Q&A-1 are effective as of July 11, 1988. Thus, patterns or repeated plan amendments adopted and effective before July 11, 1988 will be disregarded in determining whether such amendments have created an ongoing optional form of benefit under the plan.

(d) Benefits that are not section 411(d)(6) protected benefits. the following benefits are examples of items that are not section 411(d)(6) protected benefits: (1) ancillary life insurance protection; (2) accident or health insurance benefits; (3) social security supplements described in section 411(a)(9); (4) the availability of loans (other than the distribution of an employee's accrued benefit upon default under a loan); (5) the right to make after-tax employee contributions or elective deferrals described in section 402(g)(3); (6) the right to direct investments; (7) the right to a particular form of investment (e.g., investment in employer stock or securities or investment in certain types of securities, commercial paper, or other investment media); (8) the allocation dates for contributions, forfeitures and earnings, the time for making contributions (but not the conditions for receiving an allocation of contributions or forfeitures for a plan year after such conditions have been satisfied), and the valuation dates for account balances; (9) administrative procedures for distributing benefits, such as provisions relating to the particular dates on which notices are given and by which election must be made; and (10 rights that derive from administrative and operational provisions, such as mechanical procedures for allocating investment experience among accounts in defined contribution plans.

Q-2: To what extent may section 411(d)(6) protected benefits under a plan be reduced or eliminated?

A-2: (a) Reduction or elimination of section 411(d)(6) protected benefits—(1) In general. A plan may not be amended to eliminate or reduce a section 411(d)(6) protected benefit that has already accrued, except as provided in sections 412(c)(8) and 4281, and in paragraph (b) of this Q&A-2. This is generally the case even if such elimination or reduction is contingent upon the employee's

consent. However, a plan may be amended to eliminate or reduce section 411(d)(6) protected benefits with respect to benefits not yet accrued as of the later of the amendment's adoption date or effective date without violating section 411(d)(6).

(2) Selection of optional forms of benefit—(i) General rule. A plan may treat a participant as receiving his entire nonforfeitable accrued benefit under the plan if the participant receives his benefit in an optional form of benefit in an amount determined under the plan that is at least the actuarial equivalent of the employee's nonforfeitable accrued benefit payable at normal retirement age under the plan. This is true even though the participant could have elected to receive an optional form of benefit with a greater actuarial value than the value of the optional form received, such as an optional form including retirement-type subsidies, and without regard to whether such other, more valuable optional form could have commenced immediately or could have become available only upon the employee's future satisfaction of specified eligibility conditions.

(ii) Election of an optional form. Except as provided in paragraph (a)(2)(iii) of this Q&A-2, a plan does not violate section 411(d)(6) merely because an employee's election to receive a portion of his nonforfeitable accrued benefit in one optional form of benefit precludes the employee from receiving that portion of his benefit in another optional form of benefit. Such employee retains all 411(d)(6) protected rights with respect to the entire portion of such employee's nonforfeitable accrued benefit for which no distribution election was made. For purposes of this rule, an elective transfer of an otherwise distributable benefit is treated as the selection of an optional form of benefit. See Q&A-3 of this section.

(iii) Buy-back rule. Notwithstanding paragraph (a)(2)(ii) of this Q&A-2, an employee who received a distribution of his nonforfeitable benefit from a plan that is required to provide a repayment opportunity to such employee if he returns to service within the applicable period pursuant to the requirements of section 411(a)(7) and who, upon subsequent reemployment, repays the full amount of such distribution in accordance with section 411(a)(7)(C) must be reinstated in the full array of section 411(d)(6) protected benefits that existed with respect to such benefit prior to distribution.

(iv) Examples. The rules in this paragraph (a)(2) can be illustrated by the following examples:

Example 1. Defined benefit plan X provides, among its optional forms of benefit, for a subsidized early retirement benefit payable in the form of an annuity and available to employees who terminate from employment on or after their 55th birthdays. In addition plan X provides for a single sum distribution available on termination from employment or termination of the plan. The single sum distribution is determined on the basis of the present value of the accrued normal retirement benefit and does not take the early retirement subsidy into account. Plan X is terminated December 31, 1991. Employees U, age 47, V, age 55, and W, age 47, all continue in the service of the employer. Employees X, age 47, Y, age 55 and Z, age 47, terminate from employment with the employer during 1991. Employees U and V elect to take the single sum optional form of distribution at the time of plan termination. Employees X and Y elect to take the single sum distribution on termination from employment with the employer. The elimination of the subsidized early retirement benefit with respect to employees U, V, X and Y does not result in a violation of section 411(d)(6). This is the result even though employees U and X had not yet satisfied the conditions for the subsidized early retirement benefit. Because employees W and Z have not selected an optional form of benefit, they continue to have a 411(d)(6) protected right to the full array of section 411(d)(6) protected benefits provided under the plan, including the single sum distribution form and the subsidized early retirement benefit.

Example 2. A partially vested employee receives a single sum distribution of the present value of his entire nonforfeitable benefit on account of separation from service under a defined benefit plan providing for a repayment provision. Upon reemployment with the employer such employee makes repayment in the required amount in accordance with section 411(a)(7). Such employee may, upon subsequent termination of employment, elect to take such repaid benefits in any optional form provided under the plan as of the time of the employee's initial separation from service. If the plan was amended prior to such repayment, to eliminate the single sum optional form of benefit with respect to benefits accrued after the date of the amendment, such participant has a 411(d)(6) protected right to take distribution of the repaid benefit in the form of a single sum distribution.

(3) Certain transactions—(i) Plan mergers and benefit transfers. The prohibition against the reduction or elimination of section 411(d)(6) protected benefits already accrued applies to plan mergers, spinoffs, transfers, and transactions amending or having the effect of amending a plan or plans to transfer plan benefits. Thus, for example, if plan A, a profit-sharing plan that provides for distribution of plan benefits in annual installments over ten or twenty years, is merged with plan B, a profit-sharing plan that provides for distribution of plan benefits in annual installments over life expectancy at time of retirement, the merged plan must retain the ten or twenty year installment option for participants with respect to benefits already accrued under plan A as of the merger and the installments over life expectancy for participants with benefits already accrued under plan B. Similarly, for example, if an employee's benefit under a defined contribution plan is transferred to another defined contribution plan (whether or not of the same employer), the optional forms of benefit available with respect to the employee's benefit accrued under the transferor plan may not

be eliminated or reduced except as otherwise permitted under this regulation. See Q&A-3 of this section with respect to the transfer of benefits between and among defined benefit and defined contribution plans.

(ii) Annuity contracts—(A) General rule. The protection provided by section 411(d)(6) may not be avoided by the use of annuity contracts. Thus, section 411(d)(6) protected benefits already accrued may not be eliminated or reduced merely because a plan uses annuity contracts to provide such benefits, without regard to whether the plan, a participant, or a beneficiary of a participant holds the contract or whether such annuity contracts are purchased as a result of the termination of the plan. However, to the extent that an annuity contract constitutes payment of benefits in a particular optional form elected by the participant, the plan does not violate section 411(d)(6) merely because it provides that other optional forms are no longer available with respect to such participant. See paragraph (a)(2) of this Q&A-2.

(B) Examples. The provisions of this paragraph (a)(3)(ii) can be illustrated by the following examples:

Example 1. A profit-sharing plan that is being terminated satisfies section 411(d)(6) only if the plan makes available to participants annuity contracts that provide for all section 411(d)(6) protected benefits under the plan that may not otherwise be reduced or eliminated pursuant to this Q&A-2. Thus, if such a plan provided for a single sum distribution upon attainment of early retirement age, and a provision for payment in the form of 10 equal annual installments, the plan would satisfy section 411(d)(6) only if the participants had the opportunity to elect to have their benefits provided under an annuity contract that provided for the same single sum distribution upon the attainment of the participant's early retirement age and the same 10 year installment optional form of benefit.

Example 2. A defined benefit plan permits each participant who separates from service on or after age 62 to receive a qualified joint and survivor annuity or a single life annuity commencing 45 days after termination from employment. For a participant who separates from service before age 62, payments under these optional forms of benefit commence 45 days after the participant's 62nd birthday. Under the plan, a participant is to elect among these optional forms of benefit during the 90-day period preceding the annuity starting date. However, during such period, a participant may defer both benefit commencement and the election of a particular benefit form to any later date, subject to section 401(a)(9). In January 1990, the employer decides to terminate the plan as of July 1, 1990. The plan will fail to satisfy section 411(d)(6) unless the optional forms of benefit provided under the plan are preserved under the annuity contract purchased on plan termination. Thus, such annuity contract must provide a participant the same optional benefit commencement rights that the plan provided. In addition, such contract must provide the same election rights with respect to such benefit options. This is the case even if, for example, in conjunction with the termination, the employer amended the plan to permit participants to elect a qualified joint and survivor annuity, single life annuity, or single sum distribution commencing on July 1, 1990.

(4) Benefits payable to a spouse or beneficiary. Section 411(d)(6) protected benefits may not be eliminated merely because they are payable with respect to a spouse or other beneficiary.

(b) Section 411(d)(6) protected benefits that may be eliminated or reduced only as permitted by the Commissioner—(1) In general. The Commissioner may, consistent with the provisions of this section, provide for the elimination or reduction of section 411(d)(6) protected benefits that have already accrued only to the extent that such elimination or reduction does not result in the loss to plan participants of either a valuable right or an employer-subsidized optional form of benefit where a similar optional form of benefit with a comparable subsidy is not provided or to the extent such elimination or reduction is necessary to permit compliance with other requirements of section 401(a) (e.g., sections 401(a)(4), 401(a)(9) and 415). The Commissioner may exercise this authority only through the publication of revenue rulings, notices, and other documents of general applicability.

(2) Section 411(d)(6) protected benefits that may be eliminated or reduced. The elimination or reduction of certain section 411(d)(6) protected benefits that have already accrued in the following situations does not violate section 411(d)(6). The rules with respect to permissible eliminations and reductions provided in this paragraph (b)(2) are effective January 30, 1986. These exceptions create no inference with respect to whether any other applicable requirements are satisfied (for example, requirements imposed by section 401(a)(9) and section 401(a)(14)).

(i) Change in statutory requirement. A plan may be amended to eliminate or reduce a section 411(d)(6) protected benefit if the following three requirements are met: the amendment constitutes timely compliance with a change in law affecting plan qualification; there is an exercise of section 7805(b) relief by the Commissioner; and the elimination or reduction is made only to the extent necessary to enable the plan to continue to satisfy the requirements for qualified plans. In general, the elimination or reduction of a section 411(d)(6) protected benefit will not be treated as necessary if it is possible through other modifications to the plan (e.g., by expanding the availability of an optional form of benefit to additional employees) to satisfy the applicable qualification requirement.

(ii) Joint and survivor annuity. A plan that provides a range of three or more actuarially equivalent joint and survivor annuity options may be amended to eliminate any of such options, other

than the options with the largest and smallest optional survivor payment percentages, even if the effect of such amendment is to change which of the options is the qualified joint and survivor annuity under section 417. Thus, for example, if a money purchase pension plan provides three joint and survivor annuity options with survivor payments of 50%, 75% and 100%, respectively, that are uniform with respect to age and are actuarially equivalent, then the employer may eliminate the option with the 75% survivor payment, even if this option had been the qualified joint and survivor annuity under the plan.

(iii) In-kind distributions after plan termination—(A) In general. If a plan includes an optional form of benefit under which benefits are distributed in specified property (other than cash), such optional form of benefit may be modified for distributions after plan termination by substituting cash for the specified property to the extent that, on plan termination, an employee has the opportunity to receive the optional form of benefit in the specified property. This exception is not available, however, if the employer that maintains the terminating plan also maintains another plan that provides an optional form of benefit in the specified property.

(B) Example. This paragraph (b)(2)(iii) can be illustrated by the following example:

Example. An employer maintains a stock bonus plan under which a participant, upon termination from employment, may elect to receive his benefits in a single sum distribution in employer stock. This is the only plan maintained by the employer under which distributions in employer stock are available. The employer decides to terminate the stock bonus plan. If such plan is amended to make available a single sum distribution in employer stock on plan termination, the plan will not fail section 411(d)(6) solely because the optional form of benefit providing a single sum distribution in employer stock on termination from employment is modified to provide that such distribution is available only in cash.

(iv) Coordination with diversification requirement. A tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) may be amended to provide that a distribution is not available in employer securities to the extent that an employee elects to diversify benefits pursuant to section 401(a)(28).

(v) Involuntary distributions. A plan may be amended to provide for the involuntary distribution of an employee's benefit to the extent such involuntary distribution is permitted under sections 411(a)(11) and 417(e). Thus, for example, an involuntary distribution provision may be amended to require that an employee who terminates from employment with the employer receive a single sum distribution in the event that the present value of the employee's benefit is not more than $1,750, by substituting $3,500 for $1,750, without violating section 411(d)(6). In addition, for example, the employer may amend the plan to reduce the involuntary distribution threshold from $3,500 to any lower amount and to eliminate the involuntary single sum option for employees with benefits between $3,500 and such lower amount without violating section 411(d)(6). This rule does not permit a plan provision permitting employer discretion with respect to optional forms of benefit for employees the present value of whose benefit is less than $3,500.

(vi) Distribution exception for certain profit-sharing plans—(A) In general. If a defined contribution plan that is not subject to section 412 and does not provide for an annuity option is terminated, the plan may be amended to provide for the distribution of a participant's accrued benefit upon termination in a single sum optional form without the participant's consent. The preceding sentence does not apply if the employer maintains any other defined contribution plan (other than an employee stock ownership plan as defined in section 4975(e)(7)).

(B) Examples. The provisions of this paragraph (b)(2)(vi) can be illustrated by the following examples:

Example 1. Employer X maintains a defined contribution plan that is not subject to section 412. The plan provides for distribution in the form of equal installments over five years or equal installments over twenty years. X maintains no other defined contribution plans. X terminates its defined contribution plan after amending the plan to provide for the distribution of all participants' accrued benefits in the form of single sum distributions, without obtaining participant consent. Pursuant to the rule in this paragraph (b)(2)(iv), this amendment does not violate the requirements of section 411(d)(6).

Example 2. Corporations X and Y are members of controlled group employer XY. Both X and Y maintain defined contribution plans. X's plan, which is not subject to section 412, covers only employees working for X. Y's plan, which is subject to section 412, covers only employees working for Y. X terminates its defined contribution plan. Because employer XY maintains another defined contribution plan, plan X may not provide for the distribution of participants' accrued benefits upon termination without a participants' consent.

(vii) Distribution of benefits on default of loans. Notwithstanding that the distribution of benefits arising from an execution on an account balance used to secure a loan on which there has been a default is an optional form of benefit, a plan may be amended to eliminate or change a provision for loans, even if such loans would be secured by an employee's account balance.

(viii) Provisions for transfer of benefits between and among defined contribution plans and defined

benefit plans of the employer. A plan may be amended to eliminate provisions permitting the transfer of benefits between and among defined contribution plans and defined benefit plans of the employer.

(ix) De minimis change in the timing of an optional form of benefit. A plan may be amended to modify an optional form of benefit by changing the timing of the availability of such optional form if, after the change, the optional form is available at a time that is within two months of the time such optional form was available before the amendment. To the extent the optional form of benefit is available prior to termination of employment, six months may be substituted for two months in the prior sentence. Thus, for example, a plan that makes in-service distributions available to employees once every month may be amended to make such in-service distributions available only once every six months. This exception to section 411(d)(6) relates only to the timing of the availability of the optional form of benefit. Other aspects of an optional form of benefit may not be modified and the value of such optional form may not be reduced merely because of an amendment permitted by this exception.

(c) Serial amendments. A plan amendment that modifies an optional form of benefit with respect to benefits already accrued will be evaluated in light of previous amendments. Thus, for example, amendments made at different times that, when taken together, constitute the elimination or reduction of a valuable right, will be treated as the impermissible elimination or reduction of an optional form of benefit even though each amendment, considered alone, may otherwise be permissible.

(d) ESOP and stock bonus plan exception—(1) In general. Subject to the limitations in paragraph (d)(2) of this Q&A-5, a tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) will not be treated as violating the requirements of section 411(d)(6) merely because of any of the circumstances described in paragraphs (d)(1)(i) through (d)(1)(iv) of this Q&A-2. In addition, a stock bonus plan that is not an employee stock ownership plan will not be treated as violating the requirements of section 411(d)(6) merely because of any of the circumstances described in paragraphs (d)(1)(ii) and (d)(1)(iv) of this Q&A-2.

(i) Single sum or installment optional forms of benefit. The employer eliminates, or retains the discretion to eliminate, with respect to all participants, a single sum optional form or installment optional form with respect to benefits that are subject to section 409(h)(1)(B), provided such elimination or retention of discretion is consistent with the distribution and payment requirements otherwise applicable to such plans (e.g., those required by section 409).

(ii) Employer becomes substantially employee-owned. The employer eliminates, or retains the discretion to eliminate, with respect to all participants, in cases in which the employer becomes substantially employee-owned, optional forms of benefit by substituting cash distributions for distributions in the form of employer stock with respect to benefits subject to section 409(h). This exception is available only if the employer otherwise meets the requirements of section 409(h)(2) with respect to restrictions on the ownership of outstanding employer stock.

(iii) Employer securities become readily tradable. The employer eliminates, or retains the discretion to eliminate, with respect to all participants, in cases in which the employer securities become readily tradable, optional forms of benefit by substituting distributions in the form of employer securities for distributions in cash with respect to benefits that are subject to section 409(h).

(iv) Employer securities cease to be readily tradable or certain sales. The employer eliminates, or retains the discretion to eliminate, with respect to all participants, optional forms of benefit by substituting cash distributions for distributions in the form of employer stock with respect to benefits that are subject to section 409(h) in the following circumstances:

(A) The employer stock ceases to be readily tradable;

(B) The employer stock continues to be readily tradable but there is a sale of substantially all of the stock of the employer or a sale of substantially all of the assets of a trade or business of the employer and, in either situation, the purchasing employer continues to maintain the plan.

In the situation described in paragraph (d)(1)(iv)(B) of this Q&A-2, the employer may also substitute distributions in the purchasing employer's stock for distributions in the form of employer stock of the predecessor employer.

(2) Limitations on ESOP and stock bonus plan exceptions—(i) Nondiscrimination requirement. Plan amendments and the retention and exercise of discretion permitted under the exceptions in paragraph (d)(1) must meet the nondiscrimination requirements of section 401(a)(4).

(ii) ESOP investment requirement. Except as provided in paragraph (d)(2)(iii) of this Q&A-2, benefits provided by employee stock ownership plans will not be eligible for the exceptions in paragraph (d)(1) of this Q&A-2 unless the benefits have been held in a tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) subject to section 409(h) for the five-year period prior to the exercise of employer discretion or any amendment affecting such benefits and permitted under paragraph (d)(1) of this Q&A-2. For purposes of the preceding sentence, if benefits held under an employee stock ownership plan are transferred to a plan that is an employee stock ownership plan at the time of the transfer, then the consecutive periods under the transferor and transferee employee stock ownership plans may be aggregated for purposes of meeting the five-year requirement. If the benefits are held in an employer stock ownership plan throughout the entire period of their existence, and such total period of existence is less than five years, then such lesser period may be substituted for the five year requirement.

(3) Effective date. The provisions of this paragraph (d) are effective beginning with the first day of the first plan year commencing on or after January 1, 1989. Prior to this effective date the reduction or elimination of a section 411(d)(6) protected benefit by a tax credit employee stock ownership plan (as defined in section 409(a)) or an employee stock ownership plan (as defined in section 4975(e)(7)) will not be treated as violating the requirements of section 411(d)(6) if such reduction or elimination reflects a reasonable interpretation of the statutory language of section 411(d)(6)(C).

(4) Additional exceptions and requirements. The Commissioner may, in revenue rulings, notices or other documents of general applicability, prescribe such additional rules and exceptions, consistent with the purposes of this section, as may be necessary or appropriate.

Q-3 Does the transfer of benefits between and among defined benefit plans and defined contribution plans (or similar transactions) violate the requirements of section 411(d)(6)?

A-3 (a) Transfers and similar transactions—(1) General rule. Section 411(d)(6) protected benefits may not be eliminated by reason of transfer or any transaction amending or having the effect of amending a plan or plans to transfer benefits. Thus, for example, except as otherwise provided in this section, an employer who maintains a money purchase pension plan that provides for a single sum optional form of benefit may not establish another plan that does not provide for this optional form of benefit and transfer participants' account balances to such new plan.

(2) Defined benefit feature and separate account feature. The defined benefit feature of an employee's benefit under a defined benefit plan and the separate account feature of an employee's benefit under a defined contribution plan are section 411(d)(6) protected benefits. Thus, for example, the elimination of the defined benefit feature of an employee's benefit under a defined benefit plan, through transfer of benefits from a defined benefit plan to a defined contribution plan or plans, will violate section 411(d)(6).

(3) Waiver prohibition. In general, an employee may not elect to waive section 411(d)(6) protected benefits. Thus, for example, the elimination of the defined benefit feature of an employee's benefit under a defined plan by reason of a transfer of such benefits to a defined contribution plan pursuant to an employee election, at a time when the benefit is not distributable to the employee, violates section 411(d)(6).

(b) Elective transfers of benefits between plans—(1) Elective transfer. A transfer of a participant's benefits between qualified plans that results in the elimination or reduction of section 411(d)(6) protected benefits does not violate section 411(d)(6) if the transfer meets the requirements of section 411(*l*) and the following requirements are met:

(i) Voluntary election—(A) Participant election. The plan from which the benefits are transferred must provide that the transfer is conditioned upon a voluntary, fully informed election by the participant to transfer such participant's benefit to another plan maintained by the employer.

(B) Benefit retention alternative. In making the voluntary election provided for in paragraph (b)(1)(i)(A) of this Q&A-3, the participant must have an alternative that retains such employee's section 411(d)(6) protected benefits (including all optional forms of benefit) under the plan. Thus, either of the following two requirements must be met:

(1) If the plan from which the benefits are transferred is terminating, the terminating plan must satisfy the requirements of section 401(a)(2) and section 411(d)(6), or

(2) If the plan from which the benefits are transferred is not terminating, the participant must be given the option of leaving his benefit in the ongoing plan to the extent required by section 411(a)(11) and section 417(e);

(C) Spousal election. If sections 401(a)(11) and 417 apply to the plan from which the benefits are transferred, the spousal consent requirements of such section must be met with respect to the transfer of benefits.

(D) Notice requirement. The notice requirements under section 417, requiring a written explanation with respect to an election not to receive benefits in the form of a qualified joint and survivor annuity, must be met with respect to the participant and spousal transfer election.

(ii) Distributability of benefits. The participant whose benefits are transferred must be eligible, under the terms of the plan from which the benefits are transferred, to receive an immediate distribution from such plan under provisions in the plan not inconsistent with section 401(a).

(iii) Amount of benefit transferred. The amount of the benefit transferred must equal the entire nonforfeitable accrued benefit under the plan of the participant whose benefit is being transferred, calculated to be at least the greater of the single sum distribution provided for under the plan for which the participant is eligible (if any) or the present value of the participant's accrued payable at normal retirement age and calculated by using an interest rate subject to the restrictions of section 417(e) and subject to the overall limitations imposed by section 415.

(iv) Benefit under the transferee plan. The participant must be fully vested in the transferred benefit in the transferee plan. In a transfer from a defined contribution plan to a defined benefit plan, the defined benefit plan must provide a minimum benefit, for each participant whose benefits are transferred, equal to the benefit, expressed as an annuity payable at normal retirement age, that is derived solely on the basis of the amount transferred with respect to such participant.

(2) Status of elective transfer as distribution. The transfer of benefits pursuant to the elective transfer rules of this paragraph (b) generally is to be treated as a distribution of a participant's accrued benefit under a plan for purposes of section 401(a). For example, a transfer option is an optional form of benefit under section 411(d)(6); the availability of such optional form of benefit is subject to the nondiscrimination requirements of section 401(a)(4); and the transfer is treated as a distribution subject to the cash-out rules in section 411(a)(7), the early termination requirements of section 411(d)(2) and the requirements of sections 401(a)(11) and 417. However, the transfer is not treated as a distribution for purposes of the minimum distribution requirements of section 401(a)(9).

(3) Effective date. The rules with respect to transfers are generally effective January 30, 1986. However, with respect to transfers from defined benefit plans to defined contribution plans and from defined contribution plans to defined benefit plans, the rules of this paragraph (b) are effective beginning August 10, 1988. On or after January 30, 1986, and prior to August 10, 1988 the transitional rules provided in paragraph (c) of this Q&A-3 are effective with respect to such transfers.

(c) Transitional rule. Prior to the effective date in paragraph (b)(3) of this Q&A-3, the transfer of benefits from a defined contribution plan to a defined benefit plan, or a defined benefit plan to a defined contribution plan, does not violate section 411(d)(6) solely by reason of the elimination of section 411(d)(6) protected benefits, if the benefits transferred were distributable under the plan or could have been distributable under section 401(a) and either of the following requirements are met:

(1) Transfer exception. The transfer satisfies the rules in paragraph (b) of this Q&A-3, or

(2) Direct transfer. The plan to which the benefits are to be transferred provides, or is amended to provide, for all section 411(d)(6) protected benefits provided under the transferor plan with respect to the benefits transferred (with the sole exception of the defined benefit feature of the benefit under a defined benefit plan and the defined contribution feature under a defined contribution plan); the transferred benefits are treated as held under a transferee plan for purposes of the requirements of sections 401(a)(11) and 417; the transferred amounts meet the requirements of section 414(*l*) with respect to the transfer of assets and liabilities, and the benefits transferred do not exceed the limitations imposed by section 415. Amendments required for purposes of satisfying this rule must be made by the date for making any amendments required for purposes of conforming the plan to the requirements of section 410(b) as amended by TRA '86. However, plans covered by this rule must comply with these requirements in operation and any required amendments must be retroactive to the date on which the benefits were transferred.

(d) Examples. If a transfer complying with the elective transfer rules of paragraph (b) of this Q&A-3 is made from a defined benefit plan to a profit-sharing plan that does not provide for a life annuity distribution form, the profit-sharing plan to which the benefits are transferred would not be required to provide for a qualified joint and surviv-

or annuity with respect to the transferred benefits. If the same transfer is made under the direct transfer transitional rule of paragraph (c)(2) of this Q&A-3, the defined contribution plan is treated as a transferee plan with respect to the transferred benefits for purposes of the requirements of section 401(a)(11) and section 417. Thus, for example, if such benefits are transferred without spousal consent to a profit-sharing plan that did not previously provide for a life annuity distribution form, such plan would be required to provide for a qualified joint and survivor annuity for the participants whose benefits were transferred with respect to the transferred benefits.

Q-4: May a plan provide that the employer may, through the exercise of discretion, deny a participant a section 411(d)(6) protected benefit for which the participant is otherwise eligible?

A-4: (a) In general. Except as provided in paragraph (d) of Q&A-2 of this section with respect to certain employee stock ownership plans, a plan that permits the employer, either directly or indirectly, through the exercise of discretion, to deny a participant a section 411(d)(6) protected benefit provided under the plan for which the participant is otherwise eligible (but for the employer's exercise of discretion) violates the requirements of section 411(d)(6). A plan provision that makes a section 411(d)(6) protected benefit available only to those employees as the employer may designate is within the scope of this prohibition. Thus, for example, a plan provision under which only employees who are designated by the employer are eligible to receive a subsidized early retirement benefit constitutes an impermissible provision under section 411(d)(6). In addition, a pension plan that permits employer discretion to deny the availability of a section 411(d)(6) protected benefit violates the definitely determinable requirement of section 401(a), including section 401(a)(25). See § 1.401-1(b)(1)(i). This is the result even if the plan specifically limits the employer's discretion to choosing among section 411(d)(6) protected benefits, including optional forms of benefit, that are actuarially equivalent. In addition, the provisions of sections 411(a)(11) and 417(e) that allow a plan to make involuntary distributions of certain amounts are not excepted from this limitation on employer discretion. Thus, for example, a plan may not permit employer discretion with respect to whether benefits will be distributed involuntarily in the event that the present value of the employee's benefit is not more than $3,500 within the meaning of sections 411(a)(11) and 417(e). (An exception is provided for such provisions with respect to the nondiscrimination requirements of section 401(a)(4). See § 1.401(a)-4 Q&A-4.)

(b) Exception for administrative discretion. A plan may permit limited discretion with respect to the ministerial or mechanical administration of the plan, including the application of objective plan criteria specifically set forth in the plan. Such plan provisions do not violate the requirements of section 411(d)(6) or the definitely determinable requirement of section 401(a), including section 401(a)(25). For example, these requirements are not violated by the following provisions that permit limited administrative discretion:

(1) Commencement of benefit payments as soon as administratively feasible after a stated date or event;

(2) Employer authority to determine whether objective criteria specified in the plan (e.g., objective criteria designed to identify those employees with a heavy and immediate financial need or objective criteria designed to determine whether an employee has a permanent and total disability) have been satisfied; and

(3) Employer authority to determine, pursuant to specific guidelines set forth in the plan, whether the participant or spouse is dead or cannot be located.

Q-5: When will the exercise of discretion by some person or persons, other than the employer, be treated as employer discretion?

A-5: For purposes of applying the rules of this section and § 1.401(a)-4, the term "employer" includes plan administrator, fiduciary, trustee, actuary, independent third party, and other persons. Thus, if a plan permits any person, other than the participant (and other than the participant's spouse), the discretion to deny or limit the availability of a section 411(d)(6) protected benefit for which the employee is otherwise eligible under the plan (but for the exercise of such discretion), such plan violates the requirements of sections 401(a), including section 411(d)(6) and, where applicable, the definitely determinable requirement of section 401(a), including section 401(a)(25).

Q-6: May a plan condition the availability of a section 411(d)(6) protected benefit on the satisfaction of objective conditions that are specifically set forth in the plan?

A-6: (a) Certain objective conditions permissible —(1) In general. The availability of a section 411(d)(6) protected benefit may be limited to employees who satisfy certain objective conditions provided the conditions are ascertainable, clearly

set forth in the plan and not subject to the employer's discretion except to the extent reasonably necessary to determine whether the objective conditions have been met. Also, the availability of the section 411(d)(6) protected benefit must meet the nondiscrimination requirements of section 401(a)(4). See § 1.401(a)-4.

(2) Examples of permissible conditions. The following examples illustrate of permissible objective conditions: a plan may deny a single sum distribution form to employees for whom life insurance is not available at standard rates as defined under the terms of the plan at the time the single sum distribution would otherwise be payable; a plan may provide that a single sum distribution is available only if the employee is in extreme financial need as defined under the terms of the plan at the time the single sum distribution would otherwise be payable; a plan my condition the availability of a single sum distribution on the execution of a covenant not to compete, provided that objective conditions with respect to the terms of such covenant and the employees and circumstances requiring execution of such covenant are set forth in the plan.

(b) Conditions based on factors within employer's discretion generally impermissible. A plan may not limit the availability of section 411(d)(6) protected benefits permitted under the plan on objective conditions that are within the employer's discretion. For example, the availability of section 411(d)(6) protected benefits in a plan may not be conditioned on a determination with respect to the level of the plan's funded status, because the amount of plan funding is within the employer's discretion. However, for example, although conditions based on the plan's funded status are impermissible, a plan may limit the availability of a section 411(d)(6) protected benefit (e.g., a single sum distribution) in an objective manner, such as the following:

(1) Single sum distributions of $25,000 and less are available without limit; and

(2) Single sum distributions in excess of $25,000 are available for a year only to the extent that the total amount of such single sum distributions for the year is not greater than $5,000,000; and

(3) An objective and nondiscriminatory method for determining which particular single sum distributions will not be available during a year in order for the $5,000,000 limit to be satisfied is set forth in the plan.

Q-7: May a plan be amended to add employer discretion or conditions restricting the availability of a section 411(d)(6) protected benefit?

A-7: No. The addition of employer discretion or objective conditions with respect to a section 411(d)(6) protected benefit that has already accrued violates section 411(d)(6). Also, the addition of conditions (whether or not objective) or any change to existing conditions with respect to section 411(d)(6) protected benefits that results in any further restriction violates section 411(d)(6). However, the addition of objective conditions to a section 411(d)(6) protected benefit may be made with respect to benefits accrued after the later of the adoption or effective date of the amendment. In addition, objective conditions may be imposed on section 411(d)(6) protected benefits accrued as of the date of an amendment where permitted under the transitional rules of § 1.401(a)-4 Q&A-5 and Q&A-8 of this section. Finally, objective conditions may be imposed on section 411(d)(6) protected benefits to the extent permitted by the permissible benefit cutback provisions of Q&A-2 of this section.

Q-8: If a plan contains an impermissible employer discretion provision with respect to a section 411(d)(6) protected benefit, what acceptable alternative exist for amending the plan without violating the requirements of section 411(d)(6)?

A-8: (a) In general. The following rules apply for purposes of making necessary amendments to existing plans (as defined in Q&A-9 of this section) that contain discretion provisions with respect to the availability of section 411(d)(6) protected benefits that violate the requirements of section 401(a), including sections 401(a)(25) and 411(d)(6), and this section. These transitional rules are provided under the authority of section 411(d)(6) and section 7805(b).

(b) Transitional alternatives. If the availability of an optional forms of benefit, early or late retirement benefit, or retirement-type subsidy under an existing plan is conditioned on the exercise of employer discretion, the plan must be amended either to eliminate the optional form of benefit, early or late retirement benefit, or retirement-type subsidy to make such benefit available to all participants without limitation, or to apply objective and nondiscriminatory conditions to the availability of the optional form of benefit, early or later retirement benefit, or retirement-type subsidy. See paragraph (d) of this Q&A-8 for rules limiting the period during which section 411(d)(6) protected benefits may be eliminated or reduced under this paragraph.

(c) Compliance and amendment date provisions—(1) Operational compliance requirement. On or before the applicable effective date for the plan (as determined under Q&A-9 of this section), the plan sponsor must select one of the alternatives permitted under paragraph (b) of the Q&A-8 with respect to each affected section 411(d)(6) protected benefit and the plan must be operated in accordance with this selection. This is an operational requirement and does not require a plan amendment prior to the period set forth in paragraph (c)(2) of this Q&A-8. There are no special reporting requirements under the Code or this section with respect to this selection.

(2) Deferred amendment date. If paragraph (c)(1) of this Q&A-8 is satisfied, a plan amendment conforming the plan to the particular alternative selected under paragraph (b) of this Q&A-8 must be adopted within the time period permitted for amending plans in order to meet the requirements of section 410(b) as amended by TRA '86. The plan amendment to conform the plan to these regulations may be made at an earlier date. Such conforming amendment must be consistent with the sponsor's selection as reflected by plan practice during the period from the effective date to the date the amendment is adopted. Thus, for example, if any existing calendar year noncollectively bargained defined benefit plan has a single sum distribution option that is subject to employer discretion as of August 1, 1986, and such employer makes one or more single sum distributions available on or after January 1, 1989 and before the effective date by which plan amendment is required pursuant to this section, then such employer may not adopt a plan amendment eliminating the single sum distribution, but rather must adopt an amendment eliminating the discretion provision. Any objective conditions that are adopted as part of such amendment must not be inconsistent with the plan practice for the applicable period prior to the amendment. A conforming amendment under this paragraph (c)(2) must be made with respect to each section 411(d)(6) protected benefit for which such amendment is required and must be retroactive to the applicable effective date.

(d) Limitation on transitional alternatives. The transitional alternatives permitting the elimination or reduction of section 411(d)(6) protected benefits are only permissible until the applicable effective date for the plan (see Q&A-9 of this section). After the applicable effective date, any amendment (other than one permitted under paragraph (c)(2) of this Q&A-8) that eliminates or reduces a section 411(d)(6) protected benefit or imposes new objective conditions on the availability of such benefit will fail to qualify for the exception to section 411(d)(6) provided in this Q&A-8. This is the case without regard to whether the section 411(d)(6) protected benefit is subject to employer discretion.

Q-9: What are the applicable effective date rules for purposes of this section?

A-9: (a) General effective date. Except as otherwise provided in this section, the provisions of this section are effective January 30, 1986.

(b) New plans—(1) In general. Unless otherwise provided in paragraph (b)(2) of this Q&A-9, plans that are either adopted or made effective on or after August 1, 1986, are "new plans". With respect to such new plans, this section is effective August 1, 1986. This effective date is applicable to such plans whether or not they are collectively bargained.

(2) Exception with respect to certain new plans. Plans that are new plans as defined in paragraph (b)(1) of this Q&A-9; under which the availability of a section 411(d)(6) protected benefit is subject to employer discretion; and that receive a favorable determination letter that covered such plan provisions with respect to an application submitted prior to July 11, 1988, will be treated as existing plans with respect to such section 411(d)(6) protected benefit for purposes of the transitional rules of this section. Thus, such plans are eligible for the compliance and amendment alternatives set forth in the transitional rule in Q&A-8 of this section.

(c) Existing plans—(1) In general. Plans, including plans that are adoptions of master or prototype plans, that are both adopted and in effect prior to August 1, 1986, are "existing plans" for purposes of this section. In addition, a plan that is established after July 31, 1986, but before January 1, 1989, as an initial adoption of a master or prototype plan for which a favorable opinion letter was issued by the Service after July 18, 1985 and before January 1, 1989, will be deemed to be an existing plan for purposes of this section. See sections 4.01 and 4.02 of Rev. Proc. 84-23, 1984-1 C.B. 457, 459, for the definitions of master prototype plans. However, if such plan ceases to be covered under an opinion letter of the type described above, as a result of amendment of the plan or adoption of a new plan, prior to the first day of the first plan year beginning on or after January 1, 1989, then the effective date for such plan will be determined as though the plan were a new plan initially adopted as of the date of such

amendment or adoption of a new plan. Finally, new plans described in paragraph (b)(2) of this Q&A-9 are treated as existing plans with respect to certain section 411(d)(6) protected benefits. Subject to the limitations in paragraph (c) of this Q&A-9, the effective dates set forth in paragraphs (c)(2), (c)(3), and (c)(4) of this Q&A-9 apply to these existing plans for purposes of this section:

(2) Existing noncollectively bargained plans. With respect to existing plans other than collectively bargained plans this section is effective for the first day of the first plan year commencing on or after January 1, 1989.

(3) Existing collectively bargained plans. With respect to existing collectively bargained plans this section is effective for the later of the first day of the first plan year commencing on or after January 1, 1989, or the first day of the first plan year that the requirements of section 410(b) as amended by TRA '86 apply to such plan.

(4) Existing master and prototype plans. With respect to existing plans that are adoptions of master or prototype plans the effective date will be the first day of the first plan year commencing on or after January 1, 1989.

(d) Delayed effective date not applicable to new alternatives or conditions—(1) In general. The delayed effective dates in paragraphs (c)(2) and (c)(3) of this Q&A-9 for existing plans are only applicable with respect to a section 411(d)(6) protected benefit if both the section 411(d)(6) protected benefit and the condition providing employer discretion as to the availability of such benefit are both adopted and in effect prior to August 1, 1986. If the preceding sentence is not satisfied with respect to a particular section 411(d)(6) protected benefit, this section is effective with respect to such section 411(d)(6) protected benefit as if the plan were a new plan.

(2) Addition of discretion on or after January 30, 1986. The delayed effective dates in paragraphs (c)(2) and (c)(3) of this Q&A-9 are not available with respect to any section 411(d)(6) protected benefit if the section 411(d)(6) protected benefit was provided for in the plan prior to January 30, 1986, and the availability of such benefit was made subject to the exercise of employer discretion on or after January 30, 1986. If the conditions set forth in this paragraph are not satisfied with respect to a particular section 411(d)(6) protected benefit, this section is effective with respect to such section 411(d)(6) protected benefit as if the plan were a new plan. A limited exception is provided with respect to existing plans that provided a particular section 411(d)(6) protected benefit prior to January 30, 1986, and then amended the plan after January 30, 1986, and before August 1, 1986, to add a provision for employer discretion with respect to the availability of such benefit. Such plans are required to have been amended retroactively by December 31, 1987, to remove such provision for employer discretion, and, if the benefit made subject to such discretion was subsequently eliminated, the plan is required to have been further amended, by the same date, to retroactively reinstate the benefit.

(3) Exception for certain amendments covered by a favorable determination letter. If an amendment adding a section 411(d)(6) protected benefit subject to employer discretion was adopted or made effective after August 1, 1986, and the plan receives a favorable determination letter covering such provision with respect to an application for such letter made prior to July 11, 1988, then the effective date for purposes of amending such provision under the transitional rules is the applicable effective date determined under the rules with respect to existing plans.

(e) Transitional rule effective date. The transitional rule provided in Q&A-8 of this section is effective January 30, 1986.

[T.D. 8212, 53 F.R. 26058, July 11, 1988]

§ 1.411(d)–5 Class year plans; plan years beginning after October 22, 1986.

(a) Plan years beginning prior to 1989. (1) The requirements of section 411(a)(2) shall be treated as satisfied in the case of a class-year plan if such plan provides that 100 percent of each employee's right to or derived from the contributions of the employer on the employee's behalf with respect to any plan year is nonforfeitable not later than when such participant was performing services for the employer as of the close of each of 5 plan years (whether or not consecutive) after the plan year for which the contributions were made.

(2) For purposes of paragraph (a)(1) of this section if—

(i) Any contributions are made on behalf of a participant with respect to any plan year, and

(ii) Before such participant meets the requirements of paragraph (a)(1) of this section, such participant was not performing services for the employer as of the close of each of any 5 consecutive plan years after such plan year, then the plan may provide that the participant forfeits any right

to or derived from the contributions made with respect to such plan year.

(3) This paragraph (a) applies to contributions made for plan years beginning after October 22, 1986.

(b) Plan years beginning after 1988. (1) The special class year vesting rule in section 411(d)(4) was repealed by section 1113(b) of the Tax Reform Act of 1986 (1986 Act). The repeal is generally effective for plan years beginning after December 31, 1988. See section 1111(e) of the 1986 Act for a special effective date rule applicable to certain plans maintained pursuant to collectively bargaining agreements.

(2)(i) This subparagraph (2) provides a special rule for class year plans that were in compliance with section 411(d)(4) immediately before the first plan year beginning after section 411(d)(4) is repealed. These plans are not required to retroactively compute years of service under the general section 411(a)(2) rules. Instead, a participant must receive a year of service for each such prior plan year if the employee was performing services on the last day of such year. Similarly, if the participant was not performing services on the last day of such years, the participant will be treated as if a one-year break in service occurred for such plan year. This subdivision (i) applies to plan years to which this section applies.

(ii) In the case of a plan year to which § 1.411(d)-3 applied, a class year plan must compute years of service and breaks in service in a manner consistent with the rules in this paragraph (b)(2)(i), giving appropriate regard to the statutory changes made to section 411(d)(4).

[T.D. 8219, 53 FR 31854, Aug. 22, 1988; T.D. 8219, 53 FR 48534, Dec. 1, 1988]

§ 1.412(b)–2 Amortization of experience gains in connection with certain group deferred annuity contracts.

(a) Experience gain treatment. Dividends, rate credits, and credits for forfeitures arising in a plan described in paragraph (b) of this section are experience gains described in section 412(b)(3)(B)(ii) (relating to the amortization of experience gains).

(b) Plan. A plan is described in this paragraph (b) if—

(1) The plan is funded solely through a group deferred annuity contract,

(2) The annual single premium required under the contract for the purchase of the benefits accruing during the plan year is treated as the normal cost of the plan for that year, and

(3) The amount necessary to pay in equal annual installments, over the appropriate amortization period, an amount equal to the single premium necessary to provide all past service benefits not initially funded, together with interest thereon, is treated as the annual amortization amount determined under section 412(b)(2)(B)(i), (ii) or (iii).

(c) Effective date. This section applies for the first plan year to which section 412 applies that begins after May 22, 1981.

[T.D. 7764, 46 FR 6923, Jan. 22, 1981]

§ 1.412(b)–5 Election of the alternative amortization method of funding.

(a) Alternative amortization method in general. Section 1013(d) of the Employee Retirement Income Security Act of 1974 provides an alternative method which may be used by certain multiemployer plans (as defined in section 414(f)) which were in existence on January 1, 1974, for funding certain unfunded past service liability. The multiemployer plans which may elect to use this alternative method are those plans (1) under which, on January 1, 1974, contributions were based on a percentage of pay, (2) which use actuarial assumptions with respect to pay that are reasonably related to past and projected experience, and (3) which use rates of interest that are determined on the basis of reasonable actuarial assumptions. The unfunded past service liability to which this method applies is that amount existing as of the date 12 months after the date on which section 412 first applies to the plan. The alternative method allows the plan to fund this liability over a period of 40 plan years by charging the funding standard account with an equal annual percentage of the aggregate pay of all participants in the plan instead of the level dollar charges required under section 412(b)(2)(B). Paragraphs (b), (c), (d) and (e) of this section contain procedural rules for electing this alternative method.

(b) Election procedure. To elect the alternative amortization method, a multiemployer plan must attach a statement to the annual report required under section 6058(a) for the plan year for which the election is made, stating that the alternative method for funding unfunded past service liability is being adopted. Advance approval from the Internal Revenue Service is not required. The alternative method must be adopted on or before

the last day prescribed for filing the annual report corresponding to the last plan year beginning before January 1, 1982.

(c) Charges to which the alternative amortization method is applicable. Once elected, the alternative amortization method is applicable to the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. This results in charges to the funding standard account which are in lieu of—

(1) Charges required under clause (i) of section 412(b)(2)(B), and

(2) Charges required under clause (iii) of section 412(b)(2)(B) if the plan amendments referred to in such clause result in a net increase in the unfunded past service liability existing as of the date 12 months after the date on which section 412 first applies to the plan. Such charges generally will arise only with respect to plan amendments adopted in the first plan year to which section 412 applies.

If the election is made on an annual report corresponding to a plan year after the first plan year to which section 412 applies, recomputation of the contributions due in the prior years (to which section 412 applied) will be necessary.

(d) Limitation. The sum of the charges described in this paragraph may not be less than the interest on the unfunded past service liabilities described in section 412(b)(2)(B)(i) and (iii), determined as of the date 12 months after the date on which section 412 first applies to the plan.

(e) Reporting requirements. Each annual report required by section 6058(a) and periodic report of the actuary required by section 6059 must include all additional information relevant to the use of the alternative amortization method as may be required by the applicable forms and the instructions for such forms.

[T.D. 7702, 45 FR 40113, June 13, 1980]

§ 1.412(c)(1)–1 Determinations to be made under funding method—terms defined.

(a) Actuarial cost method and funding method. Section 3(31) of the Employee Retirement Income Security Act of 1974 ("ERISA") provides certain acceptable (and unacceptable) actuarial cost methods which may (or may not) be used by employee plans. The term "funding method" when used in section 412 has the same meaning as the term "actuarial cost method" in section 3(31) of ERISA. For shortfall method for certain collectively bargained plans, see § 1.412(c)(1)–2; for principles applicable to funding methods in general, see regulations under section 412(c)(3).

(b) Computations included in funding method. The funding method of a plan includes not only the overall funding method used by the plan but also each specific method of computation used in applying the overall method. However, the choice of which actuarial assumptions are appropriate to the overall method or to the specific method of computation is not a part of the funding method. For example, the decision to use or not to use a mortality factor in the funding method of a plan is not a part of such funding method. Similarly, the specific mortality rate determined to be applicable to a particular plan year is not part of the funding method. See section 412(c)(5) for the requirement of approval to change the funding method used by a plan.

[T.D. 7733, 45 FR 75202, Nov. 14, 1980]

§ 1.412(c)(1)–2 Shortfall method.

(a) **In general—(1) Shortfall method.** The shortfall method is a funding method that adapts a plan's underlying funding method for purposes of section 412. As such, the use of the shortfall method is subject to section 412(c)(3). A plan described in paragraph (a)(2) of this section may elect to determine the charges to the funding standard account required by section 412(b) under the shortfall method. These charges are computed on the basis of an estimated number of units of service or production (for which a certain amount per unit is to be charged). The difference between the net amount charged under this method and the net amount that otherwise would have been charged under section 412 for the same period is a shortfall loss (gain) and is to be amortized over certain subsequent plan years.

(2) Eligibility for use of shortfall. No plan may use the shortfall method unless—

(i) The plan is a collectively bargained plan described in section 413(a), and

(ii) Contributions to the plan are made at a rate specified under the terms of a legally binding agreement applicable to the plan.

For purposes of this section, a plan maintained by a labor organization which is exempt from tax under section 501(c)(5) is treated as a collectively bargained plan and the governing rules of the organization (such as its constitution, bylaws, or other document that can be altered only through

action of a convention of the organization) are treated as a collectively bargained agreement.

(b) **Computation and effect of net shortfall charge—(1) In general.** The "net shortfall charge" to the funding standard account under the shortfall method is the product of (i) the estimated unit charge described in paragraph (c) of this section that applies for a particular plan year, multiplied by (ii) the actual number of base units (for example, units of service or production) which occurred during that plan year. When the shortfall method is used, the net shortfall charge is a substitute for the specific charges and credits to the funding standard account described in section 412(b)(2) and (3)(B).

(2) **Example.** Paragraph (b)(1) of this section may be illustrated by the following example:

Example. A pension plan uses the calendar year as the plan year and the shortfall method. Its estimated unit charge applicable to 1980 is 80 cents per hour of covered employment. During 1980, there were 125,000 hours of covered employment. The net shortfall charge for the plan year is $100,000, (*i.e.*, 125,000 × $.80) regardless of the amount which would be charged and credited to the funding standard account under section 412(b)(2) and (3)(B) had the shortfall method not applied. The funding standard account for 1980 will be separately credited for the amount considered contributed for the plan year under section 412(b)(3)(A). The other items which may be credited, if applicable, are a waived funding deficiency and the alternative minimum funding standard credit adjustment under section 412(b)(3)(C) and (D) because these items are not credits under section 412(b)(3)(B).

(3) **Plans with more than one contract, contribution rate, employer, or benefit level—(i) General rule.** A single plan with more than one contract, contribution rate, employer, or benefit level may compute a separate net shortfall charge for each contract, contribution rate, each employer, or each benefit level. The sum of these charges is the plan's total net shortfall charge, under § 1.412(c)(1)-1(b), the use of separate computations would be a specific method of computation used in applying the overall funding method. See also paragraph (f)(5) of this section.

(ii) **Single valuation.** Only one actuarial valuation shall be made for the single plan on each actuarial valuation date.

(iii) **Reasonableness test.** The specific method of computation of the net shortfall charge must be reasonable, determined in the light of the facts and circumstances.

(c) **Estimated unit charge.** The estimated unit charge is the annual computation charge described in paragraph (d) of this section divided by the estimated base units of service or production described in paragraph (e) of this section.

(d) **Annual computation charge.** The annual computation charge for a plan year is the sum of the following amounts:

(1) The net charges and credits which, but for using the shortfall method, would be made under section 412(b)(2) and (b)(3)(B).

(2) The amount described in paragraph (g)(3) of this section, if applicable, for amortization of shortfall gain or loss.

(e) **Estimated base units—(1) In general.** The estimated base units are the expected units of service or production for a plan year (hours, days, tons, dollars of compensation, etc.), determined as of the base unit estimation date for that plan year under paragraph (f) of this section. This estimate must be based on the past experience of the plan and the reasonable expectations of the plan for the plan year. The specific type of unit used must be described in the statement of funding method for the plan year. (See paragraph (i)(3) of this section for reporting requirements.)

(2) **Reasonable expectations.** The reasonableness of expectations used under paragraph (e)(1) of this section is determined under the facts and circumstances of the plan for each plan year as of the relevant base unit estimation date. Expectations will be considered unreasonable if, for example, they do not reflect a consistent and substantial decline or growth in actual base units that has occurred over the course of recent years and that is likely to continue beyond the base unit estimation date. This determination of reasonableness is independent of determinations made under section 412(c)(3) of the reasonableness of actuarial assumptions.

(f) **Base unit estimation date—(1) In general.** The base unit estimation date for the current plan year is determined under this paragraph (f). This date shall be an actuarial valuation date no earlier than the last actuarial valuation date occurring at least one year before the earliest date any current collectively bargained agreement in existence during the plan year came into effect.

(2) **Four-month rule.** For purposes of this paragraph (f), a current collectively bargained agreement is one in effect during at least four months of the current plan year.

(3) **Effective date of agreement.** For purposes of this paragraph (f), a collectively bargained agreement shall be deemed to have come into effect on the effective date of the agreement containing the currently effective provision for contri-

butions to the plan or the benefits provided under the plan.

(4) **Long-term contract rule.** The effective date of a collectively bargained agreement shall be deemed not to occur prior to the first day of the third plan year preceding the current year.

(5) **Special rule for plans computing separate net shortfall charge.** A plan that computes a separate net shortfall charge for each contract, contribution rate, employer, or benefit level under paragraph (b)(3) of this section shall determine the base unit estimation date for each separate charge without regard to any collectively bargained agreement that does not relate to that contract, contribution rate, employer, or benefit level. If a collective bargaining agreement requiring contributions by a certain employer, or prescribing a certain benefit level, is in effect on December 31, 1980, the preceding sentence shall not apply to the computation of a separate net shortfall charge for that employer or benefit level until the earlier of—

(i) The first plan year beginning after the date on which expires the collective bargaining agreement requiring contributions by that employer (or the last collective bargaining agreement relating to that benefit level), or

(ii) The first plan year beginning after December 31, 1983.

(6) **Example.** The rules contained in paragraph (f) of this section are illustrated by the following table. In the table, "V" signifies actuarial valuation date (January 1 in each case shown); "B" signifies beginning of a contract; and "E" signifies end of a contract. The table shows the resulting earliest base unit estimation date with respect to the following assumed items:

COMPUTATION OF EARLIEST BASE UNIT ESTIMATION DATE

Example	Plan year (calendar year basis)											
	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Plan A	V			V			V			V		
Contract 1	.....	.....	E/B	.....	.....	E/B	.....	E/B	.....	.....	.....	E/B
Base unit estimation date [1]				1973	1973	1973	1976	1976	1979	1979	1979	1979
Plan B	V			V			V			V		
Contract 2	[2]	[2]	[2]	B*	.....	E/B	.....	.....	.....	E/B*	.....	.....
Contract 3	E/B	.....	.....	E/B	.....	.....	E/B	.....	.....	E/B	.....	.....
Base unit estimation date [1]	.....	.....	.....	1973	1973	1973	1976	1976	1976	1976	1979	1979
Plan C	V	V	V	V	V	V	V	V	V	V	V	V
Contract 4	.....	.....	E/B	.....	.....	E/B*	.....	.....	.....	E/B*	.....	.....
Contract 5	.....	.....	E/B	.....	.....	E/B*	.....	.....	.....	.....	E/B*	.....
Base unit estimation date [1]				1974	1974	1977	1977	1977	1977	1978	1979	1981

[1] The base unit estimation date may be on or any time after the actuarial valuation date in the year indicated on this line.
[2] No contract.
* Denotes that a prior contract ends and a new contract begins prior to the fifth month of a plan year.

(g) **Amortization of shortfall gain or loss—(1) Definition.** The shortfall gain for a plan is the excess for the plan year of—

(i) The net shortfall charge computed under paragraph (b) of this section over.

(ii) The annual computation charge described in paragraph (d) of this section.

The shortfall loss for a plan is the excess for the plan year of the annual computation charge over the net shortfall charge.

(2) **Shortfall amortization period—(i) First year.** The plan year in which the amortization of a shortfall gain or loss must begin is the earlier of two years: the fifth plan year following the plan year in which the shortfall gain or loss arose, or the first plan year beginning after the latest scheduled expiration date of a collectively bargained agreement in effect with respect to the plan during the plan year in which the shortfall gain or loss arose. For purposes of this subparagraph, a contract expiring on the last day of a plan year shall be deemed to be renewed on such last day for the same period of years as the contract that succeeds the expiring contract.

(ii) **Last year.** The plan year in which the amortization of a shortfall gain or loss must end is the 15th plan year following the plan year in which the shortfall gain or loss arose. For a multiemployer plan described in section 414(f), the amortization must end with the 20th plan year instead of the 15th.

(3) Annual amortization amount. The shortfall gain or loss must be amortized in equal annual installments. The total amount to be amortized must be adjusted for interest at the rate used for determining the plan's normal cost.

(4) Shortfall gain or loss under spread gain type of funding method—(i) In general. A spread gain type of funding method spreads experience gains and losses over future periods as part of a plan's normal cost. (Examples of spread gain types of funding methods are the aggregate cost method, the frozen initial liability method, and the attained age normal method.) However, a shortfall gain or loss is not an experience gain or loss. Therefore, a plan using a spread gain type of funding method together with the shortfall method must amortize shortfall gains and losses and otherwise meet the requirements of paragraph (g) of this section.

(ii) Asset adjustment for aggregate method. A plan using the shortfall method with the aggregate cost method of funding must adjust its plan assets for a shortfall gain or loss in calculating normal cost. The unamortized portion of any shortfall gain is subtracted from plan assets. The unamortized portion of any shortfall loss is added to plan assets.

(5) Reconciliation of shortfall gain or loss with funding standard account. At the beginning of each year, the actual unfunded liability under the method used by the plan must equal the outstanding balance of all amortization bases, including bases for shortfall gains and losses, less the credit balance under the funding standard account at the end of the prior year.

(6) Example. This paragraph is illustrated by the following examples:

Example (1). A multiemployer plan described in section 414(f) is maintained with the calendar year as the plan year and uses the shortfall method. The plan uses the frozen initial liability funding method. A five percent interest assumption is used by the plan, with payments computed as of the first day of each plan year for all items. The expiration dates of contracts in effect during plan years 1976, 1977, and 1978 are such that the amortization of gains or losses for each year must begin in the fifth following plan year. The assumed plan costs and estimated base units for selected years, and the computations under this section which follow from such assumptions are shown in the following table. In the table, "*" denotes an assumed item. The remaining figures have been calculated on the basis of these assumptions.

(A) Computation of Net Shortfall Charge and Shortfall Gain or Loss

Plan year	1976	1977	1978
1. Normal cost* ..	$100,000	$100,000	$100,000
2. Amortization of unfunded liability*	50,000	50,000	50,000
3. Total annual computation charges	$150,000	$150,000	$150,000
4. Estimated base units*	100,000	100,000	100,000
5. Estimated unit charge (line 3 ÷ line 4)	$1.50	$1.50	$1.50
6. Actual units during year*	80,000	90,000	110,000
7. Net shortfall charge for year (line 5 × line 6)	120,000	135,000	165,000
8. Shortfall (gain) or loss (line 3 – line 7)	30,000	15,000	($15,000)

(B) Annual Amortization Amount

Plan Year	1976	1977	1978
9. Year of shortfall gain or loss	1976	1977	1978
10. First year of amortization	1981	1982	1983
11. Last year of amortization	1996	1997	1998
12. (Gain) or loss adjusted for interest to year amortization begins (1–1–76 to 1–1–81, etc.)	$38,288	$19,144	($19,144)
13. Annual amortization (16 years)	$3,364	$1,682	($1,682)

(C) Computation of Net Shortfall Charges for Selected Years (Including Shortfall Amortization)

Plan year	1981	1982	1983
14. Normal cost*	$120,000	$125,000	$130,000
15. Amortization of unfunded liability*	50,000	50,000	50,000
16. Shortfall amortization (see line 13) from:			
1976..........	3,364	3,364	3,364
1977..........	....	1,682	1,682
1978..........	....	....	(1,682)
17. Total annual computation charges	173,364	180,046	183,364
18. Estimated base units*	110,000	110,000	110,000
19. Estimated unit charge (line 17 ÷ line 18)	1.576	1.637	1.667
20. Actual units during year*	105,000	110,000	105,000
21. Net shortfall charge for year (line 19 × line 20)	165,480	180,070	175,035
22. Shortfall (gain) loss (line 17 – line 21)	7,884	(24)	8,329

The amounts in line 22 will be amortized beginning 1986, 1987, and 1988, respectively. The $24 gain in 1982 results from rounding the estimated unit charge.

Example (2). Assume the facts in Example (1). Also assume that the plan uses the frozen initial liability funding method, that the unfunded liability as of January 1, 1976 (corresponding to a 40-year charge of $50,000 due at the beginning of the year) is $900,850, and that actual contributions at the rate of $1.75 per unit are paid at mid-year in 1976.

(A) COMPUTATION OF THE UNFUNDED LIABILITY AS OF DECEMBER 31, 1976

1. Unfunded liability as of 1/1/76	$900,850
2. Normal cost (that used in the calculation of the total annual computation charges) ...	100,000
3. Interest at 5% due on items 1 and 2	50,043
4. Contribution with interest: $1.75 × 80,000 × 1.025 (actual contribution rate times actual base units times interest adjustment from mid-year)	143,500
5. Unfunded liability as of 12/31/76: item 1 + item 2 + item 3 – item 4	907,393

(B) COMPUTATION OF THE OUTSTANDING BALANCE OF THE BASES AS OF DECEMBER 31, 1976

1. Original base: ($900,850 – $50,000) × 1.05	$893,393
2. Shortfall loss $30,000 × 1.05............	31,500
3. Total................................	924,893

(C) COMPUTATION OF THE CREDIT BALANCE AS OF DECEMBER 31, 1976

1. Net shortfall charge (§ 1.412(c)(1)–2(b)) adjusted for interest: $120,000 × 1.05	$126,000
2. Actual contributions with interest	143,500
3. Credit balance as of 12/31/76: item 2 – item 1....................................	17,500

(D) RECONCILIATION OF COMPUTATIONS.

As of January 1, 1977, the unfunded liability ($907,393) equals the outstanding balance of the bases minus the credit balance ($924,893 – $17,500 = $907,393).

(h) Amortization of experience gain or loss—(1) General rule. In the case of a plan using an immediate gain type of funding method, an experience gain or loss shall be amortized pursuant to section 412(b)(2)(B)(iv) or (b)(3)(B)(ii). (Examples of the immediate gain type of funding method are the unit credit method, the entry age normal cost method, and the individual level premium cost method.) For purposes of this section, a shortfall gain or loss is not an experience gain or loss. The amount of the experience gain or loss must be adjusted for interest at the rate used for determining the plan's normal cost.

(2) Experience amortization period under shortfall method—(i) First year. The plan year in which the amortization of an experience gain or loss must begin in the case of a plan using the shortfall method is the earlier of two years: the fifth plan year following the plan year in which the experience gain or loss arose, or the first plan year beginning after the last scheduled expiration date of a contract in effect during the plan year in which the experience gain or loss arose. For purposes of this subparagraph a contract expiring on the last day of the plan year shall be deemed to be renewed on such last day for the same period of years as the contract that succeeds the expiring contract.

(ii) Last year. The plan year in which the amortization of an experience gain or loss must end in the case of a plan using the shortfall method is the 15th plan year following the plan year in which the experience gain or loss arose. For a multi-employer plan described in section 414(f), the amortization must end with the 20th plan year instead of the 15th.

(3) Use of annual computation charge in determining experience gain or loss. In the case of a plan using an immediate gain type of funding method, an experience gain or loss is the difference between the expected unfunded liability and the actual unfunded liability under the plan. The expected unfunded liability as of the end of a plan year equals the actual unfunded liability as of the beginning of the year plus normal cost, minus contributions, all adjusted for interest. If the plan adopts the shortfall method, the expected unfunded liability is computed by using the normal cost applicable for the plan year in determining the annual computation charge under paragraph (d) of this section. The same normal cost is used in computing the unfunded liability under the frozen initial liability funding method.

(4) Example. This paragraph is illustrated by the following example:

Example. Assume the facts in Example (2) from paragraph (g)(6) of this section, except that the entry age normal funding method is used. Also assume that as of December 31, 1976, the actual unfunded liability is $900,000.

(A) COMPUTATION OF EXPECTED UNFUNDED LIABILITY

1. Actual unfunded liability as of 1–1–76....	$900,850
2. Normal cost portion of annual computation charge as of 1–1–76	100,000
3. Interest at 5% due on items 1 and 2	50,043
4. Contribution received with interest: $1.75 × 80,000 × 1.025 (actual contribution rate times actual base units times interest adjustment at mid-year).......................	143,500
5. Expected unfunded liability as of 12–31–76 (item 1 + item 2 + item 3 – item 4)	907,393

(B) COMPUTATION OF GAIN OR LOSS

1. Expected unfunded liability as of 12–31–76	$907,393
2. Actual unfunded liability as of 12–31–76..	900,000
3. Gain (or loss) (item 1 – item 2)..........	7,393

(i) **Election procedure—(1) In general.** To elect the shortfall method, a collectively bargained plan must attach a statement to the annual report required under section 6058(a) for the first plan year to which it is applied. The statement shall state that the shortfall method is adopted, beginning with the plan year covered by such report. Advance approval from the Internal Revenue Service is not required if the shortfall method is first adopted on or before the later of—

(i) The first plan year to which section 412 applies or

(ii) The last plan year commencing before December 31, 1981.

However, approval must be received pursuant to section 412(c)(5) prior to the adoption of the shortfall method at a later time, or the discontinuance of such method, once adopted.

(2) **Use of specific computation method.** A specific method of computation under the shortfall method is described in paragraph (b)(3) of this section, regarding the treatment of more than one contract, employer, or benefit level under the plan. This specific method may be adopted with respect to any plan year to which the shortfall method applies. Approval from the Commissioner must be received under section 412(c)(5) prior to the adoption of this specific computation method for a plan year subsequent to the first plan year to which the shortfall method applies, or prior to the discontinuance of a specific computation method, once adopted.

(3) **Reporting requirements.** Each annual report required by section 6058(a) and periodic report of the actuary required by section 6059 must include all additional information relevant to the use of the shortfall method as may be required by the applicable forms and the instructions for such forms.

(j) **Transitional rule.** In lieu of paragraphs (g)(2) and (h)(2) of this section relating to the amortization period for shortfall and experience gains and losses, for gains and losses arising in plan years beginning before January 1, 1981, a plan may rely on the prior published position of the Internal Revenue Service with respect to the amortization period for shortfall and experience gains and losses.

(k) **Supersession.** This section and § 1.412(c)(1)–1 supersede §§ 11.412(c)(1)–1 and (c)(1)–2 of the Temporary Income Tax Regulations Under the Employee Retirement Income Security Act of 1974.

[T.D. 7733, 45 FR 75202, Nov. 14, 1980]

§ 1.412(c)(2)–1 Valuation of plan assets; reasonable actuarial valuation methods.

(a) **Introduction—(1) In general.** This section prescribes rules for valuing plan assets under an actuarial valuation method which satisfies the requirements of section 412(c)(2)(A). An actuarial valuation method is a funding method within the meaning of section 412(c)(3) and the regulations thereunder. Therefore, certain changes affecting the actuarial valuation method are identified in this section as changes in a plan's funding method.

(2) **Exception for certain bonds, etc.** The rules of this section do not apply to bonds or other evidences of indebtedness for which the election described in section 412(c)(2)(B) has been made, nor are such assets counted in applying paragraphs (b) or (c) of this section. Also, an election under section 412(c)(2)(B) is not a change in funding method within the meaning of section 412(c)(5).

(3) **Money purchase pension plan.** A money purchase pension plan must value assets for the purpose of satisfying the requirements of section 412(c)(2)(A) solely on the basis of their fair market value (under paragraph (c) of this section).

(4) **Defined benefit plans.** (i) To satisfy the requirements of section 412(c)(2)(A), an actuarial method valuing assets of a defined benefit plan must meet the requirements of paragraph (b) of this section.

(ii) In general, the purpose of paragraph (b) of this section is to permit use of reasonable actuarial valuation methods designed to mitigate short-run changes in the fair market value of plan assets. The funding of plan benefits and the charges and credits to the funding standard account required by section 412 are generally based upon the assumption that the defined benefit plan will be continued by the employer. Thus, short-run changes in the value of plan assets presumably will offset one another in the long term. Accordingly, in the determination of the amount required to be contributed under section 412 it is generally not necessary to recognize fully each change in fair market value of the assets in the period in which it occurs.

(iii) The asset valuation rules contained in paragraph (b) produce a "smoothing" effect. Thus, investment performance, including appreciation or depreciation in the market value of the assets

occurring in each plan year, may be recognized gradually over several plan years. This "smoothing" is in addition to the "smoothing" effect which results, for example, from amortizing experience losses and gains over 15 or 20 years under section 412(b)(2)(B)(iv) and (3)(B)(ii).

(b) Asset valuation method requirements—(1) Consistent basis. (i) The actuarial asset valuation method must be applied on a consistent basis. Any change in meeting the requirements of this paragraph (b) is a change in funding method subject to section 412(c)(5).

(ii) A method may satisfy the consistency requirement even though computations are based only on the period elapsed since the adoption of the method or on asset values occurring during that period.

(2) Statement of plan's method. The method of determining the actuarial value (but not fair market value) of the assets must be specified in the plan's actuarial report (required under section 6059). The method must be described in sufficient detail so that another actuary employing the method described would arrive at a reasonably similar result. Whether a deviation from the stated actuarial valuation method is a change in funding method is to be determined in accordance with section 412(c)(5) and the regulations thereunder. A deviation to include a type of asset not previously held by the plan would not be a change in funding method.

(3) Consistent valuation dates. The same day or days (such as the first or the last day of a plan year) must be used for all purposes to value the plan's assets for each plan year, or portion of plan year, for which a valuation is made. For purposes of this section, each such day is a valuation date. A change in the day or days used is a change in funding method.

(4) Reflect fair market value. The valuation method must take into account fair market value by making use of the—

(i) Fair market value (determined under paragraph (c) of this section), or

(ii) Average value (determined under paragraph (b)(7) of this section) of the plan's assets as of the applicable asset valuation date. This is done either directly in the computation of their actuarial value or indirectly in the computation of upper or lower limits placed on that value.

(5) Results above and below fair market or average value. A method will not satisfy the requirements of this paragraph (b) if it is designed to produce a result which will be consistently above or below the values described in paragraph (b)(4)(i) and (ii). However, a method designed to produce a result which consistently falls between fair market value and average value will satisfy this requirement. See Example (5) in paragraph (b)(9) of this section for an illustration of a method described in the preceding sentence.

(6) Corridor limits. (i) Regardless of how the method reflects fair market value under paragraph (b)(4), the method must result in an actuarial value of the plan's assets which is not less than a minimum amount and not more than a maximum amount. The minimum amount is the lesser of 80 percent of the current fair market value of plan assets as of the applicable asset valuation date or 85 percent of the average value (as described in subparagraph (7)) of plan assets as of that date. The maximum amount is the greater of 120 percent of the current fair market value of plan assets as of the applicable asset valuation date or 115 percent of the average value of plan assets as of that date.

(ii) Under a plan's method, a preliminary computation of the expected actuarial value may fall outside the prescribed corridor. A method meets the requirements of paragraph (b)(6)(i) of this section in such a case only by adjusting the expected actuarial value to the nearest corridor limit applicable under the method. A plan may use an actuarial valuation method with a narrower corridor than the general corridor required under paragraph (b)(6)(i). The adjustment to the nearest corridor limit of such a method for purposes of this subdivision (ii) would be determined by the narrower corridor stated in the description of the plan's method.

(7) Average value. The average value of plan assets is computed by—

(i) Determining the fair market value of plan assets at least annually,

(ii) Adding the current fair market value of the assets (as of the applicable valuation date) and their adjusted values (as described in paragraph (b)(8) of this section) for a stated period not to exceed the five most recent plan years (including the current year), and

(iii) Dividing this sum by the number of values (including the current fair market value) considered in computing the sum described in subdivision (ii).

(8) Adjusted value. (i) The adjusted value of plan assets for a prior valuation date is their fair market value on that date with certain positive and negative adjustments. These adjustments reflect changes that occur between the prior asset valuation date and the current valuation date. However, no adjustment is made for increases or decreases in the total value of plan assets that result from the purchase, sale, or exchange of plan assets or from the receipt of payment on a debt obligation held by the plan.

(ii) In determining the adjusted value of plan assets for a prior valuation date, there is added to the fair market value of the plan assets of that date the sum of all additions to the plan assets since that date, excluding appreciation in the fair market value of the assets. The additions would include, for example, any contribution to the plan; any interest or dividend paid to the plan; and any asset not taken into account in a prior valuation of assets, but taken into account for the current year, in computing the fair market value of plan assets under paragraph (c) of this section.

(iii) In determining the adjusted value of plan assets for a prior valuation date, there is subtracted from the fair market value of the plan assets on that date the sum of all reductions in plan assets since that date, excluding depreciation in the fair market value of the assets. The reductions would include, for example, any benefit paid from plan assets; any expense paid from plan assets; and any asset taken into account in a prior valuation of assets but not taken into account for the current year, in computing the fair market value of plan assets under paragraph (c) of this section.

(9) Examples. This paragraph (b) may be illustrated by the following examples. In each example, assume that the pension plan uses a consistent actuarial method of valuing its assets within the meaning of paragraph (b)(1), (2), and (3) of this section.

Example (1). Plan A considers the value of its assets to be initial cost, increased by an assumed rate of growth of X percent annually. Under the circumstances, the X-percent factor used by the plan is a reasonable assumption. Thus, this method is not designed to produce results consistently above or below fair market value as prohibited by paragraph (b)(5) of this section. Also, the method requires that the actuarial value be adjusted as required to fall within the corridor under paragraph (b)(6) and (7) of this section. Therefore, the method reflects fair market value as required by paragraph (b)(4) of this section.

Example (2). Plan B computes the actuarial value of its assets as follows: It determines the fair market value of the plan assets. Then the fair market value is adjusted to the extent necessary to make the actuarial value fall within a "5 percent" corridor. This corridor is plus or minus 5 percent of the following amount: the fair market value of the assets at the beginning of the valuation period plus an assumed annual growth of 4 percent with adjustments for contributions and benefit payments during the period. This method reflects fair market value in a manner prescribed by paragraph (b)(4) of this section. If the 4 percent factor used by the plan is a reasonable assumption, this method is not designed to produce results consistently above or below fair market value, and thus it satisfies paragraph (b)(5). However, this method is unacceptable because in some instances it may result in an actuarial value outside the corridor described in paragraph (b)(6) of this section. This method would be permitted if a second corridor were imposed which would adjust the value of the total plan assets to the corridor limits as required by paragraph (b)(6).

Example (3). Plan C values its assets by multiplying their fair market value by an index number. The use of the index results in the hypothetical average value that plan assets present on the valuation date would have had if they had been held during the current and four preceding years, and had appreciated or depreciated at the actual yield rates including appreciation and depreciation experienced by the plan during that period. However, the method requires an adjustment to the extent necessary to bring the resulting actuarial value of the assets inside the corridor described in the statement of the plan's actuarial valuation method. In this case, the stated corridor is 90 to 110 percent of fair market value, a corridor narrower than that described in paragraph (b)(7) of this section. This method is permitted.

Example (4). Plan D values its assets by multiplying their fair market value by 95 percent. Although the method reflects fair market value and the results of this method will always be within the required corridor, it is not acceptable because it will consistently result in a value less than fair market value.

Example (5). Plan E values its assets by using a five-year average method with appropriate adjustments for the period. Under the particular method used by Plan E, assets are not valued below 80 percent of fair market value or above 100 percent of fair market value. If the average produces a value that exceeds 100 percent of fair market value, the excess between 100 and 120 percent is recorded in a "value reserve account." In years after one in which the average exceeds 100 percent of fair market value, amounts are subtracted from this account and added, to the extent necessary, to raise the value produced by the average for that year to 100 percent of fair market value. This method is permitted because it reflects fair market value under paragraph (b)(4) of this section by appropriately computing an average value, it satisfies paragraph (b)(5) by producing a result that falls consistently between fair market value and average value, and it properly reflects the corridor described in paragraph (b)(7).

Example (6). All assets of Plan F are invested in a trust fund and the plan year is the calendar year. The actuarial value is determined by averaging fair market value over 4 years. An actuarial valuation is performed as of December 31, 1988.

(i) The average value as of December 31, 1988, is computed as follows:

	1986	1986	1987	1987	1988	1988
Fair market value: Jan. 1	....	$150,000	....	$196,500	....	$238,000
Contributions	$65,000	....	$62,000	....	$66,000	....
Benefit payments	(22,000)	....	(24,000)	....	(25,000)	....

	1986	1986	1987	1987	1988	1988
Expenses	(6,500)	....	(7,000)	....	(7,500)	....
Interest and dividends	8,000	44,500	7,500	38,500	7,000	240,500
Net realized gains (losses)	....	(2,000)	....	6,000	....	(8,000)
Balancing item [1]	....	4,000	....	(3,000)	....	(42,000)
Fair market value: Dec. 31	....	196,500	....	238,000	....	228,000

[1] This equals the increase (decrease) in unrealized appreciation.

Adjusted values	1985	1986	1987	1988
Fair market value: Dec. 31	$150,000	$196,500	$238,000	$228,000
Net adjustments:				
1988	40,500	40,500	40,500	....
1987	38,500	38,500	....	....
1986	44,500	....	....	....
Total	273,500	275,500	278,500	228,000

Average value: 1988 = $273,500 + $275,500 + $278,500 + $228,000 ÷ 4 = $263,875

(ii) Plan F properly determines an average value under paragraph (b)(7) of this section for use as an actuarial value. Therefore, the valuation method meets the requirements of this section.

Example (7). Plan G computes the actuarial value of the plan assets as follows: The current fair market value of the plan assets is averaged with the most recent prior adjusted actuarial value. This average value is adjusted up or down toward the current fair market value by 20 percent of the difference between it and the current fair market value of the assets. This value is further adjusted to the extent necessary to fall within the corridor described in the statement of the plan's actuarial valuation method. The lower end of the corridor is the lesser of 80 percent of the fair market value of the plan assets or 85 percent of the average value of the plan assets. The higher end of the corridor is the greater of 120 percent of the fair market value of plan assets or 115 percent of the average value of plan assets. Average value for purposes of the corridor is determined under paragraph (b)(7) of this section. Assuming the numerical data of Example (6), the application of the corridor is as follows. The actuarial asset value as of December 31, 1988, must not be less than $182,400 (80 percent of current fair market value, $228,000) nor greater than $303,456 (115 percent of average value, $263,875). This method is permitted because it reflects fair market value in a manner permitted by paragraph (b)(4) of this section, it produces an actuarial value which is neither consistently above nor consistently below fair market or average value to satisfy paragraph (b)(5), and it is appropriately limited by the corridor described in paragraph (b)(6).

(c) Fair market value of assets—(1) General rules. Except as otherwise provided in this paragraph (c), the fair market value of a plan's assets for purposes of this section is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

(2) [Reserved]

(d) Methods for taking into account the fair market value of certain agreements. [Reserved]

(e) Effective date and transition rules—(1) Effective date. This section applies to plan years to which section 412, or section 302 of the Employee Retirement Income Security Act of 1974, applies.

(2) Special rule for certain plan years. For plan years beginning prior to November 12, 1980, the amounts required to be determined under section 412 may be computed on the basis of any reasonable actuarial method of asset valuation which takes into account the fair market value of the plan's assets, even if the method does not meet all of the requirements of paragraphs (a) through (c) of this section.

(3) Plan years beginning on or after November 12, 1980. Paragraphs (a) through (c) of this section apply beginning with the first valuation of plan assets made for a plan year to which section 412 applies that begins on or after November 12, 1980. The statement of the plan's actuarial asset valuation method required by paragraph (b)(2) of this section must be included with the plan's actuarial report for that year, in addition to any subsequent reports.

(4) Effect of change of asset valuation method. A plan which is required to change its asset valuation method to comply with paragraphs (a) through (c) of this section must make the change no later than the time when the plan is first required to comply with this section under paragraph (e)(3). A method of adjustment must be used to take account of any difference in the actuarial value of the plan's assets based on the old and new valuation methods. The plan may use either—

(i) A method of adjustment described in paragraph (e)(5) or (e)(6) of this section without prior approval by the Commissioner, or

(ii) Any other method of adjustment if the Commissioner gives prior approval under section 412(c)(5).

(5) **Retroactive recomputation method.** (i) Under this method of adjustment, the plan recomputes the balance of the funding standard account as of the beginning of the first plan year for which it uses its new asset valuation method to comply with paragraphs (a) through (c) of this section. This new balance is recomputed by retroactively applying the plan's new method as of the first day of the first plan year to which section 412 applies.

(ii) Beginning with the first plan year for which it uses its new method, the plan computes the normal cost and amortization charges and credits to the funding standard account based on the retroactive application of its new method as of the first day of the first plan year to which section 412 applies.

(iii) If the recomputed aggregate charges exceed the recomputed aggregate credits to the funding standard account as of the end of the first plan year for which the plan uses its new method, an additional contribution to the plan may be necessary to avoid an accumulated funding deficiency in that year. The use of the retroactive recomputation method may also result in an accumulated funding deficiency for years prior to that first year. In such cases, the rules of section 412(c)(10), relating to the time when certain contributions are deemed to have been made, apply.

(6) **Prospective gain or loss adjustment method.** (i) Under this method of adjustment the plan values its assets under its new method no later than the valuation date for the first plan year beginning after [the publication date of this section]

(ii) Regardless of the type of funding method used by a plan, the difference in the value of the assets under the old and the new asset valuation methods may be treated as arising from an experience loss or gain; or alternatively it may be treated as arising from a change in actuarial assumptions.

(iii) The treatment of this difference as an experience gain or loss or as a change in actuarial assumptions must be consistent with the treatment of such gains, losses, or changes under the funding method used by the plan. Thus, if a plan uses a spread gain type funding method other than the aggregate cost method, the difference in the value of assets under the old and the new asset valuation methods may be either amortized or spread over future periods as a part of normal cost. Examples of this type of funding method are the frozen initial liability cost method and the attained age normal cost method. With an aggregate method, the difference in the value of assets under the old and the new asset valuation methods must be spread over future periods as a part of normal cost.

[T.D. 7734, 45 FR 74718, Nov. 12, 1980]

§ 1.412(c)(3)–1 Reasonable funding methods.

(a) **Introduction—(1) In general.** This section prescribes rules for determining whether or not, in the case of an ongoing plan, a funding method is reasonable for purposes of section 412(c)(3). A method is unreasonable only if it is found to be inconsistent with a rule prescribed in this section. The term "reasonable funding method" under this section has the same meaning as the term "acceptable actuarial cost method" under section 3(31) of the Employee Retirement Income Security Act of 1974 (ERISA).

(2) **Computations included in method.** See § 1.412(c)(1)–1(b) for a discussion of matters that are, and are not, included in the funding method of a plan.

(3) **Plans using shortfall.** The shortfall method is a method of determining charges to the funding standard account by adapting the underlying funding method of certain collectively bargained plans in the manner described in § 1.412(c)(1)–2. As such, the shortfall method is a funding method. The underlying method of a plan that uses the shortfall method must be a reasonable funding method under this section. The rules contained in this section, relating to cost under a reasonable funding method, apply in the shortfall method to the annual computation charge under § 1.412(c)(1)–2(d).

(4) **Scope of funding method.** Except for the shortfall method, a reasonable funding method is applied to the computation of—

(i) The normal cost of a plan for a plan year; and, if applicable,

(ii) The bases established under section 412(b)(2)(B), (C), and (D), and (3)(B) ("amortizable bases").

(b) **General rules for reasonable funding methods—(1) Basic funding formula.** At any time, except as provided by the Commissioner, the present value of future benefits under a reasonable funding method must equal the sum of the following amounts:

(i) The present value of normal costs (taking into account future mandatory employee contribu-

tions, within the meaning of section 411(c)(2)(C), in the case of a contributory plan) over the future working lifetime of participants;

(ii) The sum of the unamortized portions of amortizable bases, if any, treating credit bases under section 412(b)(3)(B) as negative numbers; and

(iii) The plan assets, decreased by a credit balance (and increased by a debit balance) in the funding standard account under section 412(b).

(2) Normal cost. Normal cost under a reasonable funding method must be expressed as—

(i) A level dollar amount, or a level percentage of pay, that is computed from year to year on either an individual basis or an aggregate basis; or

(ii) An amount equal to the present value of benefits accruing under the method for a particular plan year.

(3) Application to shortfall. Paragraph (b)(2) will not fail to be satisfied merely because an amount described in (i) or (ii) is expressed as permitted under the shortfall method.

(c) Additional requirements—(1) Inclusion of all liabilities. Under a reasonable funding method, all liabilities of the plan for benefits, whether vested or not, must be taken into account.

(2) Production of experience gains and losses. If each actuarial assumption is exactly realized under a reasonable funding method, no experience gains or losses are produced.

(3) Plan population—(i) In general. Under a reasonable funding method, the plan population must include three classes of individuals: participants currently employed in the service of the employer; former participants who either terminated service with the employer, or retired, under the plan; and all other individuals currently entitled to benefits under the plan. See § 1.412(c)(3)-1(d)(2) for rules concerning anticipated future participants.

(ii) Limited exclusion for certain recent participants. Under a reasonable funding method, certain individuals may be excluded from the first class of individuals described in paragraph (c)(3)(i) of this section unless otherwise provided by the Commissioner. The excludable individuals are participants who would be excluded from participation by the minimum age or service requirement of section 410 but who, under the terms of the plan, participate immediately upon entering the service of the employer.

(iii) Special exclusion for "rule of parity" cases. Under a reasonable funding method, certain individuals may be excluded from the second class of individuals described in paragraph (c)(3)(i) of this section. The excludable individuals are those former participants who have terminated service with the employer without vested benefits and whose service might be taken into account in future years because the "rule of parity" of section 411(a)(6)(D) does not permit that service to be disregarded. However if the plan's experience as to separated employees' returning to service has been such that the exclusion described in this subparagraph would be unreasonable, the exclusion would no longer apply.

(4) Use of salary scale—(i) General acceptability. The use of a salary scale assumption is not inappropriate merely because of the funding method with which it is used. Therefore, in determining whether actuarial assumptions are reasonable, a salary scale will not be considered to be prohibited merely because a particular funding method is being used.

(ii) Projection to appropriate salary. Under a reasonable funding method, salary scales reflected in projected benefits must be the expected salary on which benefits would be based under the plan at the age when the receipt of benefits is expected to begin.

(5) Treatment of allocable items. Under a reasonable funding method that allocates assets to individual participants to determine costs, the allocation of assets among participants must be reasonable. An initial allocation of assets among participants will be considered reasonable only if it is in proportion to related liabilities. However, the Commissioner may determine, based on the facts and circumstances, that it is unreasonable to continue to allocate assets on this basis beyond the initial year. Under a reasonable funding method that allocates liabilities among different elements of past and future service, the allocation of liabilities must be reasonable.

(d) Prohibited considerations under a reasonable funding method—(1) Anticipated benefit changes—(i) In general. Except as otherwise provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective after the first day of, but during, a current plan year.

(ii) **Exception for collectively bargained plans.** A collectively bargained plan described in section 413(a) may on a consistent basis anticipate benefit increases scheduled to take effect during the term of the collective-bargaining agreement applicable to the plan. A plan's treatment of benefit increases scheduled in a collective bargaining agreement is part of its funding method. Accordingly, a change in a plan's treatment of such benefit increases (for example, ignoring anticipated increases after taking them into account) is a change of funding method.

(2) **Anticipated future participants.** A reasonable funding method must not anticipate the affiliation with the plan of future participants not employed in the service of the employer on the plan valuation date. However, a reasonable funding method may anticipate the affiliation with the plan of current employees who have not satisfied the participation requirements of the plan.

(e) **Special rules for certain funding methods—(1) Applicability of special rules.** Paragraph (e) of this section applies to a funding method that determines normal cost under paragraph (b)(2)(ii) of this section.

(2) **Use of salary scale.** For rules relating to use of a salary scale assumption, see paragraph (c)(4) of this section.

(3) **Allocation of liabilities.** In determining a plan's normal cost and accrued liability for a particular plan year, the projected benefits of the plan must be allocated between past years and future years. Except in the case of a career average pay plan, this allocation must be in proportion to the applicable rates of benefit accrual under the plan. Thus, the allocation to past years is effected by multiplying the projected benefit by a fraction. The numerator of the fraction is the participant's credited years of service. The denominator is the participant's total credited years of service at the anticipated benefit commencement date. Adjustments are made to account for changes in the rate of benefit accrual. An allocation based on compensation is not permitted. In the case of a career average pay plan, an allocation between past and future service benefits must be reasonable.

(f) **Treatment of ancillary benefit costs—(1) General rule.** Under a reasonable funding method, except as otherwise provided by this paragraph (f), ancillary benefit costs must be computed by using the same method used to compute retirement benefit costs under a plan.

(2) **Ancillary benefit defined.** For purposes of this paragraph an ancillary benefit is a benefit that is paid as a result of a specified event which—

(i) Occurs not later than a participant's separation from service, and

(ii) Was detrimental to the participant's health.

Thus, for example, benefits payable if a participant dies or becomes disabled prior to separation from service are ancillary benefits because the events giving rise to the benefits are detrimental to the participant's health. However, an early retirement benefit, a social security supplement (as defined in § 1.411(a)–7(c)(4)(ii)), and the vesting of plan benefits (even if more rapid than is required by section 411) are not ancillary benefits because those benefits do not result from an event which is detrimental to the participant's health.

(3) **Exception for certain insurance contracts.** Under a reasonable funding method, regardless of the method used to compute retirement benefit costs, the cost of an ancillary benefit may equal the premium paid for that benefit under an insurance contract if—

(i) The ancillary benefit is provided under the contract, and

(ii) The benefit is guaranteed under the contract.

(4) **Exception for 1-year term funding and other approved methods.** [Reserved]

(5) **Section 401(h) benefits.** Section 412 does not apply to benefits that are described in section 401(h) and for which a separate account is maintained.

(g) **Examples.** The principles of this section are illustrated by the following examples:

Example (1). Assume that a plan, using funding method A, is in its first year. No contributions have been made to the plan, other than a nominal contribution to establish a corpus for the plan's trust. There is no past service liability, and the normal cost is a constant percentage of an annually determined amount. The constant percentage is 99 percent, and the annually determined amount is the excess of the present value of future benefits over plan assets. The present value of future benefits is $10,000. Under paragraph (b)(1) of this section, the present value of future benefits must equal the present value of future normal costs plus plan assets. (No amortizable bases exist, nor are there credit or debit balances). Under method A, the present value of future normal costs would equal the sum of a series of annually decreasing amounts. Because of the constant percentage factor, the present value of future normal costs over the years can never equal $10,000, the present value of future benefits. In effect, then, assets under method A can never equal the present value of future benefits if all assumptions are exactly realized. Therefore, method A is not a reasonable funding method.

Example (2). Assume that a plan, using funding method B, determines normal cost by computing the present value of benefits expected to be accrued under the plan by the end of 10 years after the valuation date and adding to this the present value of benefits expected to be paid within these 10 years. Plan assets are subtracted from the sum of the two present value amounts. The difference then is divided by the present value of salaries projected over the 10 years. Under paragraph (c)(1) of this section, all liabilities of a plan must be taken into account. Because method B takes into account only benefits paid or accrued by the end of 10 years, it is not a reasonable funding method.

Example (3). Assume that a plan, using funding method C, determines normal cost as a constant percentage of compensation. (This percentage is determined as follows: The excess of projected benefits over accrued benefits is computed. Then the present value of this excess is divided by the present value of future salaries.) However, the accrued liability is computed each year as the present value of accrued benefits. (This computation does not reflect normal cost as a constant percentage of compensation. Thus, normal cost under the plan does not link accrued liabilities under the plan for consecutive years as would be the case, for example, under a unit credit cost method). In determining gains and losses, method C compares the actual unfunded liability (the accrued liability less assets) with the expected unfunded liability (the sum of the actual unfunded liability in the previous year and the normal cost for the previous year less the contribution made for the previous year, all adjusted for interest). Under paragraph (c)(2) of this section, if actuarial assumptions are exactly realized, experience gains and losses must not be produced. Under method C, the use of a constant percentage in computing normal cost (and the expected unfunded liability) coupled with the manner of computing the accrued liability (and the actual unfunded liability) generally produces gains in the earlier years and losses in the later years if each actuarial assumption is exactly realized. Therefore, method C is not a reasonable funding method.

Example (4). Assume that a plan, using funding method D, bases benefits on final average pay. Under method D, the past service liability on any date equals the present value of the accrued benefit on that date based on compensation as of that date. The normal cost for any year equals the present value of a certain amount. That amount is the excess of the projected accrued benefit as of the end of the year over the actual accrued benefit at the beginning of the year. Accrued benefits, projected as of the end of a year, reflect a 1-year salary projection. Under paragraph (c)(4) of this section, salary scales reflected in projected benefits must project salaries to the salary on which benefits would be based under the plan at the age when the receipt of benefits under the plan is expected to begin. Because the plan is not a career average pay plan and compensation is projected only 1 year, method D is not a reasonable funding method. (Under paragraph (c)(4) of this section, the use of a salary scale assumption could be required with a unit credit method if, without the use of a salary scale, assumptions in the aggregate are unreasonable.)

Example (5). Assume that a plan, using method E, a unit credit funding method, calculates a participant's accrued benefit according to the following formula: 2 percent of final salary for the first 10 years of service and 1 percent of final salary for the years of service in excess of 10. Under the plan, no employee may be credited with more than 25 years of service. The actuarial assumptions for the valuation include a salary scale of 5 percent per year. For a participant at age 40 with 15 years of service, a current salary of $20,000 and a normal retirement age of 65, the accrued liability for the retirement benefit is the present value of an annuity of $16,932 per year, commencing at age 65. The $16,932 is calculated as follows:

$$\$20{,}000 \times 3.3864 \times 35\% \times \frac{(10 \times 2) + (5 \times 1)}{(10 \times 2) - (15 \times 1) + (15 \times 0)}$$

(3.3864 is 1.05 raised to the 25th power; the 25th power reflects the difference between normal retirement age and attained age (65–40).)

Salary under this method is projected to the age when the receipt of benefits is expected to begin. Therefore, method E meets the requirement of paragraph (c)(4) of this section. Also, the allocation of benefits under method E between past and future years of service meets the requirements of paragraph (e)(3) of this section.

Example (6). Assume that a plan that has two participants and that previously used the unit credit cost method wishes to change the funding method at the beginning of the plan year to funding method F, a modification of the aggregate cost method. The modification involves determining normal cost for each of the two participants under the plan. Therefore, it requires an allocation of assets to each participant for valuation purposes. The actuary proposes to allocate the assets on hand at the beginning of the plan year of the change in funding method in proportion to the accrued liabilities calculated under the unit credit cost method. The relevant results of the calculations are shown below:

	Employees		
	M	N	Totals
Accrued Liabilities (unit credit method):			
Dollar amount	15,670	906	16,576
Per cent of total	94.53	5.47	100.00
Assets:			
Dollar amount	7,835	453	8,288
Per cent of total	94.53	5.47	100.00

The proposed allocation in proportion to the accrued liabilities under the unit credit cost method satisfies the requirements of paragraph (c)(5) of this section at the beginning of the first plan year for which the new method is used.

Example (7). The facts are the same as in Example (6). However, the actuary proposes to allocate all the assets to employee M, the older employee. Method F, under these facts, is not an acceptable funding method because the allocation is not in proportion to related liabilities as required under paragraph (c)(5) of this section.

[T.D. 7746, 45 FR 86430, Dec. 31, 1980]

§ 1.412(c)(3)–2 Effective dates and transitional rules relating to reasonable funding methods.

(a) Introduction. This section prescribes effective dates for rules relating to reasonable funding methods, under section 412(c)(3) and § 1.412(c)(3)–1. Also, this section sets forth rules concerning adjustments to a plan's funding standard account that are necessitated by a change in funding method, and a provision setting forth procedural requirements for use of an optional phase-in of required changes.

(b) Effective date—(1) General rule. Except as otherwise provided by subparagraph (2) of this

paragraph, § 1.412(c)(3)–1 applies to any valuation of a plan's liabilities (within the meaning of section 412(c)(9)) as of a date after April 30, 1981.

(2) **Exception.** If a collective bargaining agreement which determines contributions to a plan is in effect on April 30, 1981, then § 1.412(c)(3)–1 applies to any valuation of that plan's liabilities as of a date after the earlier of the date on which the last such collective bargaining agreement expires or April 30, 1984.

(3) **Transitional rule.** The reasonableness of a funding method used in making a valuation of a plan's liability as of a date before the effective date determined under subparagraph (1) or (2) of this paragraph is determined on the basis of such published guidance as was available on the date as of which the valuation was made.

(c) **Change of funding method without approval—(1) In general.** A plan that is required to change its funding method to comply with § 1.412(c)(3)–1 is not required to submit the change of funding method for approval as otherwise required by section 412(c)(5). However, this change must be described on Form 5500, Schedule B for the plan year with respect to which the change is first effective.

(2) **Amortization base.** An amortization base must be established in the plan year of the change in method equal to the change in the unfunded liability due to the change (where both unfunded liabilities are based on the same actuarial assumptions). Such a base must be amortized over 30 years in determining the charges or credits to the funding standard account, unless the Commissioner upon application permits amortization over a shorter period.

(d) **Phase-in of additional funding required by new method—(1) In general.** A plan that is required to change its funding method to comply with § 1.412(c)(3)–1 may elect to charge and credit the funding standard account as provided in this paragraph. An election under this paragraph shall be irrevocable.

(2) **Credit in year of change.** In the plan year of the change in method the funding standard account may be credited with an amount not in excess of 0.8 multiplied by the excess (if any) of—

(i) The normal cost under the new method plus the amortization charge (or minus the amortization credit) computed as described in § 1.412(c)(3)–2(c)(2), over

(ii) The normal cost under the prior method, for the plan year of the change in method.

(3) **Credits in the next three years.** In the three years following the year of the change the funding standard account may be credited with an amount not in excess of 0.6, 0.4, and 0.2 respectively in the first, second, and third years, multiplied by either of the following amounts, computed as of the last day of the year of credit—

(i) The excess described in § 1.412(c)(3)–2(d)(2) multiplied by a fraction (not greater than 1), the numerator of which is the number of participants in the year of the credit and the denominator of which is the number of participants in the year of the change, or, at the option of the plan,

(ii) The excess (if any) in the year of credit of—

(A) The net charge to the funding standard account based on the new method, over

(B) The net charge to the funding standing account based on the prior method.

(4) **Computational rules.** For purposes of the calculation described in § 1.412(c)(3)–2(d)(3)(ii), the net charge is the excess of charges under section 412(b)(2)(A) and (B) over the credits under section 412(b)(3)(B) (including the charge or credit described in § 1.412(c)(3)–2(c)) which would be required using the actuarial assumptions and plan benefit structure in effect on the last day of the plan year of change.

(5) **Fifteen-year amortization of credits.** The funding standard account shall be charged with 15-year amortization of each credit described in § 1.412(c)(3)–2(d)(2) and (3) beginning in the year following each such credit.

(6) **Manner of election.** An election under this paragraph shall be made by the claiming of the credits described in § 1.412(c)(3)–2(d)(2) and (3) on Schedule B to Form 5500 and by filing such other information as may be required by the Commissioner.

(e) **Effect on shortfall method.** The charges and credits described in this section apply in the shortfall method to the annual computation charge described in § 1.412(c)(1)–2(d). The amounts described in § 1.412(c)(3)–2(d) shall be determined before the application of the shortfall method. [T.D. 7746, 45 FR 86432, Dec. 31, 1980]

§ 1.412(i)–1 Certain insurance contract plans.

(a) In general. Under section 412(h)(2) of the Internal Revenue Code of 1954, as added by section 1013(a) of the Employee Retirement Income Security Act of 1974 (88 Stat. 914) (hereinafter referred to as "the Act"), an insurance contract plan described in section 412(i) for a plan year is not subject to the minimum funding requirements of section 412 for that plan year. Consequently, if an individual or group insurance contract plan satisfies all of the requirements of paragraph (b)(2) or (c)(2) of this section, whichever are applicable, for the plan year, the plan is not subject to the requirements of section 412 for that plan year. The effective date for section 412 of the Code is determined under section 1017 of the Act. In general, in the case of a plan which was not in existence on January 1, 1974, this section applies for plan years beginning after September 2, 1974, and in the case of a plan in existence on January 1, 1974, to plan years beginning after December 31, 1975.

(b) Individual insurance contract plans. (1) An individual insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of paragraph (b)(2) of this section for the plan year.

(2) The requirements of this paragraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies (licensed under the law of a State or the District of Columbia to do business with the plan) of individual annuity or individual insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of individual annuity or individual insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411(c)(2) (relating to accrued benefit from employee contributions).

(ii) The individual annuity or individual insurance contracts issued under the plan must provide for level annual, or more frequent, premium payments to be paid under the plan for the period commencing with the date each individual participating in the plan became a participant and ending not later than the normal retirement age for that individual or, if earlier, the date the individual ceases his participation in the plan. Premium payments may be considered to be level even though items such as experience gains and dividends are applied against premiums. In the case of an increase in benefits, the contracts must provide for level annual payments with respect to such increase to be paid for the period commencing at the time the increase becomes effective. If payment commences on the first payment date under the contract occurring after the date an individual becomes a participant or after the effective date of an increase in benefits, the requirements of this subdivision will be satisfied even though payment does not commence on the date on which the individual's participation commenced or on the effective date of the benefit increase, whichever is applicable. If an individual accrues benefits after his normal retirement age, the requirements of this subdivision are satisfied if payment is made at the time such benefits accrue. If the provisions required by this subdivision are set forth in a separate agreement with the issuer of the individual contracts, they need not be included in the individual contracts.

(iii) The benefits provided by the plan for each individual participant must be equal to the benefits provided under his individual contracts at his normal retirement age under the plan provisions.

(iv) The benefits provided by the plan for each individual participant must be guaranteed by the life insurance company, described in paragraph (b)(2)(i) of this section, issuing the individual contracts to the extent premiums have been paid.

(v) Except as provided in the following sentence, all premiums payable for the plan year, and for all prior plan years, under the insurance or annuity contracts must have been paid before lapse. If the lapse has occurred during the plan year, the requirements of this subdivision will be considered to have been met if reinstatement of the insurance policy, under which the individual insurance contracts are issued, occurs during the year of the lapse and before distribution is made or benefits commence to any participant whose benefits are reduced because of the lapse.

(vi) No rights under the individual contracts may have been subject to a security interest at any time during the plan year. This subdivision shall not apply to contracts which have been distributed to participants if the security interest is created after the date of distribution.

(vii) No policy loans, including loans to individual participants, on any of the individual contracts may be outstanding at any time during the plan year. This subdivision shall not apply to contracts

which have been distributed to participants if the loan is made after the date of distribution. An application of funds by the issuer to pay premiums due under the contracts shall be deemed not to be a policy loan if the amount of the funds so applied, and interest thereon, is repaid during the plan year in which the funds are applied and before distribution is made or benefits commence to any participant whose benefits are reduced because of such application.

(c) Group insurance contract plans. (1) A group insurance contract plan is described in section 412(i) during a plan year if the plan satisfies the requirements of subparagraph (2) for the plan year.

(2) The requirements of this subparagraph are:

(i) The plan must be funded exclusively by the purchase from an insurance company or companies, described in paragraph (b)(2)(i) of this section, of group annuity or group insurance contracts, or a combination thereof. The purchase may be made either directly by the employer or through the use of a custodial account or trust. A plan shall not be considered to be funded otherwise than exclusively by the purchase of group annuity or group insurance contracts merely because the employer makes a payment necessary to comply with the provisions of section 411(c)(2) (relating to accrued benefit derived from employee contributions).

(ii) In the case of a plan funded by a group insurance contract or a group annuity contract the requirements of paragraph (b)(2)(ii) of this section must be satisfied by the group contract issued under the plan. Thus, for example, each individual participant's benefits under the group contract must be provided for by level annual, or more frequent, payments equivalent to the payments required to satisfy such paragraph. The requirements of this subdivision will not be satisfied if benefits for any individual are not provided for by level payments made on his behalf under the group contract.

(iii) The group annuity or group insurance contract must satisfy the requirements of clauses (iii), (iv), (v), (vi), and (vii) of paragraph (b)(2). Thus, for example, each participant's benefits provided by the plan must be equal to his benefits provided under the group contract at his normal retirement age.

(iv)(A) If the plan is funded by a group annuity contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual annuity contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(B) If the plan is funded by a group insurance contract, the value of the benefits guaranteed by the insurance company issuing the contract under the plan with respect to each participant under the contract must not be less than the value of such benefits which the cash surrender value would provide for that participant under any individual insurance contract plan satisfying the requirements of paragraph (b) and approved for sale in the State where the principal office of the plan is located.

(v) Under the group annuity or group insurance contract, premiums or other consideration received by the insurance company (and, if a custodial account or trust is used, the custodian or trustee thereof) must be allocated to purchase individual benefits for participants under the plan. A plan which maintains unallocated funds in an auxiliary trust fund or which provides that an insurance company will maintain unallocated funds in a separate account, such as a group deposit administration contract, does not satisfy the requirements of this subdivision.

(d) Combination of plans. A plan which is funded by a combination of individual contracts and a group contract shall be treated as a plan described in section 412(i) for the plan year if the combination, in the aggregate, satisfies the requirements of this section for the plan year.

[T.D. 7746, 45 FR 47676, July 16, 1980; 45 FR 50563, July 30, 1980]

§ 1.413–1 Special rules for collectively bargained plans.

(a) Application of section 413(b) to certain collectively bargained plans—(1) In general. Section 413(b) sets forth special rules applicable to certain pension, profit-sharing, and stock bonus plans (and each trust which is a part of such a plan), hereinafter referred to as "section 413(b) plans", described in paragraph (a)(2) of this section. Notwithstanding any other provision of the Code, a section 413(b) plan is subject to the special rules of section 413(b)(1) through (8) and paragraphs (b) through (i) of this section.

(2) Requirements. Section 413(b) applies to a plan (and each trust which is a part of such plan) if the plan is a single plan which is maintained

pursuant to one or more agreements which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers. A plan which provides benefits for employees of more than one employer is considered a single plan subject to the requirements of section 413(b) and this section if the plan is considered a single plan for purposes of applying section 414(*l*)(see § 1.414(*l*)–1(b)(1)). For purposes of determining whether one or more plans (or agreements) are a single plan, under sections 413(a) and 414(*l*), it is irrelevant that there are in form two or more separate plans (or agreements). For example, a single plan will be considered to exist where agreements are entered into separately by a national labor organization (or one or more local units of such organization), on one hand, and individual employers, on the other hand, if the plan is considered a single plan for purposes of applying section 414(*l*).

(3) Additional rules and effective dates. (i) If a plan is a section 413(b) plan at a relevant time, the rules of section 413(b) and this section apply, and the rules of section 413(c) and § 1.413–2 do not apply to the plan.

(ii) The qualification of a section 413(b) plan, at any relevant time, under section 401(a), 403(a), or 405(a), as modified by section 413(b) and this section, is determined with respect to all employers maintaining the plan. Consequently, the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the plan for all employers maintaining the plan.

(iii) Except as otherwise provided, section 413(a) and (b) and this section apply to a plan for plan years beginning after December 31, 1953.

(b) Participation. Section 410 and the regulations thereunder shall be applied as if all employees of each of the employers who are parties to the collective-bargaining agreement and all such employees who are subject to the same benefit computation formula under the plan were employed by a single employer.

(c) Discrimination, etc.—(1) General rule. Section 401(a)(4) (relating to prohibited discrimination) and section 411(d)(3) (relating to vesting required on termination, partial termination, or discontinuance of contributions) shall be applied as if all the participants in the plan, who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement, are employed by a single employer.

(2) Application of discrimination rules. Under section 401(a)(4) and the regulations thereunder a plan is not qualified unless the contributions or benefits provided under the plan do not discriminate in favor of officers, shareholders or highly compensated employees (hereinafter referred to collectively as "the prohibited group"). The presence or absence of such discrimination under a plan to which this section applies at any time shall not be determined on an employer-by-employer basis, but rather by testing separately each group of employees who are subject to the same benefit computation formula to determine if there is discrimination within such group. Consequently, discrimination in contributions or benefits among two or more different groups or among employees in different groups covered by the plan may be present without causing the plan to be disqualified. However, the presence of prohibited discrimination within one such group will result in the disqualification of the plan for all groups. Section 401(a)(4) and the regulations thereunder provide rules relating to the determination of which employees are members of the prohibited group and to the determination of discrimination in contributions or benefits which are applicable to a plan to which this section applies. The determination of whether or not an individual employee is a highly compensated employee shall be based on the relationship of the compensation of the employee to the compensation of all the other employees of all employers who are maintaining the plan and have employees covered under the same benefit computation formula, whether or not such other employees are covered by the plan or are covered under the same benefit computation formula, rather than to the compensation of all the other employees of the employer of such individual employee.

(3) Application of termination, etc., rules. Section 411(d)(3) and the regulations thereunder (relating to vesting required in the case of a termination, partial termination, or complete discontinuance of contributions) apply to a plan subject to the provisions of this section. The requirements of section 411(d)(3) shall be applied as if all participants in the plan who are subject to the same benefit computation formula and who are employed by employers who are parties to the collective bargaining agreement are employed by a single employer. The determination of whether or not there is a termination, partial termination, or complete discontinuance of contributions shall be made separately for each such group of participants who are treated as employed by a single employer. Consequently, if there are two or more

groups of participants, a termination, partial termination, or complete discontinuance can take place under a plan with respect to one group of participants but not with respect to another such group of participants or for the entire plan. See § 1.411(d)–2 for rules prescribed under section 411(d)(3).

(4) **Effective dates and transitional rules.** (i) Section 413(b)(2) and this paragraph apply to a plan for plan years beginning after December 31, 1953.

(ii) In applying the rules of this paragraph to a plan for plan years to which section 411 does not apply, section 401(a)(7) (as in effect on September 1, 1974) shall be substituted for section 411(d)(3). See § 1.401–6 for rules prescribed under section 401(a)(7) as in effect on September 1, 1974. See § 1.411(a)–2 for the effective dates of section 411.

(5) **Examples.** The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A is a defined benefit plan subject to the provisions of this section and covers two groups of participants, local unions 1 and 2. Each local union has negotiated its own bargaining agreement with employers X, Y, and Z to provide its own benefit computation formula. The following table indicates the composition of the plan A participants:

	Employer X	Employer Y	Employer Z	Total
Local union 1 ..	20	10	70	100
Local union 2 ..	30	70	100	200

Under the rules of subparagraph (2) of this paragraph, the determination of whether contributions or benefits provided under the plan discriminate in favor of the prohibited group is made by applying the rules of section 401(a)(4) separately to participants who are members of local union 1 and local union 2. Thus, plan A will satisfy the qualification requirements of section 401(a)(4) if, within local union 1 and local union 2, respectively, plan benefits do not discriminate in favor of participants who are prohibited group employees within local union 1 and local union 2. Under the rules of subparagraph (2) of this paragraph, the determination under section 401(a)(4) of whether or not any individual employee, included within the 300 participants in plan A, is a highly compensated employee is based on the relationship of the compensation of such individual employee to the compensation of all the employees of Employers X, Y, and Z, whether or not such employees are participants in plan A. Thus, if there are 20 participants who are prohibited group employees within the 100 participants of local union 1, discrimination is determined by comparing the benefits of the 20 prohibited group participants to the benefits of the other 80 participants within local union 1. The same comparison would have to be made for the local union 2 participants between the prohibited group participants and the other participants in local union 2. Discrimination in benefits, if any, between the participants in local union 1 and local union 2, or among the employees of X, Y, or Z, would not affect the qualification of plan A under section 401(a)(4).

Example (2). Assume the same facts as in example (1). Employer X withdraws from the plan. Under subparagraph (3) of this paragraph, whether or not as a result of the withdrawal there is a partial termination under section 411(d)(3) is to be determined by applying the requirements of such section separately to the local union 1 and local union 2 participants. See § 1.411(d)–2 for the requirements relating to partial terminations. The application of such requirements raises the following possibilities with respect to the plan: (1) A partial termination as to local union 1, (2) a partial termination as to local union 2, (3) a partial termination as to both local unions 1 and 2, or (4) no partial termination for either local union.

Example (3). Assume the same facts as in example (1). Plan A is amended to cease future benefit accruals under the plan for local union 1 participants. Under subparagraph (3) of the paragraph, whether or not as a result of the cessation there is a partial termination under section 411(d)(3) is to be determined by applying the requirements of such section separately to the local union 1 and local union 2 participants.

Example (4). Plan A is a defined benefit plan that provides for two normal retirement benefits, X and 2X. A participant receives benefit X if the collective bargaining agreement covering his employment provides for a contribution rate, M. If such agreement provides for a contribution rate of N, the participant receives benefit 2X. Benefit X and benefit 2X constitute separate benefit computation formulas.

Example (5). Plan B is a defined benefit plan that provides for a normal retirement benefit, X. Benefit X is provided for all plan participants even though there are two collective bargaining agreements providing for different contribution rates, M and N. Plan B has a single benefit computation formula, even though there are two contribution rates.

(d) **Exclusive benefit.** Under section 401(a), a plan is not qualified unless the plan is for the exclusive benefit of the employees (and their beneficiaries) of the employer establishing and maintaining the plan. Other qualification requirements under section 401(a) require the application of the exclusive benefit rule (for example, section 401(a)(2), which precludes diversion of plan assets). For purposes of applying the requirements of section 401(a) in determining whether a plan subject to this section is, with respect to each employer establishing and maintaining the plan, for the exclusive benefit of its employees (and their beneficiaries), all of the employees participating in the plan shall be treated as employees of each such employer. Thus, for example, contributions by employer A to a plan subject to this section could be allocated to employees of other employers maintaining the plan without violating the requirements of section 401(a)(2), because all the employees participating in the plan are deemed to be employees of A.

(e) **Vesting.** Section 411 (other than section 411(d)(3) relating to termination or partial termination; discontinuance of contributions) and the regulations thereunder shall be applied as if all employers who have been parties to the collective-bargaining agreement constituted a single employer. The application of any rules with respect to breaks in service under section 411 shall be made

under regulations prescribed by the Secretary of Labor. Thus, for example, all the hours which an employee worked for each employer in a collectively-bargained plan would be aggregated in computing the employee's hours of service under the plan. See also 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans.)

(f)–(h) [Reserved]

(i) Employees of labor unions—(1) General rule. For purposes of section 413(b) and this section, employees of employee representatives shall be treated as employees of an employer establishing and maintaining a plan to which section 413(b) and this section apply if, with respect to the employees of such representatives, the plan satisfies the nondiscrimination requirements of section 401(a)(4) (determined without regard to section 413(b)(2)) and the minimum participation and coverage requirements of section 410 (determined without regard to section 413(b)(1)). For purposes of the preceding sentence, the plan and any affiliated employee health or welfare plan shall be deemed to be an employee representative. If employees of employee representatives, the plan, or an affiliated employee health or welfare plan are covered by the plan and are not treated as employees of an employer establishing and maintaining the plan under the provisions of this paragraph, the plan fails to satisfy the qualification requirements of section 401(a). In addition, in order for such a plan to be qualified, the plan must satisfy the requirements of section 413(b)(1) and (2), relating to participation and discrimination, respectively; see paragraphs (b) and (c) of this section. For purposes of this paragraph, an affiliated health or welfare plan is a health or welfare plan that is maintained under the same collective bargaining agreement or agreements, and that covers the same membership.

(2) Effective dates and transitional rules. (i) Section 413(b)(8) and this paragraph apply to a plan for plan years beginning after December 31, 1953.

(ii) In applying the rules of this paragraph to a plan for plan years to which section 410 does not apply, section 401(a)(3) (as in effect on September 1, 1974) shall be substituted for section 410. See § 1.401–3 for rules prescribed under section 401(a)(3) as in effect on September 1, 1974. See § 1.410(a)–2 for the effective dates of section 410.

(3) Examples. The provisions of this paragraph are illustrated by the following examples:

Example (1). Plan A is a defined benefit plan, maintained pursuant to a collective bargaining agreement between employers, X, Y, and Z and labor union, L, which covers members of L employed by X, Y, and Z. In 1978, plan A is amended to cover, under the same benefit formula, all five employees of L who have satisfied the minimum age and service requirements of the plans (age 25 and 1 year of service). Assume that plan A is subject to section 413(b) and satisfies the requirements of section 413(b)(1) and (2). Assume further that with respect to employees of L, plan A (i) satisfies the nondiscrimination requirements of section 401(a)(4), (ii) meets the minimum participation requirements of section 410(a), and (iii) meets the minimum coverage requirements of section 410(b)(1)(A). Under the rules of subparagraph (1) of this paragraph, because such requirements are all satisfied, the employees of L are treated as employees of an employer establishing and maintaining plan A.

Example (2). Assume the same facts as example (1), except that plan A is amended to cover only one of the five employees of L, none of whom is covered by any other plan. Assume further that, under plan A, L does not satisfy the minimum percentage coverage requirement of section 410(b)(1)(A) with respect to employees of L. Assume further that the compensation of the one L employee who is covered by the plan is such that he is highly compensated relative to the four employees of L not covered by the plan. Consequently, L does not satisfy the minimum coverage requirements of section 410(b)(1)(B), with respect to employees of L. Under the rules of subparagraph (1) of this paragraph, the employees of L cannot be treated as employees of an employer establishing and maintaining the A plan because such coverage requirements are not satisfied by L. Consequently, the A plan fails to satisfy the qualification requirements of section 401(a).

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by 42 FR 47198, Sept. 20, 1977; T.D. 7654, 44 FR 65063, Nov. 9, 1979]

§ 1.413–2 Special rules for plans maintained by more than one employer.

(a) Application of section 413(c)—(1) In general. Section 413(c) describes certain plans (and each trust which is a part of any such plan) hereinafter referred to as "section 413(c) plans." A plan (and each trust which is a part of such plan) is deemed to be a section 413(c) plan if it is described in subparagraph (2) of this paragraph. Notwithstanding any other provision of the code (not specifically in conflict with the special rules hereinafter mentioned), a section 413(c) plan is subject to the special rules of section 413(c)(1) through (6) and paragraphs (b) through (g) of this section.

(2) Section 413(c) plan. A plan (and each trust which is a part of such plan) is a section 413(c) plan if—

(i) The plan is a single plan, within the meaning of section 413(a) and § 1.413–1(a)(2), and

(ii) The plan is maintained by more than one employer.

For purposes of subdivision (ii) of this subparagraph, the number of employers maintaining the plan is determined by treating any employers described in section 414(b) (relating to a controlled group of corporations) or any employers described in section 414(c) (relating to trades or businesses under common control), whichever is applicable, as if such employers are a single employer. See § 1.411(a)–5(b)(3) for rules relating to the time when an employer maintains a plan. A master or prototype plan is not a section 413(c) plan unless such a plan is described in this subparagraph. Similarly, the mere fact that a plan, or plans, utilizes a common trust fund or otherwise pools plan assets for investment purposes does not, by itself, result in a particular plan being treated as a section 413(c) plan.

(3) Additional rules. (i) If a plan is a collectively bargained plan described in § 1.413–1(a), the rules of section 413(c) and this section do not apply, and the rules of section 413(b) and § 1.413–1 do apply to the plan.

(ii) The special rules of section 413(b)(1) and § 1.413–1(b) relating to the application of section 410, other than the rules of section 410(a), do not apply to a section 413(c) plan. Thus, for example, the minimum coverage requirements of section 410(b) are generally applied to a section 413(c) plan on an employer-by-employer basis, taking into account the generally applicable rules such as section 401(a)(5) and section 414(b) and (c).

(iii) The special rules of section 413(b)(2) and § 1.413–1(c) (relating to (A) section 401(a)(4) and prohibited discrimination, and (B) 411(d)(3) and vesting required on termination, partial termination, or discontinuance of contributions) do not apply to a section 413(c) plan. Thus, for example, the determination of whether or not there is a termination, within the meaning of section 411(d)(3), of a section 413(c) plan is made solely by reference to the rules of sections 411(d)(3) and 413(c)(3).

(iv) The qualification of a section 413(c) plan, at any relevant time, under section 401(a), 403(a) or 405(a), as modified by section 413(c) and this section, is determined with respect to all employers maintaining the section 413(c) plan. Consequently, the failure by one employer maintaining the plan (or by the plan itself) to satisfy an applicable qualification requirement will result in the disqualification of the section 413(c) plan for all employers maintaining the plan.

(4) Effective dates. Except as otherwise provided, section 413(c) and this section apply to a plan for plan years beginning after December 31, 1953.

(b) Participation. Section 410(a) and the regulations thereunder shall be applied as if all employees of each of the employers who maintain the plan were employed by a single employer.

(c) Exclusive benefit. In the case of a plan subject to this section, the exclusive benefit requirements of section 401(a) shall be applied to the plan in the same manner as under section 413(b)(3) and § 1.413–1(d).

(d) Vesting. Section 411 and the regulations thereunder shall be applied as if all employers who maintain the plan constituted a single employer. The application of any rules with respect to breaks in service under section 411 shall be made under regulations prescribed by the Secretary of Labor. Thus, for example, all the hours which an employee worked for each employer maintaining the plan would be aggregated in computing the employee's hours of service under the plan. See also 29 CFR Part 2530 (Department of Labor regulations relating to minimum standards for employee pension benefit plans).

[T.D. 7501, 42 FR 42340, Aug. 23, 1977, as amended by 42 FR 47198, Sept. 20, 1977; T.D. 7654, 44 FR 65065, Nov. 9, 1979]

§ 1.414(b)–1 Controlled group of corporations.

(a) Definition of controlled group of corporations. For purposes of this section, the term "controlled group of corporations" has the same meaning as is assigned to the term in section 1563(a) and the regulations thereunder, except that (1) the term "controlled group of corporations" shall not include an "insurance group" described in section 1563(a)(4), and (2) section 1563(e)(3)(C) (relating to stock owned by certain employees' trusts) shall not apply. For purposes of this section, the term "members of a controlled group" means two or more corporations connected through stock ownership described in section 1563(a) (1), (2), or (3), whether or not such corporations are "component members of a controlled group" within the meaning of section 1563(b). Two or more corporations are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph). For purposes of this section, if a corporation is a member of more than one controlled group of corporations, such corporation shall be treated as a member of each controlled group.

(b) Single plan adopted by two or more members. If two or more members of a controlled group of corporations adopt a single plan for a plan year, then the minimum funding standard provided in section 412, the tax imposed by section 4971, and the applicable limitations provided by section 404(a) shall be determined as if such members were a single employer. In such a case, the amount of such items and the allocable portion attributable to each member shall be determined in the manner provided in regulations under sections 412, 4971, and 404(a).

(c) Cross reference. For rules relating to the application of sections 401, 408(k), 410, 411, 415, and 416 with respect to two or more trades or businesses which are under common control, see section 414(c) and the regulations thereunder.

[T.D. 8179, 53 FR 6605, March 2, 1988]

§ 1.414(c)–1 Commonly controlled trades or businesses.

For purposes of applying the provisions of sections 401 (relating to qualified pension, profit-sharing, and stock bonus plans), 408(k) (relating to simplified employee pensions), 410 (relating to minimum participation standards), 411 (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 416 (relating to top-heavy plans), all employees of two or more trades or businesses under common control within the meaning of § 1.414(c)-2 for any period shall be treated as employed by a single employer. See sections 401, 408(k), 410, 411, 415, and 416 and the regulations thereunder for rules relating to employees of trades or businesses which are under common control. See § 1.414(c)-5 for effective date.

[T.D. 8179, 53 FR 6606, March 2, 1988]

§ 1.414(c)–2 Two or more trades or businesses under common control.

(a) In general. For purposes of this section, the term "two or more trades or businesses under common control" means any group of trades or businesses which is either a "parent-subsidiary group of trades or businesses under common control" as defined in paragraph (b) of this section, a "brother-sister group of trades or businesses under common control" as defined in paragraph (c) of this section, or a "combined group of trades or businesses under common control" as defined in paragraph (d) of this section. For purposes of this section and §§ 1.414(c)-3 and 1.414(c)-4, the term "organization" means a sole proprietorship, a partnership (as defined in section 7701(a)(2)), a trust, an estate, or a corporation.

(b) Parent-subsidiary group of trades or businesses under common control—(1) In general. The term "parent-subsidiary group of trades or businesses under common control" means one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of § 1.414(c)-4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of § 1.414(c)-4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing such controlling interest, any direct ownership interest by such other organizations.

(2) Controlling interest defined—(i) Controlling interest. For purposes of paragraphs (b) and (c) of this section, the phrase "controlling interest" means:

(A) In the case of an organization which is a corporation, ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;

(B) In the case of an organization which is a trust or estate, ownership of an actuarial interest of at least 80 percent of such trust or estate;

(C) In the case of an organization which is a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and

(D) In the case of an organization which is a sole proprietorship, ownership of such sole proprietorship.

(ii) Actuarial interest. For purposes of this section, the actuarial interest of each beneficiary of trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary. The factors and methods prescribed in § 20.2031-7 or § 20.2031-10 (Estate Tax Regulations), whichever is appropriate, for use in ascertaining the value of an interest in property for estate tax purposes shall be used

for purposes of this subdivision in determining a beneficiary's actuarial interest.

(c) **Brother-sister group of trades or businesses under common control—(1) In general.** The term "brother-sister group of trades or businesses under common control" means two or more organizations conducting trades or businesses if (i) the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)-4) a controlling interest in each organization, and (ii) taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control of each organization. The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

(2) **Effective control defined.** For purposes of this paragraph, persons are in "effective control" of an organization if—

(i) In the case of an organization which is a corporation, such persons own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of such corporation;

(ii) In the case of an organization which is a trust or estate, such persons own an aggregate actuarial interest of more than 50 percent of such trust or estate;

(iii) In the case of an organization which is a partnership, such persons own an aggregate of more than 50 percent of the profits interest or capital interest of such partnership; and

(iv) In the case of an organization which is a sole proprietorship, one of such persons owns such sole proprietorship.

(d) **Combined group of trades or businesses under common control.** The term "combined group of trades or businesses under common control" means any group of three or more organizations, if (1) each such organization is a member of either a parent-subsidiary group of trades or businesses under common control or a brother-sister group of trades or businesses under common control, and (2) at least one such organization is the common parent organization of a parent-subsidiary group of trades or businesses under common control and is also a member of a brother-sister group of trades or businesses under common control.

(e) **Examples.** The definitions of parent-subsidiary group of trades or businesses under common control, brother-sister group of trades or businesses under common control, and combined group of trades or businesses under common control may be illustrated by the following examples.

Example (1). (a) The ABC partnership owns stock possessing 80 percent of the total combined voting power of all classes of stock entitled to voting of S corporation. ABC partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC partnership and S Corporation.

(b) Assume the same facts as in (a) and assume further that S owns 80 percent of the profits interest in the DEF Partnership. The ABC Partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, S Corporation, and the DEF Partnership. The result would be the same if the ABC Partnership, rather than S, owned 80 percent of the profits interest in the DEF Partnership.

Example (2). L Corporation owns 80 percent of the only class of stock of T Corporation, and T, in turn, owns 40 percent of the capital interest in the GHI Partnership. L also owns 80 percent of the only class of stock of N Corporation and N, in turn, owns 40 percent of the capital interest in the GHI Partnership. L is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of L Corporation, T Corporation, N Corporation, and the GHI Partnership.

Example (3). ABC Partnership owns 75 percent of the only class of stock of X and Y Corporations; X owns all the remaining stock of Y, and Y owns all the remaining stock of X. Since interorganization ownership is excluded (that is, treated as not outstanding) for purposes of determining whether ABC owns a controlling interest of at least one of the other organizations, ABC is treated as the owner of stock possessing 100 percent of the voting power and value of all classes of stock of X and of Y for purposes of paragraph (b)(1)(ii) of this section. Therefore, ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, X Corporation, and Y Corporation.

Example (4). Unrelated individuals A, B, C, D, E, and F own an interest in sole proprietorship A, a capital interest in the GHI Partnership, and stock of corporations M, W, X, Y, and Z (each of which has only one class of stock outstanding) in the following proportions:

	ORGANIZATIONS						
Individuals	A	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B.........	—	40%	—	15%	40%	50%	30%
C.........	—	—	—	—	10%	10%	10%
D	—	—	—	25%	—	20%	—
E.........	—	10%	—	—	10%	—	—
	100%	100%	100%	100%	100%	100%	100%

Under these facts the following four brother-sister groups of trades or businesses under common control exist: GHI, X and Z; X, Y and Z; W and Y; A and M. In the case of GHI, X, and Z, for example, A and B together have effective control of each organization because their combined identical ownership of GHI, X and Z is greater than 50%. (A's identical ownership

of GHI, X and Z is 40% because A owns at least a 40% interest in each organization. B's identical ownership of GHI, X and Z is 30% because B owns at least a 30% interest in each organization.) A and B (the persons whose ownership is considered for purposes of the effective control requirement) together own a controlling interest in each organization because they own at least 80% of the capital interest of partnership GHI and at least 80% of the total combined voting power of corporations X and Z. Therefore, GHI, X and Z comprise a brother-sister group of trades or businesses under common control. Y is not a member of this group because neither the effective control requirement nor the 80% controlling interest requirement are met. (The effective control requirement is not met because A's and B's combined identical ownership in GHI, X, Y and Z (20% for A and 30% for B) does not exceed 50%. The 80% controlling interest test is not met because A and B together only own 70% of the total combined voting power of the stock of Y.) A and M are not members of this group because B owns no interest in either organization and A's ownership of GHI, X and Z, considered alone, is less than 80%.

Example (5). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

	Corporations	
	U	V
Individuals	(percent)	(percent)
A	12	12
B	12	12
C	12	12
D	12	12
E	13	13
F	13	13
G	13	13
H	13	13
	100	100

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of a brother-sister group of trades or businesses under common control because at least 80 percent of the stock of each corporation is not owned by the same five or fewer persons.

Example (6). A, an individual, owns a controlling interest in ABC Partnership and DEF Partnership. ABC, in turn, owns a controlling interest in X Corporation. Since ABC, DEF, and X are each members of either a parent-subsidiary group or a brother-sister group of trades or businesses under common control, and ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of ABC and X, and also a member of a brother-sister group of trades or businesses under common control consisting of ABC and DEF, ABC Partnership, DEF Partnership, and X Corporation are members of the same combined group of trades or businesses under common control.

[T.D. 8179, 53 FR 6606, March 2, 1988]

§ 1.414(c)–3 Exclusion of certain interests or stock in determining control.

(a) In general. For purposes of § 1.414(c)-2(b) (2) (i) and (c)(2), the term "interest" and the term "stock" do not include an interest which is treated as not outstanding under paragraph (b) of this section in the case of a parent-subsidiary group of trades or businesses under common control or under paragraph (c) of this section in the case of a brother-sister group of trades or businesses under common control. In addition, the term "stock" does not include treasury stock or nonvoting stock which is limited and preferred as to dividends. For definitions of certain terms used in this section, see paragraph (d) of this section.

(b) Parent-subsidiary group of trades or businesses under common control—(1) In general. If an organization (hereinafter in this section referred to as "parent organization") owns (within the meaning of paragraph (b)(2) of this section)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation.

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of § 1.414(c)-2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether the parent organization or such other organization (hereinafter in this section referred to as "subsidiary organization") is a member of a parent-subsidiary group of trades or businesses under common control, an interest in such subsidiary organization excluded under paragraph (b) (3), (4), (5), or (6) of this section shall be treated as not outstanding.

(2) Ownership. For purposes of paragraph (b)(1) of this section, a parent organization shall be considered to own an interest in or stock of another organization which it owns directly or indirectly with the application of paragraph (b)(1) of § 1.414(c)-4 and—

(i) In the case of a parent organization which is a partnership, a trust, or an estate, with the application of paragraphs (b) (2), (3), and (4) of § 1.414(c)-4, and

(ii) In the case of a parent organization which is a corporation, with the application of paragraph (b)(4) of § 1.414(c)-4.

(3) Plan of deferred compensation. An interest which is an interest in or stock of the subsidiary organization held by a trust which is part of a plan of deferred compensation (within the meaning of section 406(a)(3) and the regulations thereunder)

for the benefit of the employees of the parent organization or the subsidiary organization shall be excluded.

(4) Principal owners, officers, etc. An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of § 1.414(c)-4) by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization shall be excluded.

(5) Employees. An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of § 1.414(c)-4) by an employee of the subsidiary organization shall be excluded if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of the parent or subsidiary organization.

(6) Controlled exempt organization. An interest which is an interest in or stock of the subsidiary organization shall be excluded if owned (directly and with the application of § 1.414(c)-4) by an organization (other than the parent organization):

(i) To which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by the parent organization or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer, partner, or fiduciary of the parent organization, or by any combination thereof.

(c) Brother-sister group of trades or businesses under common control—(1) In general. If five or fewer persons (hereinafter in this section referred to as "common owners") who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)-4)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock or such corporation,

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of § 1.414(c)-2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether such organization is a member of a brother-sister group of trades or businesses under common control, an interest in such organization excluded under paragraph (c) (2), (3), or (4) of this section shall be treated as not outstanding.

(2) Exempt employees' trust. An interest which is an interest in or stock of such organization held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be excluded if such trust is for the benefit of the employees of such organization.

(3) Employees. An interest which is an interest in or stock of such organization owned (directly and with the application of § 1.414(c)-4) by an employee of such organization shall be excluded if such interest or stock is subject to conditions which run in favor of a common owner of such organization or in favor of such organization and which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or stock, the direct or record owner's right) to dispose of such interest or stock.

(4) Controlled exempt organization. An interest which is an interest in or stock of such organization shall be excluded if owned (directly and with the application of § 1.414(c)-4) by an organization:

(i) To which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by such organization, by an individual, estate, or trust that is a principal owner of such organization, by an officer, partner, or fiduciary of such organization, or by any combination thereof.

(d) Definitions—(1) Employee. For purposes of this section, the term "employee" has the same meaning such term is given in section 3306(i) of the Code (relating to definitions for purposes of the Federal Unemployment Tax Act).

(2) Principal owner. For purposes of this section, the term "principal owner" means a person who owns (directly and with the application of § 1.414(c)-4)—

(i) In the case of a corporation, 5 percent or more of the total combined voting power of all classes of stock entitled to vote in such corporation or 5 percent of more of the total value of shares of all classes of stock of such corporation;

(ii) In the case of a trust or estate, an actuarial interest of 5 percent or more of such trust or estate; or

(iii) In the case of a partnership, 5 percent or more of the profits or capital interest of such partnership.

(3) Officer. For purposes of this section, the term "officer" includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of a corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.

(4) Partner. For purposes of this section, the term "partner" means any person defined in section 7701(a)(2) (relating to definitions of partner).

(5) Fiduciary. For purposes of this section and § 1.414(c)-4, the term "fiduciary" has the same meaning as such term is given in section 7701(a)(6) and the regulations thereunder.

(6) Substantial conditions. (i) In general. For purposes of this section, an interest in or stock of an organization is subject to conditions which substantially restrict or limit the right to dispose of such interest or stock and which run in favor of another person if the condition extends directly or indirectly to such person preferential rights with respect to the acquisition of the direct owner's (or the record owner's) interest or stock. For a condition to be in favor of another person it is not necessary that such person be extended a discriminatory concession with respect to price. A right of first refusal with respect to an interest or stock in favor of another person is a condition which substantially restricts or limits the direct or record owner's right of disposition which runs in favor of such person. Further, any legally enforceable condition which prohibits the direct or record owner from disposing of his or her interest or stock without the consent of another person will be considered to be a substantial limitation running in favor of such person.

(ii) Special rule. For purposes of paragraph (c)(3) of this section only, if a condition which restricts or limits an employee's right (or direct or record owner's right) to dispose of his or her interest or stock also applies to the interest or stock in such organization held by a common owner pursuant to a bonafide reciprocal purchase arrangement, such condition shall not be treated as a substantial limitation or restriction. An example of a reciprocal purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal within the meaning of this subdivision.

(7) Control. For purposes of paragraphs (b)(6) and (c)(4) of this section, the term "control" means control in fact. The determination of whether there exists control in fact will depend upon all of the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

(e) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). ABC Partnership owns 70 percent of the capital interest and of the profits interest in the DEF Partnership. The remaining capital interest and profits interest in DEF is owned as follows: 4 percent by A (a general partner in ABC), and 26 percent by D (a limited partner in ABC). ABC satisfies the 50-percent capital interest or profits interest ownership requirement of paragraph (b)(1)(iii) of this section with respect to DEF. Since A and D are partners of ABC, under paragraph (b)(4) of this section the capital and profits interests in DEF owned by A and D are treated as not outstanding for purposes of determining whether ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control under § 1.414 (c)-2(b). Thus, ABC is considered to own 100 percent (70% 0170) of the capital interest and profits interest in DEF. Accordingly, ABC and DEF are members of a parent-subsidiary group of trades or businesses under common control.

Example (2). Assume the same facts as in example (1) and assume further that A owns 15 shares of the 100 shares of the only class of stock of S Corporation and DEF Partnership owns 75 shares of such stock. ABC satisfies the 50 percent stock requirement of paragraph (b)(1)(i) of this section with respect to S since ABC is considered as owning 52.5 percent (70 percent × 75 percent) of the S stock with the application of § 1.414 (c)-4(b)(2). Since A is a partner of ABC, the S stock owned by A is treated as not outstanding for purposes of determining whether S is a member of a parent-subsidiary group of trades or businesses under common control. Thus, DEF Partnership is considered to own stock possessing 88.2 percent (75% 0185) of the voting power and value of the S stock. Accordingly, ABC Partnership, DEF Partnership, and S Corporation are members of a parent-subsidiary group of trades or businesses under common control.

Example (3). ABC Partnership owns 60 percent of the only class of stock of Corporation Y. D, the president of Y, owns the remaining 40 percent of the stock of Y. D has agreed that if she offers her stock in Y for sale she will first offer the stock to ABC at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since D is an employee of Y within the meaning of section 3306(i) of the Code and her stock in Y is subject to a condition which substantially restricts or limits her right to dispose of such stock and runs in favor of ABC Partnership, under paragraph

(b)(5) of this section such stock is treated as not outstanding for purposes of determining whether ABC and Y are members of a parent-subsidiary group of trades or businesses under common control. Thus, ABC Partnership is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, ABC Partnership and Y Corporation are members of a parent-subsidiary group of trades or businesses under common control. The result would be the same if D's husband, instead of D, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of ABC Partnership.

(f) Exception—(1) In general. If an interest in an organization (including stock of a corporation) is owned by a person directly or with the application of the rules of paragraph (b) of § 1.414 (c)-4 and such ownership results in the membership of that organization in a group of two or more trades or businesses under common control for any period, then the interest will not be treated as an excluded interest under paragraph (b) or (c) of this section if the result of applying such provisions is that the organization is not a member of a group of two or more trades or businesses under common control for the period.

(2) Example. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. A, an officer of P, owns directly 30 shares of S stock which P has an option to acquire. If, under paragraph (b)(4) of this section, the 30 shares owned directly by A are treated as not outstanding, P would be treated as owning stock possessing only 71 percent (50/70) of the total voting power and value of S stock, and S should not be a member of a parent-subsidiary group of trades or businesses under common control. However, because the 30 shares owned by A that P has an option to purchase are considered as owned by P under paragraph (b)(2) of this section, and that ownership plus P's direct ownership of 50 shares result in S's membership in a parent-subsidiary group of trades or businesses under common control for 1985, the provisions of this paragraph apply. Therefore, A's stock is not treated as an excluded interest and S is a member of a parent-subsidiary group consisting of P and S.

[T.D. 8179, 53 FR 6607, March 2, 1988; T.D. 8179, 53 FR 8302, March 14, 1988]

§ 1.414(c)–4 Rules for determining ownership.

(a) In general. In determining the ownership of an interest in an organization for purposes of § 1.414(c)-2 and § 1.414(c)-3, the constructive ownership rules of paragraph (b) of this section shall apply, subject to the operating rules contained in paragraph (c). For purposes of this section the term "interest" means: in the case of a corporation, stock; in the case of a trust or estate, an actuarial interest; in the case of a partnership, an interest in the profits or capital; and in the case of a sole proprietorship, the proprietorship.

(b) Constructive ownership—(1) Options. If a person has an option to acquire any outstanding interest in an organization, such interest shall be considered as owned by such person. For this purpose, an option to acquire an option, and each one of a series of such options shall be considered as an option to acquire such interest.

(2) Attribution from partnerships—(i) General. An interest owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the profits or capital of the partnership in proportion to such partner's interest in the profits or capital, whichever such proportion is greater.

(ii) Example. The provisions of paragraph (b)(2)(i) of this section may be illustrated by the following example:

Example. A, B, and C, unrelated individuals, are partners in the ABC Partnership. The partners' interest in the capital and profits of ABC are as follows:

(In percent)

Partner	Capital	Profits
A	36	25
B	60	71
C	4	4

The ABC Partnership owns the entire outstanding stock (100 shares) of X Corporation. Under paragraph (b)(2)(i) of this section, A is considered to own the stock of X owned by the partnership in proportion to his interest in capital (36 percent) or profits (25 percent), whichever such proportion is greater. Therefore, A is considered to own 36 shares of X stock. Since B has a greater interest in the profits of the partnership than in the capital, B is considered to own X stock in proportion to his interest in such profits. Therefore, B is considered to own 71 shares of X stock. Since C does not have an interest of 5 percent or more in either the capital or profits of ABC, he is not considered to own any shares of X stock.

(3) Attribution from estates and trusts—(i) In general. An interest in an organization (hereinafter called an "organization interest") owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of such estate or trust who has an actuarial interest of 5 percent or more in such organization interest, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of the organization interest to satisfy the beneficiary's rights. A beneficiary of an estate or trust who

cannot under any circumstances receive any part of an organization interest held by the estate or trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such organization interest. Thus, where stock owned by a decedent's estate has been specifically bequeathed to certain beneficiaries and the remainder of the estate has been specifically bequeathed to other beneficiaries, the stock is attributable only to the beneficiaries to whom it is specifically bequeathed. Similarly a remainderman of a trust who cannot under any circumstances receive any interest in the stock of a corporation which is a part of the corpus of the trust (including any accumulated income therefrom or the proceeds from a disposition thereof) does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him. The factors and methods prescribed in § 20.2031-7 or § 20.2031-10 (Estate Tax Regulations), whichever is appropriate for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest in an organization interest owned directly or indirectly by or for an estate or trust.

(ii) Special rules for estates. (A) For purposes of this paragraph (b)(3) with respect to an estate, property of a decedent shall be considered as owned by his or her estate if such property is subject to administration by the executor or administrator for the purposes of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death.

(B) For purposes of this paragraph (b)(3) with respect to an estate, the term "beneficiary" includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution.

(C) For purposes of this paragraph (b)(3) with respect to an estate, a person shall no longer be considered a beneficiary of an estate when all the property to which he or she is entitled has been received by him or her, when he or she no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property from him or her or to seek payment from him or her by contribution or otherwise to satisfy claims against the estate or expenses of administration.

(iii) Grantor trusts, etc. An interest owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E, part I, subchapter J of the Code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

(4) Attribution from corporations—(i) General. An interest owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (directly and, in the case of a parent-subsidiary group of trades or businesses under common control, with the application of paragraph (b)(1) of this section, or in the case of a brother-sister group of trades or business under common control, with the application of this section), 5 percent or more in value of the stock in that proportion which the value of the stock which such person so owns bears to the total value of all the stock in such corporation.

(ii) Example. The provisions of paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. B, an individual, owns 60 of the 100 shares of the only class of outstanding stock of corporation P. C, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, B is considered to own 30 shares of the S stock ($60/100 \times 50$), and X is considered to own 18 shares of S stock ($36/100 \times 50$). Since C does not own 5 percent or more in the value of P stock, he is not considered as owning any of the S stock owned by P. If in this example, C's wife had owned directly 1 share of the P stock, C and his wife would each be considered as owning 5 shares of the P stock, and therefore C and his wife would be considered as owning 2.5 shares of the S stock ($5/100 \times 50$).

(5) Spouse—(i) General rule. Except as provided in paragraph (b)(5)(ii) of this section, an individual shall be considered to own an interest owned, directly or indirectly, by or for his or her spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

(ii) Exception. An individual shall not be considered to own an interest in an organization owned, directly or indirectly, by or for his or her spouse on any day of a taxable year of such organization, provided that each of the following conditions are satisfied with respect to such taxable year:

(A) Such individual does not, at any time during such taxable year, own directly any interest in such organization;

(B) Such individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization at any time during such taxable year;

(C) Not more than 50 percent of such organization's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and

(D) Such interest in such organization is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such interest and which run in favor of the individual or the individual's children who have not attained the age of 21 years. The principles of § 1.414(c)-3(d)(6)(i) shall apply in determining whether a condition is a condition described in the preceding sentence.

(iii) Definitions. For purposes of paragraph (b)(5)(ii)(C) of this section, the gross income of an organization shall be determined under section 61 and the regulations thereunder. The terms "interest", "royalties", "rents", "dividends", and "annuities" shall have the same meaning such terms are given for purposes of section 1244(c) and § 1.1244(c)-1(e)(1).

(6) Children, grandchildren, parents, and grandparents—(i) Children and parents. An individual shall be considered to own an interest owned, directly or indirectly, by or for the individual's children who have not attained the age of 21 years, and if the individual has not attained the age of 21 years, an interest owned, directly or indirectly, by or for the individual's parents.

(ii) Children, grandchildren, parents, and grandparents. If an individual is in effective control (within the meaning of § 1.414(c)-2(c)(2)), directly and with the application of the rules of this paragraph without regard to this subdivision, of an organization, then such individual shall be considered to own an interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren, and children who have attained the age of 21 years.

(iii) Adopted children. For purposes of this section, a legally adopted child of an individual shall be treated as a child of such individual.

(iv) Example. The provisions of this subparagraph (6) may be illustrated by the following example:

Example—(A) Facts. Individual F owns directly 40 percent of the profits interest of the DEF Partnership. His son, M, 20 years of age, owns directly 30 percent of the profits interest of DEF, and his son, A, 30 years of age, owns directly 20 percent of the profits interest of DEF. The 10 percent remaining of the profits interest and 100 percent of the capital interest of DEF is owned by an unrelated person.

(B) F's ownership. F owns 40 percent of the profits interest in DEF directly and is considered to own the 30 percent profits interest owned directly by M. Since, for purposes of the effective control test contained in paragraph (b)(6)(ii) of this section, F is treated as owning 70 percent of the profits interest of DEF, F is also considered as owning the 20 percent profits interest of DEF owned by his adult son, A. Accordingly, F is considered as owning a total of 90 percent of the profits interest in DEF.

(C) M's ownership. Minor son, M. owns 30 percent of the profits interest in DEF directly, and is considered to own the 40 percent profits interest owned directly by his father, F. However, M is not considered to own the 20 percent profits interest of DEF owned directly by his brother, A, and constructively by F, because an interest constructively owned by F by reason of family attribution is not considered as owned by him for purposes of making another member of his family the constructive owner of such interest. (See paragraph (c)(2) of this section.) Accordingly, M is considered as owning a total of 70 percent of the profits interest of the DEF Partnership.

(D) A's ownership. Adult son, A, owns 20 percent of the profits interest in DEF directly. Since, for purposes of determining whether A effectively controls DEF under paragraph (b)(6)(ii) of this section, A is treated as owning only the percentage of profits interest he owns directly, he does not satisfy the condition precedent for the attribution of the DEF profits interest from his father. Accordingly, A is considered as owning only the 20 percent profits interest in DEF which he owns directly.

(c) Operating rules—(1) In general. Except as provided in paragraph (c)(2) of this section, an interest constructively owned by a person by reason of the application of paragraph (b) (1), (2), (3), (4), (5), or (6) of this section shall, for the purposes of applying such paragraph, be treated as actually owned by such person.

(2) Members of family. An interest constructively owned by an individual by reason of the application of paragraph (b) (5) or (6) of this section shall not be treated as owned by such individual for purposes of again applying such subparagraphs in order to make another the constructive owner of such interest.

(3) Precedence of option attribution. For purposes of this section, if an interest may be considered as owned under paragraph (b)(1) of this section (relating to option attribution) and under any other subparagraph of paragraph (b) of this section, such interest shall be considered as owned by such person under paragraph (b)(1) of this section.

(4) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, 30 years of age, has a 90 percent interest in the capital and profits of DEF Partnership. DEF owns all the outstanding stock of corporation X and X owns 60 shares of the 100 outstanding shares of corporation Y. Under paragraph (c)(1) of this section, the 60 shares of Y constructively owned by DEF by reason of paragraph (b)(4) of this section are treated as actually owned by DEF for purposes of applying paragraph (b)(2) of this section. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example (2). Assume the same facts as in example (1). Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B) under paragraph (b)(6)(i) of this section, under paragraph (c)(2) of this section such stock may not be treated as owned by C for purposes of applying paragraph (b)(6)(ii) of this section in order to make A the constructive owner of such stock.

Example (3). Assume the same facts as in example (2), and further assume that C has an option to acquire the 40 shares of Y stock owned by his son, B. The rule contained in paragraph (c)(2) of this section does not prevent the reattribution of such 40 shares to A because, under paragraph (c)(3) of this section, C is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since A is in effective control of Y under paragraph (b)(6)(ii) of this section, the 40 shares of Y stock constructively owned by C are reattributed to A. A is considered as owning a total of 94 shares of Y stock.

[T.D. 8179, 53 FR 6609, March 2, 1988; T.D. 8179, 53 FR 8302, March 14, 1988]

§ 1.414(c)–5 Effective date.

(a) General rule. Except as provided in paragraph (b), (c), (e), or (f) of this section, the provisions of § 1.414(b)-1 and §§ 1.414(c)-1 through 1.414 (c)-4 shall apply for plan years beginning after September 2, 1974.

(b) Existing plans. In the case of a plan in existence on January 1, 1974, unless paragraph (c) of this section applies, the provisions of "§ 1.414 (b)-1 and §§ 1.414(c)-1 through 1.414(c)-4 shall apply for plan years beginning after December 31, 1975. For definition of the term "existing plan", see § 1.410(a)-2(c).

(c) Existing plans electing new provisions. In the case of a plan in existence on January 1, 1974, for which the plan administrator makes an election under § 1.410 (a)-2 (d), the provisions of § 1.414 (b)-1 and §§ 1.414 (c)-1 through 1.414 (c)-4 shall apply to the plan years elected under § 1.410 (a)-2 (d).

(d) Application. For purposes of the Employee Retirement Income Security Act of 1974, the provisions of § 1.414 (b)-1 and §§ 1.414 (c)-1 through 1.414 (c)-4 do not apply for any period of time before the plan years described in paragraph (a), (b), or (c) of this section, whichever is applicable.

(e) Special rule. Notwithstanding paragraph (a), (b), or (c) of this section, § 1.414 (c)-3 (f) is effective April 1, 1988.

(f) Transitional rule—(1) In general. The amendments made by T.D. 8179 apply to the plan years or period described in paragraphs (a), (b), or (c) of this section, whichever is applicable.

(2) Exception. In the case of a plan year or period beginning before March 2, 1988, if an organization—

(i) Is a member of a brother-sister group of trades or businesses under common control under § 11.414 (c)-2 (c), as in effect before removal by T.D. 8179 ("old group"), for such plan year or period, and

(ii) Is not such a member for such plan year or period because of the amendments made by such Treasury decision,

such member (whether or not a corporation) nevertheless will be treated as a member of such old group for purposes of section 414(c) for that plan year or period to the extent provided in § 1.1563-1 (d)(2). Also, such member will be treated as a member of an old group for all purposes of the Code for such plan year or period if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of §1.1563-1 (d)(3) with respect to such plan year or period.

[T.D. 8179, 53 FR 6611, March 2, 1988]

§ 1.414(e)–1 Definition of church plan.

(a) General rule. For the purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, the term "church plan" means a plan established and at all times maintained for its employees by a church or by a convention or association of churches (hereinafter included within the term "church") which is exempt from tax under section 501(a), provided that such plan meets the requirements of paragraphs (b) and (if applicable) (c) of this section. If at any time during its existence a plan is not a church plan because of a failure to meet the requirements set forth in this section, it cannot thereafter become a church plan.

(b) Unrelated businesses—(1) In general. A plan is not a church plan unless it is established and maintained primarily for the benefit of employees (or their beneficiaries) who are not em-

ployed in connection with one or more unrelated trades or businesses (within the meaning of section 513).

(2) Establishment or maintenance of a plan primarily for persons not employed in connection with one or more unrelated trades or businesses. (i)(A) A plan, other than a plan in existence on September 2, 1974, is established primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses if on the date the plan is established the number of employees employed in connection with the unrelated trades or businesses eligible to participate in the plan is less than 50 percent of the total number of employees of the church eligible to participate in the plan.

(B) A plan in existence on September 2, 1974, is to be considered established as a plan primarily for the benefit of employees (or their beneficiaries) who are not employed in connection with one or more unrelated trades or businesses if it meets the requirements of both paragraphs (b)(2)(ii)(A) and (B) (if applicable) in either of its first 2 plan years ending after September 2, 1974.

(ii) For plan years ending after September 2, 1974, a plan will be considered maintained primarily for the benefit of employees of a church who are not employed in connection with one or more unrelated trades or businesses if in 4 out of 5 of its most recently completed plan years—

(A) Less than 50 percent of the persons participating in the plan (at any time during the plan year) consist of and in the same year

(B) Less than 50 percent of the total compensation paid by the employer during the plan year (if benefits or contributions are a function of compensation) to employees participating in the plan is paid to,

employees employed in connection with an unrelated trade or business. The determination that the plan is not a church plan will apply to the second year (within a 5 year period) for which the plan fails to meet paragraph (b)(2)(ii)(A) or (B) (if applicable) and to all plan years thereafter unless, taking into consideration all of the facts and circumstances as described in paragraph (b)(2)(iii) of this section, the plan is still considered to be a church plan. A plan that has not completed 5 plan years ending after September 2, 1974, shall be considered maintained primarily for the benefit of employees not employed in connection with an unrelated trade or business unless it fails to meet paragraphs (b)(2)(ii)(A) and (B) in at least 2 such plan years.

(iii) Even though a plan does not meet the provisions of paragraph (b)(2)(ii) of this section, it nonetheless will be considered maintained primarily for the benefit of employees who are not employed in connection with one or more unrelated trades or businesses if the church maintaining the plan can demonstrate that based on all of the facts and circumstances such is the case. Among the facts and circumstances to be considered in evaluating each case are:

(A) The margin by which the plan fails to meet the provisions of paragraph (b)(2)(ii) of this section, and

(B) Whether the failure to meet such provisions was due to a reasonable mistake as to what constituted an unrelated trade or business or whether a particular person or group of persons were employed in connection with one or more unrelated trades or businesses.

(iv) For purposes of this section, an employee will be considered eligible to participate in a plan if such employee is a participant in the plan or could be a participant in the plan upon making mandatory employee contributions to the plan.

(3) Employment in connection with one or more unrelated trades or businesses. An employee is employed in connection with one or more unrelated trades or businesses of a church if a majority of such employee's duties and responsibilities in the employ of the church are directly or indirectly related to the carrying on of such trades or businesses. Although an employee's duties and responsibilities may be insignificant with respect to any one unrelated trade or business, such employee will nonetheless be considered as employed in connection with one or more unrelated trades or businesses if such employee's duties and responsibilities with respect to all of the unrelated trades or businesses of the church represent a majority of the total of such person's duties and responsibilities in the employ of the church.

(c) **Plans of two or more employers.** The term "church plan" does not include a plan which, during the plan year, is maintained by two or more employers unless—

(1) Each of the employers is a church that is exempt from tax under section 501(a), and

(2) With respect to the employees of each employer, the plan meets the provisions of paragraph (b)(2)(ii) of this section or would be determined to be a church plan based on all the facts and

circumstances described in paragraph (b)(2)(iii) of this section.

Thus, if with respect to a single employer the plan fails to meet any provision of this paragraph, the entire plan ceases to be a church plan unless that employer ceases maintaining the plan for all plan years beginning after the plan year in which it receives a final notification from the Internal Revenue Service that it does not meet the provisions of this paragraph. If the employer does cease maintaining the plan in accordance with this paragraph, the fact that the employer formerly did maintain the plan will not prevent the plan from being a church plan for prior years.

(d) Special rule. (1) Notwithstanding paragraph (c)(1) of this section, a plan maintained by a church and one or more agencies of such church for the employees of such church and of such agency or agencies, that is in existence on January 1, 1974, shall be treated as a church plan for plan years ending after September 2, 1974, and beginning before January 1, 1983, provided that the plan is described in paragraph (c) of this section without regard to paragraph (c)(1) of this section, and the plan is not maintained by an agency which did not maintain the plan on January 1, 1974.

(2) For the purposes of section 414(e) and this section, an agency of a church means an organization which is exempt from tax under section 501 and which is either controlled by, or associated with, a church. For example, an organization, a majority of whose officers or directors are appointed by a church's governing board or by officials of a church, is controlled by a church within the meaning of this paragraph. An organization is associated with a church if it shares common religious bonds and convictions with that church.

(e) Religious orders and religious organizations. For the purpose of this section the term "church" includes a religious order or a religious organization if such order or organization (1) is an integral part of a church, and (2) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise.

(f) Separately incorporated fiduciaries. A plan which otherwise meets the provisions of this section shall not lose its status as a church plan because of the fact that it is administered by a separately incorporated fiduciary such as a pension board or a bank.

(g) Cross reference. (1) For rules relating to treatment of church plans, see section 410(c), 411(e), 412(h), 4975(g), and the regulations thereunder.

(2) For rules relating to church plan elections, see section 410(d) and the regulations thereunder.

[T.D. 7688, 45 FR 20797, March 31, 1980]

§ 1.414(f)–1 Definition of multiemployer plan.

(a) **General rule.** For purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, a plan is a multiemployer plan for a plan year if all of the following requirements are satisfied:

(1) **Number of contributing employers.** More than one employer is required by the plan instrument or other agreement to contribute (or to have contributions made on its behalf) to the plan for the plan year.

(2) **Collective bargaining agreement.** The plan is maintained for the plan year pursuant to one or more collective bargaining agreements between employee representatives and more than one employer.

(3) **Amount of contributions.** Except as provided by paragraph (c) of this section (relating to the special rule for contributions exceeding 50 percent), the amount of contributions made under the plan for the plan year by or on behalf of each employer is less than 50 percent of the total amount of contributions made under the plan for such plan year by or on behalf of all employers.

(4) **Benefits.** The plan provides that the amount of benefits payable with respect to each employee participating in the plan is determined without regard to whether or not his employer continues as a member of the plan. If benefits accrued as a result of the participant's service with his employer during a period before such employer was a member of the plan, this requirement does not apply to the amount of those benefits, except that this requirement does apply to the amount of those benefits (i) which are accrued benefits derived from employee contributions, or (ii) which are accrued under a plan maintained by an employer prior to the time such employer became a member of the plan to which the requirements of this paragraph (a) are applied.

(5) **Other requirements.** The plan satisfies such other requirements as the Secretary of Labor by regulations prescribes under the authority of section 414(f)(1)(E) of the Code and section 3(37) of the Employee Retirement Income Security Act of 1974 (Pub. L. 93–406, 88 Stat. 839). See 29 CFR 2510.3–37.

(b) Special rules—(1) Amount of contributions. For purposes of paragraphs (a)(3) and (c) of this section, the amount of contributions made under the plan for the plan year by or on behalf of each employer shall be the sum of such contributions made on or before the last day of the plan year. For purposes of determining whether contributions are made on or before the last day of the plan year, the rule of section 412(c)(10) and the regulations thereunder (relating to the treatment of certain contributions made after the last day of the plan year as made on such last day) shall apply.

(2) Benefits. (i) For purposes of paragraph (a)(4) of this section, certain benefit amounts are treated as accrued as a result of the participant's service with an employer during a period before such employer was a member of the plan. The amount of such a benefit so treated is the difference (if any) between two calculated amounts. The first calculated amount is the participant's total accrued benefit calculated under the plan as of the date the employer ceased to be a member of the plan. The second calculated amount is the participant's accrued benefit calculated without regard to his service with such employer during the period before such employer was a member of the plan. However, under a special limitation, this difference may not exceed the benefit a participant accrued from service before his employer became a member of the plan. For purposes of this limitation, this benefit is the benefit accrued as of the date the employer ceases to be a member of the plan. An employer shall be deemed to be a member of the plan in a plan year if the employer is required by the plan instrument or other agreement to contribute (or to have contributions made on its behalf) to the plan for such plan year or if an employee of the employer accrues a benefit, on account of service with the employer during such plan year, under the plan for that plan year.

(ii) The provisions of paragraphs (a)(4) and (b)(2)(i) of this section are illustrated by the following example:

Example. On January 1, 1976, employer W became a member of the noncontributory XYZ pension plan which uses the calendar year as the plan year. W did not maintain any plan prior to that date. The plan provided for benefits of $4 per month per year of service (including service with W before January 1, 1976). On January 1, 1980, following adoption of a new collective bargaining agreement, the benefits were increased to $12 per month per year of service for all years of service (including service with W before January 1, 1976). On January 1, 1991, W ceased to be a member of the plan.

A, an employee of W, had 15 years of service before January 1, 1976, 4 years of service between January 1, 1976, and December 31, 1979, and 11 years of service between January 1, 1980, and December 31, 1990. On December 31, 1990, A's accrued benefit was $360 per month ($12 per month × 30). On January 1, 1991, the portion of A's accrued benefit retained and the portion forfeited under the terms of the XYZ pension plan were determined as follows:

Years	Monthly accrued benefit retained	Monthly accrued benefit forfeited
Before Jan. 1, 1976	....	$12 × 15 years = $180
Jan. 1, 1976 to Dec. 31, 1979	$4 × 4 years = $16	$8 × 4 years = $32
Jan. 1, 1980 to Dec. 31, 1990	$12 × 11 years = $132	....
Total	$148	$212

The XYZ plan does not satisfy the requirements of paragraphs (a)(4) and (b)(2)(i) of this section because no benefit can be forfeited with respect to service after W began participating in the plan. Thus, the maximum accrued benefit that may be forfeited is $180 per month (the accrued benefit with respect to A's service prior to January 1, 1976). Therefore, in order for the plan to meet the requirements of paragraphs (a)(4) and (b)(2)(i) of this section, the plan must provide for A's accrued benefit after W ceased to be a member of the plan to be at least $180 per month ($360 per month total accrued benefit less $180 per month benefit accrued for service prior to W's membership in the plan).

(iii) For purposes of paragraphs (a)(4) and (b)(2) of this section, if an employer for a period employs two or more individuals who, solely by reason of their employment, are participants in the plan and who do not belong to the same collective bargaining unit, the dates on which the employer became and ceased to be a member of the plan shall be determined separately on a class basis for individuals who belong to separate collective bargaining units, as separate classes, and for individuals who do not belong to a collective bargaining unit, as a further single separate class. Thus, such dates shall be determined with respect to individuals as a class who belong to the same collective bargaining unit (or who do not belong to a collective bargaining unit) without consideration of the employment by the employer of, or the participation in the plan by, other individuals (who do not belong to such collective bargaining unit and who may belong to another collective bargaining unit) or whether the employer is a member of the plan with respect to such other individuals. In no event, however, may service not attributable to service with a particular collective bargaining unit be disregarded under paragraphs (a)(4) and (b)(2) of this section merely because the employer ceases to maintain the plan with respect to such unit. Thus, for example, paragraphs (a)(4) and (b)(2) of

this section do not permit the disregard of a period of service of an individual belonging to a collective bargaining unit prior to the time the employer became a member of the plan with respect to such unit to the extent that, during such period of service, the individual belonged to another collective bargaining unit with respect to which the employer was a member of the plan.

(3) Controlled groups. For purposes of section 414(f) and this section, all corporations which are members of a controlled group of corporations (within the meaning of section 1563(a) and the regulations thereunder, but determined without regard to section 1563(e)(3)(C) and the regulations thereunder) are deemed to be one employer.

(c) Contributions exceeding 50 percent. If a plan was a multiemployer plan as defined in this section for any plan year (including plan years ending prior to September 3, 1974), "75 percent" shall be substituted for "50 percent" in applying paragraph (a)(3) of this section for subsequent plan years until the first plan year following a plan year in which the amount contributed by or on behalf of one employer is 75 percent or more of the total amount of contributions made under the plan for that plan year by or on behalf of all of the employers making contributions. In such case "75 percent" shall not again be substituted for "50 percent" until the plan has met the requirements of paragraph (a) of this section (determined without regard to this paragraph) for one plan year.

(d) Examples. The application of this section is illustrated by the following examples. For purposes of these examples, assume that the plan meets the requirements of paragraphs (a)(1), (2), (4), and (5) of this section for each plan year.

Example (1). On January 1, 1970, U, V, and W, three employers none of which is a member of a controlled group of corporations with any of the other two employers, establish a plan with a plan year corresponding to the calendar year. U, V, and W each contribute less than one-half of the total contributions made under the plan for each of the years 1970, 1971, and 1972. For the years 1973, 1974, and 1975, U contributes 70 percent and V and W each contribute 15 percent of the total contributions made under the plan for each year. The plan is a multiemployer plan under section 414(f) and this section for 1975 because no employer has contributed 75 percent or more of the total amount contributed for each of the plan years subsequent to 1972.

Example (2). (i) **First plan year.** On January 1, 1975, X, Y, and Z, three employers none of which is a member of a controlled group of corporations with any of the other two employers, establish a plan with a plan year corresponding to the calendar year. X, Y, and Z each contribute less than one-half of the total contributions made under the plan for 1975. The plan is a multiemployer plan for 1975 because it meets the 50 percent contribution requirement of paragraph (a)(3) of this section.

(ii) **Second plan year.** For the second plan year, 1976, X contributes 70 percent and Y and Z each contribute 15 percent of the total contributions made under the plan. The plan is a multiemployer plan for 1976 because it was a multiemployer plan for the preceding plan year and satisfies the 75 percent contribution requirement of paragraph (c) of this section.

(iii) **Third plan year.** For the third plan year, 1977, X contributes 80 percent and Y and Z each contribute 10 percent of the total contributions made under the plan. The plan is not a multiemployer plan for 1977 because it fails to satisfy the 75 percent contribution requirement of paragraph (c) of this section.

(iv) **Fourth plan year.** For the fourth plan year, 1978, Y contributes 60 percent and X and Z each contribute 20 percent of the total contributions made under the plan. The 75 percent contribution requirement of paragraph (c) of this section does not apply. The plan is not a multiemployer plan for 1978 because it fails to satisfy the 50 percent contribution requirement of paragraph (a)(3) of this section.

(v) **Fifth plan year.** For the fifth plan year, 1979, X, Y, and Z each contribute less than one-half of the total contributions made under the plan. The 75 percent contribution requirement of paragraph (c) of this section does not apply. The plan is a multiemployer plan for 1979 because it again meets the 50 percent contribution requirement of paragraph (a)(3) of this section.

(vi) **Sixth plan year.** For the sixth plan year, 1980, the plan will continue to be a multiemployer plan, provided that no employer contributes 75 percent or more of the total amount of contributions made under the plan for the plan year.

(e) Retention of records. (1) For plan years ending prior to September 3, 1974, a plan may be required to furnish proof that it met the requirements of section 414(f) and this section for each plan year ending prior to that date to the extent necessary to show the applicability of the 75 percent test provided in paragraph (c) of this section.

(2) For plan years ending after September 2, 1974, a plan may be required to furnish proof that it met the requirements of section 414(f) and this section for 6 immediately preceding plan years.

[T.D. 7552, 43 FR 29940, July 12, 1978]

§ 1.414(g)–1 Definition of plan administrator.

(a) In general. For purposes of part I of subchapter D of chapter 1 of the Code and the regulations thereunder, if the instrument under which the plan is operated for a plan year specifically designates a person or a group of persons as plan administrator, the person or group of persons collectively is the plan administrator for the plan year. The instrument may specifically designate a plan administrator—

(1) By name,

(2) By reference to the person or group of persons holding a named position or positions,

(3) By reference to a procedure established under the terms of the instrument pursuant to which a plan administrator is designated, or

(4) By reference to the person or group of persons charged with specific responsibilities of plan administrator. Consistent with the provisions of section 405(c)(1) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1105(c)(1)), a plan may provide for the allocation of specific responsibilities of plan administrator among named persons and for named persons to designate others to carry out such responsibilities. A person or group of persons may be designated as plan administrator in accordance with the rules of this paragraph even though the person or group of persons does not carry the specific title "plan administrator". In the absence of a person or group of persons designated as the plan administrator (individually, collectively, or by designation of different specific administrative responsibilities), the plan administrator for the plan year is the person or group of persons specified in paragraph (b) of this section.

(b) Plan administrator not specifically designated. If no person or group of persons is specifically designated as the plan administrator for a plan year by the instrument under which the plan is operated, the plan administrator for such year is the person or group of persons determined under the following rules:

(1) Single employer. In the case of a plan maintained by a single employer, the employer is the plan administrator. If the employer is a corporation, the corporation is the plan administrator. However, the corporation's board of directors may authorize a person or group of persons to fulfill responsibilities of the corporation as plan administrator. In the absence of such authorization, any corporate officer authorized under law, corporate by-laws, or resolution of the board of directors to act on behalf of the corporation with respect to contracts of a value equivalent to the fair market value of the assets of the plan shall be presumed to have authority to fulfill responsibilities of the corporation as plan administrator. For purposes of this paragraph (b)(1), "employer" means the "employer" as defined in section 3(5) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1003(5)).

(2) Employee organization. In the case of a plan maintained by an employee organization, the employee organization is the plan administrator.

(3) Group representing the parties. In the case of a plan maintained by two or more employers, or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who maintain the plan, as the case may be, is the plan administrator. For purposes of this subparagraph (3), a plan shall be considered maintained by two or more employers or jointly by one or more employers and one or more employee organizations only if none of the parties has the express power, under the terms of the instrument under which the plan is operated, to terminate the plan unilaterally.

(4) Person in control of assets. In any case where a plan administrator may not be determined by application of paragraphs (a) and (b)(1), (2), and (3) of this section, the plan administrator is the person or persons actually responsible, whether or not under the terms of the plan, for the control, disposition, or management of the cash or property received by or contributed to the plan, irrespective of whether such control, disposition, or management is exercised directly by such person or persons or indirectly through an agent or trustee designated by such person or persons.

[T.D. 7618, 44 FR 27657, May 11, 1979]

§ 1.414(*l*)–1 Mergers and consolidations of plans or transfers of plan assets.

(a) In general—(1) Scope of the regulations. Sections 401(a)(12) and 414(*l*) apply only to plans to which section 411 applies without regard to section 411(e)(2). Thus, for example, these sections do not apply to a governmental plan within the meaning of section 414(d); a church plan, within the meaning of section 414(e), for which there has not been made the election under section 410(d) to have the participation, vesting, funding, etc. requirements apply; or a plan which at no time after September 2, 1974, provided for employer contributions.

(2) General rule. Under section 414(*l*),

(i) A trust which forms a part of a plan will not constitute a qualified trust under section 401, and

(ii) A plan will not be treated as being qualified under section 403(a) and 405(a), unless, in the case of a merger or consolidation (as defined in paragraph (b)(2) of this section), or a transfer of assets or liabilities (as defined in paragraph (b)(3) of this section), the following condition is satisfied. This condition requires that each participant receive benefits on a termination basis (as defined in paragraph (b)(5) of this section) from the plan immediately after the merger, consolidation or transfer

which are equal to or greater than the benefits the participant would receive on a termination basis immediately before the merger, consolidation, or transfer.

(b) Definitions. For purposes of this section:

(1) Single plan. A plan is a "single plan" if and only if, on an ongoing basis, all of the plan assets are available to pay benefits to employees who are covered by the plan and their beneficiaries. * * * For purposes of the preceding sentence, all the assets of a plan will not fail to be available to provide all the benefits of a plan merely because the plan is funded in part or in whole with allocated insurance instruments. A plan will not fail to be a single plan merely because of the following:

(i) The plan has several distinct benefit structures which apply either to the same or different participants,

(ii) The plan has several plan documents,

(iii) Several employers, whether or not affiliated, contribute to the plan,

(iv) The assets of the plan are invested in several trusts or annuity contracts, or

(v) Separate accounting is maintained for purposes of cost allocation but not for purposes of providing benefits under the plan.

However, more than one plan will exist if a portion of the plan assets is not available to pay some of the benefits. This will be so even if each plan has the same benefit structure or plan document, or if all or part of the assets are invested in one trust with separate accounting with respect to each plan.

(2) Merger or consolidation. The terms "merger" or "consolidation" means the combining of two or more plans into a single plan. A merger or consolidation will not occur merely because one or more corporations undergo a reorganization (whether or not taxable). Furthermore, a merger or consolidation will not occur if two plans are not combined into a single plan, such as by using one trust which limits the availability of assets of one plan to provide benefits to participants and beneficiaries of only that plan.

(3) Transfer of assets or liabilities. A "transfer of assets or liabilities" occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumption of these liabilities by another plan. For example, the shifting of assets or liabilities pursuant to a reciprocity agreement between two plans in which one plan assumes liabilities of another plan is a transfer of assets or liabilities. However, the shifting of assets between several funding media used for a single plan (such as between trusts, between annuity contracts, or between trusts and annuity contracts) is not a transfer of assets or liabilities.

(4) Spinoff. The term "spinoff" means the splitting of a single plan into two or more plans.

(5) Benefits on a termination basis. (i) The term "benefits on a termination basis" means the benefits that would be provided exclusively by the plan assets pursuant to section 4044 of the Employee Retirement Income Security Act of 1974 ("ERISA") and the regulations thereunder if the plan terminated. Thus, the term does not include benefits that are guaranteed by the Pension Benefit Guaranty Corporation, but not provided by the plan assets.

(ii) For purposes of determining the benefits on a termination basis, the allocation of assets to various priority categories under section 4044 of ERISA must be made on the basis of reasonable actuarial assumptions. The assumptions used by the Pension Benefit Guaranty Corporation as of the date of the merger or spinoff are deemed reasonable for this purpose.

(iii) If a change in the benefit structure of a plan in conjunction with a merger, consolidation, or transfer of assets or liabilities alters the benefits on a termination basis, the change should be designated, at the time the merger, consolidation, or transfer occurs, to be effective either immediately before or immediately after that occurrence. In the event that no designation is made, the change in the benefit structure will be deemed to occur immediately after the merger, consolidation, or transfer of assets or liabilities.

(6) Lower funded plan. (i) The term "lower funded plan" generally means the plan which, immediately prior to the merger, would have its assets exhausted in a higher priority category than the other plan.

(ii) Where two plans, immediately prior to the merger, would have their assets exhausted in the same priority category of section 4044 of ERISA in the event of termination, the lower funded plan is the one in which the assets would satisfy a lesser proportion of the liability allocated to that priority category.

(7) Priority category. The term "priority category" means the category of benefits described in each paragraph of section 4044(a) of ERISA.

References to higher or highest priority categories refer to those priority categories which receive the first allocation of assets, *i.e.* the lowest paragraph numbers in section 4044(a).

(8) Separate accounting of assets. The term "separate accounting of assets" means the maintenance of an asset account with respect to a given group of participants which is:

(i) Credited with contributions made to the plan on behalf of the participants and with its allocable share of investment income, if any, and

(ii) Charged with benefits paid to the participants, and with its allocable share of investment losses or expenses.

(9) Present value of accrued benefit. For purposes of this section, the present value of an accrued benefit must be determined on the basis of reasonable actuarial assumptions. For this purpose, the assumptions used by the Pension Benefit Guaranty Corporation as of the date of the merger or spinoff are deemed reasonable.

(10) Valuation of plan assets. In determining the value of a plan's assets, the standards set forth in regulations prescribed by the Pension Benefit Guaranty Corporation (29 CFR Part 2611) shall be applied.

(11) Date of merger or spinoff. The actual date of a merger or spinoff shall be determined on the basis of the facts and circumstances of the particular situation. For purposes of this determination, the following factors, none of which is necessarily controlling, are relevant:

(i) The date on which the affected employees stop accruing benefits under one plan and begin coverage and benefit accruals under another plan.

(ii) The date as of which the amount of assets to be eventually transferred is calculated.

(iii) If the merger or spinoff agreement provides that interest is to accrue from a certain date to the date of actual transfer, the date from which such interest will accrue.

(c) Application of section 414(*l*)—(1) Two or more plans. (i) Section 414(*l*) does not apply unless more than a single plan is involved. It also does not apply unless at least a single plan assumes liabilities from another plan or obtains assets from another plan (as in a merger or spinoff). For purposes of section 414(*l*), a transfer of assets or liabilities will not be deemed to occur merely because a defined contribution plan is amended to become a defined benefit plan. This rule will apply even if, under the facts and circumstances of a particular case, a termination of the defined contribution plan will be considered to have occurred for purposes of other provisions of the Code.

(ii) The requirements of this subparagraph may be illustrated as follows:

Example. After acquiring Corporation B, Corporation A amends Corporation B's defined benefit plan (Plan B) to provide the same benefits as Corporation A's defined benefit plan (Plan A). The assets of Plan B are transferred to the trust containing the assets of Plan A in such a manner that the assets of each plan: (1) are separately accounted for, and (2) are not available to pay benefits of the other plan. Because of condition (2) there are still two plans and, therefore, a merger did not occur. As a result, section 414(*l*) does not apply. If at some later date Corporation A were to sell Corporation B and transfer the assets of Plan B that were separately accounted for to another trust or to an annuity contract solely for the purpose of providing Plan B's benefits, this transfer would also not involve section 414(*l*). This is so because Plan B was a separate plan before the entire transaction and because no plan assumed liabilities or obtained assets from another plan. If, on the other hand, Corporation A merged Plan A and Plan B at the time of the acquisition of Corporation B by deleting condition (2) above, then section 414(*l*) would apply both to the merger of Plan A and Plan B and to the spinoff of Plan B from the merged plan. The spinoff would have to satisfy the requirements of paragraph (n) of this section, even if the assets attributable to Plan A and Plan B were separately accounted for in order to allocate funding costs.

(2) Multiemployer plans. Except to the extent provided by regulations of the Pension Benefit Guaranty Corporation, section 414(*l*) does not apply to any transaction to the extent that participants either before or after that transaction are covered under a multiemployer plan within the meaning of section 414(f). Until these regulations are issued, section 414(*l*) does not apply to any of the following situations:

(i) A multiemployer plan is split into two or more plans, one or more of which are not multiemployer plans, or (ii) A single employer plan is merged into a multiemployer plan.

Therefore, if some (but not all) of the participants in a single employer plan become participants in a multiemployer plan under an agreement in which the multiemployer plan assumes all the liabilities of the single employer plan with respect to these participants and in which some or all of the assets of the single employer plan are transferred to the multiemployer plan, section 414(*l*) applies, but only with respect to the participants in the single employer plan who did not transfer to the multiemployer plan.

(d) Merger of defined contribution plans. In the case of a merger of two or more defined contribution plans, the requirements of section

414(l) will be satisfied if all of the following conditions are met:

(1) The sum of the account balances in each plan equals the fair market value (determined as of the date of the merger) of the entire plan assets.

(2) The assets of each plan are combined to form the assets of the plan as merged.

(3) Immediately after the merger, each participant in the plan as merged has an account balance equal to the sum of the account balances the participant had in the plans immediately prior to merger.

(e) Merger of defined benefit plans—(1) General rule. Section 414(l) compares the benefits on a termination basis before and after the merger. If the sum of the assets of all plans is not less than the sum of the present values of the accrued benefit (whether or not vested) of all plans, the requirements of section 414(l) will be satisfied merely by combining the assets and preserving each participant's accrued benefits. This is so because all the accrued benefits of the plan as merged are provided on a termination basis by the plan as merged. However, if the sum of the assets of all plans is less than the sum of the present values of the accrued benefits (whether or not vested) in all plans, the accrued benefits in the plan as merged are not provided on a termination basis.

(2) Special schedule of benefits. Generally, for some participants, the benefits provided on a termination basis for the plan as merged would be different from the benefits provided on a termination basis in the plans prior to merger if the assets were merely combined and if each participant retained his accrued benefit. Some participants would, therefore, receive greater benefits on a termination basis as a result of the merger and some other participants would receive smaller benefits. Accordingly, the requirements of section 414(l) would not be satisfied unless the distribution on termination were modified in some manner to prevent any participant from receiving smaller benefits on a termination basis as a result of the merger. This is accomplished through modifying the application of section 4044 of ERISA by inserting a special schedule of benefits.

(f) Operational rules for the special schedule. The application of section 4044 of ERISA as modified by the schedule of benefits is accomplished by the following steps:

(1) Section 4044 is applied in the plan as merged through the priority categories fully satisfied by the assets of the lower funded plan immediately prior to the merger.

(2) The assets in the plan as merged are then allocated to the next priority category as a percentage of the value of the benefits that would otherwise be allocated to that priority category. That percentage is the ratio of (i) the assets allocated to the first priority category not fully satisfied by the lower funded plan immediately prior to the merger to (ii) the assets that would have been allocated had that priority category been fully satisfied.

(3) A schedule of benefits is formed listing participants and scheduled accrued benefits. The scheduled accrued benefit is the excess of the benefits provided on a termination basis with respect to any participant from the plans immediately prior to the merger, over the benefits provided on a termination basis in subparagraphs (1) and (2) of this paragraph immediately after the merger. After allocating the assets in accordance with subparagraph (2) of this paragraph, the assets are allocated to the schedule of benefits as follows:

(i) First the assets are allocated to the scheduled benefits to the extent that the participant would have benefits provided in subparagraph (4) of this paragraph if there were no scheduled benefits.

(ii) Then the assets are allocated to the scheduled benefits to the extent that the participant would have benefits provided pursuant to subparagraph (5) of this paragraph if there were no scheduled benefits.

These assets should be allocated first to those scheduled benefits that are in the highest priority category under section 4044.

(4) The assets are then allocated to those benefits in the priority category described in subparagraph (2) of this paragraph with respect to which assets were not allocated. This allocation is made to the extent that these benefits are not associated with benefits in the schedule.

(5) Finally, the assets are allocated in accordance with section 4044 with respect to priority categories lower than the priority category described in subparagraph (4) of this paragraph. This allocation is made to the extent that these benefits are not associated with benefits in the schedule.

(g) Successive mergers—(1) In general. In the case of a current merger of a defined benefit plan with another defined benefit plan which as a result of a previous merger has a special schedule, the

rules of paragraphs (e) and (f) of this section apply as if the schedule were considered a category described in section 4044 of ERISA. Thus, a second schedule may be formed as a result of the current merger. The second schedule will be inserted in the priority category of section 4044 described in paragraph (f)(2) of this section as of the date of the current merger. This priority category may be higher, lower, or within the schedule of benefits existing on account of a previous merger. If this priority schedule is inserted within a schedule of benefits, a new single schedule of benefits replacing the old schedule of benefits would in effect be created.

(2) Allocation of assets. Assets in the new schedule of benefits are allocated as follows:

(i) First to the benefits remaining in the old schedule to the extent that there are assets immediately prior to the second merger to satisfy the original benefits,

(ii) Then to the benefits provided on a termination basis from the plans immediately prior to the second merger to the extent that they are not provided before the schedule after the second merger or in subdivision (i) of this subparagraph,

(iii) Then to benefits remaining in the original schedule not included in subdivision (i) of this subparagraph.

(h) De minimis rule for merger of defined benefit plan—(1) In general. In the case of a merger of a defined benefit plan ("smaller plan") whose liabilities (*i.e.*, the present value of accrued benefits, whether or not vested) are less than 3 percent of the assets of another defined benefit plan ("larger plan") as of at least one day in the larger plan's plan year in which the merger of the two plans occurs, section 414(*l*) will be deemed to be satisfied if the following condition is met. The condition requires that a special schedule of benefits (consisting of all the benefits that would be provided by the smaller plan on a termination basis just prior to the merger) be payable in a priority category higher than the highest priority category in section 4044 of ERISA. Assets will be allocated to that schedule in accordance with the allocation of assets to scheduled benefits in paragraph (f)(3) of this section.

(2) Application to a series of mergers. In the case of a series of such mergers in a given plan year of the larger plan, the rule described in subparagraph (1) of this paragraph will apply only if the sum of the liabilities (whether or not vested) assumed by the larger plan are less than 3 percent of the assets of the larger plan as of at least one day in the plan year of the larger plan in which the mergers occurred.

(3) Application to a merger occurring over more than one plan year. In the case of a merger of a smaller plan or a portion thereof with a larger plan designed to occur in steps over more than one plan year of the larger plan, the entire transaction will be deemed to occur in the plan year of the larger plan which contains the first of these steps.

(4) Liabilities of the smaller plan. For purposes of subparagraphs (2) and (3) of this paragraph, mergers satisfying paragraphs (e), (f) or (g) of this section will be ignored in determining the sum of the liabilities assumed by the larger plan.

(i) Data maintenance—(1) Alternative to the special schedule. In the case of a merger which would require the creation of a special schedule in order to satisfy section 414(*l*), the schedule need not be created at the time of the merger if data sufficient to create the schedule is maintained. The schedule would only have to be created in the event of a subsequent plan termination or a subsequent spinoff. In that case the schedule must be determined as of the date of the merger.

(2) Required data. The data that must be maintained depends on the plan, and care should be taken to ensure that all necessary data is maintained. Furthermore, in order to take advantage of the data maintenance alternative provided in this paragraph, an enrolled actuary must certify to the plan administrator that each element of data necessary to determine the schedule as of the date of the merger is maintained. This certification must be based either upon the enrolled actuary's independent examination of the data, or upon his reliance, which under the circumstances of the particular situation must be reasonable, upon a written statement of the plan administrator concerning what data is actually being maintained.

(j) Five year rule—(1) Limitation on the required use of the special schedule. A plan will not fail to satisfy the requirements of section 414(*l*) merely because the effects of the special schedule created pursuant to paragraphs (e)(2) or (h) of this section are ignored 5 years after the date of a merger. Furthermore, the date maintained pursuant to paragraph (i) of this section need not be maintained for more than 5 years after the merger, if the plan does not have a spinoff or a termination within 5 years.

(2) Illustration. If Plans A and B merge to form Plan AB and if Plan AB merges with Plan C 3 years later to form Plan ABC and if Plan ABC

terminates 4 years later, the data relating to the merger of Plans A and B need not be maintained for more than 5 years after the merger of Plans A and B. In addition, after 5 years have elapsed after the merger of Plans A and B, the effect of any special schedule created by the merger of Plans A and B on the schedule created by the merger of Plans AB and C may be ignored in determining the later schedule.

(k) **Examples.** The provisions of paragraphs (e) through (j) of this section may be illustrated by the following examples:

Example (1). Plan A, whose assets are $220,000, is to be merged with Plan B, whose assets are $200,000. Plan A has three employees. Plan B has two employees. If Plans A and B were to terminate just prior to the merger, the benefits provided on a termination basis would be as follows:

Plan A

Priority category of section 4044 of ERISA	(1)—Annual accrued benefits			(2)—Present value of accrued benefits			(3)—Fair market value of assets allocated to priority category	(4)—Benefits on a termination basis		
	EE_1	EE_2	EE_3	EE_1	EE_2	EE_3		EE_1	EE_2	EE_3
3	$10,000	......	......	$120,000	....	....	$120,000	$10,000	......	......
4	2,000	$4,000	......	24,000	$44,000	....	68,000	2,000	$4,000	......
5	....	3,000	$4,000	....	33,000	$40,000	32,000	....	[1]1,315	[2]$1,753
6	....	......	1,000	....	....	10,000	....	....	......	......
Total	....	......	......	....	....	....	220,000	12,000	5,315	1,753

[1] $3,000 × $32,000 ÷ $73,000 i.e. accrued benefit × assets available for priority category 5—Total present value of accrued benefits in category 5.
[2] $4,000 × $32,000 ÷ $73,000.

Plan B

Priority category of section 4044 of ERISA	(1)—Annual accrued benefits					(2)—Present value of accrued benefits					(3)—Fair market value of assets allocated to priority category	(4)—Benefits on a termination basis				
	EE_1	EE_2	EE_3	EE_4	EE_5	EE_1	EE_2	EE_3	EE_4	EE_5		EE_1	EE_2	EE_3	EE_4	EE_5
3	....	....	......	$15,000	.....	....	....	....	$195,000	......	$195,000	....	....	....	$15,000	.....
4	....	....	......	......	$5,000	....	....	....	....	$50,000	5,000	....	....	....	......	[1]$500
5	....	....	......	......	8,000	....	....	....	....	80,000	....	....	....	....	......	.....
Total	....	....	....	......	.....	....	....	....	....	......	200,000	....	....	....	15,000	500

[1] $5,000 ÷ $5,000 × $50,000.

Because Plan B's assets are exhausted in a higher priority category than Plan A's assets, Plan B is the lower funded plan. A schedule will, therefore, be inserted in Priority Category 4 of the plan as merged after providing 10% of the benefits provided in category 4, *i.e.* the ratio of $5,000 assets in Plan B allocated to category 4 to the $50,000 liability in category 4. The schedule would be constructed as follows:

EE	(1)—Benefits on a termination basis before merger	(2)—Benefits provided from priority categories higher than Category 4	(3)—10% of benefits provided in priority Category 4	(4)—Benefits provided before schedule (2) + (3)	(5)—Schedule of benefits (1) − (4)
1	$12,000	$10,000	$200	$10,200	$1,800
2	5,315	....	400	400	4,915
3	1,753	....	....	....	1,753
4	15,000	15,000	....	15,000	....
5	500	....	500	500	....

Example (2). The facts are the same as in Example (1). The plan, however, terminates one year later. Furthermore, no employee has accrued additional benefits during the year except that the $2,000 benefit for EE_1 that was originally in category 4 is now in category 3. The assets would be allocated to the priority categories to the extent that there are assets to cover the following benefits.

Priority termination category	EE_1	EE_2	EE_3	EE_4	EE_5
3	$12,000	....	....	$15,000	....
10% of 4	....	$400	....	....	$500
Schedule of benefits included in balance of Category 4	....	3,600	....	....	....
Schedule of benefits included in Category 5	....	1,315	$1,753	....	....
Schedule of benefits included in Category 6	....	....	....	....	....
Balance of Category 4 not included in schedule	....	....	....	....	4,500
Balance of Category 5 not included in schedule	....	1,685	2,247	....	8,000
Balance of Category 6 not included in schedule	....	....	1,000	....	....

(*l*) **Merger of defined benefit and defined contribution plan.** In the case of a merger of a defined benefit plan with a defined contribution plan, one of the plans before the merger should be converted into the other type of plan (*i.e.*, the defined benefit converted into a defined contribution or the defined contribution converted into a defined benefit) and either paragraph (d) or paragraphs (e) through (j) of this section, whichever is appropriate, should be applied.

(m) **Spinoff of a defined contribution plan.** In the case of a spinoff of a defined contribution plan, the requirements of section 414(*l*) will be satisfied if after the spinoff—

(1) The sum of the account balances for each of the participants in the resulting plans equals the account balance of the participant in the plan before the spinoff, and

(2) The assets in each of the plans immediately after the spinoff equals the sum of the account balances for all participants in that plan.

(n) **Spinoff of a defined benefit plan—(1) General rule.** In the case of a spinoff of a defined benefit plan, the requirements of section 414(*l*) will be satisfied if—

(i) All of the accrued benefits of each participant are allocated to only one of the spun off plans, and

(ii) The value of the assets allocated to each of the spun off plans is not less than the sum of the present value of the benefits on a termination basis in the plan before the spinoff for all participants in that spun off plan.

(2) **De minimis rule.** In the case of a spin off the requirements of section 414(*l*) will be deemed to be satisfied if the value of the assets spun off—

(i) Equals the present value of the accrued benefits spun off (whether or not vested), and

(ii) In conjunction with other assets spun off during the plan year in which the spinoff occurs in accordance with this subparagraph, is less than 3 percent of the assets as of at least one day in that year. Spinoffs occurring in previous or subsequent plan years are ignored if they are not part of a single spinoff designed to occur in steps over more than one plan year.

(3) **Special temporary rule.** In the case of a defined benefit plan maintained for different groups of employees, which is a single plan (as defined in paragraph (b)(1) of this section) and under which there has been separate accounting of assets for each group, a spinoff of the plan on or before July 1, 1978, into a separate plan for each group will be deemed to satisfy section 414(*l*) if—

(i) All the liabilities with respect to each group of employees are allocated to a separate plan for that group of employees, and

(ii) The assets that are separately accounted for with respect to each group of employees are allocated to the separate plan for that group of employees.

For purposes of this subparagraph, a separate accounting of assets will not be considered to have occurred to the extent that the assets allocated to each single plan are determined by an historical re-creation of benefits, contributions, investment gains, etc.

(*o*) **Transfers of assets or liabilities.** Any transfer of assets or liabilities will for purposes of section 414(*l*) be considered as a combination of separate mergers and spinoffs using the rules of paragraphs (d), (e) through (j), (*l*), (m), or (n) of this section, whichever is appropriate. Thus, for example, if in accordance with the transfer of one or more employees, a block of assets and liabilities are transferred from Plan A to Plan B, each of which is a defined benefit plan, the transaction will be considered as a spinoff from Plan A and a merger of one of the spinoff plans with Plan B. The spinoff and merger described in the previous sentence would be subject to the requirements of paragraphs (n) and (e) through (j) of this section respectively.

[T.D. 7638, 44 FR 48195, Aug. 17, 1979]

§ 1.414(q)–1T Highly compensated employee (temporary).

The following questions and answers relate to the definition of "highly compensated employee" provided in section 414(q). The definitions and rules provided in these questions and answers are provided solely for purposes of determining the group of highly compensated employees.

Table of contents.

Q-1: To what employee benefit plans and statutory provisions is the definition of highly compensated employee contained in section 414(q) applicable?

A-1: (a) In general. This definition is applicable to statutory provisions that incorporate the definition by reference.

(b) Qualified retirement plans—(1) In general. Generally, this definition is incorporated in many of the nondiscrimination requirements applicable to pension, profit-sharing, and stock bonus plans qualified under section 401(a). See, e.g., the nondiscrimination provisions of sections 401(a) (4) and (5), 401(k)(3), 401(*l*), 401(m), 406(b), 407(b), 408(k), 410(b) and 411(d)(1). The definition is also incorporated by certain other provisions with respect to such plans, including the aggregation rules of section 414(m) and section 4975 (tax on prohibited transactions).

(2) Not applicable where not incorporated by reference. This definition is not applicable to qualified plan provisions that do not incorporate it. See, e.g., section 415 (limitations on contributions and benefits), with the exception of section 415(c)(3)(C) and 415(c)(6) (special rules for permanent and total disability and employee stock ownership plans respectively).

(c) Other employee benefit plans or arrangements. This definition is incorporated by various sections relating to employee benefit provisions. See, e.g., section 89 (certain other employee benefit plans), section 106 (accident and health plans), 117(d) (qualified tuition reduction), section 125 (cafeteria plans), section 129 (dependent care assistance programs), section 132 (certain fringe benefits), section 274 (certain entertainment, etc. expenses), section 423(b) (employee stock purchase plan provisions), section 501(c) (17) and (18) (certain exempt trusts providing benefits to employees), and section 505 (certain exempt organizations or trusts providing benefits to individuals). See the respective sections for the applicable effective dates.

(d) ERISA. This definition is not determinative with respect to any provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), unless it is explicitly incorporated by reference (e.g., section 408(b)(1)(B)).

Q-2: Who is a highly compensated employee?

A-2: The group of employees (including former employees) who are highly compensated employees consists of both highly compensated active employees (see A-3 of this § 1.414(q)-1T) and highly compensated former employees (see A-4 of this § 1.414(q)-1T). In many circumstances, highly compensated active employees and highly compensated former employees are considered separately in applying the provisions for which the definition of highly compensated employees in section 414(q) is applicable. Specific rules with respect to the treatment of highly compensated active employees and highly compensated former employees will be provided in the regulations with respect to the sections to which the definition of highly compensated employees is applicable.

Q-3: Who is a highly compensated active employee?

A-3: (a) General rule. For purposes of the year for which the determination is being made (the determination year), a highly compensated active employee is any employee who, with respect to the employer, performs services during the determination year and is described in any one or more of the following groups applicable with respect to the look-back year calculation and/or determination year calculation for such determination year. See A-14 for rules relating to the periods for which the look-back year calculation and determination year calculation are to be made.

(1) Look-back year calculation.

(i) 5-percent owner. The employee is a 5-percent owner at any time during the look-back year (i.e., generally, the 12-month period immediately preceding the determination year; see A-14. (See A-8 of this § 1.414(q)-1T.)

(ii) Compensation above $75,000. The employee receives compensation in excess of $75,000 during the look-back year.

(iii) Compensation above $50,000 and top-paid group. The employee receives compensation in excess of $50,000 during the look-back year and is a member of the top-paid group for the look-back year. (See A-9 of this § 1.414(q)-1T.)

(iv) Officer. The employee is an "includible officer" during the look-back year. (See A-10 of this § 1.414(q)-1T.)

(2) Determination year calculation.

(i) 5-percent owner. The employee is a 5-percent owner at any time during the determination year. (See A-8 of this § 1.414(q)-1T.)

(ii) Top-100 employees. The employee is both (A) described in paragraph (a)(1)(i), (ii) and/or (iv) of this A-3, when such paragraphs are modified to substitute the determination year for the look-back year, and (B) one of the 100 employees who receive the most compensation from the employer during the determination year.

(b) Rounding and tie-breaking rules. In making the look-back year and determination year calculations for a determination year, it may be necessary for an employer to adopt a rule for rounding calculations (e.g., in determining the number of employees in the top-paid group). In addition, it may be necessary to adopt a rule breaking ties among two or more employees (e.g., in identifying those particular employees who are in the top-paid group or who are among the 100 most highly compensated employees). In such cases, the employer may adopt any rounding or tie-breaking rules it desires, so long as such rules are reasonable, nondiscriminatory, and uniformly and consistently applied.

(c) Adjustments to dollar thresholds—(1) Indexing of dollar thresholds. The dollar amounts in paragraph (a)(1) (i) and (ii) of this A-3 are indexed at the same time and in the same manner as the section 415(b)(1)(A) dollar limitation for defined benefit plans.

(2) Applicable dollar threshold. The applicable dollar amount for a particular determination year or look-back year is the dollar amount for the calendar year in which such determination year or look-back year begins. Thus, the dollar amount for purposes of determining the highly compensated active employees for a particular look-back year is based on the calendar year in which such look-back year begins, not the calendar year in which such look-back year ends or in which the determination year with respect to such look-back year begins.

(d) Employees described in more than one group. An individual who is a highly compensated active employee for a determination year, by reason of being described in one group in paragraph (a) of this A-3, under either the look-back year calculation or the determination year calculation, is not disregarded in determining whether another individual is a highly compensated active employee by reason of being described in another group under paragraph (a). For example, an individual who is a highly compensated active employee for a determination year, by reason of being a 5-percent owner during such year, who receives compensation in excess of $50,000 during both the look-back year and the determination year, is taken into account in determining the group of employees who are highly compensated active employees for such determination year by reason of receiving more than $50,000, and being in the top-paid group under either or both the look-back year calculation or determination year calculation for such determination year.

(e) Examples. The following examples, in which the determination year and look-back year are the calendar year, are illustrative of the rules in paragraph (a) of this A-3. For purposes of these examples, the threshold dollar amounts in paragraph (a)(1) (ii) and (iii) of this A-3 are not increased pursuant to paragraph (c) of this A-3.

Example (1). Employee A, who is not at any time a 5-percent owner, an officer, or a member of the top-100 within the meaning of paragraph (a)(1) (i), or (iv), or (a)(2) (i) or (ii), but who was a member of the top-paid group for each year, is included in or excluded from the highly compensated groups as specified below for the following years:

Year	Compensation	Status	Comments
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitutes the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	80,000	Excl	Excluded because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1986).

Year	Compensation	Status	Comments
1988	80,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1987).
1989	45,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1988).
1990	45,000	Excl	Excluded because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1989).

Example (2). Assuming the same facts as those given in Example (1), except that A is a member of the top-100 employees within the meaning of paragraph (a)(2)(ii) of this A-3 for the 1987 year and 1990 year, the results are as follows:

Year	Compensation	Status	Comments
1986	$45,000	N/A	Although prior to 414(q) effective date, 1986 constitutes the look-back year for purposes of determining the highly compensated group for the 1987 determination year.
1987	80,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the determination year (1987) and was described in paragraph (a)(2)(ii) of this A–3 in that year.
1988	80,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1987).
1989	45,000	Incl	Included because A was an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1988).
1990	45,000	Excl	Excluded even though in top-100 employees during 1990 determination year because A was not an employee described in paragraph (a)(1)(ii) or (iii) of this A–3 for the look-back year (1989) or for the determination year (1990).

A-4: Who is a highly compensated former employee?

Q-4: (a) General rule. Except to the extent provided in paragraph (d) of this A-4, a highly compensated former employee for a determination year is any former employee who, with respect to the employer, had a separation year (as defined in A-5 of this § 1.414(q)-1T) prior to the determination year and was a highly compensated active employee as defined in A-3 of this § 1.414(q)-1T for either such employee's separation year or any determination year ending on or after the employee's 55th birthday. Thus, for example, an employee who is a highly compensated active employee for such employee's separation year, by reason of receiving over $75,000 during the look-back year, is a highly compensated former employee for determination years after such employee's separation year.

(b) Special rule for employees who perform no services for the employer in the determination year. For purposes of this rule, employees who perform no services for an employer during a determination year are treated as former employees. Thus, for example, an employee who performed no services for the employer during a determination year, by reason of a leave of absence during such year, is treated as a former employee for such year.

(c) Dollar amounts for pre-1987 determination years. For determination years beginning before January 1, 1987, the dollar amounts in paragraph (a)(1)(B) and (C) of A-2 of this § 1.414(q)-1T are $75,000 and $50,000 respectively.

(d) Special rule for employees who separated from service before January 1, 1987—(1) Election of special rule. Employers may elect to apply paragraph (d)(2) of this A-4 in lieu of paragraph (a) of this A-4 in determining whether former employees who separated from service prior to January 1, 1987, are highly compensated former employees. If this election is made with respect to any qualified plan, it must be provided for in the plan. If the employer makes this election with respect to any employee benefit plan, such election must be used uniformly for all purposes for which the section 414(q) definition is applicable. The election, once made, cannot be changed without the consent of the Commissioner.

(2) Special definition of highly compensated former employee. A highly compensated former employee includes any former employee who separated from service with the employer prior to January 1, 1987, and was described in any one or more of the following groups during either the employee's separation year (or the year preceding such separation year) or any year ending on or after such individual's 55th birthday (or the last year ending before such employee's 55th birthday):

(i) 5-percent owner. The employee was a 5-percent owner of the employer at any time during the year.

(ii) Compensation amount. The employee received compensation in excess of $50,000 during the year.

The determinations provided for in this paragraph (b)(2) may be made on the basis of the calendar year, the plan year, or any other twelve month period selected by the employer and applied on a reasonable and consistent basis.

(e) Rules with respect to former employees—(1) In general. For specific provisions with respect to the treatment of former employees and of highly compensated former employees, refer to the rules with respect to which the section 414(q) definition of highly compensated employee is applicable.

(2) Former employees excluded in determining top-paid group, top-100 employees and includible officers. Former employees are not included in the top-paid group, the group of the top-100 employees, or the group of includible officers for purposes of applying section 414(q) to active employees. In addition, former employees are not counted as employees for purposes of determining the number of employees in the top-paid group.

Q-5: What is a separation year for purposes of section 414(q)?

A-5: (a) Separation year—(1) In general. The separation year generally is the determination year during which the employee separates from service with the employer. For purposes of this rule, an employee who performs no services for the employer during a determination year will be treated as having separated from service with the employer in the year in which such employee last performed services for the employer. Thus, for example, an employee who performs no services for the employer by reason of being on a leave of absence throughout the determination year is considered to have separated from service with the employer in the year in which such employee last performed services prior to beginning the leave of absence.

(2) Deemed separation. An employee who performs services for the employer during a determination year may be deemed to have separated from service with the employer during such year pursuant to the rules in paragraph (a)(3) of this A-5. Such deemed separation year is relevant for purposes of determining whether such employee is a highly compensated former employee after such employee actually separates from service, not for purposes of identifying such employee as either an active or former employee. Because employees to whom the provisions of paragraph (a)(2) of this A-5 apply are still performing services for the employer during the determination year, they are treated as active employees. Thus, for example, an employee who has a deemed separation year in 1989, a year during which he was a highly compensated employee, who continues to work for the employer until he retires from employment in 1995, is an active employee of the employer until 1995 and is either highly compensated or not highly compensated for any determination year during such period based on the rules with respect to highly compensated active employees. For determination years after the year of such employee's retirement, such employee is a highly compensated former employee because such employee was a highly compensated active employee for the deemed separation year.

(3) Deemed separation year. An employee will be deemed to have a separation year if, in a determination year prior to attainment of age 55, the employee receives compensation in an amount less than 50% of the employee's average annual compensation for the three consecutive calendar years preceding such determination year during which the employee received the greatest amount of compensation from the employer (or the total period of the employee's service with the employer, if less).

(4) Leave of absence. The deemed separation rules contained in paragraph (a)(2) and (3) of this A-5 apply without regard to whether the reduction in compensation occurs on account of a leave of absence.

(b) Deemed resumption of employment. An employee who is treated as having a deemed separation year by reason of the provisions of paragraph (a) of this A-5 will not be treated as a highly compensated former employee (by reason of such deemed separation year) after such employee actually separates from service with the employer if, after such deemed separation year, and before the year of actual separation, such employee's services for and compensation from the employer for a determination year increase significantly so that such employee is treated as having a deemed resumption of employment. The determination of whether an employee who has incurred a deemed separation year has an increase in services and compensation sufficient to result in a deemed resumption of employment will be made on the basis of all the surrounding facts and circumstances pertaining to each individual case. At a minimum, there must be an increase in compensation from the employer to the extent that such compensation would not result in a deemed separation year under the tests in paragraph (a)(2) of this A-5

using the same three-year period taken into account in such paragraph.

(c) Examples. Paragraphs (a) and (b) of this A-5 are illustrated by the following examples based on calendar years. For purposes of these examples the threshold dollar amounts in A-5(a) of this § 1.414(q)-1T have not been increased pursuant to A-5(b) of this § 1.414(q)-1T.

Example (1). Assume that in 1990 A is a highly compensated employee of X by reason of having earned more than $75,000 during the 1989 look-back year. In 1987, 1988 and 1989, A's years of greatest compensation received from X, A received $76,000, $80,000 and $79,000 respectively. In February of 1990, A received $30,000 in compensation. Because A's compensation during the 1990 determination year is less than 50% of A's average annual compensation from X during A's high three prior determination years, A is deemed to have a separation year during the 1990 determination year pursuant to the provisions of paragraph (a) of this A-5. Since A is a highly compensated employee for X in 1990, A's deemed separation year, A will be treated as a highly compensated former employee after A actually separates from service with the employer unless A experiences a deemed resumption of employment within the meaning of paragraph (b) of this A-5.

Example (2). Assume that in 1990 A is a highly compensated employee by reason of having been an officer (with annual compensation in excess of the section 415(c)(1)(A) dollar limitation) during the 1989 look-back year. A's compensation from X during 1990 is $37,000. A's average compensation from X for the three-year period ending with or within January, 1990, was $60,000. A's compensation during the 1990 determination year is not less than 50% of the compensation earned during the test period. Therefore, A is not deemed to have a separation year under paragraph (a)(2)(i) of this A-5.

Example (3). Assume that in 1990 C is 35 and a highly compensated employee of Z for the reasons given in Example (1) with the same compensation set forth in that example. During 1990, C leaves C's 40 hour a week position as director of the actuarial division of Z and starts working as an actuary for the same division, producing actuarial reports approximately 15 to 20 hours a week, approximately half of these hours at home. C contemplates returning to full-time employment with Z when C's child enters school. During the 1990 determination year, C's compensation is less than 50% of C's compensation during her high three preceding determination years. Therefore, C has a deemed separation year during the 1990 determination year. In 1991 C commences working 32 hours a week for X at X's place of business and receives compensation in an amount equal to 80 percent of her average annual compensation during her high three prior determination years. The C's increased compensation, considered in conjunction with the reasons for the reduction in service, the nature and extent of the services performed before and after the reduction in services, and the lack of proximity of C's age to age 55 at the time of the reduction are sufficient to establish that C has a deemed resumption of employment within the meaning of paragraph (b) of this A-5. Therefore, when C separates from service with the employer, C will not be treated as a highly compensated former employee by reason of C's deemed separation year in 1990.

Q-6: Who is the employer?

A-6: (a) Aggregation of certain entities. The employer is the entity employing the employees and includes all other entities aggregated with such employing entity under the aggregation requirements of section 414(b), (c), (m) and (*o*). Thus, the following entities must be taken into account as a single employer for purposes of determining the employees who are "highly compensated employees" within the meaning of section 414(q):

(1) All corporations that are members of a controlled group of corporations (as defined in section 414(b)) that includes the employing entity.

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) which group includes the employing entity.

(3) All organizations (whether or not incorporated) that are members of an affiliated service group (as defined in section 414(m)) that includes the employing entity.

(4) Any other entities required to be aggregated with the employing entity pursuant to section 414(*o*) and the regulations thereunder.

(b) Priority of aggregation provisions. The aggregation requirements of paragraph (a) of this A-6 and of A-7(b) of this section with respect to leased employees are applied before the application of any of the other provisions of section 414(q) and this section.

(c) Line of business rules. The section 414(r) rules with respect to separate lines of business are not applicable in determining the group of highly compensated employees.

Q-7: Who is an employee for purposes of section 414(q)?

A-7: (a) General rule. Except as provided in paragraph (b) of this A-7, the term "employee" for purposes of section 414(q) refers to individuals who perform services for the employer and are either common-law employees of the employer or self-employed individuals who are treated as employees pursuant to section 401(c)(1). This rule with respect to the inclusion of certain self-employed individuals in the group of highly compensated employees is applicable whether or not such individuals are eligible to participate in the plan or benefit arrangement being tested.

(b) Leased employees—(1) In general. The term "employee" includes a leased employee who is treated as an employee of the recipient pursuant to the provisions of section 414(n)(2) or 414(*o*)(2). Employees that an employer treats as leased employees under section 414(n), pursuant to the requirements of section 414(*o*), are considered to be leased employees for purposes of this rule.

(2) Safe-harbor exception. For purposes of qualified retirement plans, if an employee who would be a leased employee within the meaning of section 414(n)(2) is covered in a safe-harbor plan described in section 414(n)(5) (a qualified money purchase pension plan maintained by the leasing organization), and not otherwise covered under a qualified retirement plan of the employer, then such employee is excluded from the term "employee" unless the employer elects to include such employee pursuant to the provisions of paragraph (4) of this paragraph (b).

(3) Other employee benefit plans. The exception in paragraph (b)(2) of this A-7 is not applicable to the determination of the highly compensated employee group for purposes of the sections enumerated in section 414(n)(3)(C). Thus, for example, a leased employee covered by a safe-harbor plan is considered to be an employee in applying the nondiscrimination provisions of section 89 to statutory benefit plans. Consequently, an employer with leased employees covered in a safe-harbor plan may have 2 groups of highly compensated employees, one with respect to its retirement plans and another with respect to its statutory benefit plans.

(4) Election with respect to leased employee exclusion. An employer may elect to include the employees excepted under the provisions of paragraph (b)(2) of this A-7 in determining the highly compensated group with respect to an employer's retirement plans. Thus, for example, by electing to forego the exception in paragraph (b)(2) of this A-7, an employer may achieve more uniform highly compensated employee groups for purposes of its retirement plans and welfare benefit plans. The election to include such employees must be made on a reasonable and consistent basis and must be provided for in the plan.

Q-8: Who is a 5-percent owner of the employer?

A-8: An employee is a 5-percent owner of the employer for a particular year if, at any time during such year, such employee is a 5-percent owner as defined in section 416(i)(B)(i) and § 1.416-1 A T-17&18. Thus, if the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner. Thus, for example, an individual who is a 5-percent owner of a subsidiary corporation that is part of a controlled group of corporations within the meaning of section 414(b) is treated as a 5-percent owner for purposes of these rules.

Q-9: How is the "top-paid group" determined?

A-9: (a) General rule. An employee is in the top-paid group of employees for a particular year if such employee is in the group consisting of the top 20 percent of the employer's employees when ranked on the basis of compensation received from the employer during such year. The identification of the particular employees who are in the top-paid group for a year involves a two-step procedure:

(1) The determination of the number of employees that corresponds to 20 percent of the employer's employees, and

(2) The identification of the particular employees who are among the number of employees who receive the most compensation during this year.

Employees who perform no services for the employer during a year are not included in making either of these determinations for such year.

(b) Number of employees in the top-paid group —(1) Exclusions. The number of employees who are in the top-paid group for a year is equal to 20 percent of the total number of active employees of the employer for such year. However, solely for purposes of determining the total number of active employees in for a year, the employees excluded in paragraphs (i), (ii), and (iii) of this paragraph (b)(1) are disregarded.

(i) Age and service exclusion. The following employees are excluded on the basis of age or service absent an election by the employer pursuant to the rules in paragraph (b)(2) of this A-9:

(A) Employees who have not completed 6 months of service by the end of such year. For purposes of this paragraph (A), an employee's service in the immediately preceding year is added to service in the current year in determining whether the exclusion is applicable with respect to a particular employee in the current year. For example, given a plan with a calendar determination year, if employee A commences work August 1, 1989, and terminates employment May 31, 1990, A may be excluded under this paragraph (b)(1)(i)(A) in 1989 because A completed only 5 months of service by December 31, 1989. However, A cannot be excluded pursuant to this rule in

1990 because A has completed 10 months of service, for purposes of this rule, by the end of 1990.

(B) Employees who normally work less than 17½ hours per week as defined in paragraph (d) of this A-9 for such year.

(C) Employees who normally work during less than 6 months during any year as defined in paragraph (e) of this A-9 for such year.

(D) Employees who have not had their 21st birthdays by the end of such year.

(ii) Nonresident alien exclusion. Employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) are excluded.

(iii) Collective bargaining exclusion—(A) In general. Except as provided in paragraph (B) of this paragraph (b)(1)(iii), employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer, which agreement satisfies section 7701(a)(46) and § 301.7701-17T (Temporary), are included in determining the number of employees in the top-paid group.

(B) Percentage exclusion provision. If 90 percent or more of the employees of the employer are covered under collective bargaining agreements that the Secretary of Labor finds to be collective bargaining agreements between employee representatives and the employer, which agreements satisfy section 7701(a)(46) and § 301.7701-17T (Temporary), and the plan being tested covers only employees who are not covered under such agreements, then the employees who are covered under such collective bargaining agreements are not counted in determining the number of noncollective bargaining employees who will be included in the top-paid group for purposes of testing such plan. In addition, such employees are not included in the top-paid group for such purposes. Thus, if the conditions of this paragraph (b)(1)(iii)(B) are satisfied, a separate calculation is required to determine the number and identity of noncollective bargaining employees who will be highly compensated employees by reason of receiving over $50,000 and being in the top-paid group of employees for purposes of testing those plans that cover only noncollective bargaining employees.

(2) Alternative exclusion provisions—(i) Age and service exclusion election. An employer may elect, on a consistent and uniform basis, to modify the permissible exclusions set forth in paragraph (b)(1)(i) (A), (B), (C), and (D) of this A-9 by substituting any shorter period of service or lower age than that specified in such paragraph. These exclusions may be modified to substitute a zero service or age requirement.

(ii) Election not to apply percentage exclusion provision. An employer may elect not to exclude employees under the rules in paragraph (b)(1)(iii)(B) of this A-9.

(iii) Method of election. The elections in this paragraph (b)(2) must be provided for in all plans of the employer and must be uniform and consistent with respect to all situations in which the section 414(g) definition is applicable to the employer. Thus, with respect to all plan years beginning in the same calendar year, the employer must apply the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business rules set forth in section 414(r). If either election is changed during the determination year, no recalculation of the look-back year based on the new election is required, provided the change in election does not result in discrimination in operation.

(c) Identification of top-paid group members. With the exception of the paragraph (b)(1)(iii) of this A-9 exclusion for certain employees covered by collective bargaining agreements, the exclusions in paragraph (b)(1) of this A-9 are not applicable for purposes of identifying the particular employees in the top-paid group. Thus, for example, even if an employee who normally works for less than 17½ hours is excluded in determining the number of employees in the top-paid group such employee may be a member of the top-paid group. Similarly, if during a determination year, employee A receives over $75,000 and is one of the top-100 employees ranked by compensation, then employee A is a highly compensated active employee for such determination year. This is true even though employee A has worked less than six months and thus may be excluded in determining the number of persons in the top-paid group for the determination year.

(d) Example. Paragraphs (b) and (c) of this A-9 are illustrated by the following example:

Example. Employer X has 200 active employees during the 1989 determination year, 100 of whom normally work less than 17½ hours per week during such year and 80 of whom normally work less than 15 hours per week during such year. X elects to exclude all employees who normally work less than 15 hours per week in determining the number of employees in the top-paid group. Thus, X excludes 80 employees in determining the number of employees in the top-paid group. X's top-paid group for the 1989 determination year consists of 20%

of 120 or 24 employees. All 200 of X's employees must then be ranked in order by compensation received during the year, and the 24 employees X paid the greatest amount of compensation during the year are top-paid employees with respect to X for the 1989 determination year.

(e) 17½ hour rule—(1) In general. The determination of whether an employee normally works less than 17½ hours per week is made independently for each year based on the rules in paragraph (e)(2) and (3) of this A-9. In making this determination, weeks during which the employee did not work for the employer are not considered. Thus, for example, if an employee normally works twenty hours a week for twenty-five weeks during the fall and winter school quarters, 10 hours a week for the 12 week spring quarter, and does not work for the employer during the three-month summer quarter, such employee is treated as normally working more than 17½ hours per week under the rule of this paragraph (e).

(2) Deemed above 17½ . An employee who works 17½ hours a week or more, for more than fifty percent of the total weeks worked by such employee during the year, is deemed to normally work more than 17½ hours a week for purposes of this rule.

(3) Deemed below 17½ . An employee who works less than 17½ hours a week for fifty percent or more of the total weeks worked by such employee during the year is deemed to normally work less than 17½ hours a week for purposes of this rule.

(4) Application. The determination provided for in paragraph (e)(1), (2), and (3) of this A-9 may be made separately with respect to each employee, or on the basis of groups of employees who fall within particular job categories as established by the employer on a reasonable basis. For example, under the rule of this paragraph (e)(4) an employer may exclude all office cleaning personnel if, for the year in question, the employees performing this function normally work less than 17½ hours a week. This is true even though one or more employees within this group normally work in excess of 17½ hours. The election to make this determination on the basis of individuals or groups is operational and does not require a plan provision.

(5) Application based on groups. (i) Groups of employees who perform the same job are not required to be considered as one category for purposes of the rule in paragraph (e)(4) of this A-9. Thus, for example, an employer supermarket may determine its highly compensated employees by excluding part-time grocery checkers if such personnel normally work less than 17½ hours a week while continuing to include full-time personnel performing this function. In general, 80 percent of the positions within a particular job category must be filled by employees who normally work less than 17½ hours a week before any employees may be excluded under this rule on the basis of their membership in that job category.

(ii) Alternatively, an employer may exclude employees who are members of a particular job category if the median number of hours of service credited to employees in that category during a determination or look-back year is 500 or less.

(f) 6-month rule—(1) In general. The determination of whether employees normally work during not more than 6 months in any year is made on the basis of the facts and circumstances of the particular employer as evidenced by the employer's customary experience in the years preceding the determination year. An employee who works on one day during a month is deemed to have worked during that month.

(2) Application of prior year experience. In making the determination under this paragraph (f), the experience for years immediately preceding the determination year will generally be weighed more heavily than that of earlier years. However, this emphasis on more recent years is not appropriate if the data for a particular year reflects unusual circumstances. For example, if fishermen working for employer X worked 9 months in 1987 and 1988, 8 months in 1989, and then, because of abnormal ice conditions, worked only 5 months in 1990, such fishermen could not be excluded under this rule in 1990. Furthermore, the data with respect to 1990 would not be weighed more heavily in making a determination with respect to subsequent years.

(3) Individual or group basis. This determination may be made separately with respect to each employee or on the basis of groups of employees who fall within particular job categories in the manner set forth in paragraph (e)(4) of this A-8.

Q-10. For purposes of determining the group of highly compensated employees, which employees are officers and which officers must be included in the highly compensated group?

A-10: (a) In general. Subject to the limitations set forth in paragraph (b) of this A-10 and the top-100 employee rule set forth in A-2, an employee is an includible officer for purposes of this section and is a member of the group of highly compensated employees if such employee is an officer of the employer (within the meaning of section 416(i) and § 1.416-1 A-T 13 & A-T 15) at

any time during the determination year or look-back year and receives compensation during such year that is greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the determination or look-back year begins. In addition, an officer who does not meet the 415(c)(1)(A) dollar limitation requirement may be an includible officer based on the minimum inclusion rules set forth in paragraph (c) of this A-10.

(b) Maximum limitation—(1) In general. Nor more than 50 employees (or, if lesser, the greater of 3 employees or 10 percent of the employees without regard to any exclusions) shall be treated as officers for purposes of this provision in determining the group of highly compensated employees for any determination year or look-back year.

(2) Total number of employees. The total number of employees for purposes of the limitation in this paragraph (b) is the number of employees the employer has during the particular determination year or look-back year. For purposes of this A-10, employees include only those individuals who perform services for the employer during the determination or look-back year. The exclusions applicable for purposes of determining the number of employees in the top-paid group are not applicable for purposes of the limitations in this paragraph (b).

(3) Inclusion ranking. If the number of the employer's officers who satisfy paragraph (a) of this A-10 during either the determination year or the look-back year exceeds the limitation under this paragraph (b), then the officers who will be considered as includible officers for purposes of this rule are those who receive the greatest compensation from the employer during such determination or look-back year. The definition of compensation in A-13 is to be used for this purpose.

(c) Minimum inclusion rule. This paragraph (c) is applicable when no officer of the employer satisfies the compensation requirements of paragraph (a) of this A-10 during either a determination year or look-back year. In such case, the highest paid officer of the employer for such year is treated as a highly compensated employee by reason of being an officer, without regard to the amount of compensation paid to such officer in relation to the section 415(c)(1)(A) dollar amount for the year. This is true whether or not such employee is also a highly compensated employee on any other basis. Thus, for example, if no officer of employer X meets the compensation requirements of paragraph (a) of this A-10 during the 1989 look-back year, and employee A is both the highest paid officer during such year and a 5-percent owner, employee A is treated as an includible officer satisfying the minimum inclusion rules of this paragraph.

(d) Separate application. The maximum and minimum officer inclusion rules of paragraphs (b) and (c) of this A-10 apply separately with respect to the determination year calculation and the look-back year calculation. Thus, for example, if no officer of employer X receives compensation above the threshold amount in paragraph (a) of this A-10 during either the determination year or look-back year, application of the minimum inclusion rule would result in the officer of employer X who received the greatest compensation during the look-back year being treated as a highly compensated employee and, in addition, the officer of employer X who receives the most compensation during the determination year would be included in the highly compensated group if such officer is also in the top-100 employees of employer X for such year. Thus, two officers may be treated as highly compensated active employees for a determination year by reason of the provisions of the minimum inclusion rule.

Q-11: To what extent must family members who are employed by the same employer be aggregated for purposes of section 414(q)?

A-11: (a) Family aggregation—(1) In general. Aggregation is required with respect to an employee who is, during a particular determination year or look-back year, a family member (as defined in A-12) of either (i) a 5-percent owner who is an active or former employee or (ii) a highly compensated employee who is one of the ten most highly compensated employees ranked on the basis of compensation paid by the employer during such year.

(2) Aggregation of contributions or benefits. As prescribed in regulations under the provisions to which section 414(q) is applicable, a family member and a 5-percent owner or top-10 highly compensated employee aggregated under this rule are generally treated as a single employee receiving an amount of compensation and a plan contribution or benefit that is based on the compensation, contributions, and benefits of such family member and 5-percent owner or top-10 highly compensated employee.

(b) Exclusion status irrelevant. Family members are subject to this aggregation rule whether or not they fall within the categories of employees that may be excluded for purposes of determining the number of employees in the top-paid group and

whether or not they are highly compensated employees when considered separately.

(c) Order of determination—(1) Determination of highly compensated employees. The determination of which employees are highly compensated employees and which highly compensated employees are among the ten most highly compensated employees in making the look-back year calculation or the determination year calculation for a determination year will be made prior to the application of the rules in paragraph (a) of this A-11.

(2) Determination of top-paid group and top-100 employees. The determination of the number and identity of employees in the top-paid group under the look-back year calculation or the determination year calculation for a determination year and the identity of individuals in the top-100 employees under the determination year calculation for a determination year is made prior to application of the rules in paragraph (a) of this A-11.

(d) Determination period. The rules under paragraph (a) of this A-11 apply separately to the determination year and the look-back year. Thus, assuming there are no 5-percent owners, if employees A, B, C, D, E, F, G, H, I and J are the top 10 highly compensated employees in the 1988 look-back year, and employees F, G, H, I, J, K, L, M, N and O are the top 10 highly compensated employees in the 1989 determination year, then family aggregation would be required with respect to all fifteen of such employees (i.e. employees A, B, C, D, E, F, G, H, I, J, K, L, M, N, and O).

Q-12: Which individuals are family members for purposes of the aggregation rules in section 414(a)(6)(A) and A-11?

A-12: (a) Definition of family member. Individuals who are family members for purposes of these provisions include, with respect to any employee or former employee, such employee's or former employee's spouse and lineal ascendants or descendants and the spouses of such lineal ascendants and descendants. In determining whether an individual is a family member with respect to an employee or former employee, legal adoptions shall be taken into account.

(b) Test period. If an individual is a family member with respect to an employee or former employee on any day during the year, such individual is treated as a family member for the entire year. Thus, for example, if an individual is a family member with respect to an employee on the first day of a year, such individual continues to be a family member with respect to such employee throughout the year even though their relationship changes as a result of death or divorce.

Q-13: How is "compensation" determined for purposes of determining the group of "highly compensated employees."

A-13: (a) In general. For purposes of section 414(q), the term "compensation" means compensation within the meaning of section 415(c)(3) without regard to sections 125, 402(a)(8), and 402(h)(1)(B) and, in the case of employer contributions made pursuant to a salary reduction agreement, without regard to section 403(b). Thus, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity.

(b) Determination period. For purposes of determining the group of highly compensated employees, compensation must be calculated on the basis of the applicable period for the determination year and look-back year respectively.

(c) Compensation taken into account. Only compensation received by an employee during the determination year or during the look-back year is considered in determining whether such employee is a highly compensated active employee under either the look-back year calculation or determination year calculation for such determination year. Thus, compensation is not annualized for purposes of determining an employee' compensation in the determination year or the look-back year in applying the rules of paragraph (a) of this A-13.

Q-14: What periods must be used for determining who is a highly compensated employee for a determination year?

A-14: (a) Determination year and look-back year—(1) In general. For purposes of determining the group of highly compensated employees for a determination year, the determination year calculation is made on the basis of the applicable year of the plan or other entity for which a determination is being made and the look-back year calculation is made on the basis of the twelve month period immediately preceding such year. Thus, in testing plans X and Y of an employer, if plan X has a calendar year plan year and plan Y has a July 1 to June 30 plan year, the determination year calculation and look-back year calculation for plan X must be made on the basis of the calendar year. Similarly, the determination year calculation and look-back year calculation for plan Y must be made on the basis of the July 1 to June 30 year.

(2) Applicable year. For purposes of this A-14, the applicable year is the plan year of the qualified plan or other employee benefit arrangement to

which the definition of highly compensated employees is applicable as defined in the written plan document or otherwise identified in regulations pursuant to sections to which the definition of highly compensated employees is applicable. To the extent that the definition of highly compensated employees is applicable to entities of other arrangements that do not have an otherwise identified plan year, then either the calendar year of the employer's fiscal year may be treated as the plan year.

(3) Look-back year. The look-back year is never less than a twelve month period.

(b) Calendar year calculation election—(1) In general. An employer may elect to make the look-back year calculation for a determination year on the basis of the calendar year ending with or within the applicable determination year (or, in the case of a determination year that is shorter than twelve months, the calendar year ending with or within the twelve-month period ending with the end of the applicable determination year). In such case, the employer must make the determination year calculation for the determination year on the basis of the period (if any) by which the applicable determination year extends beyond such calendar year (i.e., the lag period). If the applicable year for which the determination is being made is the calendar year, the employer still may elect to make the calendar year calculation election under this A-14(b). In such case, the look-back year calculation is made on the basis of the calendar year determination year and, because there is no lag period, a separate determination year calculation under A-3(a)(2) of this § 1.414(q)-1 is not required.

(2) Lag period calculation. In making the determination year calculation under A-3(a)(2) of this § 1.414(q)-1 on the basis of the lag period, the dollar amounts applicable under A-3(a)(1) (B) and (C) of this § 1.414(q)-1 are to be adjusted by multiplying such dollar amounts by a fraction, the numerator of which is the number of calendar months that are included in the lag period and the denominator of which is twelve.

(3) Determination of active employees. An employee will be considered an active employee for purposes of a determination year for which the calendar year calculation election is in effect so long as such employee performs services for the employer during the applicable year for which the determination is being made. This is the case even if such employee does not perform services for the employer during the lag-period for such determination year.

(4) Election requirement. If the employer elects to make the calendar year calculation election with respect to one plan, entity, or arrangement, such election must apply with respect to all plans, entities, and arrangements of the employer. In addition, such election must be provided for in the plan.

(c) Change in applicable years. Where there is a change in the applicable year for which a determination is being made with respect to a plan entity, or other arrangement that is not subject to the calendar year calculation election, the look-back year calculation for the short applicable year is to be made on the basis of the twelve month period preceding the short applicable year (i.e., generally, the old applicable year) and the determination year calculation for the short applicable year is to be made on the basis of the short applicable year. In addition, the dollar amounts under A-3(a)(1) (B) and (C) are to be adjusted for such determination year calculation as if the short applicable year were a lag period under paragraph (b)(2) of this A-14.

(d) Example. The following examples illustrates the rules of this A-14:

Example 1.

Employer X has a single plan (Plan A) with an April 1 to March 31 plan year. Employer X makes no election to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1989 to March 31, 1990 plan year, the determination year is the plan year ending March 31, 1990 and the look-back year is the plan year ending March 31, 1989.

Example 2.

Assume the same facts given above. With respect to the plan year beginning in 1990, employer X elects to use the calendar year for the determination period. Therefore, in determining the group of highly compensated employees for the April 1, 1990 to March 31, 1991 plan year, the lag-period determination year is the period from January 1, 1991, through March 31, 1991, and the applicable look-back year is the 1990 calendar year.

Example 3.

Employer Y has a single plan (Plan B) with a calendar plan year. With respect to the plan year beginning in 1990, employer Y elects to make the look-back year calculation for the 1990 determination year on the basis of the calendar year ending with or within the 1990 determination year. Because employer Y's determination year is the 1990 calendar year there is no lag period and employer Y determines the group of highly compensated employees for purposes of the 1990 calendar plan year on the basis of such plan year alone.

Q-15: Is there any transition rule in determining the group of highly compensated employees for 1987 and 1988?

A-15: (a) In general. Solely for purposes of section 401(k)(3) and (m)(2) and solely for twelve-month plan years beginning in 1987 and 1988, an

eligible employer may elect to define the group of highly compensated employees as the group consisting of 5-percent owners of the employer at any time during the plan year and employees who receive compensation in excess of $50,000 during the plan year. This rule would apply in lieu of the look-back year calculation and determination year calculation otherwise applicable under A-3(a) of this § 1.44(q)-1. In addition, an eligible employer may elect to make the determinations permitted under this transition rule on the basis of the calendar year ending in the plan year and the period by which such plan year extends beyond such calendar year, in accordance with the rules of A-14(b), in lieu of making the determinations under this transition rule on the basis of the plan year for which the determinations are being made.

(b) Eligible employers. An employer is an eligible employer under this A-15 if such employer satisfies both of the following requirements:

(1) The employer does not maintain any top-heavy plan within the meaning of section 416 at any time during 1987 and 1988; and

(2) Under each plan of the employer to which section 401(k)(3) or 401(m)(2) is applicable, the group of eligible employees that comprises the highest 25% of eligible employees ranked on the basis of compensation includes at least one employee whose compensation is $50,000 or below. This requirement must be met separately with respect to each such plan of the employer.

(c) Uniformity requirement. An eligible employer may not make the election under paragraph (a) of this A-15 unless the election applies to all of the plans maintained by the employer to which section 401(k)(3) or 401(m)(2) applies.

(d) Election requirements. This election is operational and does not require a plan provision.
[T.D. 8173, 53 FR 4967, Feb. 19, 1988]

§ 1.414(s)–1T Compensation (temporary).

The following questions and answers relate to the definition of compensation provided in section 414(s). The definitions and rules provided in these questions and answers are provided solely for purposes of defining "compensation" under this section.

Table of Contents

Q-1: What is the basic definition of compensation for purposes of section 414(s) and when is this definition applicable?

A-1: (a) In general. For purposes of section 414(s), the term "compensation" means compensation received during the applicable period by the employee from the employer, other than compensation in the form of qualified or previously qualified deferred compensation, that (taking into account the provisions of this chapter) is currently includible in gross income for income tax purposes. See A-3 and A-4 of this § 1.414(s)-1 for adjustments and alternatives to this basis definition.

(b) For purposes of this section, the "applicable period" is the period of time specified under the particular rule for which the section 414(s) definition of compensation is applicable. Thus, the regulations applicable to a particular rule that utilizes the section 414(s) definition of compensation will specify the applicable period under section 414(s) for purposes of such rule.

(c) Applicability. The definition in paragraph (a) of this A-1 is generally applicable for purposes of applying the nondiscrimination rules of sections 401 through 419A (including the actual deferral percentage test for a cash or deferred arrangement and the actual contribution percentage test for employee and employer matching contributions contained in section 401(k)(3) and 401(m)(3) respectively). However, the definition of compensation in paragraph (a) of this A-1 does not apply to sections that specifically define compensation in a different manner. Examples of provisions for which the section 414(s) definition of compensation is not applicable include, but are not limited to, the definition of highly compensated employees contained in section 414(q), the limitations on benefits and contributions set forth in section 415, and the deduction provisions of section 404(a) and (b).

Q-2: How is compensation determined for self-employed individuals within the meaning of section 401(c)(1)?

A-2: The basis definition of compensation, for purposes of self-employed individuals, is earned income (as defined in section 401(c)(1)) for the applicable period (as defined in A-1(c) of this § 1.414(s)-1) derived from such individual's trade or business.

Q-3: May an employer elect to treat certain deferrals as compensation?

A-3: Yes. An employer may elect to include in the basic definition of compensation all elective contributions made by the employer on behalf of its employees that are not includible in the gross income of an employee under sections 125, 402(a)(8), 402(h), or 403(b). This election must be made on a consistent and uniform basis with respect to all employees and all plans of the employer for any particular year, must be made on a reasonable and consistent basis from year to year, and must be provided for in the plan. The employer may change this election provided such change does not result in discrimination in favor of highly compensated employees.

Q-4: What, if any, alternative definitions of compensation may be used by an employer?

A-4: (a) Alternative basic definitions. For applicable periods beginning in 1987 and 1988, an employer may elect to use the following alternative definitions of compensation in lieu of the basic definition set forth in A-1 of this section. Any such election must be provided for in the plan and made on a reasonable and consistent basis from year to year. An employer may change an election made under this A-4(a) provided such change does not result in discrimination in favor of highly compensated employees.

(1) W-2 compensation. Compensation received during the applicable period (as defined in A-1(c) of this § 1.414(s)-1) by the employee from the employer that is required to be reported as wages on the employee's Form W-2 for income tax purposes. This election may include or exclude all amounts that are not currently includible in the employee's gross income by reason of the application of sections 125, 402(a)(8), 402(h)(1)(B) or 402(b), provided such total inclusion or exclusion is made on a consistent and uniform basis with respect to all plans of the employer for any particular year, made on a reasonable and consistent basis from year to year, and provided for in the plan. The employer may change this inclusion or exclusion election provided such change does not result in discrimination in favor of highly compensated employees.

(2) Section 415 compensation. Compensation as defined in § 1.415-2(d)(1)&(2) received during the applicable period (as defined in A-1(c) of this § 1.414(s)-1) by the employee from the employer.

(b) Alternative definitions—(1) In general. In lieu of the basic definition of compensation set forth in A-1 of this § 1.414(s)-1 (and in lieu of the alternative basic definitions set forth in (a) of this A-4), an employer may elect to use an alternative definition of compensation. Any such alternative definition is permissible under section 414(s) only if it is described in A-4(b)(2) and satisfies the nondiscrimination rule set forth in A-4(b)(3).

(2) Available alternative definitions of compensation—(i) Regular or base salary or wages. Regular or base salary or wages (excluding overtime and bonuses) received during the applicable period (defined in A-1(c) of this § 1.414(s)-1) by the employee from the employer.

(ii) Regular or base salary or wages plus overtime and/or bonuses. Regular or base salary or wages, plus either or both overtime and/or bonuses, received during the applicable period (defined in A-1(c) of this § 1.414(s)-1) by the employee from the employer.

(iii) Commissioner may make additional definitions available. The Commissioner may, consistent with the provisions of this section, make additional definitions of compensation available under this A-4(b). Any such additional definition is permissible under section 414(s) only if such definition satisfies the nondiscrimination rule set forth in A-4(b)(3).

(3) Nondiscrimination rule. An alternative definition of compensation described in A-4(b)(2) satisfies this rule only if the compensation percentage for the employer's highly compensated employees is not greater than the compensation percentage for the employer's other employees. The compensation percentage for a group of employees is calculated by averaging the separately calculated compensation ratios for each employee in the group. An employee's compensation ratio is calculated by dividing the amount of the employee's compensation that is included in the alternative definition by the amount of such employee's compensation that is included in the basic definition of compensation (set forth in A-1 of this § 1.414(s)-1 or (a) of this A-4) for the applicable period (defined in A-1(c) of this section).

[T.D. 8173, 53 FR 4975, Feb. 19, 1988]

§ 1.415–1 General rules with respect to limitations on benefits and contributions under qualified plans.

(a) **Trusts.** Under sections 415 and 401(a)(16), a trust which forms part of a pension, profit-sharing or stock bonus plan will not be qualified under section 401(a) if any one of the following conditions exists:

(1) The annual benefits under a defined benefit plan with respect to any participant for any limita-

tion year exceed the limitations of section 415(b) and § 1.415–3.

(2) The contributions and other additions credited under a defined contribution plan with respect to any participant for any limitation year exceed the limitations of section 415(c) and § 1.415–6.

(3) Where an individual has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan maintained by the same employer, the trust has been disqualified under section 415(g) and § 1.415–9.

(b) Certain annuities and accounts—(1) In general. Except as provided in paragraph (c) of this section, an annuity, account, etc., listed in section 415(a)(2) will not be considered to be described in the otherwise applicable section unless—

(i) It satisfies the requirements of § 1.415–3 (relating to limitations on benefits), § 1.415–6 (relating to limitations on contributions and other additions) or § 1.415–7 (relating to limitations where an individual has at any time participated in a defined contribution plan and also has at any time participated in a defined benefit plan maintained by the same employer), whichever is applicable, and

(ii) It has not been disqualified under § 1.415–9 (relating to disqualification of plans and trusts).

(2) Special rule for section 403(b) annuity contracts. (i) With respect to an annuity contract described in section 403(b), the provisions of subparagraph (1) of this paragraph apply only to that portion of the contract which exceeds the limitations of § 1.415–3, § 1.415–6 and § 1.415–7, whichever is applicable.

(ii) In addition, where the amount of the contribution under the section 403(b) annuity contract exceeds the applicable limitation, the exclusion allowance described in section 403(b)(2)(A) is reduced in the manner described in § 1.415–6(e)(1)(ii).

(3) Cross references to additional rules for section 403(b) annuity contracts. For additional rules relating to section 403(b) annuity contracts, see—

(i) Section 1.415–1(f)(2) (relating to the plan year for such annuity contracts),

(ii) Section 1.415–2(b)(7) (relating to the limitation year for such annuity contracts),

(iii) Section 1.415–6(e) (relating to the applicability of the alternative limitations described in section 415(c)(4) to such annuity contracts),

(iv) Sections 1.415–7(c)(2) and 1.415–7(h) (relating to rules for such annuity contracts for purposes of computing the defined contribution plan fraction),

(v) Section 1.415–8(d) (relating to rules for such annuity contracts for purposes of combining plans), and

(vi) Section 1.415–9(c) (relating to rules for such annuity contracts for purposes of determining the amount of a disqualified contribution to the annuity contract).

(c) Certain accounts, annuities and bonds established for non-employed spouse. Paragraph (b) of this section is not applicable to an account, annuity or bond as described in section 408(a), 408(b) or 409, respectively established for the benefit of the spouse of the individual who contributes to it for any year for which a deduction is allowable for the individual under section 220. For a special effective date with respect to this paragraph, see paragraph (f)(3) of this section.

(d) Plan provisions—(1) In general. Although no specific plan provision is required under section 415 in order for a plan to establish or maintain its qualification, the plan provisions must preclude the possibility that the limitations imposed by section 415 will be exceeded. For example, a plan may include provisions which automatically freeze or reduce the rate of benefit accrual (in the case of a defined benefit plan) or the annual addition (in the case of a defined contribution plan) to a level necessary to prevent the limitations from being exceeded with respect to any participant. For rules relating to this type of plan provision and the definitely determinable benefit requirement for pension plans, see § 1.401(a)–1(b)(1).

(2) Special rule for profit-sharing and stock bonus plans. The use of a plan provision by a profit-sharing or stock bonus plan which automatically freezes or reduces the amount of annual additions to insure that the limitations of section 415 will not be exceeded must comply with the requirement set forth in § 1.401–1(b)(1)(ii) and (iii) that such plans provide a definite predetermined formula for allocating the contributions made to the plan among the participants. Thus, if the operation of this provision involves discretionary action on the part of the employer, the definite predetermined allocation formula requirement will be violated. For example, if two defined contribu-

tion plans of one employer otherwise provide for aggregate contributions which may exceed the limits of section 415(c), the plan provisions must specify (without involving employer discretion) which plan will reduce contributions and allocations to prevent an excess annual addition and how the reduction will occur.

(e) Rules for plans maintained by more than one employer—(1) Plans described in section 413(b) or section 413(c). This subparagraph provides for participants of a plan described in section 413(c) or section 413(b) (other than a plan described in section 414(f)). For purposes of applying the limitations of section 415 with respect to a participant of an employer maintaining the plan, benefits or contributions attributable to such participant from all of the employers maintaining the plan must be taken into account. Furthermore, in applying the limitations of section 415 with respect to such a participant, the total compensation received by the participant from all of the employers maintaining the plan may be taken into account.

(2) Plans described in section 414(f). (i) This subparagraph provides rules for participants of a multiemployer plan described in section 414(f). For purposes of applying the limitations of section 415 with respect to a participant of an employer maintaining the plan, only the benefits or contributions provided by the employer of such participant shall be taken into account. The benefits provided by an employer under such a plan shall equal the excess of the plan benefit over the plan benefit computed as if the participant had no covered service with that employer.

(ii) As an alternative to applying the limitations of section 415 with respect to a participant of an employer maintaining the multiemployer plan in the manner described in subdivision (i) of this subparagraph, the rules described in subparagraph (1) of this paragraph may be used for purposes of applying the section 415 limitations in connection with that participant.

(iii) For rules relating to the limitation year for a multiemployer plan, see § 1.415–2(b)(6). See also § 1.415–8(e) for a special rule relating to the aggregation of multiemployer plans.

(f) Rules relating to the effective date of section 415—(1) In general. Except as otherwise provided in this paragraph, §§ 1.415–1 through 1.415–10 are applicable for plan years beginning after 1975 and for limitation years ending with or within plan years beginning after 1975. However, for all such plan years and limitation years through the plan year beginning before January 7, 1981, a reasonable interpretation of the rules set forth in section 415 of the Code and in Rev.Rul. 75–481, 1975–2 C.B. 188, may be relied upon.

(2) Plan year for certain annuity contracts and individual retirement plans. For purposes of section 415 and §§ 1.415–1 through 1.415–10—

(i) An annuity contract described in section 403(b) shall be considered to have a plan year coinciding with the taxable year of the individual on whose behalf the contract has been purchased, and

(ii) An individual retirement plan (as described in section 7701(a)(37)) shall be considered to have a plan year coinciding with the taxable year of the individual on whose behalf the plan is maintained,

unless the individual demonstrates to the satisfaction of the Commissioner that a different 12 month period should be considered to be the plan year.

(3) Special effective date for certain accounts, annuities and bonds established for non-employed spouse. Notwithstanding subparagraph (1) of this paragraph, the provisions of section 415(a)(3) and paragraph (c) of this section are not applicable until taxable years beginning after December 31, 1976.

(4) Special rules for certain defined contribution plans with respect to the first limitation year to which section 415 applies. In the case of a defined contribution plan whose plan year does not coincide with the limitation year, the rules of this subparagraph shall be effective with respect to applying the limitations described in section 415(c) and § 1.415–6 for the first limitation year to which section 415 and §§ 1.415–1 through 1.415–10 apply.

(i) Annual additions (as defined in section 415(c)(2) and § 1.415–6(b)) which are allocated under the plan prior to the first day of the first plan year to which section 415 and §§ 1.415–1 through 1.415–10 are effective do not have to be taken into account.

(ii) The amount of compensation (as defined in § 1.415–2(d)) taken into account in applying the limitations may include compensation for the entire limitation year.

(5) Special effective date for special benefit limitation with respect to certain collectively bargained plans. Notwithstanding subparagraph (1) of this paragraph, section 415(b)(7) is not applicable until limitation years beginning after December 31, 1978.

(6) Special effective date for excess contributions to section 403(b) annuity contracts. (i) Notwithstanding subparagraph (1) of this paragraph, the provisions of § 1.415–6(e)(1)(ii) (relating to the manner in which contributions to a section 403(b) annuity contract which exceed the limitations of section 415(c)(1) are treated) are only applicable to taxable years beginning after January 24, 1980.

(ii) For all prior taxable years for which the limitations of section 415 are applicable to section 403(b) annuity contracts, any contribution to the account of an individual under a section 403(b) annuity contract for a taxable year which exceeds the limitations of section 415(c)(1), instead of being treated in the manner described in § 1.415–6(e)(1)(ii), shall reduce the exclusion allowance under section 403(b)(2) for such taxable year to the extent of the excess.

(7) Special effective date for rules relating to change of limitation year. Notwithstanding subparagraph (1) of this paragraph, the provisions of § 1.415–2(b)(4) (relating to the effect of a change of the limitation year) are required to be applied only for changes in limitation years which occur after January 7, 1981. These provisions may also be used for all prior changes in limitation years. However, if the provisions of § 1.415–2(b)(4) are not used for changes in limitation years which occur prior to January 7, 1981, the requirements of § 2.01(4) of Rev.Rul. 75–481, 1975–2 C.B. 188, shall be applicable with respect to such changes.

(8) Special effective date for TRASOP's. The limitations of section 415 apply to an Employee Stock Ownership Plan under section 301(d) of the Tax Reduction Act of 1975 ("TRASOP"). The earliest date on which the first plan year of a TRASOP may begin is January 22, 1974. Therefore, notwithstanding subparagraph (1) of this paragraph, the limitations of section 415 are applicable for TRASOP plan years beginning before 1975 and for limitation years ending with or within plan years beginning before 1975. However, the aggregation rules of § 1.415–8 do not apply to a limitation year of a TRASOP ending with or within a plan year beginning before 1975.

(9) Transitional rules. For special transitional rules, see—

(i) Section 1.415–4 (relating to a transitional rule for defined benefit plans),

(ii) Section 1.415–7(b)(2) (relating to the defined benefit plan fraction applicable to certain participants),

(iii) Section 1.415–7(d) (relating to transitional rules for the defined contribution plan fraction), and

(iv) Section 1.415–7(g) (relating to a special rule for certain plans in effect on September 2, 1974).

(g) Supersession. Section 11.415(c)(4)–1 (relating to special elections for section 403(b) annuity contracts purchased by educational organizations, hospitals and home health service agencies) of the Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974 is superseded by this section and §§ 1.415–2 through 1.415–10.

[T.D. 7748, 46 FR 1697, Jan. 7, 1981]

§ 1.415–2 Definitions and special rules.

(a) General application. Unless otherwise provided in the appropriate section, for purposes of §§ 1.415–1 through 1.415–10, the following definitions and special rules shall apply.

(b) Limitation year—(1) In general. (i) Unless the election described in subdivision (ii) of this subparagraph is made, the limitation year, with respect to any qualified plan maintained by the employer, is the calendar year.

(ii) Instead of using the calendar year, an employer may elect to use any other consecutive twelve month period as the limitation year. This includes a fiscal year with an annual period varying from 52 to 53 weeks, so long as the fiscal year satisfies the requirements of section 414(f). If the case of a group of employers which constitute either a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) which are under common control (within the meaning of section 414(c) as modified by section 45(h)), the election to use a consecutive twelve month period other than the calendar year as the limitation year must be made by all members of the group that maintain a qualified plan.

(2) Method of election to use a limitation year other than the calendar year or to change limitation year. (i) The election described in subparagraph (1)(ii) of this paragraph shall be made by the adoption of a written resolution by the employer. This requirement is satisfied if the election is made in connection with the adoption, by the employer, of the plan or any amendments to such plan.

(ii) This resolution will not be considered a change of the limitation year, if it is adopted or modified on or before the later of the adoption date of the first amendment conforming an existing plan to the Employee Retirement Income Security Act of 1974, or December 31, 1976.

(3) **Election of multiple limitation years.** Any employer that maintains more than one qualified plan may elect to use different limitation years for each such plan in accordance with rules determined by the Commissioner. The rule described in this subparagraph also applies to a controlled group of employers (within the meaning of section 414(b) or (c), as modified by section 415(h)).

(4) **Effect of change of limitation year.** (i) Once established, the limitation year may be changed only by making the election in the manner described in subparagraph (2) of this paragraph.

(ii) Any change in the limitation year must be a change to a twelve-month period commencing with any day within the current limitation year.

(iii) For purposes of this paragraph, the limitations of section 415 are to be applied in the normal manner to the new limitation year. Moreover, the limitations of section 415 are to be separately applied to a "limitation period" which begins with the first day of the current limitation year and which ends on the day before the first day of the first limitation year for which the change is effective. The dollar limitation with respect to this limitation period is determined by multiplying (A) the applicable dollar limitation for the calendar year in which the limitation period ends by (B) a fraction, the numerator of which is the number of months (including any fractional parts of a month) in the limitation period, and the denominator of which is 12. This adjustment of the dollar limitation only applies to a defined contribution plan.

(iv) For a special effective date with respect to this paragraph, see § 1.415–1(f)(7).

(v) The provisions of this subparagraph may be illustrated by the following example:

Example. In 1981, an employer with a qualified defined contribution plan using the calendar year as the limitation year elects to change the limitation year to a period beginning July 1 and ending June 30. Because of this change, the plan must satisfy the limitations of section 415(c) for the limitation period beginning January 1, 1981 and ending June 30 of that year. In applying the limitations of section 415(c) to this limitation period, the amount of compensation taken into account may only include compensation for this period. Furthermore, the dollar limitation for this period is the otherwise applicable dollar limitation for calendar year 1981, multiplied by $6/12$.

(5) **Limitation year for years prior to effective date.** The limitation year for all years prior to the effective date of section 415 is the consecutive twelve-month period which corresponds to the first limitation year of a plan after the effective date of section 415. (See paragraph (b)(1) of this section for rules relating to the determination of a plan's limitation year.)

(6) **Limitation year for multiemployer plans.** In the case of a multiemployer plan (as defined in section 414(f)), the limitation year is the calendar year unless the plan administrator elects otherwise under paragraph (b)(2) of this section.

(7) **Limitation year for individuals on whose behalf section 403(b) annuity contracts have been purchased.** (i) The limitation year of an individual on whose behalf a section 403(b) annuity contract has been purchased by an employer is determined in the following manner.

(ii) If the individual is not in control (within the meaning of section 414(b) or (c) as modified by section 415(h)) of any employer, the limitation year is the calendar year. However, the individual may elect to change the limitation year to another twelve-month period. To do this, the individual must attach a statement to his income tax return filed for the taxable year in which the change is made. Any change in the limitation year must comply with the rules set forth in paragraph (b)(4) of this section.

(iii) If the individual is in control (within the meaning of section 414(b) or (c) as modified by section 415(h)) of an employer, the limitation year is to be the limitation year of that employer.

(8) **Limitation year for individuals on whose behalf individual retirement plans are maintained.** The limitation year of an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) is maintained shall be determined in the manner described in paragraph (b)(7) of this section.

(c) **Defined benefit and defined contribution plan—(1) Defined benefit plan.** A "defined benefit plan" means a plan described in section 414(j).

(2) **Defined contribution plan.** A "defined contribution plan" means a plan described in section 414(i). It includes a money purchase pension plan (as described in § 1.401–1(b)(1)(i)), such as a target benefit plan (as described in § 1.410(a)–4(a)(1)). A hybrid plan (as defined in section 414(k)) is to be treated as a defined contribution plan to the extent that benefits payable

under the plan are based upon the individual account of the participant.

(d) Compensation—(1) Items includable as compensation. For purposes of applying the limitations of section 415, the term "compensation" includes—

(i) The participant's wages, salaries, fees for professional service and other amounts received for personal services actually rendered in the course of employment with an employer maintaining the plan (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips and bonuses).

(ii) In the case of a participant who is an employee within the meaning of section 401(c)(1) and the regulations thereunder, the participant's earned income (as described in section 401(c)(2) and the regulations thereunder).

(iii) For purposes of subdivisions (i) and (ii) of this subparagraph, earned income from sources outside the United States (as defined in section 911(b)), whether or not excludable from gross income under section 911 or deductible under section 913.

(iv) Amounts described in sections 104(a)(3), 105(a) and 105(h), but only to the extent that these amounts are includable in the gross income of the employee.

(v) Amounts described in section 105(d), whether or not these amounts are excludable from the gross income of the employee under that section.

(vi) Amounts paid or reimbursed by the employer for moving expenses incurred by an employee, but only to the extent that these amounts are not deductible by the employee under section 217.

(vii) The value of a non-qualified stock option granted to an employee by the employer, but only to the extent that the value of the option is includable in the gross income of the employee for the taxable year in which granted.

(viii) The amount includable in the gross income of an employee upon making the election described in section 83(b).

(2) Items not includable as compensation. The term "compensation" does not include items such as—

(i) Contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the section 415 limitations to that plan, the contributions are not includable in the gross income of the employee for the taxable year in which contributed. In addition, employer contributions made on behalf of an employee to a simplified employee pension described in section 408(k) are not considered as compensation for the taxable year in which contributed to the extent such contributions are deductible by the employee under section 219(b)(7). Additionally, any distributions from a plan of deferred compensation are not considered as compensation for section 415 purposes, regardless of whether such amounts are includable in the gross income of the employee when distributed. However, any amounts received by an employee pursuant to an unfunded non-qualified plan may be considered as compensation for section 415 purposes in the year such amounts are includable in the gross income of the employee.

(ii) Amounts realized from the exercise of a non-qualified stock option, or when restricted stock (or property) held by an employee either becomes freely transferable or is no longer subject to a substantial risk of forfeiture (see section 83 and the regulations thereunder).

(iii) Amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option.

(iv) Other amounts which receive special tax benefits, such as premiums for group term life insurance (but only to the extent that the premiums are not includable in the gross income of the employee), or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in section 403(b) (whether or not the contributions are excludable from the gross income of the employee).

(3) Compensation in limitation year. The compensation (as defined in subparagraph (1) of this paragraph) actually paid or made available to a participant within the limitation year is the compensation used for purposes of applying the limitations of section 415.

(4) Election to use compensation accrued during limitation year. Instead of using the compensation actually paid or made available to a participant during the limitation year, an employer may elect to use the compensation accrued for an entire limitation year for purposes of applying the limitations of section 415. In the case of a group of employers which constitute either a controlled group of corporations (within the meaning of sec-

tion 414(b) as modified by section 415(h)) or trades or businesses (whether or not incorporated) which are under common control (within the meaning of section 414(c) as modified by section 415(h)), the election to use accrued compensation must be made by all members of the group that maintain a qualified plan. Once an election is made, it remains in effect until it is revoked by the employer or group of employers. The election is made or revoked by the adoption of a written resolution by the employer or group of employers. The written resolution requirement described in the preceding sentence is satisfied if the election is made in connection with the adoption, by the employer, or employers, of the plan or any amendments to such plan. The rule described in this subparagraph does not apply to a section 403(b) annuity contract or to an individual retirement plan (as described in section 7701(a)(37)).

(5) Effect of change in method of determining compensation. If, in a particular limitation year, a previously effective election to use accrued compensation is revoked or an election to use accrued compensation is made, any amounts taken into account for compensation purposes for any preceding limitation year may not be counted again in determining compensation for the particular limitation year.

(6) Special rule for employees of controlled group of corporations or trades or businesses under common control. In the case of an employee of two or more corporations which are members of a controlled group of corporations (as defined in section 414(b) as modified by section 415(h)), the term "compensation" for such employee includes compensation from all employers which are members of the group, regardless of whether the employee's particular employer has a qualified plan. This special rule is also applicable to an employee of two or more trades or businesses (whether or not incorporated) which are under common control (as defined in section 414(c) as modified by section 415(h)).

(7) Special rule when section 403(b) annuity is aggregated with qualified plan of controlled employer. If a section 403(b) annuity contract is combined or aggregated with a qualified plan of a controlled employer in accordance with either § 1.415–7(h)(2)(i) or § 1.415–8(d)(2), the following rules apply:

(i) In applying separately the limitations of section 415(b) or (c) to the qualified plan and the limitations of section 415(c) and the exclusion allowance of section 403(b)(2)(A) to the section 403(b) annuity, compensation from the controlled employer may not be aggregated with compensation from the employer purchasing the section 403(b) annuity.

(ii) However, in applying the limitations of section 415(c) in connection with the combining of the section 403(b) annuity with a qualified defined contribution plan or section 415(e) in connection with the aggregating of the section 403(b) annuity with a qualified defined benefit plan, the total compensation from both employers may be taken into account.

(8) Safe harbor rule with respect to plan's definition of compensation. If a plan defines compensation for purposes of applying the limitations of section 415 to include only those items specified in subparagraph (1)(i) of this paragraph and to exclude all those items listed in subparagraph (2) of this paragraph, if applicable, the plan will automatically be considered to be using a definition of compensation which satisfies section 415(c)(3) and these regulations.

[T.D. 7748, 46 FR 1698, Jan. 7, 1981]

§ 1.415–3 Limitations for defined benefit plans.

(a) General rules—(1) Maximum limitations. Under section 415(b) and this section, to satisfy the provisions of section 415(a) for any limitation year, the annual benefit (as defined in paragraph (b)(1)(i) of this section) to which a participant is entitled at any time under a defined benefit plan may not, during the limitation year, exceed the lesser of—

(i) $75,000, or

(ii) 100 percent of the participant's average compensation for his high 3 years of service.

As required in § 1.415–1(d), in order to satisfy the limitations on benefits of this section, the plan provisions must preclude the possibility that any annual benefit exceeding these limitations will be payable at any time. Thus, a plan may fail to satisfy the limitations of this section even though no participant has actually accrued a benefit in excess of these limitations.

(2) Adjustment to dollar limitation. The dollar limitation described in section 415(b)(1)(A) and paragraph (a)(1)(i) of this section is adjusted for cost of living increases under section 415(d) and § 1.415–5(a). The adjusted figure is effective as of January 1 of each calendar year and is applicable to limitation years that end during that calendar year.

(3) Average compensation for high 3 years of service. For purposes of applying the limitation on benefits described in this section, a participant's high 3 years of service is the period of 3 consecutive calendar years (or, the actual number of consecutive years of employment for those employees who are employed for less than 3 consecutive years with the employer) during which the employee had the greatest aggregate compensation (as defined in § 1.415–2(d)) from the employer. For purposes of this subparagraph, in determining a participant's high 3 years, the plan may use any 12 month period instead of the calendar year provided that it is uniformly and consistently applied.

(b) Definitions of terms—(1) Annual benefit. (i) The term "annual benefit" means a benefit which is payable annually in the form of a straight life annuity under a plan. Such benefit does not include any benefits attributable to either employee contributions or rollover contributions (as defined in sections 402(a)(5), 403(a)(4), 408(d)(3) and 409(b)(3)(C)). Additionally, in applying the limitations on benefits described in paragraph (a)(1) of this section to the annual benefit of a participant, it is immaterial if the participant works beyond the normal retirement age as determined under the terms of the plan. Thus, for example, if an individual, who is subject to the dollar limitation of section 415(b)(1)(A) ($110,625 for 1980), retires in 1980 after working past the plan's normal retirement age of 65, the plan may only provide such individual with an annual benefit of $110,625 in 1980 and not the actuarial equivalent of the amount the individual would have been entitled to receive at age 65 in order to comply with the section 415(b) limitations.

(ii) If the plan provides for a benefit which is not payable in the form of a straight life annuity, the benefit is adjusted in accordance with paragraph (c) of this section for purposes of applying the limitations on benefits described in paragraph (a)(1) of this section.

(iii) If rollover contributions are made to the plan, the annual benefit attributable to these contributions is determined on the basis of reasonable actuarial assumptions. See paragraph (d) of this section for rules relating to employee contributions.

(iv) For purposes of this paragraph, when there is a transfer of assets or liabilities from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415. The annual benefit payable on account of the transfer for any individual that is attributable to the assets transferred will be equal to the annual benefit transferred on behalf of such individual multiple by a fraction, the numerator of which is the total assets transferred and the denominator of which is the total liabilities transferred.

(2) Retirement benefit. For purposes of this section, the term "retirement benefit" means a benefit provided under the terms of a defined benefit plan which is subject to the limitations of section 415(b) and this section.

(c) Adjustment where form of benefit is other than straight life annuity—(1) In general. (i) Where a defined benefit plan provides a retirement benefit in any form other than a straight life annuity, the plan benefit is adjusted to a straight life annuity beginning at the same age which is the actuarial equivalent of such benefit in accordance with rules determined by the Commissioner. This adjustment is for purposes of applying the limitations on benefits described in paragraph (a)(1) of this section to the annual benefit of the participant.

(ii) Examples of benefits that are not in the form of a straight life annuity are an annuity which includes a post-retirement death benefit and an annuity providing for a guaranteed number of payments.

(2) Certain benefits to which no adjustment is required. For purposes of the adjustment described in subparagraph (1) of this paragraph, the following values are not taken into account:

(i) The value of a qualified joint and survivor annuity (as defined in section 401(a)(11)(G)(iii) and the regulations thereunder) provided by the plan to the extent that such value exceeds the sum of (A) the value of a straight life annuity beginning on the same date and (B) the value of any post-retirement death benefits which would be payable even if the annuity was not in the form of a joint and survivor annuity.

(ii) The value of benefits that are not directly related to retirement benefits (such as pre-retirement disability and death benefits and post-retirement medical benefits).

(iii) The value of benefits provided by the plan which reflect post-retirement cost of living increases to the extent that such increases are in accordance with section 415(d) and § 1.415–5.

(3) Examples. The provisions of subparagraph (2)(i) of this paragraph may be illustrated by the following examples:

Example (1). (i) Corporation ABC maintains a defined benefit plan that provides a benefit in the form of a joint and 100% survivor annuity with a 10 year certain feature. The value of this benefit is equal to 126% of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable in the form of a joint and 100% survivor annuity, without a 10 year certain feature, its value would be equal to only 123% of the value of the same amount payable as a straight life annuity beginning on the same date. If the benefit were payable with a 10 year certain feature, but without the joint and 100% survivor aspect, its value would equal 110% of the value of the same amount payable as a straight life annuity beginning on the same date. Thus, the value of the post-retirement death benefits which would be payable even if the annuity were not in the form of a joint and survivor annuity is 10%.

(ii) Under subparagraph (2)(i) of this paragraph, the values which may be excluded for purposes of the adjustment required by subparagraph (1) of this paragraph are as follows: The value of the joint and survivor annuity provided by the plan (126%) to the extent that such value exceeds the sum of, the value of the straight life annuity beginning on the same date (100%) and the value of the post-retirement death benefits (10%). Therefore, the value of the joint and survivor annuity provided by the plan exceeds the value of the straight life annuity with the 10 year certain feature by 16% (126%–110%).

(iii) Although 16% of the excess benefit attributable to the annuity provided by this plan may, consequently, be ignored (because this represents the value added to the 10 year certain and life annuity benefit by the joint survivor feature), 10% of such excess benefit (the value added to the straight life annuity benefit by the 10 year certain feature) must be taken into account for purposes of adjusting the benefit under the plan to an actuarially equivalent straight life annuity. Thus, for example, if ABC Corporation were to provide a benefit equal to 95% of a participant's compensation for the high three years of service, the limitation of section 415(b)(1)(B) would be exceeded because the benefit under the plan would be the actuarial equivalent of a straight life annuity equal to 105% of a participant's compensation for the high three years.

Example (2). Corporation XYZ maintains a nondiscriminatory defined benefit plan that provides a benefit which is equal to 100% of a participant's compensation for his high 3 years of service. For married participants, the benefit is payable in the form of a joint and 100% survivor annuity. While for participants who are not married, the benefit is payable in the form of a straight life annuity. The plan also provides that married participants can elect to receive their benefits in the form of a lump sum distribution which is the actuarial equivalent of a joint and 100% survivor annuity. The special rule set forth in subparagraph (2)(i) of this paragraph only applies, however, if the benefit is payable in the form of a qualified joint and survivor annuity. Any other forms of optional benefits must be adjusted to a straight life annuity in accordance with subparagraph (1) of this paragraph. Accordingly, because the benefit payable under the plan in the form of a lump sum distribution is the actuarial equivalent of a straight life annuity which is greater than 100% of a participant's compensation for his high 3 years, the limitation of section 415(b)(1)(B) has been exceeded.

(d) Employee contributions—(1) Mandatory contributions. Where a defined benefit plan provides for mandatory employee contributions (as defined in section 411(c)(2)(C)), the annual benefit attributable to such contributions is not taken into account for purposes of applying the limitations on benefits described in paragraph (a) of this section. The annual benefit attributable to mandatory contributions is determined by using the factors described in section 411(c)(2)(B) and the regulations thereunder, regardless of whether section 411 applies to that plan.

However, the mandatory employee contributions are considered a separate defined contribution plan maintained by the employer that is subject to the limitations on contributions and other additions described in § 1.415–6. (See § 1.415–7 for provisions relating to the limitations applicable where an employer maintains a defined benefit and defined contribution plan for the same employee.)

(2) Voluntary contributions. Where a defined benefit plan provides for voluntary employee contributions, these contributions are considered a separate defined contribution plan maintained by the employer which is subject to the limitations on contributions and other additions described in § 1.415–6. (See § 1.415–7 for provisions relating to the limitations applicable where an employer maintains a defined benefit and defined contribution plan for the same employee.)

(3) Example: The provisions of this paragraph may be illustrated by the following example:

Example. A is a participant in a defined benefit plan maintained by his employer. Under the terms of the plan A must make contributions to the plan in a stated amount to accrue benefits derived from employer contributions. These contributions are mandatory employee contributions within the meaning of section 411(c)(2)(C) and, thus, the annual benefit attributable to these contributions does not have to be taken into account for purposes of testing the annual benefit derived from employer contributions against the applicable limitation on benefits. However, these contributions are considered a separate defined contribution plan maintained by A's employer. Accordingly, with respect to the current limitation year: (1) the limitation on benefits (as described in paragraph (a)(1) of this section) is applicable to the annual benefit attributable to employer contributions to the defined benefit plan; (2) the limitation on contributions and other additions (as described in § 1.415–6) is applicable to the defined contribution plan consisting of A's mandatory contributions; and (3) the provisions of § 1.415–7 (relating to the limitations where the employer maintains a defined benefit and defined contribution plan for the same employee) are applicable to the defined benefit and defined contribution plan in which A participates. These same limitations would also apply. If, instead of providing for mandatory employee contributions the plan permitted voluntary employee contributions, since both voluntary and mandatory employee contributions are treated as separate defined contribution plans maintained by the employer.

(e) Adjustment where benefit begins before age 55. Where a defined benefit plan provides a

retirement benefit beginning before age 55, the plan benefit is adjusted to the actuarial equivalent of a benefit beginning at age 55 in accordance with rules determined by the Commissioner. This adjustment is only for purposes of applying the dollar limitation described in section 415(b)(1)(A) to the annual benefit of the participant.

(f) Total annual benefits not in excess of $10,000—(1) In general. The annual benefit (without regard to the age at which benefits commence) payable with respect to a participant under any defined benefit plan is not considered to exceed the limitations on benefits described in section 415(b)(1) and in paragraph (a)(1) of this section if—

(i) The retirement benefits derived from employer contributions payable with respect to the participant under the plan and all other defined benefit plans of the employer do not in the aggregate exceed $10,000 for the limitation year, or for any prior limitation year, and

(ii) The employer has not at any time, either before or after the effective date of section 415, maintained a defined contribution plan in which the participant participated.

(2) Special rule with respect to participants in multiemployer plans. The special $10,000 exception set forth in subparagraph (1) of this paragraph is applicable to a participant in a multiemployer plan described in section 414(f) without regard to whether that participant ever participated in one or more other plans maintained by an employer who also maintains the multiemployer plan, provided that none of such other plans were maintained as a result of collective bargaining involving the same employee representative as the multiemployer plan.

(3) Special rule with respect to employee contributions. For purposes of subparagraph (1)(ii) of this paragraph, if a defined benefit plan provides for employee contributions, whether voluntary or mandatory, these contributions will not be considered a separate defined contribution plan maintained by the employer. Thus, a contributory defined benefit plan may utilize the special dollar limitation provided for in this paragraph.

(4) Computation of $10,000 amount. For purposes of subparagraph (1)(i) of this paragraph, the value of the retirement benefit payable under the plan is not adjusted upward for early retirement provisions and benefits which are not in the form of a straight life annuity (whether or not directly related to retirement benefits).

(5) Examples. The application of this paragraph may be illustrated by the following examples:

Example (1). B is a participant in a defined benefit plan maintained by this employer, X Corporation, which provides for a benefit payable in the form of a straight life annuity beginning at age 65. B's compensation for his high 3 years of service is $6,000. The plan does not provide for employee contributions and at no time has B been a participant in a defined contribution plan maintained by X. With respect to the current limitation year, B's retirement benefit under the plan is $9,500. Because B's retirement benefit does not exceed $10,000 and because B has at no time participated in a defined contribution plan maintained by X, the benefits payable under the plan are not considered to exceed the limitation on benefits otherwise applicable to B ($6,000). This result would remain the same, even if, under the terms of the plan, B's normal retirement age were age 50 or if the plan provided for employee contributions.

Example (2). Assume the same facts as in example (1), except that the plan provides for a benefit payable in the form of a life annuity with a 10 year certain feature. Assume that after the adjustment described in paragraph (c) of this section, B's annual benefit under the plan for the current limitation year is $10,500. However, for purposes of applying the special rule provided in this paragraph for total benefits not in excess of $10,000, there is no adjustment required if the retirement benefit payable under the plan is not in the form of a straight life annuity. Therefore, because B's retirement benefit does not exceed $10,000, B may receive the full $9,500 benefit without the otherwise applicable benefit limitations of this section being exceeded.

(g) Special rule for service of less than 10 years—(1) In general. Where a participant has less than 10 years of service with the employer at the time the participant begins to receive retirement benefits under the plan, the benefit limitations described in section 415(b)(1) and (4) and paragraphs (a)(1) and (f)(1) of this section are to be reduced by multiplying the otherwise applicable limitation by a fraction—

(i) The numerator of which is the number of years of service with the employer as of, and including, the current limitation year, and

(ii) The denominator of which is 10. For purposes of this subparagraph, the term "year of service" is to be determined on a reasonable and consistent basis.

(2) Examples. The provision of this paragraph may be illustrated by the following examples:

Example (1). C begins employment with Acme Corporation on January 1, 1977, at the age of 58. Acme maintains only a noncontributory defined benefit plan which provides for a straight life annuity beginning at age 65 and uses the calendar year for the limitation and plan year. Acme has never maintained a defined contribution plan. C becomes a participant in Acme's plan on January 1, 1978 and works through December 31, 1983, when he is age 65. C begins to receive benefits under the plan in 1984. C's average compensation for his high 3 years of service is $20,000. Furthermore, under the terms of

Acme's plan, for purposes of computing C's nonforfeitable percentage in his accrued benefit derived from employer contributions, C has only 7 years of service with Acme (1977–1983). Therefore, because C has less than 10 years of service with Acme at the time he begins to receive benefits under the plan, the maximum permissible annual benefit payable with respect to C is only \$14,000 (\$20,000 × 7/10).

Example (2). Assume the same facts as in example (1), except that C's average compensation for his high 3 years is \$8,000. Because C has less than 10 years of service with Acme at the time he begins to receive benefits, the maximum benefit payable with respect to C would be reduced to \$5,600 (\$8,000 × 7/10). However, the special rule for total benefits not in excess of \$10,000, provided in paragraph (f) of this section, is applicable in this case. Accordingly, C may receive an annual benefit of \$7,000 (\$10,000 × 7/10) without the benefit limitations of this section being exceeded.

Example (3). ABC corporation maintains a defined benefit plan. Instead of adjusting the benefit limitations in accordance with the method described in subparagraph (1) of this paragraph, the plan provides that the plan administrator may make the necessary adjustment by multiplying the otherwise applicable limitation by a fraction—(1) the numerator of which is the number of completed months of service with the employer, and (2) the denominator of which is 120. The plan further provides that a completed month of service with the employer is any calendar month in which the employee is credited with at least 83 hours of service. Provided that an hour of service is determined in a manner that is reasonable and consistent, the plan may use this alternative rule for making the adjustment required when a participant has less than 10 years of service with the employer at the time he begins to receive benefits under the plan.

(h) Benefits under certain collectively bargained plans. For a special rule affecting the compensation limitation described in section 415(b)(1)(B) and paragraph (a)(1)(ii) of this section, see section 415(b)(7). For a special effective date with respect to this rule, see § 1.415–1(f)(5).

[T.D. 7748, 46 FR 1700, Jan. 7, 1981]

§ 1.415–4 Transitional rule for defined benefit plans.

(a) In general. If all of the conditions described in paragraph (b) of this section are satisfied, the annual benefit payable to an individual who was a participant in a defined benefit plan at any time before October 3, 1973, will not be considered to exceed the limitations of section 415(b) and § 1.415–3(a). In the case of an individual who was a participant in more than one defined benefit plan at any time before October 3, 1973, the annual benefit payable to that individual from each plan will be deemed not to exceed the limitations of section 415(b) and § 1.415–3(a) if the benefit from each plan satisfies all of the conditions described in paragraph (b) of this section.

(b) Conditions for application of transitional rule. The conditions are—

(1) The annual benefit payable to the participant does not exceed 100 percent of that participant's annual rate of compensation (as defined in paragraph (c) of this section) on October 2, 1973, or, if earlier, as of the date the participant separated from the service of the employer.

(2) The annual benefit payable to the participant does not exceed the annual benefit which would have been payable to the participant at any time if—

(i) All the terms and conditions of the plan which were actually in effect on October 2, 1973 (or if earlier, on the date the participant separated from the service of the employer) had remained in effect, and

(ii) The participant's compensation taken into account for determining benefits under the plan for any period after October 2, 1973, did not exceed his annual rate of compensation (as defined in paragraph (c) of this section) on that date.

(3) The annual benefit payable to a participant who separated from the service of the employer before October 2, 1973, does not exceed the participant's nonforfeitable accrued benefit under the plan as of the date he separated from service.

(c) Special rules—(1) Annual rate of compensation. For purposes of this section, a participant's annual rate of compensation for a particular calendar year shall be the greater of—

(i) The participant's compensation for that calendar year as determined in accordance with the rules provided in § 1.415–2(d), or

(ii) The compensation which would be used to determine benefits under the plan if the employee separated from the service of the employer on October 2, 1973, or, if earlier, the employee's actual date of separation from the service of the employer.

(2) Cost-of-living adjustments. (i) If the plan, as in existence on October 2, 1973, provided for a post-retirement cost of living adjustment to benefits, the adjustment may be taken into account in determining the participant's allowable benefit under paragraph (b) of this section. However, under paragraph (b)(2) of this section, if a plan is amended after October 2, 1973 to provide for cost-of-living benefit increases for retired participants, the transitional rule of this section will not apply to any increased benefit attributable to the amendment.

(ii) Any cost-of-living increase in the dollar limitation described in section 415(b)(1)(A) under section 415(d) and § 1.415–5(a) may be taken advantage of by an individual who is otherwise using the transitional rule set forth in this section. Thus, for example, if, due to cost-of-living increases under section 415(d) and § 1.415–5(a), the dollar limitation for 1981 is greater than $110,625, to the extent allowed under section 415(b), a plan may provide that an individual who is otherwise receiving a benefit of $110,625 per year under the transitional rule of this section, may receive the greater amount in 1981.

(3) Retirement benefit beginning before age 55. If a defined benefit plan provides a retirement benefit beginning before age 55, no actuarial adjustment of the benefit which can be provided under the transitional rule of this section is required to be made.

(4) Retirement benefit payable in a form other than a straight life annuity. If a defined benefit plan, as in existence on October 2, 1973, provided a retirement benefit in a form other than a straight life annuity, no actuarial adjustment (as otherwise required under § 1.415–3(c)) of the benefit which can be provided under the transitional rule of this section is required to be made. However, if the plan is amended after October 2, 1973, to provide a benefit of greater value than the benefit provided under the plan as of October 2, 1973, the transitional rule of this section will not apply to the increase in the value of the benefit attributable to the amendment. (See paragraph (b)(2)(i) of this section.)

(d) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). N, a participant in a noncontributory defined benefit plan maintained by his employer, retired on February 17, 1969, and became eligible to receive benefits under the plan. At that time, N had attained age 65, the normal retirement age under the plan. N's annual rate of compensation on February 17, 1969, was $90,000. Under the terms of the plan, as in effect on February 17, 1969, N was entitled to an annual benefit of $86,000, which was N's accrued nonforfeitable benefit as of that date. Because the annual benefit payable with respect to N (i) does not exceed 100 percent of N's compensation on February 17, 1969, (ii) does not exceed the annual benefit to which N was entitled on retirement, and (iii) did not exceed N's nonforfeitable accrued benefit on retirement, the plan may provide an annual benefit of $86,000 with respect to N for limitation years to which section 415 applies without violating the limitations imposed by section 415(b) and § 1.415–3.

Example (2). Assume the same facts as in example (1) except that on February 17, 1969, when N retired and became eligible to receive benefits under the plan, N had not attained the age of 55. Because the adjustment required under section 415(b)(2)(C) for retirement benefits beginning before age 55 is only applicable to the dollar limitation described in section 415(b)(1)(A), under paragraph (c)(3) of this section, no actuarial adjustment of the annual benefit of $86,000 payable with respect to N is required to be made. Therefore, the plan may pay annual benefits of $86,000 to N, even though N retires and is eligible to receive benefits before age 55.

[T.D. 7748, 46 FR 1703, Jan. 7, 1981]

§ 1.415–5 Cost of living adjustments for defined benefit plans.

(a) Dollar limitation—(1) In general. Under section 415(d)(1)(A), the dollar limitation described in section 415(b)(1)(A) applicable to defined benefit plans for limitation years to which section 415 applies is adjusted annually to take into account increases in the cost of living. The adjustment of the dollar limitation is made by multiplying an annual adjustment factor by $75,000. For purposes of this paragraph, the annual adjustment factor is to be determined by the Commissioner.

(2) Effective date of adjustment. The adjusted dollar limitation applicable to defined benefit plans is effective as of January 1 of each calendar year and applies with respect to limitation years ending with or within that calendar year.

(3) Application of adjusted figure. The adjusted dollar limitation is applicable to employees who are participants in a defined benefit plan and to employees who have retired or otherwise terminated their service under the plan with a nonforfeitable right to accrued benefits, regardless of whether they have actually begun to receive such benefits. However, for purposes of this subparagraph, the annual benefit payable to a terminated participant, which is otherwise limited by the dollar limitation, may only be increased in accordance with cost-of-living adjustments of the dollar limitation if the plan specifically provides for such post-retirement adjustments.

(b) Average compensation for high 3 years of service limitation—(1) In general. Under section 415(d)(1)(C), with regard to participants who have separated from service with a nonforfeitable right to an accrued benefit, the compensation limitation described in section 415(b)(1)(B) applicable to limitation years to which section 415 applies may be adjusted annually to take into account increases in the cost of living. For any limitation year beginning after the separation occurs, the adjustment of the compensation limitation is made by multiplying the annual adjustment factor (as defined in paragraph (b)(2) of this section) by the compensation limitation applicable to the participant in the limitation year he separated from the

service of the employer. In the case of a participant who has separated from service prior to the first limitation year to which section 415 applies, the cost-of-living adjustment of the compensation limitation under this paragraph for all limitation years prior to the effective date of section 415 is to be determined as provided by the Commissioner. For purposes of the adjustment described in this subparagraph, the annual benefit payable to a terminated participant, which is otherwise limited by the compensation limitation, may only be increased in accordance with cost-of-living adjustments of the compensation limitation if the plan specifically provides for such post-retirement adjustments.

(2) Annual adjustment factor for compensation limitation. For any limitation year beginning after the separation occurs, the annual adjustment factor is a fraction, the numerator of which is the adjusted dollar limitation for the limitation year in which the compensation limitation is being adjusted and the denominator of which is the adjusted dollar limitation for the limitation year in which the participant separated from service. In determining the adjusted dollar limitation for purposes of computing the annual adjustment factor under this subparagraph, the rule provided in paragraph (a)(2) of this section (relating to the effective date of the adjusted dollar limitation) shall be applicable.

(3) Example. The provisions of this paragraph may be illustrated by the following example:

Example. X is a participant in a qualified defined benefit plan maintained by his employer. The plan has a calendar year limitation year. Under the terms of the plan, X is entitled to a benefit consisting of a straight life annuity equal to 100 percent of X's compensation for his high 3 years of service. X's average compensation for his high 3 years is $20,000. X separates from the service of his employer on October 3, 1980, with a nonforfeitable right to his accrued benefit, and begins to receive benefit payments on November 1, 1980. Assume that the adjusted dollar limitation for 1980 is $100,000 and that the adjusted dollar limitation for 1981 is $110,000. For the limitation year beginning January 1, 1981 (the first limitation year beginning after X separates from service), the compensation limitation applicable to X may be adjusted for cost of living increases by multiplying the annual adjustment factor by $20,000. The annual adjustment factor for this limitation year is a fraction, the numerator of which is $110,000 (the adjusted dollar limitation for the limitation year in which the compensation limitation is being adjusted) and the denominator of which is $100,000 (the adjusted dollar limitation for the limitation year in which X separates from service). Thus, for the limitation year beginning January 1, 1981, if the plan provides for post-retirement cost of living adjustments, X's maximum annual benefit could be increased to $22,000 ($110,000/$100,000 × $20,000).

(c) Automatic cost of living adjustments of dollar limitation—(1) General rule. A defined benefit plan may include a provision which provides for an annual automatic cost-of-living adjustment of the dollar limitation described in section 415(b)(1)(A) in accordance with paragraph (a) of this section. However, the provision may only provide for scheduled annual increases in the dollar limitation which become effective no sooner than the date determined in accordance with paragraph (a)(2) of this section.

(2) Example. The provisions of this paragraph may be illustrated by the following example:

Example. Plan A is a defined benefit plan. Effective January 1, 1976, the plan was amended to limit all participants' annual plan benefits, determined on a straight life annuity basis, to $75,000. The amendment also provides that, "as of January 1, of each calendar year, the dollar limitation as determined by the Commissioner of Internal Revenue for that calendar year will become effective as the Maximum Permissible Dollar Amount of the plan for that calendar year. The Maximum Permissible Dollar Amount for a calendar year applies to limitation years ending with or within that calendar year." The amendment providing for an automatic cost-of-living adjustment of the dollar limitation of Plan A is an example of a provision which satisfies the requirements of subparagraph (1) of this paragraph.

[T.D. 7748, 46 FR 1704, Jan. 7, 1981]

§ 1.415–6 Limitation for defined contribution plans.

(a) General rules—(1) Maximum limitations. Under section 415(c) and this section, to satisfy the provisions of section 415(a) for any limitation year, the annual additions (as defined in paragraph (b) of this section credited to the account of a participant in a defined contribution plan (as defined in section 414(i)), for the limitation year may not exceed the lesser of—

(i) $25,000, or

(ii) 25 percent of the participant's compensation (as defined in subparagraph (3) of this paragraph) for the limitation year.

(2) Adjustment to dollar limitation. The dollar limitation described in section 415(c)(1)(A) and subparagraph (1)(i) of this paragraph is adjusted for cost of living increases under section 415(d) and paragraph (d) of this section. The adjusted figure is effective as of January 1 of each calendar year and applies to limitation years that end during that calendar year.

(3) Participant's compensation. For purposes of this section, the term "participant's compensation" for any limitation year has the same meaning as set forth in § 1.415–2(d). The term "participant's compensation" includes all compensation actually paid or made available to the individual for the entire limitation year even though the

individual may not have been a participant for the entire limitation year.

(4) **Section 403(b) annuity contracts.** For special rules with respect to section 403(b) annuity contracts purchased by educational organizations, hospitals and home health service agencies, see paragraph (e) of this section.

(b) **Annual additions—(1) In general.** For purposes of this section, the term "annual additions" means the sum, credited to a participant's account for any limitation year, of—

(i) Employer contributions,

(ii) The lesser of the amount of employee contributions in excess of 6% of his compensation (as defined in paragraph (a)(3) of this section) for the limitation year, or one half of the employee contributions for that year, and

(iii) Forfeitures.

(2) **Employer contributions.** (i) For purposes of paragraph (b)(1)(i) of this section, the term "annual additions" includes employer contributions which are made under the plan. Furthermore, the Commissioner may in an appropriate case, considering all of the facts and circumstances treat transactions between the plan and the employer or certain allocations to participants' accounts as giving rise to annual additions.

(ii) If, in a particular limitation year, an employer contributes an amount to a participant's account because of an erroneous forfeiture in a prior limitation year, or because of an erroneous failure to allocate amounts in a prior limitation year, the contribution will not be considered an annual addition with respect to the participant for that particular limitation year, but will be considered an annual addition for the limitation year to which it relates. An example of a situation in which an employer contribution might occur under the circumstances described in the preceding sentence is a retroactive crediting of service for an employee under 29 CFR 2530.200(b)–2(a)(3) (regulations promulgated by the Department of Labor) in accordance with an award of back pay. For purposes of this subdivision, if the amount so contributed in the particular limitation year takes into account actual investment gains attributable to the period subsequent to the year to which the contribution relates, the portion of the total contribution which consists of such gains is not considered as an annual addition for any limitation year. The rule described in this subdivision is only applicable for purposes of applying the limitations of section 415.

(iii) The restoration of an employee's accrued benefits by the employer in accordance with section 411(a)(3)(D) or section 411(a)(7)(C) will not be considered an annual addition for the limitation year in which the restoration occurs. (See § 1.411(a)–7(d)(6)(iii)(B).)

(iv) The transfer of funds from one qualified plan to another will not be considered an annual addition for the limitation year in which the transfer occurs.

(v) In the case of a defined contribution plan (such as a money purchase pension plan) to which an employer makes a contribution in order to reduce an accumulated funding deficiency (as defined in section 412(a)), the contribution will be considered an annual addition for the limitation year when the contribution was otherwise required to have been made. The special rule provided in the preceding sentence is available however, only if the contribution is allocated to those participants who would have received an addition if the contribution had been timely made. For purposes of determining the amount of the annual addition under this subdivision, any reasonable amount of interest paid by the employer is disregarded. However, any interest paid by the employer that is in excess of a reasonable amount, as determined by the Commissioner, is taken into account as an annual addition for the limitation year when the contribution was otherwise required to have been made.

(vi) In the case of a defined contribution plan (such as a money purchase pension plan) for which there has been a waiver of the minimum funding standard in a prior limitation year in accordance with section 412(d), that portion of an employer contribution in a subsequent limitation year which, if not for the waiver, would have otherwise been required in the prior limitation year under section 412(a) will be considered an annual addition for the prior limitation year. For purposes of determining the amount of such annual addition for the prior limitation year, any reasonable amount of interest paid by the employer in addition to the actual make-up contribution is disregarded. However, any interest paid by the employer that is in excess of a reasonable amount, as determined by the Commissioner, is taken into account as an annual addition for the prior limitation year.

(3) **Employee contributions.** For purposes of paragraph (b)(1)(ii) of this section, the term "annual additions" includes, to the extent employee

contributions would otherwise be taken into account under this section as an annual addition, mandatory employee contributions (as defined in section 411(c)(2)(C) and the regulations thereunder) as well as voluntary employee contributions. The term "annual additions" does not include—

(i) Rollover contributions (as defined in section 402(a)(5), 403(a)(4), 408(d)(3) and 409(b)(3)(C)).

(ii) Repayments of loans made to a participant from the plan.

(iii) Repayments of amounts described in section 411(a)(7)(B) (in accordance with section 411(a)(7)(C)) and section 411(a)(3)(D) (see § 1.411(a)–7(d)(6)(iii)(B)).

The direct transfer of employee contributions from one qualified plan to another.

However, the Commissioner may in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employee or certain allocations to participants' accounts as giving rise to annual additions.

(4) Contributions other than cash. For purposes of this paragraph, a contribution by the employer or employee of property other than cash will be considered to be a contribution in an amount equal to the fair market value (as defined in § 20.2031–1 of the Estate Tax Regulations) of the property on the date the contribution is made. The contribution described in this subparagraph may, however, constitute a prohibited transaction within the meaning of section 4975(c)(1).

(5) Forfeitures. With respect to a particular limitation year, forfeitures (as well as any income attributable to the forfeiture) will be considered to be an annual addition to the plan if such forfeitures are allocated to the account of the participant as of any day within that limitation year.

(6) Excess annual additions. If as a result of the allocation of forfeitures, a reasonable error in estimating a participant's annual compensation, or under other limited facts and circumstances which the Commissioner finds justify the availability of rules set forth in this subparagraph, the annual additions under the terms of a plan for a particular participant would cause the limitations of section 415 applicable to that participant for the limitation year to be exceeded, the excess amounts shall not be deemed annual additions in that limitation year if they are treated in accordance with any one of the following subdivisions:

(i) The excess amounts in the participant's account must be allocated and reallocated to other participants in the plan. However, if the allocation or reallocation of the excess amounts pursuant to the provisions of the plan causes the limitations of section 415 to be exceeded with respect to each plan participant for the limitation year, then these amounts must be held unallocated in a suspense account. If a suspense account is in existence at any time during a particular limitation year, other than the limitation year described in the preceding sentence, all amounts in the suspense account must be allocated and reallocated to participants' accounts (subject to the limitations of section 415) before any employer contributions and employee contributions which would constitute annual additions may be made to the plan for that limitation year.

(ii) The excess amounts in the participant's account must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for that participant if that participant is covered by the plan of the employer as of the end of the limitation year. However, if that participant is not covered by the plan of the employer as of the end of the limitation year, then the excess amounts must be held unallocated in a suspense account for the limitation year and allocated and reallocated in the next limitation year to all of the remaining participants in the plan in accordance with the rules set forth in paragraph (b)(6)(i) of this section. Furthermore, the excess amounts must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for all of the remaining participants in the plan. For purposes of this subdivision, excess amounts may not be distributed to participants or former participants.

(iii) The excess amounts in the participant's account must be held unallocated in a suspense account for the limitation year and allocated and reallocated in the next limitation year to all of the participants in the plan in accordance with the rules provided in paragraph (b)(6)(i) of this section. The excess amounts must be used to reduce employer contributions for the next limitation year (and succeeding limitation years, as necessary) for all of the participants in the plan. For purposes of this subdivision, excess amounts may not be distributed to participants or former participants.

(iv) Notwithstanding subdivisions (i), (ii) or (iii) of this subparagraph, the plan may provide for the return of employee contributions (whether voluntary or mandatory), to the extent that the return would reduce the excess amounts in the participant's account. However, the return of mandato-

ry employee contributions may result in discrimination in favor of employees who are officers, shareholders or highly compensated. If the plan does not provide for the return of gains attributable to the returned employee contributions, such earnings will be considered as an employee contribution for the limitation year in which the returned contribution was made. If a suspense account is in existence at any time during the limitation year in accordance with this subparagraph, investment gains and losses and other income may, but need not, be allocated to the suspense account. To the extent that investment gains or other income or investment losses are allocated to the suspense account, the entire amount allocated to participants from the suspense account, including any such gains or other income or less any losses, is considered as the annual addition. See § 1.401(a)–2(b) for provisions relating to the disposition of a suspense account in existence upon termination of a plan.

(7) **Time when annual additions credited.** (i) For purposes of this paragraph, an annual addition is credited to the account of a participant for a particular limitation year if it is allocated to the participant's account under the terms of the plan as of any date within that limitation year. However, an amount is not deemed allocated as of any date within a limitation year if such allocation is dependent upon participation in the plan as of any date subsequent to such date.

(ii) For purposes of this subparagraph, employer contributions shall not be deemed credited to a participant's account for a particular limitation year, unless the contributions are actually made to the plan no later than 30 days after the end of the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends. If, however, contributions are made by an employer exempt from Federal income tax under section 501(a), the contributions must be made to the plan no later than the 15th day of the sixth calendar month following the close of the taxable year (or fiscal year, if no taxable year) with or within which the particular limitation year ends.

(iii) For purposes of this subparagraph, employee contributions, whether voluntary or mandatory, shall not be deemed credited to a participant's account for a particular limitation year, unless the contributions are actually made to the plan no later than 30 days after the close of that limitation year. However, in the case of employee contributions to an employee stock ownership plan which meets the requirements of either section 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38, § 1.46–7) and the regulations thereunder (§ 1.46–8) or section 409A and the regulations thereunder, such contributions shall be deemed credited to a participant's account in the limitation year for which the contribution is allocated to that account under the terms of the plan, provided that the contributions, or pledges to make the contributions, are actually made no later than the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends.

(iv) For purposes of this paragraph, amounts contributed to an individual retirement plan (as described in section 7701(a)(37)) are treated as allocated to the individual's account as of the last day of the limitation year ending with or within the taxable year for which the contribution is made.

(c) **Examples.** The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). P is a participant in a qualified profit-sharing plan maintained by his employer, ABC Corporation. The limitation year for the plan is the calendar year. P's compensation (as defined in paragraph (a)(3) of this section) for the current limitation year is $20,000 consisting exclusively of salary. Because the compensation limitation described in section 415(c)(1)(B) applicable to P for the current limitation year is lower than the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost of living increases), the maximum annual addition which can be allocated to P's account for the current limitation year is $5,000 (25 percent of $20,000).

Example (2). Assume the same facts as in Example (1), except that P's compensation for the current limitation year is $140,000. The maximum amount of annual additions that may be allocated to P's account in the current limitation year may not exceed the lesser of $35,000 (25 percent of $140,000) or the dollar limitation as in effect as of January 1 of the calendar year in which the current limitation year ends.

Example (3). Assume the same facts as in Example (1), except that P's compensation for the current limitation year consists of $20,000 salary and a bonus which is paid to P after the end of the current limitation year. Because the bonus was not actually paid or made available to P within the current limitation year, P's compensation for that year, for purposes of computing the compensation limitation described in section 415(c)(1)(B), may not include the bonus. However, if ABC Corporation had elected under § 1.415–2(d)(4) to use the compensation accrued for the current limitation year, then the amount of the bonus which accrued within the current limitation year could have been taken into account.

Example (4). Employer N maintains a qualified profit-sharing plan which uses the calendar year as its plan year and its limitation year. N's taxable year is a fiscal year beginning June 1 and ending May 31. Under the terms of the profit-sharing plan maintained by N, employer contributions are made to the plan two months after the close of N's taxable year and are allocated as of the last day of the plan year ending within the taxable year. Thus, employer contributions for the 1977 calen-

dar year limitation year are made on July 31, 1978 (the date that is two months after the close of N's taxable year ending May 31, 1978) and are allocated as of December 31, 1977. Because the employer contributions are actually made to the plan no later than 30 days after the end of the period described in section 404(a)(6) with respect to N's taxable year ending May 31, 1978, the contributions will be considered annual additions for the 1977 calendar year limitation year.

Example (5). Assume the same facts as in example (4), except that the plan year for the profit-sharing plan maintained by N is the 12-month period beginning on March 1 and ending on February 28. Under the terms of the plan, an employer contribution which is made to the plan on July 31, 1978, is allocated to participants' accounts as of February 28, 1978. Because the last day of the plan year is in the 1978 calendar year limitation year, and because, under the terms of the plan, employer contributions are allocated to participants' accounts as of the last day of the plan year, the contributions are considered annual additions for the 1978 calendar year limitation year.

Example (6). XYZ Corporation maintains a profit-sharing plan to which a participant may make voluntary employee contributions for any year not to exceed 10 percent of the participant's compensation for the year. The plan permits a participant to make retroactive make-up contributions for any year for which he contributed less than 10 percent of compensation. XYZ uses the calendar year as the plan year and the limitation year. Under the terms of the plan, voluntary employee contributions are credited to a participant's account for a particular limitation year if such contributions are allocated to the participant's account as of any date within that limitation year. Participant A's compensation is as follows:

Limitation year and compensation

1976	$10,000
1977	$12,000
1978	$14,000
1979	$16,000

Participant A makes no voluntary employee contributions during limitation years 1976, 1977 and 1978. On October 1, 1979, participant A makes a voluntary employee contribution of $5,200 (10 percent of A's aggregate compensation for limitation years 1976, 1977, 1978 and 1979 of $52,000). Under the terms of the plan, $1,000 of this 1979 contribution is allocated to A's account as of limitation year 1976; $1,200 is allocated to A's account of limitation year 1977; $1,400 is allocated to A's account as of limitation year 1978, and $1,600 is allocated to A's account as of limitation year 1979. However, under the rule set forth in paragraph (b)(7)(iii) of this section, employee contributions will not be considered credited to a participant's account for a particular limitation year for section 415 purposes unless the contributions are actually made to the plan no later than 30 days after the close of that limitation year. Thus, A's voluntary employee contribution of $5,200 made on October 1, 1979 would be considered as credited to A's account only for the 1979 calendar year limitation year, notwithstanding the plan provisions. (See section 415(c)(2)(B) and paragraph (b)(1)(ii) of this section for provisions relating to the amount of A's contribution that would be considered an annual addition to A's account for the 1979 calendar year limitation year.)

(d) Cost-of-living adjustment for defined contribution plans—(1) In general. Under section 415(d)(1)(B), the dollar limitation described in section 415(c)(1)(A) applicable to limitation years to which section 415 applies is adjusted annually to take into account increases in the cost of living. See § 1.415–5(a) for the procedure for making this adjustment and the effective date of the adjusted dollar limitation.

(2) Automatic adjustments with respect to dollar limitation. A defined contribution plan may include a provision which provides for an annual automatic cost of living adjustment of the dollar limitation described in section 415(c)(1)(A).

(e) Special election for section 403(b) contracts purchased by educational organizations, hospitals and home health service agencies—(1) In general. (i) An annuity contract described in section 403(b) is treated as a defined contribution plan for purposes of the limitations on contributions imposed by section 415. Thus, section 403(b) annuity contracts are subject to the rules regarding the amount of annual additions which may be made to a participant's account for any limitation year under section 415(C)(1) and paragraph (a)(1) of this section. Section 403(b) annuity contracts are also subject to the limitations imposed by section 403(b)(2)(A) with respect to the amount of employer contributions for the purchase of an annuity contract that may be excluded from the gross income of the employee on whose behalf the annuity contract is purchased. Therefore, unless a special election has been made as described in section 415(c)(4) and subparagraph (2) of this paragraph, the excludable amount of a contribution toward the purchase of a section 403(b) annuity contract for a particular taxable year is the lesser of the exclusion allowance computed under section 403(b)(2)(A) for that taxable year or the limitation imposed by section 415(c)(1) for the limitation year ending with or within that taxable year.

(ii) If the amount of contributions for an individual under a section 403(b) annuity contract for a taxable year exceeds the limitation of section 415(c)(1), then for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years, the excess contribution is considered as an amount contributed by the employer for an annuity contract which was excludable from the employee's gross income for a prior taxable year under section 403(b)(2)(A)(ii). Thus, for future taxable years the exclusion allowance under section 403(b)(2)(A) is reduced by the amount of the excess contribution even though that amount was not excludable from the employee's gross income in the taxable year when it was made. For a special effective date for the rule provided in this subdivision, see § 1.415–1(f)(6).

(iii) For purposes of the limitation imposed by section 415(c)(1), the amount contributed toward the purchase of a section 403(b) annuity contract is treated as allocated to the employee's account as of the last day of the limitation year ending with or within the taxable year during which the contribution is made.

(iv) For rules relating to the limitation year applicable to an individual on whose behalf a section 403(v) annuity contract has been purchased, see § 1.415–2(b)(7).

(2) *Alternative limitations.* (i) Under section 415(c)(4) and this paragraph, a special election is permitted with respect to section 403(b) annuity contracts (including custodial accounts treated as section 403(b) annuity contracts) purchased by educational organizations (as described in section 170(b)(1)(A)(ii)), home health service agencies (as described in paragraph (e)(2)(vi) of this section) and hospitals. Instead of the compensation limitation described in section 415(c)(1)(B) otherwise applicable to the amount of annual additions that may be made to the account of a participant in a defined contribution plan in any limitation year, an individual on whose behalf a section 403(b) annuity contract has been purchased may elect to have substituted for such limitation the amounts described in subparagraph (3) ("(A) election limitation") or (4) ("(B) election limitation") of this paragraph. Instead of the exclusion allowance determined under section 403(b)(2)(A) otherwise applicable for the taxable year with or within which the limitation year ends to an individual on whose behalf a section 403(b) annuity contract has been purchased, an individual may elect to have substituted for such exclusion allowance the amount described in paragraph (e)(5) ("(C) election limitation") of this section. The election shall be made at the time and in the manner prescribed in subparagraph (6) of this paragraph.

(ii) With respect to any limitation or taxable year, an election by an individual to have any one of the alternative limitations described in paragraph (e)(3), (4) or (5) of this section apply to contributions made on his behalf by the employer with respect to any section 403(b) annuity contract precludes an election to have any other of the alternative limitations apply for any future limitation or taxable year with respect to any section 403(b) annuity contract purchased by any employer of such individual.

(iii) With respect to any limitation year, an election by an individual to have paragraph (e)(3) of this section ("(A) election limitation") apply to contributions made on his behalf by the employer with respect to any section 403(b) annuity contract precludes an election to have any of the alternative limitations apply for any future limitation or taxable year with respect to any section 403(b) annuity contract purchased by any employer of such individual.

(iv) Any election made under this paragraph is irrevocable.

(v) The election made by the individual under this paragraph shall be controlling for all prior taxable years in which, in accordance with § 11.415(c)(4)–1(b), the individual had taken advantage of an alternative limitation, even if inconsistent with the alternative limitation used in determining income tax liability for those taxable years under that section. An individual, who took advantage of an alternative limitation under § 11.415(c)(4)–1(b) which is inconsistent with the one finally elected, may correct this inconsistency for each prior open taxable year in either of two ways. The individual may redetermine income tax liability as though none of the alternative limitations applied for that taxable year. Alternatively, the individual may recompute income tax liability for the particular taxable year in a manner consistent with the alternative limitation elected by the individual under this paragraph rather than the limitation originally used in accordance with § 11.415(c)(4)–1(b). Furthermore, if an individual, who had taken advantage of an alternative limitation in prior taxable years under § 11.415(c)(4)–1(b), elects under this paragraph not to have any of the alternative limitations apply, the individual, will, nevertheless, be considered to have elected the alternative limitation used under § 11.415(c)(4)–1(b). However, the rule described in the preceding sentence is not applicable if the individual recomputes income tax liability for all prior open taxable years in which an alternate limitation was taken advantage of under § 11.415(c)(4)–1(b) as though none of the alternative limitations applied for those taxable years. For purposes of section 6654 (relating to the failure of an individual to pay estimated tax), a difference in tax for such years resulting from a difference in these limitations is not treated as an underpayment. This rule only applies to the extent the difference in tax is due to the election of one of the alternative limitations or to a final election not to use one of the alternative limitations.

(vi) For purposes of this paragraph, a home health service agency is an organization described in section 501(c)(3) which is exempt from tax

under section 501(a) and which has been determined by the Secretary of Health, Education and Welfare to be a home health service agency under section 1395x(*o*) of Title 42 of the United States Code.

(3) "(A) election limitation." For the limitation year that ends with or within the taxable year in which an individual eligible to make a special election separates from the service of his employer (and only for that limitation year), the "(A) election limitation" is the exclusion allowance computed under section 403(b)(2)(A) for the individual's taxable year in which the separation occurs (without regard to section 415). However, in determining this limitation, there may only be taken into account the individual's years of service for the employer (as defined in section 403(b)(4) and the regulations thereunder) and contributions made by the employer (as described in section 403(b)(2)(A)(ii) and regulations thereunder) during the period of years (not exceeding 10) ending on the date of separation. For purposes of this subparagraph, all service for the employer performed within the period beginning ten years before the date of separation and ending on the separation date must be taken into account. However, the "(A) election limitation" may not exceed the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section) applicable to the individual for the limitation year.

(4) "(B) election limitation." For any limitation year with respect to an individual eligible to make a special election, the "(B) election limitation" is equal to the least of the following amounts—

(i) $4,000, plus 25 percent of the participant's includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for the taxable year with or within which the limitation year ends.

(ii) The amount of the exclusion allowance determined under section 403(b)(2)(A) and the regulations thereunder for the taxable year with or within which the limitation year ends.

(iii) $15,000.

(5) "(C) election limitation." For any taxable year with respect to an individual eligible to make a special election, the "(C) election limitation" is the lesser of the dollar limitation described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section) or the compensation limitation described in section 415(c)(1)(B) applicable to the individual for the limitation year ending with or within that taxable year. For purposes of determining the compensation limitation under this subparagraph for a particular limitation year, the term "compensation" has the same meaning as set forth in § 1.415–2(d).

(6) Time and method of making election. (i) With respect to any taxable year, an election by an individual to take advantage of any of the alternative limitations described in subparagraphs (3), (4) or (5) of this paragraph is made by determining income tax liability for that taxable year in a way which is consistent with one of the alternative limitations. However, an individual is only considered to have made an election for a taxable year when the use of one of the alternative limitations is necessary to support the exclusion from gross income reflected in the individual's income tax return for that taxable year.

(ii) In the case of an individual who, in accordance with § 11.415(c)(4)–1(b), took advantage of one of the alternative limitations for prior taxable years, the election described in this paragraph to take advantage of an alternative limitation will be effective only if the following two conditions are satisfied. The first condition is that the election must be made (in the manner described in subdivision (i) of this subparagraph) in the individual's income tax return for the taxable year immediately following the taxable year in which final regulations under section 415 are published in the Federal Register. The second condition is that if the individual's election is different from the limitation used under § 11.415(c)(4)–1(b) in determining income tax liability for prior taxable years, the individual must correct this inconsistency by recomputing income tax liability for all such prior open taxable years in accordance with paragraph (e)(2)(v) of this section. See paragraph (e)(2)(v) of this section for rules relating to an individual who had taken advantage of an alternative limitation in prior taxable years under § 11.415(c)(4)–1(b) but does not elect any of the alternative limitations for the taxable year immediately following the taxable year in which final regulations under section 415 are published in the Federal Register.

(iii) This subdivision provides a special rule for those individuals who, in accordance with § 11.415(c)(4)–1(b), took advantage of one of the alternative limitations for prior taxable years, but who are not participating in a section 403(b) annuity program in the taxable year following the taxable year in which final regulations under sec-

tion 415 are published in the Federal Register. In such a situation, the election described in this paragraph to take advantage of an alternative limitation (or, alternatively, not to elect any of the alternative limitations) is made by the individual by attaching a statement to the income tax return for the taxable year following the taxable year in which final section 415 regulations are published in the Federal Register. The statement must include the individual's name, address, Social Security number, the name of the section 403(b) annuity program in which the individual participated and a statement indicating the election being made. See paragraph (e)(2)(v) of this section for rules relating to the situation where the individual described in this subdivision chooses not to elect any of the alternative limitations.

(7) **Examples:** The provisions of this paragraph may be illustrated by the following examples:

Example (1). Doctor M is an employee of H Hospital (an organization described in section 501(c)(3) and exempt from taxation under section 501(a)) for the entire 1976 calendar year. M is not in control of any employer within the meaning of section 414(b) or (c), as modified by section 415(b). M uses the calendar year as the taxable year and limitation year. M has includable compensation (as defined in section 403(b)(3) and the regulations thereunder) and compensation (as defined in paragraph (a)(3) of this section) for taxable year 1976 of $30,000, and M has 4 years of service (as defined in § 1.403(b)–1(f)) with H as of December 31, 1976. During M's prior service with H, H had contributed a total of $12,000 on M's behalf for annuity contracts described in section 403(b), which amount was excludable from M's gross income for such prior years. Thus, for the limitation year ending with or within taxable year 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $12,000 ((.20 × $30,000 4)—$12,000). The limitation imposed by section 415(c)(1) that is applicable to M for limitation year 1976 is the lesser of $26,825 (the amount described in section 415(c)(1)(A) adjusted under section 415(d)(1)(b) for limitation year 1976) or $7,500 (the amount described in section 415(c)(1)(B)). Absent the special elections provided in section 415(c)(4) and this paragraph $7,500 would be the maximum contribution H could make for annuity contracts described in section 403(b) on M's behalf for limitation year 1976 without increasing M's gross income for taxable year 1976. However, because H is an organization described in section 415(c)(4), M may make a special election with respect to amounts contributed by H on M's behalf for section 403(b) annuity contracts for 1976. Assume that M does not separate from the service of H during 1976 and that, therefore, the "(A) election limitation" described in section 415(c)(4)(A) and subparagraph (3) of this paragraph is not available to M. If M elects the "(B) election limitation" for 1976, H could contribute $11,500 on M's behalf for annuity contracts described in section 403(b) for that year (the least of $11,500 (the amount described in section 415(c)(4)(B)(i))); $12,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii)). If M elects the "(C) election limitation" for 1976, H could only contribute up to $7,500 (the lower of the amounts described in section 415(c)(1)(A) or (B)) for section 403(b) annuity contracts on M's behalf for 1976 without increasing M's gross income for that year.

Example (2). Assume the same facts as in example (1) except that H had contributed a total of $18,000 on M's behalf for annuity contracts in prior years, which amount was excludable from M's gross income for such prior years. Accordingly, for 1976, M's exclusion allowance determined under section 403(b)(2)(A) is $6,000 ((.20 × $30,000 × 4)—$18,000). The limitation imposed by section 415(c)(1) applicable to M for 1976, is $7,500 (the lesser of the amount described in section 415(c)(1)(A) or (B)). Absent the special elections provided in section 415(c)(4) and this paragraph, $6,000 would be the maximum amount H could contribute for annuity contracts described in section 403(b) on M's behalf for 1976 without increasing M's gross income for that year. However, if M elects the "(C) election limitations" for 1976, H may contribute up to $7,500 without increasing M's gross income for that year.

Example (3). G, a teacher, is an employee of E, an educational organization described in section 170(b)(1)(A)(ii). G uses the calendar year as the taxable year and G uses the 12-month consecutive period beginning July 1 as the limitation year. G has includible compensation (as defined in section 403(b)(3) and the regulations thereunder) for taxable year 1976 of $12,000 and G has compensation (as defined in paragraph (a)(3) of this section) for the limitation year ending with or within taxable year 1976 of $12,000. G has 20 years of service (as defined in § 1.403(b)–1(f)) as of May 30, 1976, the date G separates from the service of E. During G's service with E before taxable year 1976, E had contributed $34,000 toward the purchase of a section 403(b) annuity contract on G's behalf, which amount was excludable from G's gross income for such prior years. Of this amount, $19,000 was so contributed and excluded during the 10 year period ending on May 30, 1976. For the taxable year 1976, G's exclusion allowance determined under section 403(b)(2)(A) is $14,000 ((.20 × $12,000 × 20)—$34,000). Absent the special elections described in section 415(c)(4) and this paragraph, $3,000 (the lesser of G's exclusion allowance for taxable year 1976 or the section 415(c)(1) limitation applicable to G for the limitation year ending with or within such taxable year) would be the maximum excludable contribution E could make for section 403(b) annuity contracts on G's behalf for the limitation year ending with or within taxable year 1976. However, because E is an organization described in section 415(c)(4), G may make a special election with respect to amounts contributed on G's behalf by E for section 403(b) annuity contracts for the limitation year ending with or within taxable year 1976.

Because G has separated from the service of E during such taxable year, G may elect the "(A) election limitation" as well as the "(B) election limitation" or the "(C) election limitation." If G elects the "(A) election limitation" for the limitation year ending with or within taxable year 1976, E could contribute up to $5,000 ((.20 × $12,000 × 10)—$19,000) on G's behalf for section 403(b) annuity contracts for such limitation year without increasing G's gross income for the taxable year with or within which such limitation year ends. If G elects the "(B) election limitation" for such limitation year, E could contribute $7,000 (the least of $7,000, the amount described in section 415(c)(4)(B)(i)); $14,000 (the amount described in section 415(c)(4)(B)(ii)); and $15,000 (the amount described in section 415(c)(4)(B)(iii)). If G elects the "(C) election limitation" for taxable year 1976, E could contribute $3,000 (the lesser of the amounts described in section 415(c)(1)(A) or (B)).

(f) Special rules with respect to the application of section 415(c)(1)(B) with section 404(e)(4). For special rules relating to the application of the compensation limitation described in section 415(c)(1)(B) with the minimum allowable deduction described in section 404(e)(4) in the case of a

plan which provides contributions for employees, some or all of whom are employees within the meaning of section 401(c)(1), see the regulations under section 404(e).

(g) Special rules for employee stock ownership plans—(1) General definitions. For purposes of this paragraph—(i) An employee stock ownership plan is a plan which meets the requirements of either section 4975(e)(7) and the regulations thereunder, or whichever of the following is applicable: section 301(d) of the Tax Reduction Act of 1975 (89 Stat. 38, 26 CFR 1.46–7) and the regulations thereunder (26 CFR 1.46–8) or section 409A and the regulations thereunder.

(ii) The term "employer securities" means, in the case of an employee stock ownership plan within the meaning of section 4975(e)(7) and the regulations thereunder, qualifying employer securities within the meaning of section 4975(e)(8), that are also described in section 301(d)(9)(A) of the Tax Reduction Act of 1975 and the regulations thereunder or section 409A(*l*) and the regulations thereunder, whichever is applicable. In the case of an employee stock ownership plan described in section 301(d)(2) of the Tax Reductions Act of 1975 or section 409A, whichever is applicable, such term means employer securities within the meaning of section 301(d)(9)(A) of that Act and the regulations thereunder or section 409A(*l*) and the regulations thereunder, which ever is applicable.

(iii) An individual is considered to own more than 10 percent of the employer's stock if, without regard to stock held under the employee stock ownership plan, the individual owns (after application of section 1563(e), relating to constructive ownership of stock) more than 10 percent of the total combined voting power of all classes of stock entitled to vote or more than 10 percent of the total value of shares of all classes of stock.

(2) Special dollar limitation. In the case of an employee stock ownership plan which meets the requirements of paragraph (g)(3) of this section, the applicable dollar limitation for a limitation year equals the sum of—

(i) The dollar amount described in section 415(c)(1)(A) (and so adjusted for that limitation year), and

(ii) The lesser of the amount determined under paragraph (g)(2)(i) of this section or the amount of employer securities within the meaning of paragraph (g)(1)(ii) of this section contributed to the employee stock ownership plan.

(3) Employee stock ownership plans to which the special dollar limitation applies. For purposes of this paragraph, the special dollar limitation is only applicable to an employee stock ownership plan for a particular limitation year for which no more than one-third of the employer contributions for the limitation year are allocated to employees who are officers, shareholders owning more than 10 percent of the employer's stock (as determined under subparagraph (1)(iii) of this paragraph), or whose compensation for the limitation year exceeds twice the dollar amount described in section 415(c)(1)(A) (as adjusted for cost-of-living increases under section 415(d)(1) and paragraph (d) of this section).

(4) Cash contributions treated as contributions of employer securities. For purposes of the special dollar limitation—

(i) In the case of an employee stock ownership plan in which the employer makes cash contributions which are used in a direct acquisition of employer securities, the cash contributions are treated as a contribution of employer securities for the limitation year, provided that the securities are employer securities within the meaning of paragraph (g)(1)(ii) of this section and are allocated to participants under the terms of the plan as of any date within that limitation year. However, this subdivision is not applicable unless the following two conditions are satisfied. The first condition is that the employer must contribute the cash to the plan no later than 30 days after the end of the period described in section 404(a)(6) applicable to the taxable year with or within which the particular limitation year ends. The second condition is that the employer securities must be purchased no later than 60 days after the end of the period described in the preceding sentence.

(ii) In the case of an employee stock ownership plan to which an exempt loan as described in § 54.4975–7(b) has been made, the employer's contribution of both principal and interest used to repay the exempt loan for the limitation year will be treated as a contribution of employer securities for that limitation year, provided that the securities allocated to participants are employer securities within the meaning of paragraph (g)(1)(ii) of this section.

(5) Amounts considered as annual additions. For purposes of applying the limitations of section 415(c)(1) and this section and for the special dollar limitation, in the case of an employee stock ownership plan to which an exempt loan as described in § 54.4975–7(b) has been made, the amount of

employer contributions which is considered an annual addition for the limitation year is calculated with respect to employer contributions of both principal and interest used to repay the exempt loan for that limitation year.

(6) **Examples.** The provisions of this paragraph may be illustrated by the following examples:

Example (1). Employee N is a participant in an employee stock ownership plan maintained by his employer, M Corporation, which meets the requirements of section 4975(e)(7) and the regulations thereunder. The plan also meets the requirements set forth in subparagraph (3) of this paragraph. M does not maintain any other qualified plan. The limitation year for the plan is the calendar year. For 1977, N has compensation (as defined in paragraph (a)(3) of this section) of $160,000. Without the special dollar limitation described in subparagraph (2) of this paragraph, under section 415(c)(1), N could only have annual additions of $28,175 (the lesser of the dollar limitation described in section 415(c)(1)(A) as adjusted for cost of living increases ($28,175) or the compensation limitation described in section 415(c)(1)(B) (25% of $160,000 = $40,000)) made to his account for the 1977 limitation year. Under the special dollar limitation, N would be able to have annual additions of $56,350 ($28,175 × 2) made to his account for the 1977 limitation year, provided that amounts contributed in excess of $28,175 consist solely of employer securities. However, N is also subject to the compensation limitation described in section 415(c)(1)(B). Therefore, even under the special dollar limitation, N may only have annual additions of $40,000 made to his account for the 1977 limitation year: *Provided*, That amounts contributed in excess of $28,175 consist solely of employer securities within the meaning of paragraph (g)(1)(ii) of this section.

Example (2). Assume the same facts as in example (1), except that N's compensation for 1977 is $300,000. Because the compensation limitation (25% of $300,000 = $75,000) is greater than the special dollar limitation of $56,350, N can have annual additions of $56,350 made to his account for the 1977 limitation year, provided that amounts contributed in excess of $28,175 consist solely of employer securities.

(h) **Special rules for level premium annuity contracts under plans benefiting owner-employees—(1) In general.** The compensation limitation described in section 415(c)(1)(B) will not be less than the contribution described in section 401(e) which is made for the benefit of an owner-employee (within the meaning of section 401(c)(3)) for a limitation year provided that—

(i) The annual additions with respect to such owner-employee for the limitation year consist solely of the contributions described in this paragraph, and

(ii) The owner-employee is not a participant at any time during the limitation year in a defined benefit plan maintained by the employer.

(2) **Application of the non-discrimination rules.** In the case of a plan which provides contributions for employees who are not owner-employees, that plan will not be treated as failing to satisfy the non-discrimination rules of section 401(a)(4) merely because contributions made on behalf of employees who are not owner-employees are not permitted to exceed the compensation limitation described in section 415(c)(1)(B).

(3) **Additional rules.** For additional rules concerning contributions described in section 401(e), see § 1.401(e)–4.

[T.D. 7748, 46 FR 1705, Jan. 7, 1981]

§ 1.415–7 Limitation in case of defined benefit and defined contribution plan for same employee.

(a) **Overall limitation—(1) In general.** Under section 415(e) and this section, in any case in which an individual has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan maintained by the same employer, to satisfy the provisions of section 415(a), the sum of the defined benefit plan fraction (as defined in paragraph (b) of this section) and the defined contribution plan fraction (as defined in paragraph (c) of this section) with respect to that participant for any limitation year may not exceed 1.4.

(2) **Application of overall limitation to employee stock ownership plan.** An employee stock ownership plan which qualifies for, and takes advantage of, the special dollar limitation provided in section 415(c)(6) and § 1.415–6(g) is still subject to the 1.4 limitation of paragraph (a)(1) of this section.

(b) **Defined benefit plan fraction—(1) In general.** For purposes of paragraph (a) of this section, the defined benefit plan fraction applicable to a participant for any limitation year is a fraction—

(i) The numerator of which is the projected annual benefit (as defined in subparagraph (3) of this paragraph) of the participant under the plan (determined as of the close of the limitation year), and

(ii) The denominator of which is the projected annual benefit (as defined in subparagraph (3) of this paragraph) of the participant under the plan (determined as of the close of the limitation year) if the plan provided such participant the maximum benefit allowable under § 1.415–3.

In the event a participant has participated in more than one defined benefit plan maintained by the employer, the numerator of the defined benefit plan fraction is the sum of the projected annual benefits under all of the defined benefit plans.

(2) **Participants described in section 2004(d)(2) of the Employee Retirement Income Security Act**

of 1974. For purposes of this paragraph, in the case of a participant described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974 (Pub.L. 93–406, 88 Stat. 987), the defined benefit plan fraction applicable to such participant is deemed not to exceed 1.0 for any limitation year to which section 415 and this section apply.

(3) Projected annual benefit. For purposes of this section, a participant's "projected annual benefit" is equal to the annual benefit (as defined in § 1.415–3(b)(1)(i)) to which a participant in a defined benefit plan would be entitled under the terms of the plan based upon the following assumptions:

(i) The participant will continue employment until reaching normal retirement age as determined under the terms of the plan (or current age, if that is later).

(ii) The participant's compensation for the limitation year under consideration will remain the same until the date the participant attains the age described in subdivision (i) of this subparagraph.

(iii) All other relevant factors used to determine benefits under the plan for the limitation year under consideration will remain constant for all future limitation years.

(c) Defined contribution plan fraction—(1) In general. For purposes of paragraph (a) of this section, the defined contribution plan fraction applicable to a participant for any limitation year is a fraction—

(i) The numerator of which is the sum of the annual additions to the participant's account as of the close of the limitation year and for all prior limitation years, and

(ii) The denominator of which is the sum of the maximum amount of annual additions which could have been made under section 415(c) and § 1.1415–6(a) (determined without regard to the special dollar limitation provided for employee stock ownership plans under section 415(c)(6) and § 1.415–6(g)) for the limitation year and for each prior limitation year of the participant's service with the employer (regardless of whether a plan was in existence during those years).

For purposes of this paragraph, the term "annual additions" has the same meaning as set forth in § 1.415–6(b).

(2) Special rules for certain annuity contracts and individual retirement plans. (i) Except as provided in subdivision (ii) of this subparagraph, in computing the defined contribution plan fraction applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased, the amount which is included in the denominator of such fraction for a particular limitation year is the maximum amount which could have been contributed under the limitations of section 415(c) and § 1.415–6(a) applicable to the individual for the particular limitation year. However, if the individual elects an alternative limitation described in either section 415(c)(4)(A) or section 415(c)(4)(B) for a particular limitation year, the denominator of the fraction for such limitation year is the maximum amount which could have been contributed under the applicable limitations of section 415(c) and § 1.415–6(a), as modified by the alternative limitation elected.

(ii) This subdivision provides a rule for computing the defined contribution plan fraction with respect to an individual on whose behalf a section 403(b) annuity has been purchased prior to commencing employment with an employer which the individual controls (within the meaning of section 414(b) or (c), as modified by section 415(h)) and which maintains a defined benefit plan. In this situation, the controlled employer is considered to be maintaining the section 403(b) annuity contract as a defined contribution plan under the rules of paragraph (h)(2)(i) of this section. However, for all years prior to commencing employment with the controlled employer, the individual does not have any years of service (within the meaning of subparagraph (1)(ii) of this paragraph) with that employer. Thus, for each limitation year in which such individual did not have a year of service with the controlled employer, the denominator of the defined contribution plan fraction applicable to the individual is deemed to equal the numerator of that fraction.

(iii) The rules described in this paragraph also apply to an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) has been maintained.

(iv) See paragraph (h)(4) of this section for special rules relating to the aggregation of a section 403(b) annuity contract and a qualified plan.

(d) Special transitional rules for defined contribution plan fraction. For purposes of determining the defined contribution plan fraction under paragraph (c) of this section for any limitation year beginning after December 31, 1975, the following rules shall apply with respect to limitation years before the first limitation year to which section 415 and this section apply.

(1) The aggregate amount taken into account under paragraph (c)(1)(i) of this section in determining the numerator of the defined contribution plan fraction is deemed not to exceed the aggregate amount taken into account under paragraph (c)(1)(ii) of this section in determining the denominator of the fraction. Thus, for example, if the aggregate amount of actual annual additions to the plan for all such limitation years is $500,000, while the aggregate amount in the denominator is $250,000, under the rule set forth in this subparagraph, the defined contribution plan fraction is $250,000 divided by $250,000, or 100 percent.

(2) The amount taken into account under section 415(c)(2)(B)(i) for each such limitation year is an amount equal to—

(i) The amount by which the aggregate amount of employee contributions (whether voluntary or mandatory) for all limitation years beginning before January 1, 1976, during which the employee was a participant in the plan exceeds 10 percent of the employee's aggregate compensation from the employer for all such limitation years, divided by

(ii) The number of full limitation years (counting any part of a limitation year as a full limitation year) beginning before January 1, 1976, during which the employee was a participant in the plan. Therefore, for purposes of computing the numerator of a participant's defined contribution plan fraction for limitation years beginning after December 31, 1975, no employee contributions made to the plan before the first limitation year to which section 415 and this section apply are taken into account as annual additions if the aggregate amount of the contributions does not exceed 10 percent of the employee's aggregate compensation from the employer for all limitation years prior to the first such limitation year.

(3) The special transitional rule concerning employee contributions provided for in paragraph (d)(2) of this section does not apply to any employee contributions (whether voluntary or mandatory) made on or after October 2, 1973, to the extent that these contributions exceed the maximum amount of employee contributions permitted under the plan as in effect on October 2, 1973. For purposes of the preceding sentence, plan amendments approved by the Internal Revenue Service before October 2, 1973, and actually put into effect before January 1, 1974, are considered in effect on October 2, 1973. Therefore, for purposes of computing the numerator of the defined contribution plan fraction for limitation years beginning after December 31, 1975, employee contributions made between October 2, 1973 and prior to the first limitation year to which section 415 and this section apply which exceed the maximum amount the employee was permitted to contribute under the provisions of the plan as in effect on October 2, 1973, are taken into account as annual additions (within the meaning of § 1.415–6(b)(1)(ii)).

(4) For purposes of this paragraph, the participant's aggregate compensation for all years (whichever are applicable under either paragraph (d)(1) or (2) of this section) with the employer before the first limitation year to which section 415 applies equals the product of the participant's compensation during the first limitation year to which section 415 applies times the number of such applicable years. However, this special rule is available only if records necessary for the determination of the participant's aggregate compensation for all such applicable years with the employer before the first limitation year to which section 415 applies are not available.

(e) **Examples.** The provisions of paragraphs (a) through (d) of this section may be illustrated by the following examples:

Example (1). (i) S is an employee of T Corporation and is a participant in both the noncontributory defined benefit plan and noncontributory defined contribution plan maintained by the corporation. S became an employee of T on July 1, 1966. S became a participant in the defined benefit plan maintained by T on January 1, 1968 and he became a participant in the defined contribution plan maintained by T on January 1, 1970. T uses the calendar year as the limitation year for both plans. The current limitation year is 1978. S's compensation (as defined in § 1.415–2(d)) from T is as follows:

Limitation year	Compensation
1966	$3,000
1967	6,000
1968	6,000
1969	8,000
1970	8,000
1971	8,000
1972	9,000
1973	10,000
1974	10,000
1975	11,000
1976	11,000
1977	12,000
1978	12,000

(ii) S's projected annual benefit (as defined in paragraph (b)(3) of this section) as of the close of the current limitation year under the terms of the plan is $9,000. S's compensation for the current limitation year is $12,000. Therefore, the defined benefit plan fraction applicable to S for the current limitation year is .75 or 75 percent (9,000÷12,000). S's defined contribution compensation limitation (as described in section 415(c)(1)(B)) for the current limitation year is $3,000 (25 percent of $12,000). For all limitation years beginning before January 1, 1978, the maximum aggregate amount of annual additions which could have been allocated to S's account under

the defined contribution plan is $25,500 (aggregate compensation of $102,000 for all years of service with T Corporation × 25 percent). Assume that annual additions totaling $11,400 have been allocated to S's account as of the end of the current limitation year. Therefore, S's defined contribution plan fraction as of the end of the current limitation year equals

$11,400 ÷ $25,500 + $3,000 = $11,400 ÷ $28,500 = 40 or 40 percent

Because the sum (115 percent) of the defined benefit plan fraction (75 percent) and the defined contribution plan fraction (40 percent) applicable to S for the current limitation year does not exceed 140 percent, the limitations of section 415(e) and this section are not exceeded.

Example (2). Assume the same facts as in example (1) except that the defined contribution plan maintained by T Corporation provides for mandatory employee contributions of 6% of compensation and voluntary employee contributions of 10% of compensation. Assume further that S made the maximum allowable employee contributions under the plan for each limitation year (including the current limitation year) during which he was a participant. For limitation years beginning before January 1, 1976, S made total employee contributions of $8,960. However because of the special transitional rule applicable to the defined contribution plan fraction with respect to employee contributions for limitation years beginning before January 1, 1976 (as described in paragraph (d)(2) of this section), only $560 of the total employee contributions of $8,960 made by S will be considered an annual addition for each of those limitation years in which S was a participant in the plan total employee contributions for limitation years in which S participated in the plan beginning before January 1, 1976 of $8,960 minus $5,600 (10 percent of total compensation of $56,000 for such years) divided by 6 (the number of such years in which S was a participant in the plan). Thus, in determining the numerator of the defined contribution plan fraction applicable to S, because S was a participant in the plan for 6 limitation years beginning before January 1, 1976, the total amount of employee contributions that must be taken into account as annual additions for such limitation years is $3,360 ($560 × 6). For limitation years beginning after January 1, 1976, S made contributions of $1,760 (for limitation year 1976), $1,920 (for limitation year 1977) and $1,920 (for limitation year 1978, the current limitation year). The amount of annual additions attributable to such contributions under section 415(c)(2)(B) is $880 (for limitation year 1976). $960 (for limitation year 1977) and $960 (for the current limitation year), for a total of $2,800. Thus, the defined contribution plan fraction applicable to S for the current limitation year is

$3,360 + $2,800 + $11,400 ÷ $28,500 = $17,560 ÷ $28,500 = 62 or 62 percent

Because the sum (137 percent) of the defined benefit plan fraction (75 percent) and the defined contribution plan fraction (62 percent) applicable to S for the current limitation year does not exceed 140 percent, the limitations of section 415(e) and this section are not exceeded.

Example (3). (i) A is an employee of M Corporation and is a participant in both the noncontributory defined benefit plan and noncontributory defined contribution plan maintained by the corporation. A became an employee of M on January 1, 1969 and immediately became a participant in both plans. M uses the calendar year as the limitation year for both plans. The current limitation year is 1978. A's compensation (as defined in § 1.415–2(d)) from M is as follows:

Limitation year	Compensation
1969	$100,000
1970	120,000
1971	130,000
1972	160,000
1973	200,000
1974	240,000
1975	280,000
1976	320,000
1977	400,000
1978	460,000

(ii) A is a participant described in section 2004(d)(2) of the Employee Retirement Income Security Act of 1974. A's projected annual benefit (as defined in paragraph (b)(3) of this section) as of the close of the current limitation year under the terms of the defined benefit plan is $100,000. The defined benefit dollar limitation (as described in section 415(b)(1)(A)) applicable to A for the current limitation year is $90,150. Absent the provisions of paragraph (b)(2) of this section, the defined benefit plan fraction applicable to A for the current limitation year would be 1.11 or 111 percent. However, under the provisions of paragraph (b)(2) of this section, for purposes of computing the overall 1.4 limitation imposed by section 415(e) and this section applicable to A for the current limitation year and all future limitation years, A's defined benefit plan fraction is considered to equal 1.0 or 100 percent.

(iii) A's defined contribution dollar limitation (as described in section 415(c)(1)(A)) for the current limitation year is $30,050. For the 9 limitation years ending before January 1, 1978, the maximum amount of annual additions which could have been allocated to A's account under the defined contribution plan is $230,000 ($25,000 × 7, plus $26,825 (adjusted figure for 1976) and $28,175 (adjusted figure for 1977)). Assume that annual additions totaling $60,000 ($10,000 of this amount being attributable to the current limitation year) have been allocated to A's account as of the close of the current limitation year. A's defined contribution plan fraction computed as of the end of the current limitation year is .23 or 23 percent

$60,000 ÷ $230,000 + $30,050 = 23 or 23 percent

Because the sum (123 percent) of the defined benefit plan fraction (1.0 or 100 percent) and the defined contribution plan fraction (.23 or 23 percent) for the current limitation year does not exceed 1.4 or 140 percent, the limitations of section 415(e) and this section are not violated.

Example (4). (i) J is an employee of M Corporation and is the only participant in the defined contribution plan maintained by the corporation. M uses the calendar year as the limitation year for the plan. The current limitation year is 1980. For all limitation years prior to 1980, the maximum allowable contribution was made to the plan. Thus, J's defined contribution plan fraction as of the end of 1979 is 1.0 or 100 percent. In 1980, before any contributions had been made to the defined contribution plan, the defined contribution plan is converted into a defined benefit plan. The defined benefit plan provides a benefit in the form of a straight life annuity equal to 50% of a participant's compensation for the high 3 years of service, but not less than the amount purchasable by J's account balance. J's average compensation for the high 3 years is $50,000.

(ii) As a result of the conversion of the defined contribution plan into the defined benefit plan, J becomes subject to the 1.4 limitation of section 415(e) and this section because he has at one time participated in a defined contribution plan and has at one time participated in a defined benefit plan maintained by M. Although the defined contribution plan is no longer in existence, J must still take the defined contribution plan fraction into account. A defined contribution plan fraction must continue to be taken into account regardless of whether the

plan has been converted into another plan or whether the plan is terminated and distributions are made to participants.

(iii) Even though J is subject to the limitations of section 415(e) and this section, in computing the defined benefit plan fraction, the special rule set forth in § 1.415–3(b)(1)(iv) is applicable based on the facts of this example. That rule provides that when there is a transfer of assets or liabilities from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415. (For purposes of section 415, a conversion of a defined contribution plan into a defined benefit plan is considered such a transfer.) Assume that one-half of J's annual benefit under the defined benefit plan is attributable to the assets transferred from the defined contribution plan. This means that by applying the special rule set forth in § 1.415–3(b)(1)(iv), only one-half of J's projected annual benefit must be taken into account in computing J's defined benefit plan fraction. Accordingly, because J's defined benefit plan fraction is only 25 percent (½ of 50% of high 3 years of compensation ($12,500) divided by 100% of high 3 years of compensation ($50,000)) and not 50 percent (which would have been the case absent) the special rule of § 1.415–3(b)(1)(iv), the 140 percent limitation of section 415(e) and this section is not violated.

(f) Special rules where records are not available for past periods—(1) In general. The rules described in paragraph (f)(2) and (3) of this section apply only if the plan is unable to compute the defined contribution plan fraction because of the unavailability of records with respect to limitation years ending before the first limitation year to which section 415 applies to the plan.

(2) Defined contribution plan fraction for first limitation year to which section 415 applies to a plan. For purposes of paragraph (c) of this section, the defined contribution plan fraction for the first limitation year to which section 415 and this section apply to a plan equals the following fraction:

(i) The numerator of the fraction is the sum of the participant's account balance as of the valuation date under the plan immediately preceding November 2, 1975, plus any additions to the participant's account made subsequent to that valuation date and through the end of the first limitation year to which section 415 applies to the plan. In determining the participant's account balance as of the valuation date under the plan immediately preceding November 2, 1975, for purposes of this subdivision, one-half of all employee contributions (whether voluntary or mandatory) are not taken into account.

(ii) The denominator of the fraction is the sum of the maximum allowable annual additions under section 415(c) and § 1.415–6 for each limitation year, including the first limitation year to which section 415 applies to the plan, in which the participant had a year of service with the employer (see § 1.415–3(g)(1) for rules relating to the determination of a year of service). In determining the maximum allowable annual additions for purposes of this subdivision, the compensation limitation (as described in section 415(c)(1)(B)) taken into account for all of such limitation years is the applicable compensation limitation for the first limitation year to which section 415 applies to the plan and the dollar limitation taken into account for each such limitation year is the dollar limitation described in section 415(c)(1)(A), as adjusted for cost-of-living increases under section 415(d)(1)(B).

(3) Defined contribution plan fraction for future limitation years. For purposes of paragraph (c) of this section, with respect to all limitation years after the first limitation year to which section 415 applies to the plan, the defined contribution plan fraction for the current limitation year equals a fraction. The numerator of the fraction is the amount determined under paragraph (g)(2)(i) of this section, plus any subsequent annual additions made to the participant's account through the end of the current limitation year. The denominator of the fraction equals the sum of—

(i) The amount determined under subparagraph (2)(ii) of this paragraph, plus

(ii) The sum of the maximum allowable annual additions under section 415(c) and § 1.415–6 for the current limitation year and all prior limitation years beginning after the end of the first limitation year to which section 415 applies to the plan.

(g) Special rule for certain plans in effect on date of enactment. In the case of an individual who, on September 2, 1974, was a participant in a defined benefit and defined contribution plan maintained by the same employer and with respect to whom the sum of the defined benefit plan fraction and the defined contribution plan fraction for the limitation year during which such date falls (determined as of the close of that limitation year) exceeded 140 percent, the sum of such fractions may continue to exceed 140 percent for any particular future limitation year, but only if the conditions set forth in paragraph (g)(1) and (2) of this section are satisfied:

(1) The defined benefit plan fraction of the participant computed as of the close of the particular limitation year does not exceed such fraction computed as of the close of the limitation year during which September 2, 1974, falls.

(2) After September 2, 1974.

(i) No employer contributions are allocated to the participant's account under any defined contribution plan,

(ii) No forfeitures arising under any defined contribution plan are allocated to the participant's account,

(iii) No voluntary employee contributions are made by the participant under any defined contribution or defined benefit plan, and

(iv) No mandatory employee contributions are made by the participant under any defined contribution plan.

(h) Special rules for section 403(b) annuity contracts—(1) In general. For purposes of section 415, the following rules shall apply:

(i) In the case of an annuity contract described in section 403(b), the participant, on whose behalf the annuity contract is purchased, is considered to have exclusive control of the annuity contract. Accordingly, the participant, and not the participant's employer who purchased the section 403(b) annuity contract, is deemed to maintain the annuity contract.

(ii) Any contributions by the employer for an annuity contract described in this subparagraph are not taken into account in computing the defined contribution plan fraction applicable to the participant for the limitation year.

(2) Special rules under which the employer is deemed to maintain the annuity contract. (i) The provisions of this paragraph and not paragraph (h)(1) of this section apply for a particular limitation year with respect to a participant on whose behalf a section 403(b) annuity contract is purchased, if that participant is in control of any employer within the meaning of section 414(b) or (c), as modified by section 415(h). Under these circumstances, the section 403(b) annuity contract for the benefit of the participant is treated as a defined contribution plan maintained by both the controlled employer and the participant for that limitation year.

(ii) The provisions of this paragraph also apply for a particular limitation year if a participant on whose behalf a section 403(b) annuity contract is purchased has elected, under section 415(c)(4)(D) and § 1.415–6(e)(6), to have the provisions of section 415(c)(4)(C) and § 1.415–6(e)(5) apply for the taxable year with or within which such limitation year ends. In such a case, the exclusion allowance determined under section 403(b)(2)(A) is not applicable to the annuity contract for the particular limitation year, and the annuity contract is treated as a defined contribution plan maintained by both the employer and the participant for that limitation year.

(iii) For purposes of the limitations of section 415(e) and this section, where a section 403(b) annuity contract is treated as a defined contribution plan maintained by the employer under this subparagraph, any contributions made for the annuity contract for a participant are taken into account in computing the defined contribution plan fraction applicable to that participant for the limitation year. Thus, for example, if a doctor is employed by an educational organization which provides him with a section 403(b) annuity contract and also maintains a private practice as a shareholder owning more than 50 percent of a professional corporation, any qualified defined benefit plan of the professional corporation must be aggregated with the section 403(b) annuity contract for purposes of applying the limitations of section 415(e) and this section.

(3) Special rule with respect to salary reduction agreements. The rules provided in this paragraph are applicable whether or not the section 403(b) annuity contract is purchased in connection with a salary reduction agreement between the employer and participant.

(4) Special rules relating to the aggregation of the annuity contract with a qualified plan. (i) Where a section 403(b) annuity contract is aggregated with a qualified defined benefit plan in a limitation year because of the application of the rules of paragraph (h)(2) of this section, all contributions made to the annuity contract for a participant in prior limitation years shall be taken into account in computing the participant's defined contribution plan fraction. However, the rule described in the preceding sentence is not applicable if the aggregation is solely attributable to the participant's election to have the provisions of section 415(c)(4)(C) apply. Accordingly, in any case in which aggregation is required as a result of the application of paragraph (h)(2)(ii) of this section, all contributions made to the annuity contract for a participant in prior limitation years in which paragraph (h)(1) of this section was applicable do not have to be taken into account in computing the defined contribution plan fraction applicable to the participant.

(ii) Any contributions made to a section 403(b) annuity contract for a participant in any limitation year in which the rules of paragraph (h)(2)(ii) of this section are applicable shall be taken into

account in subsequent limitation years even though the rules of such paragraph are no longer applicable.

(iii) See paragraph (c)(2) of this section for special rules relating to the defined contribution plan fraction for a participant on whose behalf a section 403(b) annuity contract has been purchased.

(5) Examples. The application of this paragraph may be illustrated by the following examples:

Example (1). A is employed by a hospital which is described in section 501(c)(3) and exempt from tax under section 501(a). The hospital purchases an annuity contract described in section 403(b) on A's behalf for the current limitation year. The hospital also maintains a qualified defined benefit plan during the current limitation year in which A is a participant, but it does not maintain a qualified defined contribution plan during that limitation year. With respect to the annuity contract, A does not elect to have the provisions of section 415(c)(4)(C) apply for the current limitation year. Also, A is not in control of any employer within the meaning of section 414(b) or (c), as modified by section 415(h). For purposes of section 415, under subparagraph (1) of this paragraph, A is considered to have exclusive control of the annuity contract. Therefore, because A (and not the hospital) is treated as maintaining the annuity contract and because the hospital does not maintain any defined contribution plan, the limitations of section 415(e) and this section are not applicable to A for either the annuity contract or the hospital's defined benefit plan for the current limitation year.

Example (2). Assume the same facts as in example (1), except that the hospital also maintains a qualified defined contribution plan during the limitation year in which A is a participant. Because the hospital is not considered to be maintaining the section 403(b) annuity contract, contributions made to the annuity contract on behalf of A during the current limitation year by the hospital are not taken into account in computing the defined contribution plan fraction applicable to A for the plans maintained by the hospital for that limitation year.

Example (3). Assume the same facts as in example (1), except that A has elected to have the provisions of section 415(c)(4)(C) apply to the annuity contract for the current limitation year. Under the special rules contained in subparagraph (2) of this paragraph, the annuity contract is treated as a defined contribution plan maintained by the hospital as well as a defined contribution plan maintained by A. Accordingly, because the hospital is also maintaining a qualified defined benefit plan, the limitations of section 415(e) and this section are applicable to A for the annuity contract and the defined benefit plan maintained by the hospital in the current limitation year.

Example (4). J is employed by a hospital which is described in section 501(c)(3) and exempt from tax under section 501(a). The hospital purchases an annuity contract described in section 403(b) on J's behalf for the current limitation year. The hospital does not maintain any qualified plans during that limitation year. However, for the limitation year, J is in control (within the meaning of section 414(b) or (c), as modified by section 415(h)) of employer M. M maintains a qualified defined benefit plan during that limitation year. Under the special rules contained in subparagraph (2) of this paragraph, the annuity contract is treated as a defined contribution plan maintained by M (the controlled employer) as well as a defined contribution plan maintained by J. Therefore, because M is also maintaining a qualified defined benefit plan, the limitations of section 415(e) and this section are applicable to J for the annuity contract and the defined benefit plan maintained by M in the current limitation year.

(i) Special rules for individual retirement plans. For purposes of section 415, an individual on whose behalf an individual retirement plan (as described in section 7701(a)(37)) is maintained is considered to have exclusive control of such plan. Therefore, the individual is treated as maintaining such plan. However, if that individual is in control of any employer within the meaning of section 414(b) or (c), as modified by section 415(h), the individual retirement plan for the benefit of such individual is treated as a defined contribution plan maintained by both the controlled employer and such individual.

[T.D. 7748, 46 FR 1711, Jan. 7, 1981]

§ 1.415–8 Combining and aggregating plans.

(a) In general. Under section 415(f) and this section, for purposes of applying the limitations of section 415(b), (c), and (e) applicable to a participant for a particular limitation year—

(1) All qualified defined benefit plans (without regard to whether a plan has been terminated) ever maintained by the employer will be treated as one defined benefit plan, and

(2) All qualified defined contribution plans (without regard to whether a plan has been terminated) ever maintained by the employer will be treated as one defined contribution plan.

(b) Annual compensation taken into account where employer maintains more than one defined benefit plan. If more than one qualified defined benefit plan is being aggregated under paragraph (a) of this section for a particular limitation year, in applying the defined benefit compensation limitation (as described in section 415(b)(1)(B)) to the annual benefit of a participant under each plan, the participant's high 3 years of compensation is determined in accordance with § 1.415–3(a)(3).

(c) Affiliated employers. Any qualified defined benefit plan or qualified defined contribution plan maintained by any member of a controlled group of corporations (within the meaning of section 414(b) as modified by section 415(h)) or by any trade or business (whether or not incorporated) under common control (within the meaning of section 414(c) as modified by section 415(h)) is

deemed maintained by all such members or such trades or businesses.

(d) Section 403(b) annuity contracts—(1) In general. In the case of an annuity contract described in section 403(b), except as provided in subparagraph (2) of this paragraph, the participant on whose behalf the annuity contract is purchased is considered to have exclusive control of the annuity contract. Accordingly, the participant, and not the participant's employer who purchased the section 403(b) annuity contract, is deemed to maintain the annuity contract.

(2) Special rules under which the employer is deemed to maintain the annuity contract. If a participant on whose behalf a section 403(b) annuity contract is purchased has elected to have the provisions of section 415(c)(4)(C) and § 1.415-6(e)(5) apply for a taxable year, the annuity contract is treated as a defined contribution plan maintained by both the employer that purchased the annuity contract and the participant on whose behalf it was purchased for the limitation year which ends during such taxable year. Even if the election under section 415(c)(4)(C) is not made, where a participant, on whose behalf a section 403(b) annuity contract is purchased, is in control of any employer within the meaning of section 414(b) or (c) as modified by section 415(h) for a limitation year, the annuity contract for the benefit of the participant is treated as a defined contribution plan maintained by both the controlled employer and the participant for that limitation year. Thus, for example, if a doctor is employed by an educational organization which provides him with a section 403(b) annuity contract and also maintains a private practice as a shareholder owning more than 50 percent of a professional corporation, any qualified defined contribution plan of the professional corporation must be combined with the section 403(b) annuity contract for purposes of applying the limitations of section 415(c) and § 1.415-6. For purposes of this paragraph, it is immaterial whether the section 403(b) annuity contract is purchased as a result of a salary reduction agreement between the employer and the participant.

(e) Multiemployer plans. Multiemployer plans, as defined in section 414(f), shall not be aggregated with other multiemployer plans. However, where an employer maintains both a plan which is not a multiemployer plan and a multiemployer plan, the plan which is not a multiemployer plan shall be aggregated (based on its limitation year) with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided by such employer with respect to a common participant. See § 1.415-1(e)(2) for a rule relating to the computation of the benefits provided by an employer under a section 414(f) multiemployer plan.

(f) Special rules for combining certain plans, etc. If a plan, annuity contract or arrangement is subject to a special limitation in addition to, or instead of, the regular limitations described in section 415(b) or (c), and is combined under this section with a plan which is subject only to the regular section 415(b) or (c) limitations, the following rules shall apply:

(1) Each plan, annuity contract or arrangement which is subject to a special limitation must meet its own applicable limitation and each plan subject to the regular limitations of section 415 must meet its applicable limitation.

(2) The combined limitations shall be the larger of the applicable limitations.

(g) Special priority rule for TRASOP's. For a special rule concerning allocations to a participant's account under an Employee Stock Ownership Plan under section 301(d) of the Tax Reduction Act of 1975, see § 1.46-6(d)(6)(v).

(h) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). M is an employee of ABC Corporation and XYZ Corporation. ABC maintains a qualified noncontributory defined benefit plan in which M participates and XYZ maintains a qualified defined contribution plan in which M participates. ABC Corporation and XYZ Corporation are members of a controlled group of corporations within the meaning of section 414(b) as modified by section 415(h). Because ABC Corporation and XYZ Corporation are members of a controlled group of corporations within the meaning of section 414(b) as modified by section 415(h), M is treated as being employed by a single employer. Thus, M's annual benefit under the defined benefit plan maintained by ABC may not exceed the limitations of section 415(b) and § 1.415-3; the annual additions to M's account under the defined contribution plan maintained by XYZ may not exceed the limitations of section 415(c) and § 1.415-6; and, in addition, the two plans may not exceed the limitations of section 415(e) and § 1.415-7.

Example (2). Assume the same facts as in example (1), except that the qualified defined benefit plan maintained by ABC Corporation provides for employee contributions (whether mandatory or voluntary). Under § 1.415-3(d), ABC Corporation will be considered to be maintaining a defined contribution plan consisting of M's contributions to the defined benefit plan. For purposes of applying the limitations of section 415(e) and § 1.415-7, the qualified defined benefit plan maintained by ABC must be combined with the defined contribution plan which ABC is considered to maintain. In addition, because corporations ABC and XYZ are members of a controlled group of corporations (within the meaning of section 414(b), as modified by section 415(h)), for purposes of applying the limitations of section 415(c) and § 1.415-6, the qualified defined contribution plan maintained by XYZ must be com-

bined with the defined contribution plan which ABC is considered to be maintaining and the defined contribution plans (as combined) must be aggregated with the qualified defined benefit plan maintained by ABC for purposes of the limitations imposed by section 415(e) and § 1.415–7.

[T.D. 1716, 46 FR 1715, Jan. 7, 1981]

§ 1.415–9 Disqualification of plans and trusts.

(a) In general. Under section 415(g) and this section, with respect to a particular limitation year, a plan (and the trust forming part of the plan) is disqualified in accordance with the rules provided in paragraph (b) of this section, if any of the following conditions exist:

(1) Annual additions (as defined in § 1.415–6(b)) with respect to the account of any participant in a qualified defined contribution plan maintained by the employer exceed the limitations of section 415(c) and § 1.415–6.

(2) The annual benefit (as defined in § 1.415–3(b)(1)) of a participant in a qualified defined benefit plan maintained by the employer exceeds the limitations of section 415(b) and § 1.415–3.

(3) The combination of annual additions with respect to the account of any participant in a qualified defined contribution plan and the projected annual benefit payable with respect to such participant in a qualified defined benefit plan maintained by the employer exceeds the limitations of section 415(e) and § 1.415–7.

For purposes of this paragraph, the determination of whether a plan or a combination of plans exceeds the limitations imposed by section 415 for a particular limitation year is, except as otherwise provided, made by taking into account the aggregation of plan rules provided in sections 415(f) and 414(b) and (c) (as modified by section 415(h)).

(b) Rules for disqualification of plans and trusts—(1) In general. Any plan (including a trust which forms part of such plan) that is disqualified in a particular limitation year under the rules set forth in this paragraph, shall be disqualified as of the first day of the first plan year containing any portion of the particular limitation year.

(2) Single plan. In the case of a single qualified defined benefit plan maintained by the employer that provides an annual benefit (as defined in § 1.415–3(b)(1)) in excess of the limitations of section 415(b) and § 1.415–3 for any particular limitation year, such plan is disqualified in that limitation year. Similarly, if the employer only maintains a single defined contribution plan under which annual additions (as defined in § 1.415–6(b)) allocated to the account of any participant exceed the limitations of section 415(c) and § 1.415–6 for any particular limitation year, such plan is also disqualified in that limitation year.

(3) More than one plan. In the event that the limitations of section 415(b) and § 1.415–3, or section 415(c) and § 1.415–6 are exceeded for a particular limitation year with respect to any participant because of the application of the aggregation rules of section 415(f)(1) or section 414(b) or (c), as modified by section 415(h), one or more of the plans shall be disqualified in accordance with the rules set forth in this subparagraph. Similarly, if the limitations of section 415(e) and § 1.415–7 are exceeded for a particular limitation year with respect to any participant because of the application of such aggregation rules (although if an individual participates in a defined contribution and defined benefit plan maintained by the same employer, these limitations may be exceeded even without the application of such aggregation rules), one or more of the plans shall be disqualified in accordance with the following rules:

(i) If there are two plans and one of the plans has been terminated at any time including the last day of the particular limitation year, the plan which has not been so terminated (whether or not that plan is a multiemployer plan described in section 414(f)) is disqualified in that limitation year.

(ii) If there are two plans and neither plan has been terminated at any time including the last day of the particular limitation year, and if one of the plans is a multiemployer plan described in section 414(f), the plan which is not a multiemployer plan is disqualified in that limitation year. For purposes of the preceding sentence, the determination of whether a plan is a multiemployer plan described in section 414(f) is made as of the last day of the particular limitation year.

(iii) If there are two plans of an employer and neither plan has either been terminated at any time including the last day of the particular limitation year or determined to be a multiemployer plan described in section 414(f) as of such day, the employer may elect, in a manner determined by the Commissioner, the plan that is disqualified. If the two plans described in this subdivision are involved because of the application of section 414(b) or (c), as modified by section 415(h), the employers of the controlled group may elect, in a manner determined by the Commissioner, the plan

that is disqualified. However, the election described in the preceding sentence is not effective unless made by all of the employers within the controlled group. For purposes of this subdivision, the elected plan is disqualified in the particular limitation year.

(iv) If the election described in subdivision (b)(3)(iii) of this paragraph is not made with respect to the two plans described in such subdivision, the Commissioner, taking into account all of the facts and circumstances, shall have the discretion to determine the plan that is disqualified in the particular limitation year. In making this determination, some of the factors that will be taken into account include, but are not limited to, the number of participants in each plan and the amount of benefits provided on an overall basis by each plan.

(v) If more that two plans are involved, a plan or plans shall be disqualified in the particular limitation year in accordance with the principles contained in this subparagraph.

(4) Special rules for simplified employee pension. If there are two or more plans and if one of the plans is a simplified employee pension (as defined in section 408(k)), the simplified employee pension shall not be disqualified until all of the other plans have been disqualified. However, if one of the plans has been terminated, the simplified employee pension shall be disqualified before the terminated plan. For purposes of this subparagraph, the disqualification of a simplified employee pension means that the simplified employee pension is no longer described under section 408(k).

(c) Special rules concerning section 403(b) annuity contracts—(1) In general. If aggregating or combining a section 403(b) annuity contract and a qualified plan causes the applicable limitations of section 415 to be exceeded, the exclusion allowance under section 403(b)(2) shall be adjusted first to the extent necessary to satisfy such limitations.

(2) Aggregating section 403(b) annuity contract and qualified defined benefit plan. In the event that aggregating a section 403(b) annuity contract and a qualified defined benefit plan causes the limitations of section 415(e) and § 1.415–7 to be exceeded with respect to a participant for a particular limitation year, the amount of the contribution to the annuity contract in excess of such limitations is treated as a disqualified contribution and therefore includable in the gross income of the participant for the taxable year with or within which that limitation year ends. Furthermore, for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years with respect to such participant, the disqualified contribution is treated as an amount contributed by the employer for an annuity contract which was excludable from the participant's gross income under section 403(b)(2)(A)(ii). Thus, for future taxable years, the exclusion allowance will be reduced by the amount of the disqualified contribution even though such amount was not excludable from the participant's gross income in the taxable year when it was made. See § 1.415–7(c)(2) for special rules relating to the defined contribution plan fraction applicable to an individual on whose behalf a section 403(b) annuity contract has been purchased.

(3) Combining section 403(b) annuity contract and qualified defined contribution plan. In the event that combining a section 403(b) annuity contract and a qualified defined contribution plan under the provisions of section 415(f)(1)(B) causes the limitations of section 415(c) and § 1.415–6 applicable to a participant under the defined contribution plan to be exceeded for a particular limitation year, the excess of the contributions to the annuity contract plus the annual additions to the plan over such limitations is treated as a disqualified contribution to the annuity contract and therefore includable in the gross income of the participant for the taxable year with or within which that limitation year ends. Furthermore, for purposes of computing the exclusion allowance under section 403(b)(2)(A) for future taxable years with respect to such participant, the disqualified contribution is treated an an amount contributed by the employer for an annuity contract which was excludable from the participant's gross income under section 403(b)(2)(A)(ii). Thus, for future taxable years, the exclusion allowance will be reduced by the amount of the disqualified contribution even though such amount was not excludable from the participant's gross income in the taxable year when it was made.

(4) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). N is employed by a hospital which purchases an annuity contract described in section 403(b) on N's behalf for the current limitation year. The current limitation year is N's first year of service with the hospital. Solely for the purpose of illustrating the rules set forth in this paragraph, assume that N is in control of the hospital within the meaning of section 414(b) or (c), as modified by section 415(h). Therefore, under section 415(e)(5), the section 403(b) annuity contract is treated as a defined contribution plan maintained by the hospital and N. The hospital also maintains a qualified defined contribution plan during the current limitation year in which N participates, but it does not maintain any other qualified plan.

N's compensation (within the meaning of § 1.415–2(d)) from the hospital for the current limitation year is $20,000. N does not elect any of the alternative limitations provided in section 415(c)(4) for the section 403(b) annuity contract. For the current limitation year, the hospital contributes $3,000 for the section 403(b) annuity contract on N's behalf, which is within the limitations applicable to N under the annuity contract (*i.e.*, the lesser of the exclusion allowance under section 403(b)(2)(A) ($4,000) or the limitations of section 415(c)(1) ($5,000)). The hospital also contributes $3,000 to the qualified plan on N's behalf for the current limitation year (which represents the only annual additions allocated to N's account under the plan for such year), which is within the $5,000 limitation of section 415(c)(1) applicable to N under the plan. However, under section 415(f)(1)(B), for purposes of applying the limitations of section 415(c) and § 1.415–6, the hospital is considered to maintain only one defined contribution plan and thus, all contributions to the annuity contract and to the regular plan must be combined. Because the total combined contributions ($6,000) exceed the section 415(c) limitation applicable to N under the plan ($5,000), under the special rules contained in this paragraph, $1,000 of the $3,000 contributed to the section 403(b) annuity contract is considered a disqualified contribution and therefore currently includable in N's gross income. Furthermore, in computing N's exclusion allowance for the section 403(b) annuity contract for future taxable years, besides the $3,000 contributed to the qualified plan, the $3,000 contributed for the section 403(b) annuity contract is also considered an amount contributed by the employer and excludable from N's gross income for purposes of section 403(b)(2)(A)(ii), even though only $2,000 of this amount was excludable from N's gross income.

Example (2). Assume the same facts as in example (1), except that instead of the defined contribution plan the hospital maintains a qualified defined benefit plan during the current limitation year in which N participates. Because the hospital is considered to be maintaining a defined contribution plan (in the form of a section 403(b) annuity contract) in addition to its defined benefit plan, the limitations of section 415(e) and § 1.415–7 are applicable to N for the current limitation year. If N's defined benefit plan fraction for the current limitation year is 1.0, then to satisfy the limitations of section 415(e) and § 1.415–7, N's defined contribution plan fraction may not exceed .4 for the current limitation year. This means that only $2,000 (*i.e.* 40% of $5,000—the applicable limitation to N for the annuity contract under the special rule set forth in § 1.415–7(c)(2)(i)) could have been contributed to the annuity contract on N's behalf for the current limitation year without violating the 1.4 limitation of section 415(e) and § 1.415–7. However, because the hospital contributed $3,000 to the section 403(b) annuity contract on N's behalf, under the special rules contained in this paragraph, $1,000 of this amount is considered a disqualified contribution and therefore currently includable in N's gross income. Furthermore, in computing N's exclusion allowance for the section 403(b) annuity contract for future taxable years, the $3,000 contributed to the annuity contract is considered the amount contributed by the employer and excludable from N's gross income for purposes of section 403(b)(2)(A)(ii), even through only $2,000 of this amount was excludable from N's gross income.

[T.D. 7748, 46 FR 1716, Jan. 7, 1981]

§ 1.415–10 Special aggregation rules.

(a) General rules relating to aggregation of plans during limitation year—(1) Scope of aggregation rules. This section provides rules for those situations in which two or more existing plans, which previously were unaggregated, are aggregated during a particular limitation year on or after the effective date of section 415 and these regulations, and as a result, the limitations of section 415(b), (c) or (e) are exceeded for that limitation year. The rules described in this section are also applicable with respect to the aggregation of benefits under a multiemployer plan described in section 414(f) that previously were not required to be aggregated.

(2) Controlling date of aggregation. For purposes of this section, plans which are not aggregated as of the first day of a limitation year will not be considered aggregated for that limitation year. Notwithstanding the preceding sentence, if a section 403(b) annuity contract is aggregated with a qualified plan because of the election by the individual on whose behalf the annuity contract is purchased to have the provisions of section 415(c)(4)(C) apply for the taxable year, the annuity contract and the plan are deemed to be aggregated as of the first day of the limitation year ending with or within such taxable year.

(3) Aggregation of additions and benefits. If plans are aggregated under this section, the following rules shall apply:

(i) All annual additions credited to a participant's account under a defined contribution plan prior to the aggregation of such plan shall be taken into account in computing the participant's defined contribution plan fraction for purposes of applying the limitations of section 415(e) to the aggregated plans.

(ii) The annual benefit or projected annual benefit (whichever is applicable) of a participant under a defined benefit plan prior to the aggregation of such plan shall be taken into account for purposes of applying the limitations of section 415(b) or section 415(e) to the aggregated plans.

(iii) For a special rule relating to the aggregation of contributions to a section 403(b) annuity contract upon the aggregation of the annuity contract with a qualified plan, see § 1.415–7(h)(4)(i).

(b) Aggregation of defined benefit plans. In the case of an individual who is a participant in two or more defined benefit plans and with respect to whom the limitations of section 415(b) and § 1.415–3 are exceeded for a particular limitation year because of the aggregation of the plans for that limitation year, the limitations of section 415(b) and § 1.415–3 may be exceeded for that limitation year and for future limitation years provided that there is no increase in the partici-

pant's accrued benefit derived from employer contributions during the period within which these limitations are being exceeded.

(c) Aggregation of defined benefit and defined contribution plan. In the case of an individual who has at any time participated in a defined benefit plan and also has at any time participated in a defined contribution plan and with respect to whom the limitations of section 415(e) and § 1.415–7 are exceeded for a particular limitation year because of the aggregation of the plans for that limitation year, the limitations of section 415(e) and § 1.415–7 may be exceeded for that limitation year and for future limitation years provided that the following conditions are complied with during that period:

(1) The participant's accrued benefit derived from employer contributions in the defined benefit plan is not increased.

(2) No employer contributions are allocated to the participant's account under any defined contribution plan.

(3) No forfeitures arising under any defined contribution plan are allocated to the participant's account.

(4) No voluntary employee contributions are made by the participant under any defined benefit or defined contribution plan.

(5) No mandatory employee contributions are made by the participant under any defined contribution plan.

(d) Limitation year for aggregated plans. If the plans which are aggregated under this section have different limitation years, subparagraph (1) or (2) of this paragraph must be complied with.

(1) The relevant employer or employers must elect the limitation year that is to be controlling. This election shall be made by the adoption of a written resolution by the employer or employers. See § 1.415–2(b)(4) for rules relating to a change in the limitation year.

(2) The employer or employers may continue to use different limitation years for each plan in accordance with rules determined by the Commissioner.

If, in accordance with paragraph (d)(1) of this section, one limitation year is elected, and if the plans which are aggregated covered at least one common participant prior to being aggregated, that limitation year shall be applicable for past years for purposes of computing the defined contribution fraction for those years. For special rules relating to the computation of the defined contribution plan fraction where records are not available for past periods, see § 1.415–7(f).

(e) The provisions of this section may be illustrated by the following examples:

Example (1). J is an employee of two unrelated corporations, N and M. Each corporation has a qualified defined benefit plan in which J participates. Each plan provides a benefit which is equal to 75 percent of a participant's average compensation for his high 3 years of service and is payable in the form of a straight life annuity beginning at age 65. J's average compensation (within the meaning of § 1.415–2(d)) for his high three years of service from each corporation is $80,000. Each plan uses the calendar year for the limitation and plan year. In July, 1978, N Corporation becomes a wholly owned subsidiary of M Corporation, and as a result, J is treated as being employed by a single employer under section 414(b). Therefore, because section 415(f)(1)(A) requires that all defined benefit plans of an employer be treated as one defined benefit plan, the two plans must be aggregated for purposes of applying the limitations of section 415. (Although, under paragraph (a)(2) of this section, since the plans were not aggregated as of the first day of the 1978 limitation year (January 1, 1978), they will not be considered aggregated until the limitation year beginning January 1, 1979.) As a result of such aggregation, J becomes entitled to a combined benefit which is equal to $120,000, which is in excess of the section 415(b) dollar limitation for 1979 of $98,100. However, under paragraph (b) of this section, the limitations of section 415(b) and § 1.415–3 applicable to J may be exceeded in this situation without plan disqualification, so long as J's accrued benefit derived from employer contributions is not increased during the period within which the limitations are being exceeded.

Example (2). A, age 30, owns all of the stock of X Corporation and also owns 10 percent of the stock of Z Corporation. F, A's father, directly owns 75 percent of the stock of Z Corporation. Both corporations have qualified defined contribution plans in which A participates and both plans use the calendar year for the limitation and plan year. A's compensation (within the meaning of § 1.415–6(a)(3)) for 1976 is $40,000 from Z Corporation and $150,000 from X Corporation. During 1976, annual additions of $10,000 are credited to A's account under the plan of Z Corporation, while annual additions of $26,825 are credited to A's account under the plan of X Corporation. In both instances, the amount of annual additions represent the maximum allowable under section 415(c) and § 1.415–6. On July 15, 1976, F dies, and A inherits all of F's stock in Z in 1976. Because under section 414(b), A is considered to be in control of X and Z Corporations, the two plans must be aggregated for purposes of applying the limitations of section 415. However, even though A's total annual additions for 1976 are $36,825, the limitations of section 415(c) and § 1.415–6 are not violated for 1976, because, under paragraph (a)(2) of this section, the two plans are considered separate plans for that year since they were not aggregated as of the first day of that year.

[T.D. 1718, 46 FR 1718, Jan. 7, 1981]

§ 1.416–1 Questions and answers on top-heavy plans.

The following questions and answers relate to special rules for top-heavy plans under section 416 of the Internal Revenue Code of 1954, as added by

section 240 of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub.L. 97–248) (TEFRA), and amended by sections 524 and 713(f) of the Tax Reform Act of 1984 (Pub.L. 98–369):

Table of Contents

G. General Provisions

G–1 Q. What requirement plans are subject to the top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act of 1984?

A. All stock bonus, pension, or profit-sharing plans intended to qualify under section 401(a), annuity contracts described in section 403(a), and simplified employee pensions described in section 408(k) are subject to the new top-heavy rules added to the Code by the Tax Equity and Fiscal Responsibility Act and amended by the Tax Reform Act ("TRA") of 1984.

G–2 Q. Is a multiple employer plan subject to the top-heavy requirements of section 416?

A. A multiple employer plan is subject to the requirements of section 416, but only with respect to each individual employer. Thus, if twelve employers contribute to a multiple employer plan and the accrued benefits for the key employees of one employer exceed 60 percent of the accrued benefits of all employees for such employer, the plan is top-heavy with respect to that employer. A failure by the multiple employer plan to satisfy section 416 with respect to the employees of such employer means that all employers are maintaining a plan that is not a qualified plan.

G–3 Q. As of what date must plan amendments to comply with top-heavy rules be effective?

A. Amendments required to comply with the top-heavy rules must be effective as of the first day of the first plan year which begins after 1983. See § 1.401(b)–1 for the date by which such amendments must be adopted.

T. Top-Heaviness Determinations

T–1 Q. What factors must be considered in determining whether a plan is top-heavy?

A. (a) In order to determine whether a plan is top-heavy for a plan year, it is necessary to determine which employers will be treated as a single employer for purposes of section 416; what the determination date is for the plan year; which employees are or formerly were key employees; which former employees have not performed any service for the employer maintaining the plan at any time during the five-year period ending on the determination date; which plans of such employers are required or permitted to be aggregated to determine top-heavy status; and the present value of the accrued benefits (including distributions made during the plan year containing the determination date and the four preceding plan years) of key employees, former key employees, and non-key employees.

(b) All employers that are aggregated under section 414(b), (c), and (m) must be taken into account as a single employer for the plan year in question, and those employees in all plans maintained by the employers that are aggregated must be categorized as key employees, as former key employees, or as non-key employees. See Question and Answer T–12 for the determination of which employees are or were key employees. All plans maintained by the employers in which a key employee participates, and certain other plans, must then be aggregated (the required aggregation group). See Question and Answer T–6 for rules concerning required aggregation. Other plans may in some cases be aggregated with the required aggregation group. See Question and Answer T–7 for rules concerning such permissive aggregation.

(c) Once aggregated, all plans that are required to be aggregated will either be top-heavy or not top-heavy, depending upon whether the aggregation group is top-heavy. A plan or aggregation group will be considered top-heavy if the sum of the present value of the accrued benefits for key employees is more than 60 percent of the sum of the present value of accrued benefits of all employees.

(d) Except as otherwise stated, for purposes of section 416(g), an employee is an individual currently or formerly employed by an employer. Former key employees are non-key employees and are excluded entirely from the calculation to determine top-heaviness. In all cases, the present value of accrued benefits includes distributions made during the plan year containing the determination date and the preceding four plan years. See Questions and Answers T–24 and T–25 for rules concerning the account balances and present value of accrued benefits. For plan years beginning after December 31, 1984, the accrued benefit of an employee who has not performed any service for the employer maintaining the plan at any time during the five-year period ending on the determination date is excluded from the calculation to determine top-heaviness. However, if an employ-

ee performs no services for five years and then performs services, such employee's total accrued benefit is included in the calculation for top-heaviness.

T–2 Q. To what extent are multiemployer plans and multiple employer plans to which an employer makes contributions on behalf of its employees treated as plans of that employer for top-heavy purposes?

A. Multiemployer plans described in section 414(f) and multiple employer plans described in section 413(c) to which an employer makes contributions on behalf of its employees are treated as plans of that employer to the extent that benefits under the plan are provided to employees of the employer because of service with that employer.

T–3 Q. Must a collectively-bargained plan be aggregated with other plans of the employer to determine whether some or all of the employer's plans are top-heavy?

A. A collectively-bargained plan that includes a key employee of an employer must be included in the required aggregation group for that employer. See Question and Answer T–6 for rules concerning required aggregation. A collectively-bargained plan that does not include a key employee may be included in a permissive aggregation group. See Question and Answer T–7 for rules concerning permissive aggregation. However, the special rules in section 416(b), (c), or (d) applicable to top-heavy plans do not apply with respect to any employee included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective-bargaining agreement between employee representatives and one or more employers if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. In determining whether there is a collective-bargaining agreement between employee representatives and one or more employers, the additional condition of section 7701(a)(46) must be satisfied after March 31, 1984.

T–4 Q. How is a terminated plan treated for purposes of the top-heavy rules?

A. A terminated plan is treated like any other plan for purposes of the top-heavy rules. For purposes of section 416, a terminated plan is one that has been formally terminated, has ceased crediting service for benefit accruals and vesting, and has been or is distributing all plan assets to participants or their beneficiaries as soon as administratively feasible. Such a plan must be aggregated with other plans of the employer if it was maintained within the last five years ending on the determination date for the plan year in question and would, but for the fact that it terminated, be part of a required aggregation group for such plan year. Distributions which have taken place within the five years ending on the determination date must be accounted for in accordance with section 416(g)(3). No additional vesting, benefit accruals or contributions must be provided for participants in a terminated plan.

T–5 Q. How are frozen plans treated for purposes of the top-heavy rules?

A. For purposes of section 416, a frozen plan is one in which benefit accruals have ceased but all assets have not been distributed to participants or their beneficiaries. Such plans are treated, for purposes of the top-heavy rules, as any non-frozen plan. That is, such plans must provide minimum contributions or benefit accruals, limit the amount of compensation which can be taken into account in providing benefits, and provide top-heavy vesting. A frozen defined contribution plan may not be required to provide additional contributions because of the rule in section 416(c)(2)(B).

T–6 Q. What is a required aggregation group?

A. For purposes of determining whether the plans of an employer are top-heavy for a particular plan year, the required aggregation group includes each plan of the employer in which a key employee participates in the plan year containing the determination date, or any of the four preceding plan years. In addition, each other plan of the employer which, during this period, enables any plan in which a key employee participates to meet the requirements of section 401(a)(4) or 410 is part of the required aggregation group. This concept may be illustrated by the following examples:

Example (1). An employer maintains two plans. Key employees participate in one plan, but not in the other. If the plan containing key employees independently satisfies the coverage and non-discrimination rules of sections 410 and 401(a)(4), it may be tested independently to determine whether it is top-heavy. Also, the plan not covering key employees would not be part of a required aggregation group and would not need to be tested to determine whether it is top-heavy. However, if the plan containing key employees satisfies the coverage requirements of section 410(b) or the non-discrimination requirements of section 401(a)(4) only when it is considered together with the other plan in accordance with § 1.410(b)–1(d)(3), the plan not covering key employees would be part of the required aggregation group.

Example (2). A sole proprietor terminated a Keogh plan in 1981. In 1982, the sole proprietor incorporated and established a corporate plan with a calendar-year plan year. For purposes of determining whether the corporate plan is top-heavy for its 1984 plan year, the terminated Keogh plan and the corporate plan would be part of a required aggregation

group. The sole proprietor and the corporation would be treated as a single employer under section 414(c). Under Question and Answer T-4, the terminated plan would be aggregated with the corporate plan because it was maintained within the five-year period ending on the determination date for the 1984 plan year and because, but for the fact that it terminated, it would be aggregated with the corporate plan because it covered a key employee.

T-7 Q. What is a permissive aggregation group?

A. A permissive aggregation group consists of plans of the employer that are required to be aggregated, plus one or more plans of the employer that are not part of a required aggregation group but that satisfy the requirements of sections 401(a)(4) and 410 when considered together with the required aggregation group. This concept may be illustrated by the following examples:

Example (1). (a) An employer maintains two plans:

1. Plan A covers key employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan B covers no key employees. It also independently satisfies the requirements of sections 410 and 401(a)(4).

(b) As indicated in Question and Answer T-6, Plan B is not required to be aggregated with Plan A. Further, if Plan B provided contributions or benefits that were not at least comparable to the contributions or benefits provided under Plan A, then Plan B could not be permissively aggregated with Plan A because the contributions and benefits would discriminate if the two plans were considered as a unit. However, if the benefits or contributions under Plan B were comparable to those under Plan A, the two plans would be permitted to be aggregated to determine whether or not the group consisting of both plans is top-heavy. If Plan A and Plan B are permitted to be aggregated, and if the permissive aggregation group is not top-heavy, then neither Plan A nor Plan B would be considered top-heavy.

Example (2). (a) Employer W maintains two plans.

1. Plan C covers salaried employees and independently satisfies the requirements of sections 410 and 401(a)(4).

2. Plan D covers employees who are included in a unit of employees covered by an agreement which the Secretary of Labor has found to be a collective-bargaining agreement between employee representatives and the employer and retirement benefits were bargained for between employee representatives and the employer.

(b) The fact that Plan D is a collectively-bargained plan does not necessarily mean that it may be permissively aggregated with Plan C. In order to be permissively aggregated with Plan C, Plan D must provide contributions or benefits with respect to service with Employer W that are at least comparable to the contributions or benefits provided under Plan C.

T-8 Q. May an employer permissively aggregate multiemployer plans, multiple employer plans and simplified employee pension plans to which the employer contributes with a plan covering key employees or a required aggregated group?

A. Yes. Multiemployer plans, multiple employer plans and simplified employee pensions to which an employer makes contributions may be permissively aggregated with a plan covering key employees or with a required aggregation group if the contributions or benefits provided under the multiemployer plan, multiple employer plan or simplified employee pension by the employer are comparable to the contributions or benefits provided under the plan covering key employees or the plans in the required aggregation group. In making this determination, only the employer's contribution to the simplified employee pension may be used.

T-9 Q. What plans will be treated as top-heavy if they are part of a required aggregation group that is top-heavy?

A. In the case of plans that are required to be aggregated, each plan in the required aggregation group will be top-heavy if the group is top-heavy. No plan in the required aggregation group will be top-heavy if the group is not top-heavy.

T-10 Q. If a required aggregation group is top-heavy, and one plan of the group satisfies the requirements of sections 416(b), (c), and (d), may other plans in the group include provisions which do not satisfy sections 416(b), (c) and (d)?

A. No. Each plan in a required aggregation group is top-heavy if the group is top-heavy. Thus, each plan must contain provisions satisfying the requirements of sections 416(b) and (d). If all the plans are defined contribution plans, only one plan need satisfy the requirements of section 416(c)(2) with respect to any non-key employee who participates in more than one of the plans. If all the plans are defined benefit plans, only one plan need satisfy the requirements of section 416(c)(1) with respect to any non-key employee who participates in more than one of the plans. However, in the case of non-key employees who do not participate in more than one plan, each plan must separately provide the applicable minimum contribution or benefit with respect to each such employee. See Question and Answer M-12 in the case of employees who are covered under both a defined benefit and a defined contribution plan.

T-11 Q. What plans will be treated as top-heavy if a permissive aggregation group is top-heavy?

A. If a permissive aggregation group is top-heavy, only those plans that are part of the required aggregation group will be subject to the requirements of section 416(b), (c) and (d). Plans that are not part of the required aggregation group will not be subject to these requirements. Thus, if an employer wishes to demonstrate that the plans maintained by the employer are not top-heavy, the

employer need consider only the required aggregation group. If, after considering the required aggregation group, it is determined that the plans are not top-heavy, the requirements of section 416(b), (c) and (d) will not apply to any of the plans. If, on the other hand, the plans required to be aggregated are top-heavy, the employer may wish to determine whether there are any plans that may be permissively aggregated to demonstrate that the plans are not top-heavy. Assuming that there are plans that are eligible for permissive aggregation, the employer may take these plans into consideration. If, after taking such plans into consideration, the net result is that the entire group is not top-heavy, the top-heavy requirements do not apply to any plan in the group.

T–12 Q. For purposes of determining whether a plan is top-heavy for a plan year, who is a key employee?

A. Under section 416(i)(1), a key employee is any employee (including any deceased employee) who at any time during the plan year containing the determination date for the plan year in question or the four preceding plan years (including plan years before 1984) is:

1. An officer of the employer having annual compensation from the employer for a plan year greater than 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends (see Questions and Answers T–13, T–14, and T–15),

2. One of the ten employees having annual compensation from the employer for a plan year greater than the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends and owning (or considered as owning within the meaning of section 318) both more than a ½ percent interest and the largest interests in the employer (see Question and Answer T–19),

3. A 5-percent owner of the employer, or

4. A 1-percent owner of the employer having annual compensation from the employer for a plan year more than $150,000 (see Questions and Answers T–16 and T–21).

An individual may be considered a key employee in a plan year for more than one reason. For example, an individual may be both an officer and one of the ten largest owners. However, in testing whether a plan or group is top-heavy, an individual's accrued benefit is counted only once. The terms key employee, former key employee, and non-key employee include the beneficiaries of such individuals. This Question and Answer is illustrated by the following examples:

Example (1). An employer maintains a calendar-year plan. An individual who was an employee of the employer and a 5-percent owner of the employer in 1986 was neither an employee nor an owner in 1987 or thereafter. Even though the individual is no longer an employee or owner of the employer, the individual would be treated as a key employee for purposes of determining whether the plan is top-heavy for each plan year through the 1991 plan year. However, for purposes of determining whether the plan is top-heavy for the 1992 plan year and for subsequent plan years, the individual would be treated as a former key employee.

Example (2). The facts are the same as in example (1), except that the individual died in early 1987 and his total benefit under the plan was distributed to his beneficiary in 1987. Such distribution would be treated as the accrued benefit of the individual for each year through the 1991 plan year. However, such individual would be treated as a former key employee for purposes of determining whether the plan is top-heavy for the 1992 plan year and for subsequent plan years. The conclusions are not affected by whether the beneficiary of the individual is a non-key employee or a key employee of the employer.

T–13 Q. For purposes of defining a key employee, who is an officer?

A. Whether an individual is an officer shall be determined upon the basis of all the facts, including, for example, the source of his authority, the term for which elected or appointed, and the nature and extent of his duties. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction. An employee who merely has the title of an officer but not the authority of an officer is not considered an officer for purposes of the key employee test. Similarly, an employee who does not have the title of an officer but has the authority of an officer is an officer for purposes of the key employee test. In the case of one or more employers treated as a single employer under sections 414(b), (c), or (m), whether or not an individual is an officer shall be determined based upon his responsibilities with respect to the employer or employers for which he is directly employed, and not with respect to the controlled group of corporations, employers under common control or affiliated service group. A partner of a partnership will not be treated as an officer for purposes of the key employee test merely because he owns a capital or profits interest in the partnership, exercises his voting rights as a partner, and may, for limited purposes, be authorized and does in fact act as an agent of the partnership.

T–14 Q. For purposes of determining whether a plan is top-heavy for a plan year, how many officers must be taken into account?

A. There is no minimum number of officers that must be taken into account. Only individuals who are in fact officers within the meaning of Question and Answer T–13 must be considered. For example, a corporation with only one officer and two employees would have only one officer for purposes of section 416(i)(1)(A)(i). After aggregating all employees (including leased employees within the meaning of section 414(n)) of employers required to be aggregated under section 414(b), (c) or (m), there is a maximum limit to the number of officers that are to be taken into account as officers for the entire group of employers that are so aggregated. The number of employees an employer (including all employers required to be aggregated under section 414(b), (c), or (m)) has for the plan year containing the determination date is the greatest number of employees it had during that plan year or any of the four preceding plan years. For purposes of this Question and Answer, employees include only those individuals who perform services for the employer during a plan year. If the number of employees (including part-time employees) of all the employers aggregated under section 414(b), (c) or (m) is less than 30 employees, no more than three individuals shall be treated as key employees for the plan year containing the determination date by reason of being officers. If the number of employees of all organizations aggregated under section 414(b), (c) or (m) is greater than 30 but less than 500, no more than 10% of the number of employees will be treated as key employees by reason of being officers. (If 10% of the number of employees is not an integer, the maximum number of individuals to be treated as key employees by reason of being officers shall be increased to the next integer). If the number of employees of employers aggregated under section 414(b), (c) and (m) exceeds 500, no more than 50 employees are to be considered as key employees by reason of being officers. This limited number of officers is comprised of the individual officers, selected from the group of all individuals who were officers in the plan year containing the determination date or any one of the four preceding plan years, who had annual plan year compensation (in the officer year) in excess of 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the plan year ends and who had the largest annual plan-year compensation in that five-year period. (The definition of compensation contained in Question and Answer T–21 is to be used for this purpose.) In determining the officers of an employer, an employee who is an officer shall be counted as an officer for key employee purposes without regard to whether the employee is a key employee for any other reason. However, in testing whether the plan(s) is top-heavy, an individual's present value of accrued benefits is counted only once.

Example. A company is testing to see if its plan is top-heavy for the 1985 plan year. In each year from 1980 through 1984 it has more than 500 employees. Assume that (1) because of rapid turnover among officers, the individuals who are officers each year are different from the individuals who are officers in any preceding year, and (2) the annual plan year compensation of each officer exceeds 150 percent of the dollar limitation in effect under section 415(c)(1)(A) for the calendar year in which the plan year ends. Under the limitations, only a total of 50 individuals would be considered to be key employees by virtue of being officers in testing for top-heaviness for the 1985 plan year. Further, the 50 individuals considered as key employees under this test would be determined by selecting the 50 out of 250 individuals (50 different officers each year) who had the highest annual plan-year compensation during the 1980–1984 period (while officers).

T–15 Q. For purposes of section 416, do organizations other than corporations have officers?

A. Yes. For purposes of the top-heavy rules, sole proprietorships, partnerships, associations, trusts, and labor organizations may have officers. This rule is effective for purposes of determining whether a plan is top-heavy for plan years which begin after February 28, 1985.

T–16 Q. Who is a 1-percent owner of the employer?

A. (a) If the employer is a corporation, a 1-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 1 percent of the value of the outstanding stock of the corporation or stock possessing more than 1 percent of the total combined voting power of all stock of the corporation. If the employer is not a corporation, a 1-percent owner is any employee who owns more than 1 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 1-percent owner.

(b) For purposes of determining who is a 1-percent owner, 5-percent owner, or top-ten owner, value means fair market value taking into account all facts and circumstances.

T–17 Q. Who is a 5-percent owner of the employer?

A. If the employer is a corporation, a 5-percent owner is any employee who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the value of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation. If

the employer is not a corporation, a 5-percent owner is any employee who owns more than 5 percent of the capital or profits interest in the employer. The rules of subsections (b), (c), and (m) of section 414 do not apply for purposes of determining who is a 5-percent owner.

T–18 Q. How do the rules of section 318 apply for purposes of determining ownership in an entity other than a corporation?

A. For purposes of determining ownership in an entity other than a corporation, the rules of section 318 apply in a manner similar to the way in which they apply for purposes of determining ownership in a corporation. For non-corporate interests, capital or profits interest must be substituted for stock.

T–19 Q. Which employees will be considered one of the top ten owners?

A. (a) For purposes of determining whether a plan is top-heavy for a plan year, the top ten owners are the ten employees who (1) own (or are considered as owning within the meaning of section 318) during the plan year containing the determination date or any of the four preceding plan years both more than a ½ percent ownership interest in value and the largest percentage ownership interests in value of any of the employers required to be aggregated under section 414(b), (c), or (m), and (2) have during the plan year of ownership annual plan year compensation from the employer more than the limitation in effect under section 415(c)(1)(A) for the calendar year in which such plan year ends. The five years for which the test is made will be referred to as the "testing period." An employee whose annual plan year compensation exceeds the section 415(c)(1)(A) limit in effect for the calendar year in which a plan year in the testing period ends who has an ownership interest greater than ½ percent in that plan year is considered to be one of the top ten owners unless at least ten other employees own a greater interest in the employer during any year of the testing period and have annual plan year compensation during such plan year of ownership greater than the section 415(c)(1)(A) limit in effect for the calendar year in which such plan year ends. Ownership each plan year is determined on the basis of percentage of ownership interest in total ownership value and not dollar amounts. Thus, an employee whose stock interest is valued at 15 percent of the total stock value of a corporation in year one that was worth $15,000 is ranked higher than an employee whose stock interest is valued at 5 percent of the total stock value of the same corporation in year three which is now worth $50,000.

(b) If an employee's ownership interest changes during a plan year, his ownership interest for the year is the largest interest owned at any time during the year. If two employees have the same ownership interest in the employer during the testing period, the employee having the largest annual compensation from the employer for the plan year during any part of which that ownership interest existed shall be treated as having a larger interest. Thus, if 25 employees each own 4 percent in value of the employer during the testing period, the 10 employees with the largest single plan year compensation during this period will be considered the top ten owners. For purposes of this Question and Answer, compensation has the meaning set forth in Question and Answer T–21. This Question and Answer is illustrated by the following examples:

Example 1. Corporation K maintains a calendar year defined contribution plan. On January 1, 1986, Corporation K has five owners who owned the following value percentages of K stock: A = 50%, B = 20%, C = 15%, D = 10%, and E = 5%. On June 30, 1987, the five owners of Corporation K sold all of their shares of stock. The new owners and their respective ownership percentages were: F = 40%, G = 30%, H = 10%, I = 10%, and J = 10%. Assume that, for 1986, A, B, C, D, and E had annual compensation from Corporation K greater than the section 415(c)(1)(A) limit and that, for 1987, F, G, H, I, and J also had compensation from Corporation K greater than the section 415(c)(1)(A) limit. For purposes of determining whether the plan is top-heavy for the 1991 plan year, the top ten owners will include A, B, C, D, E, F, G, H, I, and J because no 10 individuals during the testing period, 1986–1990, had a greater ownership interest than these individuals.

Example 2. Assume the same facts in Example 1, except that on June 1, 1988, F, G, H, I, and J sold their interests to new owners, K, L, M, N, and O. K, L, M, N, and O owned, respectively, 30%, 30%, 30%, 5% and 5% of the value of the shares of X. Assume also that for 1988 K, L, M, N, and O earned more than the section 415(c)(1)(A) limitation. For purposes of determining whether the plan is top-heavy for the 1991 plan year, the top ten owners will include: A, B, F, K, G, L, M, and C because these eight individuals owned the highest value percentages of the Corporation K stock. Since D, H, I, and J owned equal 10% interests in value, the two employees of this group who had the largest annual plan year compensation during the plan years of their ownership will be the last 2 top ten owners.

T–20 Q. For purposes of determining whether an employee is a key employee under section 416(i)(1)(A), what aggregation rules apply?

A. In the case of ownership percentages, each employer that would otherwise be aggregated under section 414(b), (c) and (m) is treated as a separate employer. (See section 416(i)(1)(C).) However, for purposes of determining whether an individual has compensation of $150,000, or whether an individual is a key employee by reason

of being an officer or a top ten owner, compensation from each entity required to be aggregated under sections 414(b), (c) and (m) is taken into account. These rules may be illustrated by the following example:

Example. An individual owns two percent of the value of a professional corporation, which in turn owns a 1/10th of 1 percent interest in a partnership. The entities must be aggregated in accordance with section 414(m). The individual performs services for the professional corporation and for the partnership. The individual receives compensation of $125,000 from the professional corporation and $26,000 from the partnership. The individual is considered to be a key employee with respect to the employer that comprises both the professional corporation and the partnership because he has a two percent interest in the professional corporation and because his combined compensation from both the professional corporation and the partnership is more than $150,000.

T–21 Q. For purposes of testing whether an individual has compensation of more than $150,000, what definition of compensation must be used?

A. The definition of compensation to be used is the definition in § 1.415–2(d). In the case of an individual, including a self-employed individual, § 1.415–2(d)(2)(i) excludes from compensation amounts contributed to a plan of deferred compensation. Alternatively, compensation that would be stated on an employee's Form W–2 for the calendar year that ends with or within the plan year may be used. A plan must use the same definition of compensation for all top-heavy purposes for which the definition in this Question and Answer must be used.

T–22 Q. In the case of an employer who maintains a single plan, when must the determination whether the plan is top-heavy be made?

A. Whether a plan is top-heavy for a particular plan year is determined as of the determination date for such plan year. The determination date with respect to a plan year is defined in section 416(g)(4)(C) as (1) the last day of the preceding plan year, or (2) in the case of the first plan year, the last day of such plan year. Distributions made and the present value of accrued benefits are generally determined as of the determination date. (See Questions and Answers T–24 and T–25 for more specific rules.)

T–23 Q. In the case of an aggregation group, when must the determination whether the group is top-heavy be made?

A. When two or more plans constitute an aggregation group in accordance with section 416(g)(2), the following procedures are used to determine whether the plans are top-heavy for a particular plan year. First, the present value of the accrued benefits (including distributions for key employees and all employees) is determined separately for each plan as of each plan's determination date. The plans are then aggregated by adding together the results for each plan as of the determination dates for such plans that fall within the same calendar year. The combined results will indicate whether or not the plans so aggregated are top-heavy. These rules may be illustrated by the following example:

Example. An employer maintains Plan A and Plan B, each containing a key employee. Plan A's plan year commences July 1 and ends June 30. Plan B's plan year is the calendar year. For Plan A's plan year commencing July 1, 1984, the determination date is June 30, 1984. For Plan B's plan year in 1985, the determination date is December 31, 1984. These plans are required to be aggregated. For each of these plans as of their respective determination dates, the present value of the accrued benefits for key employees and all employees are separately determined. The two determination dates, June 30, 1984, and December 31, 1984, fall within the same calendar year. Accordingly, the present values of accrued benefits as of each of these determination dates are combined for purposes of determining whether the group is top-heavy. If, after combining the two present values, the total results show that the group is top-heavy, Plan A will be top-heavy for the plan year commencing July 1, 1984, and Plan B will be top-heavy for the 1985 calendar year.

T–24 Q. How is the present value of an accrued benefit determined in a defined contribution plan?

A. The present value of accrued benefits as of the determination date for any individual is the sum of (a) the account balance as of the most recent valuation date occurring within a 12-month period ending on the determination date, and (b) an adjustment for contributions due as of the determination date. In the case of a plan not subject to the minimum funding requirements of section 412, the adjustment in (b) is generally the amount of any contributions actually made after the valuation date but on or before the determination date. However, in the first plan year of the plan, the adjustment in (b) should also reflect the amount of any contributions made after the determination date that are allocated as of a date in that first plan year. In the case of a plan that is subject to the minimum funding requirements, the account balance in (a) should include contributions that would be allocated as of a date not later than the determination date, even though those amounts are not yet required to be contributed. Thus, the account balance will include contributions waived in prior years as reflected in the adjusted account balance and contributions not paid that resulted in a funding deficiency. The adjusted account balance is described in Rev.Rul. 78–223, 1978–1 C.B. 125. Also, the adjustment in (b) should reflect the amount of any contribution

actually made (or due to be made) after the valuation date but before the expiration of the extended payment period in section 412(c)(10).

T–25 Q. How is the present value of an accrued benefit determined in a defined benefit plan?

A. The present value of an accrued benefit as of a determination date must be determined as of the most recent valuation date which is within a 12-month period ending on the determination date. In the first plan year of a plan, the accrued benefit for a current employee must be determined either (i) as if the individual terminated service as of the determination date or (ii) as if the individual terminated service as of the valuation date, but taking into account the estimated accrued benefit as of the determination date. For the second plan year of a plan, the accrued benefit taken into account for a current participant must not be less than the accrued benefit taken into account for the first plan year unless the difference is attributable to using an estimate of the accrued benefit as of the determination date for the first plan year and using the actual accrued benefit as of the determination date for the second plan year. For any other plan year, the accrued benefit for a current employee must be determined as if the individual terminated service as of such valuation date. For this purpose, the valuation date must be the same valuation date for computing plan costs for minimum funding, regardless of whether a valuation is performed that year.

T–26 Q. What actuarial assumptions are used for determining the present value of accrued benefits for defined benefit plans?

A. (a) There are no specific prescribed actuarial assumptions that must be used for determining the present value of accrued benefits. The assumptions used must be reasonable and need not relate to the actual plan and investment experience. The assumptions need not be the same as those used for minimum funding purposes or for purposes of determining the actuarial equivalence of optional benefits under the plan. The accrued benefit for each current employee is computed as if the employee voluntarily terminated service as of the valuation date. The present value must be computed using an interest and a post-retirement mortality assumption. Pre-retirement mortality and future increases in cost of living (but not in the maximum dollar amount permitted by section 415) may also be assumed. However, assumptions as to future withdrawals or future salary increases may not be used. In the case of a plan providing a qualified joint and survivor annuity within the meaning of section 401(a)(11) as a normal form of benefit, for purposes of determining the present value of the accrued benefit, the spouse of the participant may be assumed to be the same age as the participant.

(b) Except in the case where the plan provides for a nonproportional subsidy, the present value should reflect a benefit payable commencing at normal retirement age (or attained age, if later). Thus, benefits not relating to retirement benefits, such as pre-retirement death and disability benefits and post-retirement medical benefits, must not be taken into account. Further, subsidized early retirement benefits and subsidized benefit options must not be taken into account unless they are nonproportional subsidies. See Question and Answer T–27.

(c) Where the plan provides for a nonproportional subsidy, the benefit should be assumed to commence at the age at which the benefit is most valuable. In the case of two or more defined benefit plans which are being tested for determining whether an aggregation group is top-heavy, the actuarial assumptions used for all plans within the group must be the same. Any assumptions which reflect a reasonable mortality experience and an interest rate not less than five percent or greater than six percent will be considered as reasonable. Plans, however, are not required to use an interest rate in this range.

T–27 Q. In determining the present value of accrued benefits in a defined benefit plan, what standards are applied toward determining whether a subsidy is nonproportional?

A. A subsidy is nonproportional unless the subsidy applies to a group of employees that would independently satisfy the requirements of section 410(b). If two or more plans are considered as a unit for comparability purposes under § 1.410(b)–1(d)(3), subsidies may be necessary in both plans or else the subsidy may be nonproportional. Thus, for example, in the case of a plan which provides an early retirement benefit after age 55 and 20 years of service equal to the normal retirement benefit without actuarial reduction and if the employees who may conceivably reach age 55 with 20 years of service would, as a group, satisfy the requirements of section 410(b), that subsidy is proportional. However, in contrast, consider a plan that provides an early retirement benefit that is the actuarial equivalent of the normal retirement benefit. In determining the early retirement benefit, the plan imposes the section 415 limits only on the early retirement benefit (not on the normal retirement benefit before applying the early retirement reduction factors). In such a

plan, a participant with a normal retirement benefit (before limitation by section 415) in excess of the section 415 limits will receive a subsidized early retirement benefit, whereas a participant with a lower normal retirement benefit will not. Thus, such a benefit would be a nonproportional subsidy if the group of individuals who are limited by the limitations under section 415 do not, by themselves, constitute a cross section of employees that could satisfy section 410(b).

T–28 Q. For purposes of determining the present value of accrued benefits in either a defined benefit or defined contribution plan, are the accrued benefits attributable to employee contributions considered to be part of the accrued benefits?

A. The accrued benefits attributable to employee contributions are considered to be part of the accrued benefits without regard to whether such contributions are mandatory or voluntary. However, the amounts attributable to deductible employee contributions (as defined in section 72(*o*)(5)(A)) are not considered to be part of the accrued benefits.

T–29 Q. How are plans described in section 401(k) treated for purposes of the top-heavy rules?

A. No special top-heavy rules are provided for plans described in section 401(k), except a transitional rule. For plan years beginning after December 31, 1984, amounts which an employee elects to defer are treated as employer contributions for purposes of determining minimum required contributions under section 416(c)(2). However, for plan years beginning prior to January 1, 1985, amounts which an employee elects to have contributed to a plan described in section 401(k) are not treated as employer contributions for these purposes. A plan described in section 401(k) which is top-heavy must provide minimum contributions by the employer and limit the amount of compensation which can be taken into account in providing benefits under the plan.

T–30 Q. What distributions are added to the present value of accrued benefits in determining whether a plan is top-heavy for a particular plan year?

A. Under section 416(g)(3)(A), distributions made within the plan year that includes the determination date and within the four preceding plan years are added to the present value of accrued benefits of key employees and non-key employees in testing for top-heaviness. However, in the case of distributions made after the valuation date and prior to the determination date, such distributions are not included as distributions in section 416(g)(3)(A) to the extent that such distributions are included in the present value of the accrued benefits as of the valuation date. In the case of the distribution of an annuity contract, the amount of such distribution is deemed to be the current actuarial value of the contract, determined on the date of the distribution. Certain distributions that are rolled over by the employee are not included as distributions. See Question and Answer T–32. A distribution will not fail to be considered in determining the present value of accrued benefits merely because it was made before the effective date of section 416. For purposes of this question and answer, distributions mean all distributions made by a plan, including all distributions of employee contributions made during and before the plan year.

T–31 Q. Are benefits paid on account of death treated as distributions for purposes of section 416(g)(3)?

A. Benefits paid on account of death are treated as distributions for purposes of section 416(g)(3) to the extent such benefits do not exceed the present value of accrued benefits existing immediately prior to death; benefits paid on account of death are not treated as distributions for purposes of section 416(g)(3) to the extent such benefits exceed the present value of accrued benefits existing immediately prior to death. The distribution from a defined contribution plan (including the cash value of life insurance policies) of a participant's account balance on account of death will be treated as a distribution for purposes of section 416(g)(3).

T–32 Q. How are rollovers and plan-to-plan transfers treated in testing whether a plan is top-heavy?

A. The rules for handling rollovers and transfers depend upon whether they are unrelated (both initiated by the employee and made from a plan maintained by one employer to a plan maintained by another employer) or related (a rollover or transfer either not initiated by the employee or made to a plan maintained by the same employer). Generally, a rollover or transfer made incident to a merger or consolidation of two or more plans or the division of a single plan into two or more plans will not be treated as being initiated by the employee. The fact that the employer initiated the distribution does not mean that the rollover was not initiated by the employee. For purposes of determining whether two employers are to be treated as the same employer, all employers aggregated under section 414(b), (c) or (m) are treated as the same employer. In the case of unrelated

rollovers and transfers, (1) the plan making the distribution or transfer is to count the distribution as a distribution under section 416(g)(3), and (2) the plan accepting the rollover or transfer is not to consider the rollover or transfer as part of the accrued benefit if such rollover or transfer was accepted after December 31, 1983, but is to consider it as part of the accrued benefit if such rollover or transfer was accepted prior to January 1, 1984. In the case of related rollovers and transfers, the plan making the distribution or transfer is not to count the distribution or transfer under section 416(g)(3) and the plan accepting the rollover or transfer counts the rollover or transfer in the present value of the accrued benefits. Rules for related rollovers and transfers do not depend on whether the rollover or transfer was accepted prior to January 1, 1984.

T–33 Q. How are the aggregate defined benefit and defined contribution limits under section 415(e) affected by the top-heavy rules?

A. Section 416(h) modifies the aggregate limits in section 415(e) for super top-heavy plans and for top-heavy plans that are not super top-heavy but do not provide for an additional minimum contribution or benefit. A plan is a super top-heavy plan if the present value of accrued benefits for key employees exceeds 90% of the present value of the accrued benefits for all employees. In the case of a top-heavy aggregation group, the test is applied to all plans in the group as a whole. These present values are computed using the same rules as are used for determining whether the plan is top-heavy. In the case of a super top-heavy plan, in computing the denominators of the defined benefit and defined contribution fractions under section 415(e), a factor of 1.0 is used instead of 1.25 for all employees. In the case of a top-heavy plan that is not super top-heavy, the same rule applies unless each non-key employee who is entitled to a minimum contribution or benefit receives an additional minimum contribution or benefit. In the case of a defined benefit plan, the additional minimum benefit is one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2. In the case of a defined contribution plan, the additional minimum contribution is one percent of the participant's compensation. If a plan does not provide the applicable additional one percent minimum or if a plan is super top-heavy, the factor of 1.25 may be used for an individual only if there are both no further accruals for that individual under any defined benefit plan and no further annual additions for that individual under any defined contribution plan until the combined fraction satisfies the rules of section 415(e) using the 1.0 factor for that individual. The rules contained in this Question and Answer apply for each limitation year that contains any portion of a plan year for which the plan is top-heavy. This Question and Answer may be illustrated by the following example:

Example. A Corporation maintains a profit-sharing plan and a defined benefit plan, and these plans constitute a required aggregation group. Both plans use the calendar year for the plan year and the limitation year under section 415. The plans were determined to be top-heavy for plan year 1986. The plans use the 1.25 factor under section 415(e), and non-key employees covered by both the profit-sharing and the defined benefit plan accrue, under the defined benefit plan, 3% of compensation for each year of service (up to a maximum of 30%). The plans become super top-heavy for the 1990 plan year. In order to satisfy section 415, no further accruals and no further annual additions may take place for any employee covered by both plans until the combined defined benefit-defined contribution fraction for such employee is less than 1.0, using the 1.0 factor in place of 1.25.

T–34 Q. May plans be permissively aggregated to avoid being super top-heavy?

A. Yes, plans may be permissively aggregated to avoid being super top-heavy.

T–35 Q. What provisions must be contained in a plan to comply with the top-heavy requirements?

A. Section 401(a)(10)(B) provides that a plan will qualify only if it contains provisions which will take effect if the plan becomes top-heavy and which meet the requirements of section 416. See Questions and Answers T–39 and T–40 for rules on what provisions must be included. Under section 401(a)(10)(B)(ii), regulations may waive this requirement for some plans. See Question and Answer T–38 for a description of plans that need not include such provisions.

T–36 Q. For an employer who has no employee who has participated or is eligible to participate in both a defined benefit and defined contribution plan (or a simplified employee pension, "SEP") of that employer, what provisions must be in the plan(s) to comply with the top-heavy requirements?

A. (a) If the defined benefit plan has no participants who are or could be participants in a defined contribution plan of the employer (or vice versa), the defined benefit plan (or defined contribution plan) need not include provisions describing the defined benefit or defined contribution fractions for purposes of section 415 and, thus, the plan need not contain provisions to determine

whether the plan is super top-heavy or to change any plan provisions if the plan becomes super top-heavy. Furthermore, if the plan contains a single benefit structure that satisfies the requirements of section 416(b), (c), and (d) for each plan year without regard to whether the plan is top-heavy for such year, the plan need not include separate provisions to determine whether the plan is top-heavy or that apply if the plan is top-heavy. If the plan's single benefit structure does not assure that section 416(b), (c), and (d) will be satisfied in all cases, then the plan must include three types of provisions.

(b) First, the plan must contain provisions describing how to determine whether the plan is top-heavy. These provisions must include (1) the criteria for determining which employees are key employees (or non-key employees), (2) in the case of a defined benefit plan, the actuarial assumptions and benefits considered to determine the present value of accrued benefits, (3) a description of how the top-heavy ratio is computed, (4) a description of what plans (or types of plans) will be aggregated in testing whether the plan is top-heavy, and (5) a definition of the determination date and the valuation date applicable to the determination date. These determinations must be based on standards that are uniformly and consistently applied and that satisfy the rules set forth in section 416 and these Questions and Answers. The provisions in (1) and (3) above may be incorporated in the plan by reference to the applicable sections of the Internal Revenue Code without adversely affecting the qualification of the plan. However, the plan must state the definition of compensation for purposes of determining who is a key employee.

(c) Second, the plan must specifically contain the following provisions that will become effective if the plan becomes top-heavy: vesting that satisfies the minimum vesting requirements of section 416(b), benefits that will not be less than the minimum benefits set forth in section 416(c), and the compensation limitation described in section 416(d). The compensation limitation described in section 416(d) may be incorporated by reference. If a plan always meets the requirements of either section 416(b), (c) or (d), the plan need not include additional provisions to meet any such requirements.

(d) Third, the plan must include provisions insuring that any change in the plan's benefit structure (including vesting schedules) resulting from a change in the plan's top-heavy status will not violate section 411(a)(10). Thus, if a plan ceases being top-heavy, certain restrictions apply with respect to the change in the applicable vesting schedule.

T–37 Q. For an employer who maintains or has maintained both a defined benefit and a defined contribution plan (or a simplified employee pension, "SEP") and some participants do or could participate in both types of plan, what provisions must be in the plans to comply with the top-heavy requirements?

A. If an employer maintains (or has maintained) both a defined benefit plan and a defined contribution plan (or SEP), and the plans have or could have participants who participate in both types of plans, then the plans must contain more provisions than those described in Question and Answer T–36. First, the plans may exclude rules to determine whether the plan is top-heavy (or to apply when the plan is top-heavy) only if both plans contain a single benefit structure that satisfies sections 416(b), (c), and (d) without regard to whether the plans are top-heavy. Second, unless the plans always satisfy the requirements of section 415(e) using the 1.0 factor in the defined benefit and defined contribution fractions as described in section 416(h)(i), the plans must include provisions similar to those in Question and Answer T–36 (for top-heavy) to determine whether the plan is super top-heavy and to satisfy section 416(h) if it is.

T–38 Q. Are any plans exempted from including top-heavy provisions?

A. Section 401(a)(10)(B) exempts governmental plans (as defined in section 414(d)) from the top-heavy requirements and provides that regulations may exempt certain plans from including the top-heavy provisions.

A plan need not include any top-heavy provisions if the plan: (1) is not top-heavy, and (2) covers only employees who are included in a unit of employees covered by a collective-bargaining agreement (if retirement benefits were the subject of good faith bargaining) or employees of employee representatives. The requirement set forth in section 7701(a)(46) must be met before an agreement will be considered a collective-bargaining agreement after March 31, 1984.

T–39 Q. Must ratios be computed each year to determine whether a plan is top-heavy?

A. No. In order to administer the plan, the plan administrator must know whether the plan is top-heavy. However, precise top-heavy ratios need not be computed every year. If, on examination, the Internal Revenue Service requests a demonstration as to whether the plan is top-heavy (or super top-heavy; see Question and Answer T–33)

the employer must demonstrate to the Service's satisfaction that the plan is not operating in violation of section 401(a)(10)(B). For purposes of any demonstration, the employer may use computations that are not precisely in accordance with this section but which mathematically prove that the plan is not top-heavy. For example, if the employer determined the present value of accrued benefits for key employees in a simplified manner which overstated that value, determined the present value for non-key employees in a simplified manner which understated that value, and the ratio of the key employee present value divided by the sum of the present values was less than 60 percent, the plan would not be considered top-heavy. This would be a sufficient demonstration because the simplified fraction could be shown to be greater than the exact fraction and, thus, the exact fraction must also be less than 60 percent.

Several methods that may be used to simplify the determinations are indicated below.

(1) If the top-heavy ratio, computed considering all the key employees and only some of the non-key employees, is less than 60 percent, then it is not necessary to accumulate employee data on the remaining non-key employees. Inclusion of additional non-key employees would only further decrease the ratio.

(2) If the number of key employees is known but the identity of the key employees is not known (i.e. if the only key employees are officers and the limit on officers is applicable), the numerator may be determined by using a hypothetical "worst case" basis. Thus, in the case of a defined benefit plan, if the numerator of the top-heavy ratio were determined assuming each key employee's present value of accrued benefits were equal to the maximum section 415 benefits at the age that would maximize such present value, that assumption would only overstate the present value of accrued benefits for key employees. Thus, if that ratio is less than 60 percent, the plan is not top-heavy and accurate data on the key employees need not be collected.

(3) If the employer has available present value of accrued benefit computations for key and non-key employees in a defined benefit plan, and these values differ from those that would be produced under Question and Answer T–25 only by inclusion of a withdrawal assumption, the present value for the key employees (but not the non-key employees) may be adjusted to a "worst case" value by dividing by the lowest possible probability of not withdrawing from plan participation before normal retirement age. If the top-heavy ratio based on this inflated key employee value is less than 60 percent, the present value need not be recomputed without the withdrawal assumption. The methods set forth in this answer may also be used to determine whether a plan is super top-heavy by inserting "90%" for "60%" in the appropriate places.

T–40 Q. Will a plan fail to qualify if it provides that the $200,000 maximum amount of annual compensation taken into account under section 416(d) for any plan year that the plan is top-heavy may be automatically increased in accordance with regulations under section 416?

A. No.

T–41 Q. If a plan provides benefits based on compensation in excess of $200,000 and the plan becomes top-heavy, must any accrued benefits attributable to this excess compensation be eliminated?

A. No. For any year that a plan is top-heavy, section 416(d) provides that compensation in excess of $200,000 must not be taken into account. However, a top-heavy plan may continue to provide for any benefits attributable to compensation in excess of $200,000 to the extent such benefits were accrued before the plan was top-heavy. Furthermore, section 411(d)(6) will be violated if any individual's pre-top-heavy benefit is reduced by either (1) a plan amendment adding the $200,000 restriction, or (2) an automatic change in the plan benefits structure imposing the $200,000 restriction due to the plan's becoming top-heavy.

T–42 Q. Under a top-heavy defined benefit plan, are the requirements of section 416(d) satisfied if the annual compensation of an employee taken into account to determine plan benefits is limited to the amount currently described in section 416(d) for years during which the plan is top-heavy but higher compensation is taken into account for years before the plan became top-heavy?

A. No. For the top-heavy plan to meet the requirements of section 416(d), compensation for all years, including years before the plan became top-heavy, that is taken into account to determine plan benefits must not exceed the amount currently described in section 416(d). However, if the accrued benefit as of the end of the last plan year before the plan became top-heavy (ignoring any plan amendments after that date) is greater than the accrued benefit determined by limiting compensation in accordance with section 416(d), that higher accrued benefit as of the end of the last plan year before the plan became top-heavy must

not be reduced. Providing such higher accrued benefit will not cause the plan to violate section 416(d).

T–43 Q. What happens to an individual who has ceased employment before a plan becomes top-heavy?

A. If an individual has ceased employment before a plan becomes top-heavy, such individual would not be required to receive any additional benefit accruals, contributions, or vesting, unless the individual returned to employment with the employer. See Questions and Answers V–3, M–4, and M–10. In addition, if the individual is receiving benefits based on annual compensation greater than $200,000, such benefits cannot be decreased.

V. Vesting Rules for Top-Heavy Plans

V–1 Q. What vesting must be provided under a top-heavy plan?

A. Under section 416(b), the accrued benefits attributable to employer contributions must be nonforfeitable in accordance with one of two statutory standards. Either such accrued benefits must be nonforfeitable after 3 years of service or the nonforfeitable portion of accrued benefits must be at least 20 percent after 2 years of service, 40 percent after 3 years of service, 60 percent after 4 years of service, 80 percent after 5 years of service, and 100 percent after 6 years of service. The accrued benefits attributable to employer contributions has the same meaning as under section 411(c) of the Code. As under section 411(a), the accrued benefits attributable to employee contributions must be nonforfeitable at all times.

V–2 Q. What service must be counted in determining vesting requirements?

A. All service required to be counted under section 411(a) must be counted for these purposes. All service permitted to be disregarded under section 411(a)(4) may similarly be disregarded under the schedules of section 416(b).

V–3 Q. What benefits must be subject to the minimum vesting schedule of section 416(b)?

A. All accrued benefits within the meaning of section 411(a)(7) must be subject to the minimum vesting schedule. These accrued benefits include benefits accrued before the effective date of section 416 and benefits accrued before a plan becomes top-heavy. However, when a plan becomes top-heavy, the accrued benefits of any employee who does not have an hour of service after the plan becomes top-heavy are not required to be subject to the minimum vesting schedule. Accrued benefits which have been forfeited before a plan becomes top-heavy need not vest when a plan becomes top-heavy.

V–4 Q. May a top-heavy plan provide a minimum eligibility requirement of the later of age 21 or the completion of 3 years of service and provide that all benefits are nonforfeitable when accrued?

A. Yes. For plan years which begin after December 31, 1984, a top-heavy plan may provide a minimum eligibility requirement of the later of age 21, or the completion of 3 years of service, and provide that all benefits are nonforfeitable when accrued. For plan years which begin before January 1, 1985, "25" may be substituted for "21" in the preceding sentence.

V–5 Q. What does nonforfeitable mean?

A. In general, nonforfeitable has the same meaning as in section 411(a). However, the minimum benefits required under section 416 (to the extent required to be nonforfeitable under section 416(b)) may not be forfeited under section 411(a)(3)(B) or (D). Thus, if benefits are suspended (ceased) during a period of reemployment, the benefit payable upon the subsequent resumption of payments must be actuarially increased to reflect the nonpayment of benefits during such period of re-employment.

V–6 Q. Will a class-year plan automatically satisfy the minimum vesting requirements in section 416(b) if it provides that contributions with respect to any plan year become nonforfeitable no later than the end of the third plan year following the plan year for which the contribution was made?

A. No. Although this vesting schedule is similar to the 3-year minimum vesting schedule permitted by section 416(b)(1)(A), it does not satisfy that minimum. The 3-year vesting schedule in section 416(b)(1)(A) requires that, after completion of 3 years of service, the entire accrued benefit of a participant be nonforfeitable. Under the class-year vesting schedule described above, a portion of a participant's accrued benefit (that portion attributable to contributions for the prior 3 years) is forfeitable regardless of the participant's years of service.

V–7 Q. When a top-heavy plan ceases to be a top-heavy, may the vesting schedule be altered to a vesting schedule permitted without regard to section 416?

A. When a top-heavy plan ceases to be top-heavy, the vesting schedule may be changed to one that would otherwise be permitted. However, in changing the vesting schedule, the rules described in section 411(a)(10) apply. Thus, the nonforfeit-

able percentage of the accrued benefit before the plan ceased to be top-heavy must not be reduced; also, any employee with five or more years of service must be given the option of remaining under the prior (i.e., top-heavy) vesting schedule.

M. Minimum Benefits under Top-heavy Plans

M–1 Q. Which employees must receive minimum contributions or benefits in a top-heavy plan?

A. Generally, every non-key employee who is a participant in a top-heavy plan must receive minimum contributions or benefits under such plan. However, see Questions and Answers M–4 and M–10 for certain exceptions. Different minimums apply for defined benefit and defined contribution plans.

M–2 Q. What is the defined benefit minimum?

A. (a) The defined benefit minimum requires that the accrued benefit at any point in time must equal at least the product of (i) an employee's average annual compensation for the period of consecutive years (not exceeding five) when the employee had the highest aggregate compensation from the employer and (ii) the lesser of 2% per year of service with the employer or 20%.

(b) For purposes of the defined benefit minimum, years of service with the employer are generally determined under the rules of section 411(a)(4), (5) and (6). However, a plan may disregard any year of service if the plan was not top-heavy for any plan year ending during such year of service, or if the year of service was completed in a plan year beginning before January 1, 1984.

(c) In determining the average annual compensation for a period of consecutive years during which the employee had the largest aggregate compensation, years for which the employee did not earn a year of service under the rules of section 411(a)(4), (5), and (6) are to be disregarded. Thus, if an employee has received compensation from the employer during years one, two, and three, and for each of these years the employee earned a year of service, then the employee's average annual compensation is determined by dividing the employee's aggregate compensation for these three years by three. If the employee fails to earn a year of service in the next year, but does earn a year of service in the fifth year, the employee's average annual compensation is calculated by dividing the employee's aggregate compensation for years one, two, three, and five by four. The compensation required to be taken into account is the compensation described in Question and Answer T–21. In addition, compensation received for years ending in plan years beginning before January 1, 1984, and compensation received for years beginning after the close of the last plan year in which the plan is top-heavy may be disregarded.

(d) The defined benefit minimum is expressed as a life annuity (with no ancillary benefits) commencing at normal retirement age. Thus, if post-retirement death benefits are also provided, the 2% minimum annuity benefit may be adjusted. (See Question and Answer M–3.) The 2% minimum annuity benefit may not be adjusted due to the provision of pre-retirement ancillary benefits. Normal retirement age has the same meaning as under section 411(a)(8).

(e) Any accruals of employer-derived benefits, whether or not attributable to years for which the plan is top-heavy, may be used to satisfy the defined benefit minimums. Thus, if a non-key employee had already accrued a benefit of 20 percent of final average pay at the time the plan became top-heavy, no additional minimum accruals are required (although the accrued benefit would increase as final average pay increased). Accrued benefits attributable to employee contributions must be ignored. Accrued benefits attributable to employer and employee contributions have the same meaning as under section 411(c).

M–3 Q. What defined benefit minimum must be received if an employee receives a benefit in a form other than a single life annuity or a benefit other than at normal retirement age?

A. If the form of benefit is other than a single life annuity, the employee must receive an amount that is the actuarial equivalent of the minimum single life annuity benefit. If the benefit commences at a date other than at normal retirement age, the employee must receive at least an amount that is the actuarial equivalent of the minimum single life annuity benefit commencing at normal retirement age. Thus, the employee may receive a lower benefit if the benefit commences before the normal retirement age and the employee must receive a higher benefit if the benefit commences after the normal retirement age. No specific actuarial assumptions are mandated providing different actuarial equivalents. However, the assumptions must be reasonable.

M–4 Q. Which employees must accrue a minimum benefit in a top-heavy defined benefit plan?

A. Each non-key employee who is a participant in a top-heavy defined benefit plan and who

has at least one thousand hours of service (or equivalent service as determined under Department of Labor regulations, 29 CFR 2530.200b–3) for an accrual computation period must accrue a minimum benefit in a top-heavy defined benefit plan for that accrual computation period. If the accrual computation period does not coincide with the plan year, a minimum benefit must be provided, if required, for both accrual periods within the top-heavy plan year. For a top-heavy plan that does not base accruals on accrual computation periods, minimum benefits must be credited for all periods of service required to be credited for benefit accrual. (See § 1.410(a)–7). A non-key employee may not fail to accrue a minimum benefit merely because the employee was not employed on a specified date. Similarly, a non-key employee may not fail to accrue a minimum benefit because either (1) an employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions.

M–5 Q. Would the defined benefit minimum be satisfied if the plan provides a normal retirement benefit equal to the greater of the plan's projected formula or the projected minimum benefit and if benefits accrue in accordance with the fractional rule described in section 411(b)(1)(C)?

A. No. The fact that this fractional rule would not satisfy the defined benefit minimum may be illustrated by the following example. Consider a non-key employee, age 25, entering a top-heavy plan in which the projected minimum for the employee is greater than the projected benefit under the normal formula. Under the fractional rule, the employee's accrued benefit ten years later at age 35 would be 5% (20% × ($^{10}/_{40}$)). Under section 416, the employee's minimum accrued benefit after ten years of service must be at least 20%. Thus, because the 5% benefit is less than the 20% benefit required under section 416, such benefit would not satisfy the required minimum.

M–6 Q. What benefit must an employer provide in a top-heavy defined benefit employee pay-all plan?

A. The defined benefit minimum in an employee pay-all top-heavy plan is the same as that for a plan which has employer contributions. That is, the employer must provide the benefits specified in Question and Answer M–2.

M–7 Q. What is the defined contribution minimum?

A. The sum of the contributions and forfeitures allocated to the account of any non-key employee who is a participant in a top-heavy defined contribution plan must equal at least 3% of such employee's compensation (see Question and Answer T–21 for the definition of compensation) for that plan year or for the calendar year ending within the plan year. However, a lower minimum is permissible where the largest contribution made or required to be made for key employees is less than 3%. The preceding sentence does not apply to any plan required to be included in an aggregation group if such plan enables a defined benefit plan required to be included in such group to meet the requirements of section 401(a)(4) or 410. The contribution made or required to be made on behalf of any key employee is equal to the ratio of the sum of the contributions made or required to be made and forfeitures allocated for such key employee divided by the compensation (not in excess of $200,000) for such key employee. Thus, the defined contribution minimum that must be provided for any non-key employee for a top-heavy plan year is the largest percentage of compensation (not in excess of $200,000) provided on behalf of any key employee for that plan year (if the largest percentage of compensation provided on behalf of any key employee for that plan year is less than 3%).

M–8 Q. If an employer maintains two top-heavy defined contribution plans, must both plans provide the defined contribution minimum for each non-key employee who is a participant in both plans?

A. No. If one of the plans provides the defined contribution minimum for each non-key employee who participates in both plans, the other plan need not provide an additional contribution for such employees. However, the other plan must provide the vesting required by section 416(b) and must limit compensation (based on all compensation from all aggregated employers) in providing benefits as required by section 416(d).

M–9 Q. In the case of the waiver of minimum funding standards of section 412(d), how does section 416 treat the defined contribution minimum?

A. For purposes of determining the contribution that is required to be made on behalf of a key employee, a waiver of the minimum funding requirements is disregarded. Thus, if a defined contribution plan receives a waiver of the minimum funding requirement, and if the minimum contribution required under the plan without re-

gard to the waiver exceeds 3%, the exception described in Question and Answer M-7 does not apply even though no key employee receives a contribution in excess of 3% and even though the amount required to be contributed on behalf of the key employee has been waived. Also, a waiver of the minimum funding requirements will not alter the requirements of section 416. Thus, in the case of the top-heavy defined contribution plan in which the non-key employee must receive an allocation, a waiver of the minimum funding requirements may eliminate a funding violation and such waiver will preclude a violation under section 416 even though the required contribution is not made. However, the adjusted account balance (as described in Rev.Rul. 78-223, 1978-1 C.B. 125) of the non-key employees must reflect the required minimum contribution even though such contribution was not made.

M-10 Q. Which employees must receive the defined contribution minimum?

A. Those non-key employees who are participants in a top-heavy defined contribution plan who have not separated from service by the end of the plan year must receive the defined contribution minimum. Non-key employees who have become participants but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the defined contribution minimum. A non-key employee may not fail to receive a defined contribution minimum because either (1) the employee is excluded from participation (or accrues no benefit) merely because the employee's compensation is less than a stated amount, or (2) the employee is excluded from participation (or accrues no benefit) merely because of a failure to make mandatory employee contributions or, in the case of a cash or deferred arrangement, elective contributions.

M-11 Q. May either the defined benefit minimum or the defined contribution minimum be integrated with social security?

A. No.

M-12 Q. What minimum contribution or benefit must be received by a non-key employee who participates in a top-heavy plan?

A. In the case of an employer maintaining only one plan, if such plan is a defined benefit plan, each non-key employee covered by that plan must receive the defined benefit minimum. If such plan is a defined contribution plan (including a target benefit plan), each non-key employee covered by the plan must receive the defined contribution minimum. In the case of an employer who maintains more than one plan, employees covered under only the defined benefit plan must receive the defined benefit minimum. Employees covered under only the defined contribution plan must receive the defined contribution minimum. In the case of employees covered under both defined benefit and defined contribution plans, the rules are more complicated. Section 416(f) precludes, in the case of employees covered under both defined benefit and defined contribution plans, either required duplication or inappropriate omission. Therefore, such employees need not receive both the defined benefit and the defined contribution minimums.

There are four safe harbor rules a plan may use in determining which minimum must be provided to a non-key employee who is covered by both defined benefit and defined contribution plans. Since the defined benefit minimums are generally more valuable, if each employee covered under both a top-heavy defined benefit plan and a top-heavy defined contribution plan receives the defined benefit minimum, the defined benefit and defined contribution minimums will be satisfied. Another approach that may be used is a floor offset approach (see Rev.Rul. 76-259, 1976-2 C.B. 111) under which the defined benefit minimum is provided in the defined benefit plan and is offset by the benefits provided under the defined contribution plan. Another approach that may be used in the case of employees covered under both defined benefit and defined contribution plans is to prove, using a comparability analysis (see Rev.Rul. 81-202, 1981-2 C.B. 93) that the plans are providing benefits at least equal to the defined benefit minimum. Finally, in order to preclude the cost of providing the defined benefit minimum alone, the complexity of a floor offset plan and the annual fluctuation of a comparability analysis, a safe haven minimum defined contribution is being provided. If the contributions and forfeitures under the defined contribution plan equal 5% of compensation for each plan year the plan is top-heavy, such minimum will be presumed to satisfy the section 416 minimums.

M-13 Q. An employer maintains a defined benefit plan and a profit-sharing plan. Both plans are top-heavy and are members of a required aggregation group. In order to meet the minimum contribution/minimum benefit requirements, the employer decides to contribute 5% of compensation to the profit-sharing plan. What happens if for a particular plan year there are no profits out of which to make contributions to the profit-sharing plan?

A. In this particular situation, in order to satisfy the requirements of section 416(c), the employer must provide the defined contribution minimum, 5% of compensation. This rule is an exception to the general rule that an employer cannot make a contribution to a profit-sharing plan if there are no profits. Alternatively, the employer may provide the defined benefit minimum for this year.

M–14 Q. What minimum contribution or benefit must be received by a non-key employee when he is covered under both a defined benefit plan and defined contribution plan (both of which are top-heavy) of an employer and the employer desires to use a factor of 1.25 in computing the denominators of the defined benefit and defined contribution fractions under section 415(e)?

A. In this particular situation, the employer may use one of the four rules set forth in Question and Answer M–12, subject to the following modifications. The defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2. The defined contribution minimum is increased to 7½ percent of compensation. If the floor offset or comparability analysis approach is used, the defined benefit minimum must be increased by one percentage point (up to a maximum of ten percentage points) for each year of service described in Question and Answer M–2 of the participant's average compensation for the years described in Question and Answer M–2.

M–15 Q. May an employer use a different method each year to meet the requirements of Question and Answer M–12 or Question and Answer M–14 without amending the plans each year?

A. No. An employer must set forth in the plan document the method he will use to meet the requirements of Question and Answer M–12 or M–14, as the case may be. If an employer desires to change the method, the plan document must be amended.

M–16 Q. Will target benefit plans be treated as defined benefit or defined contribution plans for purposes of the top-heavy rules?

A. Target benefit plans will be treated as defined contribution plans for purposes of the top-heavy rules.

M–17 Q. Can a plan described in section 412(i) (funded exclusively by level premium insurance contracts) also satisfy the minimum benefit requirements of section 416?

A. The accrued benefits provided for a non-key employee under most level premium insurance contracts might not provide a benefit satisfying the defined benefit minimum because of the lower cash values in early years under most level premium insurance contracts, and because such contracts normally provide for level premiums until normal retirement age. However, a plan will not be considered to violate the requirements of section 412(i) merely because it funds certain benefits through either an auxiliary fund or deferred annuity contracts, if the following conditions are met:

(1) The targeted benefit at normal retirement age under the level premium insurance contract is determined, taking into account the defined benefit minimum that would be required assuming the current top-heavy (or non top-heavy) status of the plan continues until normal retirement age; and

(2) The benefits provided by the auxiliary fund or deferred annuity contracts do not exceed the excess of the defined benefit minimum benefits over the benefits provided by the level premium insurance contract.

If the above conditions are satisfied, then the plan is still exempt from the minimum funding requirements under section 412 and may still utilize the special accrued benefit rule in section 411(b)(1)(F) subject to the following modifications: Although the portion of the plan funded by the level premium annuity contract is exempt from the minimum funding requirements, the portion funded by an auxiliary fund is subject to those requirements. (Thus, a funding standard account must be maintained and a Schedule B must be filed with the annual report). The accrued benefit for any participant may be determined using the rule in section 411(b)(1)(F) but must not be less than the defined benefit minimum.

[T.D. 7997, 49 FR 50646, Dec. 31, 1984]

§ 1.417(e)–1 Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417.

(a) **Scope—(1) In general.** A plan does not satisfy the requirements of sections 401(a)(11) and 417 unless it satisfies the consent requirements, the determination of present value requirements and the other requirements set forth in this section. See section 401(a)(11) and § 1.401(a)-11A for other rules regarding the survivor annuity requirements.

(2) Additional requirements. See § 1.411(a)(11)-1(c)(6) for other rules applicable to the consent requirements.

(3) Accrued benefit. The definition of "accrued benefit" in § 1.411(a)(11)-1 applies when that term is used in this section.

(b) Consent, etc. requirements—(1) General rule. Generally plans may not commence the distribution of any portion of a participant's accrued benefit in any form unless the applicable consent requirements are satisfied. No consent of the participant or spouse is needed for distribution of a QJSA or QPSA after the benefit is no longer immediately distributable (after the participant attains (or would have attained if not dead) the later of normal retirement age (as defined in section 411(a)(8)) or age 62). No consent of the spouse is needed for distribution of a QJSA at any time. After the participant's death, a benefit may be paid to a nonspouse beneficiary without the beneficiary's consent. A distribution cannot be made at any time in a form other than a QJSA unless such QJSA has been waived by the participant and such waiver has been consented to by the spouse. A QJSA is an annuity that commences immediately. Thus, for example, a plan may not offer a participant separating from service at age 45 a choice only between a single sum distribution at separation of service and a joint and survivor annuity that satisfies all the requirements of a QJSA except that it commences at normal retirement age rather than immediately. To satisfy this section, the plan must also offer a QJSA (i.e., an annuity that satisfies all the requirements for a QJSA including the requirement that it commences immediately).

(2) Consent. (i) Written consent of the participant and, if the participant is married at the annuity starting date and the benefit is to be paid in a form other than a QJSA, the participant's spouse (or, if either the participant or the spouse has died, the survivor) is required before the commencement of the distribution of any part of an accrued benefit if the present value of the nonforfeitable benefit is greater than $3,500. No consent is valid unless the participant has received a general description of the material features, and an explanation of the relative values of, the optional forms of benefit available under the plan in a manner which would satisfy the notice requirements of section 417(a)(3). See § 1.401(a)-20 Q&A 36. No consent is required before the annuity starting date if the present value of the nonforfeitable benefit is not more than $3,500. If the present value of the accrued benefit at the time of any distribution exceeds $3,500, the present value of the accrued benefit at any subsequent time will be deemed to exceed $3,500.

(ii) In determining the present value of any nonforfeitable accrued benefit, a defined benefit plan is limited by the interest rate restriction as set forth in paragraph (d) of this section.

(3) Time of consent. A plan must provide participants with the written explanation of the QJSA required by section 417(a)(3) no less than 30 days and no more than 90 days before the annuity starting date. Written consent of the participant and the participant's spouse to the distribution must be made not more than 90 days before the annuity starting date.

(c) Permitted distributions. A plan may not require that a participant or surviving spouse begin to receive benefits without satisfying paragraph (b) of this section while such benefits are immediately distributable (see paragraph (b)(1) of this section). Once benefits are no longer immediately distributable, all benefits that the plan requires to begin must be provided in the form of a QJSA and QPSA unless the applicable written explanation, election and consent requirement of section 417 are satisfied.

(d) Present value requirement—(1) Requirements. For purpose of determining the present value of any accrued benefit and for purposes of determining the amount (subject to sections 411(c)(3) and 415) of any distribution including a single sum, a defined benefit plan is subject to the interest rate limitations described in subparagraph (2) of this paragraph (d) at the time set forth in subparagraph (3) of this paragraph (d). A plan amendment that changes the rate described in this paragraph (d) is subject to section 411(d)(6). The present value of any optional form of benefit cannot be less than the present value of the normal retirement benefit determined in accordance with this paragraph.

(2) Section 417 interest rate. The section 417 interest rate is (i) the rate or rates that would be used by the Pension Benefit Guaranty Corporation (PBGC) for a trusteed single-employer plan to value the participant's (or beneficiary's) vested benefit ("applicable interest rate") if the present value of such benefit does not exceed $25,000 and (ii) 120 percent of the applicable interest rate, as determined in accordance with (i) above, if such present value exceeds $25,000. In no event shall the present value determined by use of 120 percent of the applicable interest rate result in a present value less than $25,000. The applicable interest

rate may be a series of interest rates for any given date. For example, the applicable rate could be X percent for the first 5 years over which the benefits are valued, Y percent for the next succeeding 10 years and Z percent for the following years. In such case, 1.20 percent of the applicable interest rate would be 1.20 times X percent, 1.20 times Y percent and 1.20 times Z percent over the years described above. The applicable interest rates are the interest rates that would be used (as of the date of the distribution) by the PBGC for purposes of determining the present value of that benefit upon termination of an insufficient trusteed single-employer plan. Except as otherwise provided by the Commissioner, the applicable interest rates are determined by PBGC regulations. See 29 CFR Part 2619 for the applicable PBGC rates.

(3) Time for determining interest rate. (i) Except as provided in subdivision (ii), the section 417 interest rate limitations are determined on either the annuity starting date or the first day of the plan year that contains the annuity starting date. The plan must provide which date is applicable.

(ii) The plan may provide for the use of any other time for determining the interest rate provided that such time is not more than 120 days before the annuity starting date if such time is determined in a consistent manner and is applied uniformly to all participants.

(iii) The Commissioner may in revenue rulings, notices or other documents of general applicability prescribe other times for determining the section 417 interest rate limitations.

(iv) If a plan amendment changes the time for determining the section 417 interest rate, the amendment will not be treated as reducing an accrued benefit if the conditions of this subdivision (iv) are satisfied. Any distribution in the one-year period commencing at the time the plan amendment is effective (if the amendment is effective on or after the adoption date) must use the rate determined under the plan, either before or after the amendment, that results in the larger accrued benefit. If the plan amendment is adopted retroactively (that is, the amendment is effective prior to the adoption date), the plan must use the rate resulting in the larger accrued benefit for the period beginning with the effective date and ending one year after the adoption date.

(4) Determination of interest rates. (i) In the case of a defined benefit plan that uses a rate or rates in addition to the section 417 interest rate, the rate producing the greatest benefit must be used.

(ii) The same interest rate that is required to be used by the plan under this paragraph (d) to determine the amount of benefit must also be used to compute the present value of the benefit for purposes of determining whether consent for a distribution is required under paragraph (b) of this section.

(iii) **Example.** A qualified defined benefit plan provides that single sum distributions received on or before normal retirement age are to be determined using the lower of the rate(s) of interest guaranteed under a particular annuity contract of an unrelated insurance company or the applicable section 417 rates. The rates of interest guaranteed under the annuity contract are 10% for the first 5 years, 7.5% for the next 10 and 5% thereafter while the applicable section 417 interest rates would be 8% and 120% of such rate would be 9.6%. Because in some years over which a benefit is valued the interest rate under the PBGC rates would be the lower rate while in other years it would be the higher rate, the rate that must be used is the one that results in the greater plan benefit.

(5) Exceptions. This paragraph (d) (other than the reference to section 411(d)(6) requirements) does not apply to the amount of a distribution under a nondecreasing annuity payable for a period not less than the life of the participant or, in the case of a QPSA, the life of the surviving spouse. A nondecreasing annuity includes a QJSA, QPSA and an annuity that decreases merely because of the cessation or reduction of Social Security supplements or qualified disability payments (as defined in section 411(a)(9)).

(6) Defined contribution plans. Because the accrued benefit in a defined contribution plan equals the account balance, such plans are not subject to the interest rate requirements of this paragraph (d), even though they are subject to section 401(a)(11).

(e) Special rules for annuity contracts—(1) General rule. Any annuity contract purchased by a plan subject to section 401(a)(11) and distributed to or owned by a participant must provide that benefits under the contract are provided in accordance with the applicable consent, present value, and other requirements of sections 401(a)(11) and 417 applicable to the plan.

(f) Effective dates—(1) Annuity contracts. (i) Paragraph (e) of this section does not apply to contracts distributed to or owned by a participant prior to September 17, 1985, unless additional contributions are made under the plan by the employer with respect to such contracts.

(ii) In the case of a contract owned by the employer or distributed to or owned by a participant prior to the first plan year beginning after December 31, 1988, paragraph (e) of this section

shall be satisfied if the annuity contracts described therein satisfy the requirements in §§ 1.401(a)-11T and 1.417(e)-1T. The preceding sentence shall not apply if additional contributions are made under the plan by the employer with respect to such contracts on or after the beginning of the first plan year beginning after December 31, 1988.

(2) Interest rates. (i) A plan that uses the PBGC immediate interest rate as required by § 1.417(e)-1T(e) for distributions commencing in plan years beginning before January 1, 1987, shall be deemed to satisfy paragraph (d) of this section for such years.

(ii) For a special exception to the requirements of section 411(d)(6) for certain plan amendments that incorporate applicable interest rates, see section 1139(d)(2) of the Tax Reform Act of 1986.

(3) Other effective dates and transitional rules. (i) Except as otherwise provided, a plan will be treated as satisfying sections 401(a)(11) and 417 for plan years beginning before the first plan year that the requirements of section 410(b) as amended by TRA 86 apply to such plan, if the plan satisfied the requirements in §§ 1.401(a)-11T and 1.417(e)-1T.

(ii) See § 1.401(a)-20 for other effective dates and transitional rules that apply to plans subject to sections 401(a)(11) and 417.

[T.D. 8219, 53 FR 31854, Aug. 22, 1988]

§ 1.419–1T Treatment of welfare benefit funds (temporary).

Q–1: What does section 419 of the Internal Revenue Code provide?

A–1: Section 419 prescribes limitations upon deductions for contributions paid or accrued with respect to a welfare benefit fund. Under section 419 (a) and (b), an employer's contributions to a welfare benefit fund are not deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for production of income) but, if the requirements of section 162 or 212 are otherwise met, are deductible under section 419 for the taxable year of the employer in which paid to the extent of the welfare benefit fund's qualified cost (within the meaning of section 419(c)(1)) for the taxable year of the fund that relates to such taxable year of the employer. Under section 419(g), section 419 and this section shall also apply to the deduction by a taxpayer of contributions with respect to a fund that would be a welfare benefit fund but for the fact that there is no employer-employee relationship between the person providing the services and the person for whom the services are provided. Contributions paid to a welfare benefit fund after section 419 becomes effective with respect to such contributions are deemed to relate, first, to amounts accrued and deducted (but not paid) by the employer with respect to such fund before section 419 becomes effective with respect to such contributions and thus shall not be treated as satisfying the payment requirement of section 419. See paragraph (b) of Q&A-5 for special deduction limits applicable to employer contributions to welfare benefit funds with excess reserves.

Q–2: When do the deduction rules of section 419, as enacted by the Tax Reform Act of 1984, become effective?

A–2: (a) Section 419 generally applies to contributions paid or accrued with respect to a welfare benefit fund after December 31, 1985, in taxable years of employers ending after that date. See Q&A-9 of this regulation for special rules relating to the deduction limit for the first taxable year of a fiscal year employer ending after December 31, 1985.

(b) In the case of a welfare benefit fund which is part of a plan maintained pursuant to one or more collective bargaining agreements (1) between employee representatives and one or more employers, and (2) that are in effect on July 1, 1985 (or ratified on or before such date), sections 419 shall not apply to contributions paid or accrued in taxable years beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension thereof agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act of 1984 (i.e., requirements under sections 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreement. See § 1.419A-2T for special rules relating to the application of section 419 to collectively bargained welfare benefit funds.

(c) Notwithstanding paragraphs (a) and (b), section 419 applies to any contribution of a facility to a welfare benefit fund (or other contribution, such as cash, which is used to acquire, construct, or improve such a facility) after June 22, 1984, unless such facility is placed in service by the fund before January 1, 1987, and either (1) is acquired or improved by the fund (or contributed to the fund)

pursuant to a binding contract in effect on June 22, 1984, and at all times thereafter, or (2) the construction of which was begun by or for the welfare benefit fund before June 22, 1984. See Q&A-11 of this regulation for special rules relating to the application of section 419 to the contribution of a facility to a welfare benefit fund (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve such a facility) before section 419 generally becomes effective with respect to contributions to the fund.

Q–3. What is a "welfare benefit fund" under section 419?

A–3. (a) A "welfare benefit fund" is any fund which is part of a plan, or method or arrangement, of an employer and through which the employer provides welfare benefits to employees or their beneficiaries. For purposes of this section, the term "welfare benefit" includes any benefit other than a benefit with respect to which the employer's deduction is governed by section 83(h), section 404 (determined without regard to section 404(b)(2)), section 404A, or section 463.

(b) Under section 419(e)(3) (A) and (B), the term "fund" includes any organization described in section 501(c) (7), (9), (17) or (20), and any trust, corporation, or other organization not exempt from tax imposed by chapter 1, subtitle A, of the Internal Revenue Code. Thus, a taxable trust or taxable corporation that is maintained for the purpose of providing welfare benefits to an employer's employees is a "welfare benefit fund."

(c) Section 419(e)(3)(C) also provides that the term "fund" includes, to the extent provided in regulations, any account held for an employer by any person. Pending the issuance of further guidance, only the following accounts, and arrangements that effectively constitute accounts, as described below, are "funds" within section 419(e)(3)(C).

A retired lives reserve or a premium stabilization reserve maintained by an insurance company is a "fund," or part of a "fund," if it is maintained for a particular employer and the employer has the right to have any amount in the reserve applied against its future years' benefit costs or insurance premiums. Also, if an employer makes a payment to an insurance company under an "administrative services only" arrangement with respect to which the life insurance company maintains a separate account to provide benefits, then the arrangement would be considered to be a "fund." Finally, an insurance or premium arrangement between an employer and an insurance company is a "fund" if, under the arrangement, the employer has a right to a refund, credit, or additional benefits (including upon termination of the arrangement) based on the benefit or claims experience, administrative cost experience, or investment experience attributable to such employer. However, an arrangement with an insurance company is not a "fund" under the previous sentence merely because the employer's premium for a renewal year reflects the employer's own experience for an earlier year if the arrangement is both cancellable by the insurance company and cancellable by the employer as of the end of any policy year and, upon cancellation by either of the parties, neither of the parties can receive a refund or additional amounts or benefits and neither of the parties can incur a residual liability beyond the end of the policy year (other than, in the case of the insurer, to provide benefits with respect to claims incurred before cancellation). The determination whether either of the parties can receive a refund or additional amounts or benefits or can incur a residual liability upon cancellation of an arrangement will be made by examining both the contractual rights and obligations of the parties under the arrangement and the actual practice of the insurance company (and other insurance companies) with respect to other employers upon cancellation of similar arrangements. Similarly, a disability income policy does not constitute a "fund" under the preceding provisions merely because, under the policy, an employer pays an annual premium so that employees who became disabled in such year may receive benefit payments for the duration of the disability.

Q–4: For purposes of determining the section 419 limit on the employer's deduction for contributions to the fund for a taxable year of the employer, which taxable year of the welfare benefit fund is related to the taxable year of the employer?

A–4: The amount of an employer's deduction for contributions to a welfare benefit fund for a taxable year of the employer is limited to the "qualified cost" of the welfare benefit fund for the taxable year of the fund that is related to such taxable year of the employer. The taxable year of the welfare benefit fund that ends with or within the taxable year of the employer is the taxable year of the fund that is related to the taxable year of the employer. Thus, for example, if an employer has a calendar taxable year and it makes contributions to a fund having a taxable year ending June 30, the "qualified cost" of the fund for the taxable year of the fund ending on June 30, 1986, applies to limit the employer's deduction for contributions to the fund in the employer's 1986 taxable year.

In the case of employer contributions paid directly to an account or arrangement with an insurance company that is treated as a welfare benefit fund for the purposes of section 419, the policy year will be treated as the taxable year of the fund. See Q&A-7 of this regulation for special section 419 rules relating to the coordination of taxable years for the taxable year of the employer in which a welfare benefit fund is established and for the next following taxable year of the employer.

Q–5: What is the "qualified cost" of a welfare benefit fund for a taxable year under section 419?

A–5: (a) Under section 419(c), the "qualified cost" of a welfare benefit fund for a taxable year of the fund is the sum of: (1) The "qualified direct cost" of such fund for such taxable year of the fund, and (2) the amount that may be added to the qualified asset account for such taxable year of the fund to the extent that such addition does not result in a total amount of such account as of the end of such taxable year of the fund that exceeds the applicable account limit under section 419A(c). However, in calculating the qualified cost of a welfare benefit fund for a taxable year of the fund, this sum is reduced by the fund's "after-tax income" (as defined in section 419(c)(4)) for such taxable year of the fund. Also, the qualified cost of a welfare benefit fund is reduced further under the provisions of paragraph (b) of this Q&A.

(b)(1) Pursuant to section 419A(i), notwithstanding section 419 and § 1.419-1T, contributions to a welfare benefit fund during any taxable year of the employer beginning after December 31, 1985, shall not be deductible for such taxable year to the extent that such contributions result in the total amount in the fund as of the end of the last taxable year of the fund ending with or within such taxable year of the employer exceeding the account limit applicable to such taxable year of the fund (as adjusted under section 419A(f)(7)). Solely for purposes of this subparagraph, (i) contributions paid to a welfare benefit fund during the taxable year of the employer but after the end of the last taxable year of the fund that relates to such taxable year of the employer, and (ii) contributions accrued with respect to a welfare benefit fund during the taxable year of the employer or during any prior taxable year of the employer (but not actually paid to such fund on or before the end of a taxable year of the employer) and deducted by the employer for such or any prior taxable year of the employer, shall be treated as an amount in the fund as of the end of the last taxable year of the fund that relates to the taxable year of the employer. Contributions that are not deductible under this subparagraph are in excess of the qualified cost of the welfare benefit fund for the taxable year of the fund that relates to the taxable year of the employer and thus are treated as contributed to the fund on the first day of the employer's next taxable year.

(2) Paragraph (b)(1) of this section shall not apply to contributions with respect to a collectively bargained welfare benefit fund within the meaning of § 1.419A-2T. In addition, paragraph (b)(1) of this section shall not apply to any taxable year of an employer beginning after the end of the earlier of the following taxable years: (i) the first taxable year of the employer beginning after December 31, 1985, for which the employer's deduction limit under section 419 (after the application of paragraph (b)(1) of this section) is at least equal to the qualified direct cost of the fund for the taxable year (or years) of the fund that relates to such first taxable year of the employer, or (ii) the first taxable year of the employer beginning after December 31, 1985, with or within which ends the first taxable year of the fund with respect to which the total amount in the fund as of the end of such taxable year of the fund does not exceed the account limit for such taxable year of the fund (as adjusted under section 419A(f)(7)).

(3) For example, assume an employer with a taxable year ending June 30 and a welfare benefit fund with a taxable year ending January 31. During its taxable year ending June 30, 1987, and on or before January 31, 1987, the employer contributes $250,000 to the fund, and during the remaining portion of its taxable year ending June 30, 1987, the employer contributes $200,000. The qualified direct cost of the fund for its taxable year ending January 31, 1987, is $500,000, the account limit applicable to such taxable year (after the adjustment under section 419A(f)(7)) is $750,000, and the total amount in the fund as of January 31, 1987, is $800,000. Before the application of this paragraph, the employer may deduct the entire $450,000 contribution for its taxable year ending June 30, 1987. However, under this paragraph, the excess of (i) the sum of the total amount in the fund as of January 31, 1987 ($800,000), and employer contributions to the fund after January 31, 1987, and on or before June 30, 1987 ($200,000), over (ii) the account limit applicable to the fund for its taxable year ending January 31, 1987 ($750,000), is $250,000. Thus, under this paragraph, only $200,000 of the $450,000 contribution the employer made during its taxable year ending June 30, 1987, is deductible for such taxable year. If the excess were $450,000 or greater, no portion of the $450,000 contribution would be deductible

by the employer for its taxable year ending June 30, 1987. Such nondeductible contributions are in excess of the fund's qualified cost for the taxable year related to the employer's taxable year and thus are deemed to be contributed on the first day of the employer's next taxable year.

(c) See Q&A-7 of this regulation for special rules relating to the calculation of the qualified cost of a welfare benefit fund for an Initial Fund Year and an Overlap Fund Year (as defined in Q&A-7). See Q&A-11 of this regulation for special rules relating to the application of section 419 to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve a facility) before section 419 generally becomes effective with respect to contributions to the fund. See § 1.419A-2T for special rules relating to certain collectively bargained welfare benefit funds.

Q–6: What is the "qualified direct cost" of a welfare benefit fund under section 419(c)(3)?

A–6: (a) Under section 419(c)(3), the "qualified direct cost" of a welfare benefit fund for any taxable year of the fund is the aggregate amount which would have been allowable as a deduction to the employer for benefits provided by such fund during such year (including insurance coverage for such year) if (1) such benefits were provided directly by the employer and (2) the employer used the cash receipts and disbursements method of accounting and had the same taxable year as the fund. In this regard, a benefit is treated as provided when such benefit would be includible in the gross income of the employee if provided directly by the employer (or would be so includible but for a provision of chapter 1, subtitle A, of the Internal Revenue Code excluding it from gross income). Thus, for example, if a calendar year welfare benefit fund pays an insurance company in July 1986 the full premium for coverage of its current employees under a term health insurance policy for the twelve month period ending June 30, 1987, the insurance coverage will be treated as provided by the fund over such twelve month period. Accordingly, only the portion of the premium for coverage during 1986 will be treated as a "qualified direct cost" of the fund for 1986; the remaining portion of the premium will be treated as a "qualified direct cost" of the fund for 1987. The "qualified direct cost" for a taxable year of the fund includes the administrative expenses incurred by the welfare benefit fund in delivering the benefits for such year.

(b) If, in a taxable year of a welfare benefit fund, the fund holds an asset with a useful life extending substantially beyond the end of the taxable year (e.g., buildings, vehicles, tangible assets, and licenses) and, for such taxable year of the fund, the asset is used in the provision of welfare benefits to employees, the "qualified direct cost" of the fund for such taxable year of the fund includes the amount that would have been allowable to the employer as a deduction under the applicable Code provisions (e.g., sections 168 and 179) with respect to the portion of the asset used in the provision of welfare benefits for such year if the employer had acquired and placed in service the asset at the same time the fund received and placed in service the asset, and the employer had the same taxable year as the fund. This rule applies regardless of whether the fund received the asset through a contribution of the asset by the employer or through an acquisition or the construction by the fund of the asset. For example, assume that in 1986 a calendar year employer contributes recovery property under section 168(c) to a welfare benefit fund with a calendar taxable year to be used in the provision of welfare benefits. The employer will be treated as having sold the property in such year and thus will recognize gain to the extent that the fair market value of the property exceeds the employer's adjusted basis in the property. In this regard, see section 1239(d). Also, the employer will be treated as having made a contribution to the fund in such year equal to the fair market value of the property. Finally, the qualified direct cost of the welfare benefit fund for 1986 will include the amount that the employer could have deducted in 1986 with respect to the portion of the property used in the provision of welfare benefits if the employer had acquired the property in 1986 and had placed the property in service when the fund actually placed the property in service. Similarly, for example, assume that in 1986 a welfare benefit fund purchases and places in service a facility to be used in the provision of welfare benefits. The qualified direct cost of the fund for 1986 will include the amount that the employer could have deducted with respect to such facility if the employer had purchased and placed in service the facility at the same time that the fund purchased and placed in service the facility.

(c) The qualified direct cost of a welfare benefit fund does not include expenditures by the fund that would not have been deductible if they had been made directly by the employer. For example, a fund's purchase of land in a year for an employee recreational facility will not be treated as

a qualified direct cost because, if made directly by the employer, the purchase would not have been deductible under section 263. See also sections 264 and 274.

(d) Notwithstanding the preceding paragraphs, the qualified direct cost of a welfare benefit fund with respect to that portion of a child care facility used in the provision of welfare benefits for a year will include the amount that would have been allowable to the employer as a deduction for the year under a straight-line depreciation schedule for a period of 60 months beginning with the month in which the facility is placed in service under rules similar to those provided for section 188 property under § 1.188-1(a). For purposes of this section, a "child care facility" is tangible property of a character subject to depreciation that is located in the United States and specifically used as an integral part of a "qualified child care center facility" within the meaning of § 1.188-1(d)(4).

(e) See Q&A-7 of this regulation for special section 419 rules relating to the calculation of the qualified direct cost of a welfare benefit fund for an Initial Fund Year and an Overlap Fund Year (as defined in Q&A-7). See Q&A-11 of this regulation for special rules relating to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve a facility) before section 419 generally becomes effective with respect to contributions to the fund.

Q–7: What special rules apply for purposes of determining the section 419 limit on the employer's deduction for contributions to a welfare benefit fund for the taxable year of the employer in which the fund is established and for the next following taxable year of the employer?

A–7: (a) If the taxable year of a welfare benefit fund is the same as the taxable year of the employer, there are no special rules that apply for purposes of determining the section 419 limit on an employer's deduction for contributions to the fund for either the taxable year of the employer in which the fund is established or the next following taxable year of the employer. However, if the taxable year of a welfare benefit fund is different from the taxable year of the employer, the general section 419 rules are modified by the special rules set forth below for purposes of determining the section 419 deduction limit for the taxable year of the employer in which a fund is established and for the next following taxable year of the employer.

(b) If a welfare benefit fund is established after December 31, 1985, during a taxable year of an employer and either (i) the first taxable year of the fund ends after the close of such taxable year of the employer, or (ii) the first taxable year of the fund is six months or less and ends before the close of such taxable year of the employer and the second taxable year of the fund begins before and ends after the close of such taxable year of the employer, the taxable year of the fund that contains the closing day of such taxable year of the employer will be treated as an "Overlap Fund Year." For purposes of determining the limit on the employer's deduction for contributions to a welfare benefit fund for the taxable year of the employer in which the fund was established, the period between the beginning of the fund's Overlap Fund Year and the end of the employer's taxable year in which the Overlap Fund Year began will be treated as a taxable year of the fund ("Initial Fund Year").

(c) The qualified cost of a welfare benefit fund for its Initial Fund Year will be equal to the qualified direct cost of the fund for such Initial Fund Year. The qualified cost of a fund for its Overlap Fund Year will be determined under the general rules of Q&A-5 of this regulation and section 419(c), with the exception that such qualified cost will be reduced by the employer contributions made during the Initial Fund Year and deductible by the employer for the taxable year of the employer in which the Overlap Fund Year of the fund begins.

(d) Assume that an employer with a calendar taxable year establishes on July 1, 1986, a welfare benefit fund with a taxable year ending on June 30. The fund's first taxable year from July 1, 1986, to June 30, 1987, is an Overlap Fund Year. The employer contributes $1,000 to the fund during its taxable year ending December 31, 1986 (i.e., during the period between July 1, 1986, and December 31, 1986, which is also the Initial Fund Year) and another $1,500 to the fund during its taxable year ending December 31, 1987. Assume further that the qualified direct cost of the fund for the Initial Fund Year is $900 and that the qualified cost for the Overlap Fund Year is $2,500 (prior to the reduction required by paragraph (c) of this Q&A). Under the special rules of paragraphs (b) and (c), the employer may deduct $900 for its taxable year ending on December 31, 1986, and $1,600 for its taxable year ending on December 31, 1987. If the qualified direct cost of the fund for the Initial Fund Year had been $1,050 and the qualified cost for the Overlap Fund Year had been $2,500 (prior to the reduction required by paragraph (c) of this Q&A), the employer's

deduction for its taxable year ending December 31, 1986, would have been $1,000 and its deduction for its taxable year ending December 31, 1987, would have been $1,500.

(e) Assume that an employer with a calendar taxable year establishes on March 1, 1986, a welfare benefit fund with a taxable year ending June 30. Thus, the fund has a short first taxable year ending June 30, 1986, an Overlap Fund Year from July 1, 1986, until June 30, 1987, and an ongoing June 30 taxable year. The employer contributes $1,750 to the fund during the employer's taxable year ending December 31, 1986—$750 during the short first taxable year of the fund and $1,000 during the Initial Fund Year (i.e., the period between July 1, 1986, and December 31, 1986)—and $1,500 to the fund during its taxable year ending December 31, 1987. Assume that the qualified cost of the fund for the short first taxable year of the fund is $800, the qualified direct cost for the Initial Fund Year is $900, and the qualified cost for the Overlap Fund Year is $2,500 (prior to the reduction required by paragraph (c) of this Q&A). Under the special rules of paragraphs (b) and (c), the employer may deduct $1,700 for its taxable year ending December 31, 1986, and $1,550 for its taxable year ending December 31, 1987.

Q-8: How does section 419 treat an employer's contribution with respect to a welfare benefit fund in excess of the applicable deduction limit for a taxable year of the employer?

A-8: (a) If an employer makes contributions to a welfare benefit fund in a taxable year of the employer and such contributions (when combined with prior contributions that are deemed under the rule of this Q&A and section 419(d) to have been made in such taxable year) exceed the section 419 deduction limit for such taxable year of the employer, the excess amounts are deemed to be contributed to the fund on the first day of the next taxable year of the employer. Such deemed contributions are combined with amounts actually contributed by the employer to the fund during the next taxable year and may be deductible for such year, subject to the otherwise applicable section 419 deduction limit for such year.

(b) Contributions to a welfare benefit fund on or before December 31, 1985, that were not deductible by the employer for any taxable year of the employer ending on or before December 31, 1985, or for the first taxable year of the employer ending after December 31, 1985, as pre-1986 contributions (see Q&A-9 of this regulation) are deemed to be contributed to the fund on January 1, 1986. However, see Q&A-11 of this regulation for special rules relating to the contribution to a welfare benefit fund of amounts (such as cash) used to acquire, construct, or improve a facility before section 419 generally becomes effective with respect to contributions to the fund. Generally, such contributions (to the extent that they were made after June 22, 1984 and on or before December 31, 1985) are treated as nondeductible pre-1986 contributions and are deemed to be contributed in the form of a facility at the same time as when the facility is placed in service by the fund.

Q-9: How does an employer with a fiscal taxable year calculate its deduction limit for contributions with respect to a welfare benefit fund for the first taxable year of the employer ending after December 31, 1985?

A-9: (a) If the first taxable year of an employer ending after December 31, 1985 (or, if applicable under paragraph (b) of Q&A-2 of this section, the first taxable year of an employer beginning after termination of the last of the collective bargaining agreements pursuant to which the fund is maintained) is a fiscal year, the employer's deduction for such taxable year for contributions to a welfare benefit fund that is not a collectively bargained welfare benefit fund under § 1.419A-2T is limited to the greater of the following two amounts: (1) The contributions paid to the fund during such first taxable year up to the qualified cost of the welfare benefit fund for the taxable year of the fund that relates to such taxable year of the employer, and (2) the contributions paid to the fund during the 1985 portion of such first taxable year of the employer ("the pre-1986 contributions") to the extent that such pre-1986 contributions are deductible under the rules governing the deduction of such contributions before section 419 generally becomes effective (including the rules set forth in Q&A-10 of this regulation, modified for purposes of this Q&A-9 by substituting "December 31, 1986" for "December 31, 1985" in paragraph (c)). See Q&A-11 of this regulation for special rules relating to the contribution to a welfare benefit fund of a facility (and to the contribution of other amounts, such as cash, used to acquire, construct, or improve such a facility) before section 419 generally becomes effective with respect to contributions to such fund.

(b) For example, assume that an employer with a taxable year ending June 30, contributes to a welfare benefit fund with a taxable year ending January 31. This employer contributes $1,000 to the fund between July 1, 1985, and December 31, 1985, and an additional $500 to the fund between

January 1, 1986, and June 30, 1986. Assume further that the qualified direct cost of the fund for the taxable year of the fund ending January 31, 1986, is $500 and that the qualified cost for such taxable year is $800. Under the deduction rule set forth above, the employer's deduction for its taxable year ending June 30, 1986, is the greater of two amounts: (1) The contributions made during such full taxable year ($1,500) up to the qualified cost of the fund with respect to such taxable year ($800), and (2) the pre-1986 contributions ($1,000) to the extent that such pre-1986 contributions are deductible under the pre-section 419 rules. In determining the extent to which the pre-1986 contributions are deductible under the pre-section 419 rules, the rules contained in Q&A-10 apply as though December 31, 1985, in paragraph (c) were December 31, 1986. Assuming that only $875 is deductible under the pre-section 419 rules, because $875 is greater than $800, this employer may deduct $875 for its first taxable year ending after December 31, 1985. This full $875 deduction for 1985 is deemed to consist entirely of pre-1986 contributions.

Q–10: How do the rules of sections 263, 446(b), 461(a), and 461(h) apply in determining whether contributions with respect to a welfare benefit fund are deductible for a taxable year?

A–10: (a) Both before and after the effective date of section 419 (see Q&A-2 of this regulation), an employer is allowed a deduction for taxable year for contributions paid or accrued with respect to a "welfare benefit fund" (as defined in Q&A-3 of this regulation and section 419(e)) only to the extent that such contributions satisfy the requirements of section 162 or 212. These requirements must be satisfied after the effective date of section 419 because 419 requires that (among other requirements) contributions to a welfare benefit fund satisfy the requirements of section 162 or 212.

(b) Except as provided in paragraphs (c) and (d), in determining the extent to which contributions paid or accrued with respect to welfare benefit fund satisfy the requirements of section 162 or 212 for a taxable year (both before and after section 419 generally becomes effective with respect to such contributions), the rules of sections 263, 446(b), 461(a) (including the rules that relate to the creation of an asset with a useful life extending substantially beyond the close of the taxable year), and 461(h) (to the extent that such section is effective with respect to such contributions) are generally applicable.

(c) Notwithstanding paragraph (b), under the authority of section 7805(b), the rules of sections 263, 446(b), and 461(a) shall not be applied in determining the extent to which an employer's contribution with respect to a welfare benefit fund is deductible under section 162 or 212 with respect to any taxable year of the employer ending on or before December 31, 1985, to the extent that, for such taxable year, (1) the contribution was made pursuant to a bona fide collective bargaining agreement requiring fixed and determinable contributions to a collectively bargained welfare benefit fund (as defined in § 1.419A-2T), or (2) the contribution was not in excess of the amount deductible under the principles of Revenue Rulings 69-382, 1969-2 C.B. 28; 69-478, 1969-2 C.B. 29; and 73-599, 1973-2 C.B. 40, modified as appropriate for benefits for active employees.

(d) Notwithstanding paragraph (b), in determining the extent to which contributions paid or accrued with respect to a welfare benefit fund are deductible under section 419, the rules of sections 263, 446(b), and 461(a) will be treated as having been satisfied to the extent that such contributions satisfy the otherwise applicable rules of section 419. Thus, for example, contributions to a welfare benefit fund will not fail to be deductible under section 419 merely because they create an asset with a useful life extending substantially beyond the close of the taxable year if such contributions satisfy the otherwise applicable requirements of section 419.

(e) In determining the extent to which contributions with respect to a welfare benefit fund satisfy the requirements of section 461(h) for any taxable year for which section 461(h) is effective, pursuant to the authority under section 461(h)(2), economic performance occurs as contributions to the welfare benefit fund are made. Solely for purposes of section 461(h), in the case of an employer's taxable year ending on or after July 18, 1984, and on or before March 21, 1986, contributions made to the welfare benefit fund after the end of such taxable year and on or before March 21, 1986 shall be deemed to have been made on the last day of such taxable year.

Q–11: What special section 419 rules apply to the payment or accrual with respect to a welfare benefit fund of a facility (and the payment or accrual of other amounts, such as cash, used to acquire, construct, or improve such a facility)?

A–11: (a)(1) In the case of an employer's payment or accrual with respect to a welfare benefit fund after June 22, 1984, and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A-2 of this regulation, before section 419 generally becomes effective with respect to contri-

butions to such fund), of a facility, the rules of section 419, § 1.419-1T, and § 1.419A-2T generally apply to determine the extent to which such contribution is deductible by the employer for its taxable year of contribution. For this purpose, however, the facility is to be treated as the only contribution made to the fund and the qualified cost of the fund for the taxable year of the fund in which the facility was contributed is to be equal to the qualified direct cost directly attributable to the facility (as determined under Q&A-6 of this regulation). Also, for this purpose, the welfare benefit fund to which the facility was contributed may not be aggregated with any other fund. For purposes of this Q&A, "facility" means any tangible asset with a useful life extending substantially beyond the end of the taxable year (e.g., vehicles, buildings) and any intangible asset (e.g., licenses) related to a tangible asset, whether or not such asset is used in the provision of welfare benefits. See, however, paragraph (c) of Q&A-2 of this regulation for a binding contract exception.

(2) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and that, during 1985, the employer contributes to the fund $200,000 in cash and a facility with a fair market value of $100,000. Such facility is used in the provision of welfare benefits under the fund. The employer is treated as having sold the facility in such year and thus will recognize gain to the extent that the fair market value of the facility exceeds the employer's adjusted basis in the facility. In this regard, see section 1239(d). The extent to which the facility contribution is deductible by the employer for its 1985 taxable year is determined as though it were the only contribution made by the employer to the fund during such year and the qualified cost of the fund for the taxable year of the fund in which the contribution was made (i.e., the 1985 taxable year) were equal to the amount that would have been allowable to the employer as a deduction for such year under the applicable Code provisions with respect to the portion of the facility used in the provision of welfare benefits for such year if the employer had placed in service the facility at the time the fund placed in service the facility and if the employer had the same taxable year as the fund. If, under these assumptions, the employer would have been allowed a $10,000 deduction with respect to the facility for the 1985 taxable year, the fund's qualified cost for its 1985 taxable year would be only $10,000. Thus, only $10,000 of the $100,000 facility contribution would be deductible by the employer for its 1985 taxable year (i.e., the taxable year of the employer with or within which the applicable taxable year of the fund ends). However, in determining the extent to which the $200,000 in cash is deductible by the employer for its 1985 taxable year, the $100,000 facility is not to be disregarded. Thus, if under the applicable pre-section 419 rules the employer is allowed for 1985 a total deduction of only $175,000, the employer would be permitted a deduction for 1985 of $175,000 ($10,000 with respect to the facility and $165,000 of the cash contribution). The nondeductible portion of the cash contribution is to be treated as contributed to the fund on the first day of the next taxable year of the employer. If under the applicable pre-section 419 rules the employer were allowed a total deduction of $300,000 for 1985, the employer would be permitted a deduction for 1985 of only $210,000 ($10,000 with respect to the facility and the full $200,000 cash contribution).

(3) For example, assume that an employer has a June 30 taxable year and maintains a welfare benefit fund with a taxable year ending January 31. During the 1985 portion of its taxable year ending June 30, 1986, the employer contributes $50,000 in cash and a facility with a fair market value of $100,000; and during the 1986 portion of such taxable year, the employer contributes another $75,000 in cash to the fund. The facility is used in the provision of welfare benefits under the fund. Under the rules of Q&A-9 of this regulation, the employer's deduction for its June 30, 1986, taxable year is limited to the greater of the following two amounts: (i) The contributions paid to the fund during such taxable year ($225,000) up to the qualified cost of the fund for the taxable year of the fund ending January 31, 1986, and (ii) the contributions paid to the fund during the 1985 portion of the employer's taxable year ending June 30, 1986 ("the pre-1986 contributions") ($150,000) to the extent that such pre-1986 contributions are deductible under the rules governing the deduction of such contributions before section 419 is generally effective with respect to the fund. For purposes of this rule, the contribution of the facility on or before December 31, 1985, is to be treated as a pre-1986 contribution and the rules of section 419 and this Q&A are to be treated as rules governing the deduction of such contribution before section 419 generally becomes effective with respect to the fund. Thus, in determining the extent to which the facility is deductible as a pre-1986 contribution under the rules before section 419 generally becomes effective, the facility is treated as the only contribution to the welfare benefit fund and the qualified cost of such fund for the taxable year of the fund in which the facility was contributed is the amount that would have been allowable to the

employer as a deduction with respect to the portion of the facility used in the provision of welfare benefits if the employer had placed in service the facility at the same time that the fund placed in service the facility and the employer's taxable year ended on January 31, 1986.

(b)(1) The preceding rules shall also apply for purposes of determining when and the extent to which an employer may deduct contributions or other items and amounts after June 22, 1984 and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A-2 of this regulation, before section 419 generally becomes effective with respect to contributions to the fund) that are not facilities (e.g., cash contributions) to a welfare benefit fund that are used by the fund to acquire, construct, or improve a facility. The most recent non-facility contributions made to a welfare benefit fund before the facility in question is placed in service by the fund (up to the fair market value of the facility at such time) are to be treated as used by the fund for the acquisition, construction, or improvement (as the case may be) of such facility. To the extent that contributions before such a facility is placed in service are not at least equal to the value of the facility at such time, contributions after such date (up to the value of the facility at the time it is placed in service) are treated as used for acquisition, construction, or improvement of the facility. Such non-facility contributions, to the extent that they were made after June 22, 1984, and on or before December 31, 1985 (or, if applicable under paragraph (b) of Q&A-2 of this regulation, before section 419 generally becomes effective with respect to contributions to the fund), are not deductible by the employer as non-facility contributions for any year. Instead, the employer is permitted a deduction with respect to such contributions only under the rules of this Q&A as though the employer had contributed a facility to the fund at the same time that the fund placed in service the facility in question and, at such time, the facility had a fair market value equal to the total of such non-facility contributions.

(2) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and during 1985 the fund acquired and placed in service a facility with a fair market value of $100,000 to be used in the provision of welfare benefits. Further, during July 1984 the employer contributed $150,000 in cash to the fund and, during the portion of 1985, before the facility was placed in service by the fund, the employer contributed another $75,000 in cash to the fund; during the remaining portion of 1985, the employer contributed $125,000 in cash. The facility is used in the provision of welfare benefits under the fund. Because $25,000 of the employer's 1984 contribution is treated under this rule as used for the acquisition of a facility, such $25,000 is not deductible by the employer for 1984. For purposes of determining the employer's deduction for 1985, the employer will be treated as having contributed $125,000 in cash and a facility with a fair market value of $100,000. The employer's deduction for its 1985 taxable year will be determined under the rules relating to the contribution of a facility after June 22, 1984, and on or before December 31, 1985.

(3) For example, assume that an employer and a welfare benefit fund each has a calendar taxable year and during 1986 the fund placed in service a facility with a fair market value of $100,000 to be used in the provision of welfare benefits. During 1985, the employer contributed $125,000 in cash to the fund. During the portion of 1986 before the facility was placed in service, the employer contributed $60,000 in cash, and during the remaining portion of 1986, the employer contributed another $75,000 in cash. The facility is used in the provision of welfare benefits under the fund. Because $40,000 of its 1985 cash contribution is treated under this rule as used for the acquisition of the facility, such $40,000 is not deductible by the employer for 1985. For purposes of determining the employer's deduction for 1986, the employer will be treated as though it had contributed a $40,000 facility to the fund at the time the fund placed the facility in service.

(c) For purposes of calculating the "existing excess reserve amount" under Q&A-1 of § 1.419A-1T and the "existing reserves for post-retirement medical or life insurance benefits" under Q&A-4 of § 1.512(a)-5T (but not the exempt function income under Q&A-3 of § 1.512(a)-5T), the amount set aside as of any applicable date is to be reduced to the extent that contributions originally included in such amount are subsequently treated under this Q&A as used for the acquisition, construction, or improvement of an asset excluded from the calculation of the total amount set aside under paragraph (b) of § 1.512(a)-5T (or would be so treated under this Q&A if it applied to such asset). The reduction required under this paragraph applies for purposes of calculating the "existing excess reserve amount" and the "existing reserves for post-retirement medical or life insurance benefits" for all taxable years of the welfare benefit fund.

[T.D. 8073, 51 FR 4323, Feb. 4, 1986; 51 FR 7262, March 3, 1986; T.D. 8073, 51 FR 11303, April 2, 1986]

§ 1.419A–1T Qualified asset account limitation of additions to account (temporary).

Q–1: What does the transition rule under section 419A(f)(7) provide?

A–1: Section 419A(f)(7) provides that, in the case of a welfare benefit fund that was in existence on July 18, 1984, the account limit (as determined under section 419A(c)) for each of the first four taxable years of the fund that relate to taxable years of the employer ending after December 31, 1985 (or, if applicable under paragraph (b) of Q&A-2 of § 1.419-1T, taxable years of the employer beginning after the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained) shall be increased by the following percentages of the "existing excess reserve amount":

	Percent
First taxable year	80
Second taxable year	60
Third taxable year	40
Fourth taxable year	20

For purposes of this section, the "existing excess reserve amount" for any taxable year of a fund is the excess of (a) the assets actually set aside for purposes described in section 419A(a) at the close of the first taxable year of the fund ending after July 18, 1984 (calculated in the manner set forth in Q&A-3 of § 1.512(a)-3T, and adjusted under paragraph (c) of Q&A-11 of § 1.419-1T), reduced by employer contributions to the fund before the close of such first taxable year to the extent that such contributions are not deductible for the taxable year of the employer with or within which such taxable year of the fund ends and for any prior taxable year of the employer, over (b) the account limit which would have applied to the taxable year of the fund for which the excess is being computed (without regard to this transition rule). A welfare benefit fund is treated as in existence on July 18, 1984, for purposes of this transition rule only if amounts were actually set aside in such fund on such date to provide welfare benefits enumerated under section 419A.

[T.D. 8073, 51 FR 4329, Feb. 4, 1986; T.D. 8073, 51 FR 11303, April 2, 1986]

§ 1.419A–2T Qualified asset account limitation for collectively bargained funds (temporary).

Q–1: What account limits apply to welfare benefit funds that are maintained pursuant to a collective bargaining agreement?

A–1: Contributions to a welfare benefit fund maintained pursuant to one or more collective bargaining agreements and the reserves of such a fund generally are subject to the rules of sections 419, 419A, and 512. However, neither contributions to nor reserves of such a collectively bargained welfare benefit fund shall be treated as exceeding the otherwise applicable limits of section 419(b), 419A(b), or 512(a)(3)(E) until the earlier of: (i) The date on which the last of the collective bargaining agreements relating to the fund in effect on, or ratified on or before, the date of issuance of final regulations concerning such limits for collectively bargained welfare benefit funds terminates (determined without regard to any extension thereof agreed to after the date of issuance of such final regulations), or (ii) the date 3 years after the issuance of such final regulations.

Q–2: What is a welfare benefit fund maintained pursuant to a collective bargaining agreement for purposes of Q&A–1?

A–2: (1) For purposes of Q&A–1, a collectively bargained welfare benefit fund is a welfare benefit fund that is maintained pursuant to an agreement which the Secretary of Labor determines to be a collective bargaining agreement and which meets the requirements of the Secretary of the Treasury as set forth in paragraph 2 below.

(2) Notwithstanding a determination by the Secretary of Labor that an agreement is a collective bargaining agreement, a welfare benefit fund is considered to be maintained pursuant to a collective bargaining agreement only if the benefits provided through the fund were the subject of arms-length negotiations between employee representatives and one or more employers, and if such agreement between employee representatives and one or more employers satisfies section 7701(a)(46) of the Code. Moreover, the circumstances surrounding a collective bargaining agreement must evidence good faith bargaining between adverse parties over the welfare benefits to be provided through the fund. Finally, a welfare benefit fund is not considered to be maintained pursuant to a collective bargaining agreement unless at least 50 percent of the employees eligible to receive benefits under the fund are covered by the collective bargaining agreement.

(3) In the case of a collectively bargained welfare benefit fund, only the portion of the fund (as determined under allocation rules to be provided by the Commissioner) attributable to employees covered by a collective bargaining agreement, and from which benefits for such employees are pro-

vided, is considered to be maintained pursuant to a collective bargaining agreement.

(4) Notwithstanding the preceding paragraphs and pending the issuance of regulations setting account limits for collectively bargained welfare benefit funds, a welfare benefit fund will not be treated as a collectively bargained welfare benefit fund for purposes of Q&A–1 if and when, after July 1, 1985, the number of employees who are not covered by a collective bargaining agreement and are eligible to receive benefits under the fund increases by reason of an amendment, merger, or other action of the employer or the fund. In addition, pending the issuance of such regulations, for purposes of applying the 50 percent test of paragraph (2) to a welfare benefit fund that is not in existence on July 1, 1985, "90 percent" shall be substituted for "50 percent".

[T.D. 8034, 50 FR 27428, July 3, 1985]

Certain Stock Options

§ 1.421–1 Effective dates and meaning and use of certain terms.

(a) **Option.** (1) For the purpose of section 421, the term "option" includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (d) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1954, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1955, another 1,000 shares on or after June 1, 1956, and a further 1,000 shares on or after June 1, 1957, all shares to be purchased before June 1, 1958, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1954, of three options, each for the purchase of 1,000 shares. Similarly, if a corporation grants to an employee on January 1, 1955, the right to purchase 1,000 shares of its stock at $85 per share during 1955, or at $75 per share during 1956, or at $65 per share during 1957, such an arrangement will be construed as the grant to the employee on January 1, 1955, of three alternative options, one option for the purchase of 1,000 shares at $85 per share during 1955, an alternative option for the purchase of 1,000 shares at $75 per share during 1956, and a third alternative option for the purchase of 1,000 shares at $65 per share during 1957.

(b) **Time and date of granting of option.** (1) For the purpose of section 421, the words "the date of the granting of the option" and "the time such option is granted", and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a restricted stock option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. A special rule is provided by section 421(d)(5) for options subject to stockholder approval. If the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of some regulatory or govern-

mental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of its parent or subsidiary corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1954, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation stock, exercisable by X on or after June 1, 1955, provided he is employed by the corporation on June 1, 1955. Such an option is granted to X on June 1, 1954.

(c) Stock. For the purpose of section 421, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock. The term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term "stock" as used in section 421, provided such stock otherwise possesses the rights and characteristics of capital stock.

(d) Option price. (1) For the purpose of section 421, the term "option price" or "price paid under the option" means the consideration in money or property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased.

(2)(i) With respect to its option price, a restricted stock option must, when granted, meet either of the following requirements:

(a) The option price must be fixed or determinable at the time the option is granted; or

(b) In the case of an option exercised during any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954, the option price must be determinable under a variable price option as defined in subdivision (ii) of this subparagraph.

An option which does not meet the requirements of either (a) or (b) of this subdivision when granted will not be treated as a restricted stock option unless it is subsequently changed to meet such requirements. In case of such a change, see paragraph (c)(2) of § 1.421–4.

(ii)(a) The term "variable price option" means an option under which the option price is determined by a formula in which the only variable is the fair market value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Except as provided in (b) of this subdivision, such formula may provide for determining such price by reference to such value on any particular day in such 6-month period, or by reference to an average value of the stock over either the whole of such 6-month period or over any shorter period included in such 6-month period. Such 6-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than \$85, nor more than \$110. Another example of a formula which meets the requirements of this subdivision is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than \$95. However, the requirements of this subdivision are not met by a formula which provides that if the profits of the employer for the year do not exceed \$100,000, the option price shall be \$15 under the fair market value of the stock at the time the option is exercised, but if such profits exceed \$100,000, the option price shall be \$20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this subdivision also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a)(1) of § 1.421–2.

(b) In the case of an option granted after September 30, 1958, the term "variable price option" does not include any option in which the formula provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised. Whether an option meets the requirement of this subdivision shall be determined solely by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial.

Thus, an option, granted after September 30, 1958, and containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised, is subject to the new limitation and does not meet the requirement of this subdivision, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 421(d)(1)(A). For example, a formula which provides that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than $85, will not qualify under this subdivision since under this formula the price may be determinable by reference to a higher prior value. On the other hand, a formula which provides that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, will qualify. In the case of an option granted after September 30, 1958, the only way that a formula which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the requirement of this subdivision is to provide that the option price is to be determined by reference to such fair market value only if such fair market value is not greater than the average fair market value of the stock during the month in which the option is exercised. If under the terms of an option the price is to be determined by reference to the fair market value of the stock at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock only when such value is lower than such average value of the stock, such option can qualify as a restricted stock option. The average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

(e) **Exercise.** For the purpose of section 421, the term "exercise", when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. An agreement or undertaking by the employee to make payments under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(f) **Transfer.** For the purpose of section 421, the term "transfer", when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a restricted stock option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(g) **Effective dates.** Sections 1.421–1 through 1.421–5 are applicable only to options granted after February 26, 1945, and before January 1, 1964, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, before the amendments made by section 221 of the Revenue Act of 1964 (78 Stat. 63). Section 1.421–6 is applicable only to options granted on or after February 26, 1945, and all references to sections of the Code are to the Internal Revenue Code of 1954, as amended. Sections 1.421–7 and 1.421–8 are applicable only to options granted after December 31, 1963, and all references therein to sections of the Code are to the Internal Revenue Code of 1954, as amended.

[T.D. 6500, 25 FR 11692, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 410, Jan. 19, 1961; T.D. 6887, 31 FR 8786, June 24, 1966]

§ 1.421–2 Restricted stock option.

(a) **In general.** (1) A "restricted stock option" is an option granted after February 26, 1945, to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option; and

(ii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iii) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For the purpose of applying the rule of subdivision (i) of this subparagraph if the option price is determined by a formula described in paragraph (d)(2)(ii) of § 1.421–1, the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is granted. For example, if on June 15, 1959, an option is granted providing that the option price shall be $10 under the average fair market value of the stock during the month in which the option is exercised or the average fair market value of the stock during the preceding month, whichever is lower, and if on June 15, 1959, the value of the stock subject to the option is $100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average fair market value of the stock during the months of May and June 1959. If such lower average fair market value is $95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of its parent or subsidiary corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any of such corporations; and

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option; and

(iii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iv) Such option by its terms is not exercisable after the expiration of five years from the date on which such option was granted, or such option is exercised before August 17, 1955.

(3) At the time the option is granted, the relationship between the individual to whom an option is granted and the corporation granting the option (or a corporation which is a parent or subsidiary thereof) must be the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see section 3401(c) and the regulations thereunder. An option granted before employment or after termination of employment is not a restricted stock option. As to the granting of an option conditioned upon employment, see paragraph (b)(2) of § 1.421–1. The option must be granted for a reason connected with the individual's employment by the corporation or by its parent or subsidiary corporation.

(4) An option may qualify as a restricted stock option only if, under the terms of the option, it is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a restricted stock option. However, in case the option contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a restricted stock option.

(5) Any reasonable valuation methods may be used for the purpose of determining whether at the time the option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option. Such methods include the valuation methods described in § 20.2031–2 of this chapter (Estate Tax Regulations).

(b) Ownership of 10 percent of stock. In determining the amount of stock owned by an individual, for the purpose of applying the 10 percent test

of section 421(d)(1)(C), stock of the employer corporation or of its parent or subsidiary owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust. [T.D. 6500, 25 FR 11693, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961]

§ 1.421–3 Exercise of restricted stock option.

(a) The special rules of income tax treatment provided in section 421(a) and (b) are applicable only if the following conditions exist with respect to the transfer of a share of stock to an individual:

(1) The share of stock is transferred to the individual pursuant to his exercise after 1949 of a restricted stock option; and

(2) At the time the option is exercised by him, the individual is an employee of the corporation granting such option (or parent or subsidiary thereof), or of a corporation (or parent or subsidiary thereof) which issued or assumed the option under section 421(g) (see paragraph (d) of § 1.421–4), or was an employee of any such corporations within three months before the date the option is exercised.

(b)(1) Section 421 is applicable to the exercise of a restricted stock option only if at the time the individual exercises the option he is a bona fide employee of the corporation granting the option, or of a corporation which is at the time the option is exercised a parent or subsidiary of such corporation, unless the old option has been assumed or a new option has been issued in its place under section 421(g). See paragraph (d) of § 1.421–4. In case of such an assumption of the old option or such issuance of a new option, the individual exercising the option must, at the time he exercises the option, be a bona fide employee of the corporation so assuming or issuing the option, or a parent or subsidiary of such corporation. Section 421 is also applicable if the individual exercising the option was a bona fide employee of any of such corporations within three months before the exercise of the option. For purposes of determining whether an individual meets the requirement of this subparagraph, the term "employer corporation", as used in section 421(d)(2) and (3), shall be read as "grantor corporation" or "corporation issuing or assuming a stock option in a transaction to which section 421(g) is applicable", as the case may be. Therefore, for purposes of the employment requirement, the determination of whether a corporation is a parent corporation or a subsidiary corporation is based upon whether the corporation is a parent or subsidiary of the corporation granting an option or of a corporation which issued or assumed an option under section 421(g).

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1954, X Corporation granted a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1955, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises this restricted stock option on June 1, 1955, section 421 is not applicable to such exercise, because on June 1, 1955, A is not employed by the corporation which granted the option or by a parent or subsidiary of such corporation. Nor was he employed by any of such corporations within three months before June 1, 1955.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 421(g). If A exercises the option to purchase the share of M stock on June 1, 1955, section 421 is applicable for A is then employed by a corporation which issued an option under section 421(g).

Example (3). Assume that P Corporation which owns all of the stock of S Corporation grants a restricted stock option to E, an employee of S Corporation. If E exercises the option, section 421 is applicable since E is employed by a corporation which is a subsidiary of the corporation which granted the restricted stock option.

(c)(1) The determination whether an option ultimately exercised is a restricted stock option is made as of the date such option is granted. An option which is a restricted stock option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a restricted stock option when granted does not become such an option by reason of subsequent events. See, however, § 1.421–4, relating to modification, extension, or renewal of an option.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). S–1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1954, P grants to an employee of P a restricted stock option to purchase a share of stock of S–1. On January 1, 1955, S sells a portion of the S–1 stock which it owns to an unrelated

corporation and, as of that date, S–1 ceases to be a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has exercised a restricted stock option.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1954, S–1 is not a subsidiary of either S or P. Such option is not a restricted stock option on June 1, 1954. On January 1, 1955, S purchases from an unrelated corporation a sufficient number of shares of S–1 stock to make S–1, as of that date, a subsidiary of S. On May 1, 1955, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has not exercised a restricted stock option.

(d) For the rules applicable to an exercise of a restricted stock option by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of § 1.421–5.

[T.D. 6500, 25 FR 11694, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961]

§ 1.421–4 Modification, extension, or renewal.

(a) In general. Section 421(e) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a restricted stock option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) in the case of an exercise of an option in any taxable year of the optionee which begins after December 31, 1953, and ends after August 16, 1954.

(b) Effect of a modification, extension, or renewal. (1) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(2) Except as otherwise provided in subparagraph (3) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for the purpose of applying the rule of section 421(d)(1)(A)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(3)(i) The rules of subparagraph (2) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1954, a restricted stock option was granted to purchase before July 1, 1955, a share of stock for $85. The fair market value of such stock on June 1, 1954, was $100. On June 15, 1955, when the fair market value of the stock is $60, such option is extended so that it is exercisable at any time before July 1, 1956, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1955, is as follows:

1954	
June	$100
July	90
August	80
September	70
October	80
November	80
December	90
1955	
January	90
February	80
March	70
April	60
May	60

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less

than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1955, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (2) of this paragraph would have been applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(c) Definition of modification, extension, or renewal. (1) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (b) of § 1.421–1. For the purpose of section 421, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change, which accelerates the time when the option is first exercisable, or which provides more favorable terms for the payment for the stock purchased under the option, is a modification. A mere change in the terms of the option, with respect to the number or price of the shares of stock subject to the option, to reflect a stock dividend or stock split-up is not a modification of the option. In case there is an assumption or substitution of the option by reason of certain corporate transactions, see paragraph (d) of this section. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(2) Any change in the terms of an option for the purpose of qualifying the option as a restricted stock option grants additional benefits and, therefore, is a modification. For example, if an option was granted to purchase for $80 a share of stock, the fair market value of which was $100 at such time, and if later the option price is increased to $85 in order to meet the requirement of section 421(d)(1)(A), such change is a modification of the option, although the price is increased. Accordingly, the option, despite the change, is not a restricted stock option if the fair market value of the share is more than $100 when the price is increased. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution, such change is not a modification, provided the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted.

(3) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(d) Assumption or substitution of restricted stock options in connection with certain corporate transactions. (1) Where, by reason of a corporate transaction, as defined in this paragraph, an employer corporation, or its parent or subsidiary corporation, assumes an existing option, or issues a new option in place of the old option, such assumption or issuance is not a modification, if—

(i) The excess of the aggregate fair market value of the stock subject to the option immediately after such assumption or issuance over the aggregate option price is not more than the excess of the aggregate fair market value of the stock subject to the option immediately before such assumption or issuance over the aggregate option price, and

(ii) Such assumption of the old option, or issuance of the new option, does not give the optionee additional benefits under the option.

For the purpose of this paragraph, the term "corporate transaction" means a corporate merger, consolidation, purchase or acquisition of property or stock, separation, reorganization, or liquidation. Thus, for this purpose, a "corporate transaction" includes a taxable transaction (such as, a purchase of stock or property for cash) and any corporate reorganization (whether or not it comes within the definition of such term in section 368) and any corporate liquidation (whether or not section 332 is applicable).

(2)(i) Section 421(g) provides rules under which a new employer, or parent or subsidiary of a new employer, may by reason of a corporate transaction assume a restricted stock option granted by the former employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. For example, section 421(g) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to

assume restricted stock options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a restricted stock option to purchase its stock in place of the restricted stock option which they had to purchase stock of X Corporation.

(ii) Section 421(g) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a restricted stock option granted by the employer or parent or subsidiary thereof, or issue a new restricted stock option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 421(g) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a restricted stock option to buy stock of X Corporation in place of the restricted stock option which they have to purchase the stock of Y Corporation.

(iii) Section 421(g) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 421(g) may apply where as a result of a corporate transaction a restricted stock option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 421(g) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 421(g).

(3) For section 421(g) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 421(g) may apply where the option which is being assumed or replaced expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 421(g) cannot be applied to revive a restricted stock option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 421(g). For section 421(g) to apply, the assumed or substituted option must qualify as a restricted stock option.

(4) Section 421(g) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Thus, section 421(g) would not apply if the old option had just two years to run but the new option has more than two years to run.

(5) For the purpose of applying section 421(g), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 421(g), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 421(g) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 421(g) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the restricted stock option which employee E has entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at $42.50 a share, was granted when the stock had a fair market value of $50 a share, and the stock was worth $100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth $50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at $21.25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at $21.25 a share in substitution for his

right to purchase 50 of the shares covered by the old option.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031–2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 421(g), the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(e) **Effect on qualification.** A restricted stock option may, as a result of a modification, extension, or renewal, thereafter cease to be a restricted stock option, or any option may, by modification, extension, or renewal, thereafter become a restricted stock option.

(f) **Examples.** The rule stated in section 421(e) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under section 421(e), the X Corporation is deemed to have granted an option to the employee on February 1, 1955. Unless the value of the stock has substantially declined making paragraph (b)(3) of this section applicable, such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee after February 1, 1955, is not the exercise of a restricted stock option.

Example (2). On June 1, 1954, the X Corporation grants to an employee a restricted stock option to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1955, and on or before June 1, 1956. On June 1, 1954, the fair market value of X Corporation's stock is $100 per share. On February 1, 1955, X Corporation modifies the option to provide that the option shall be exercisable on or after February 1, 1955, and on or before June 1, 1956. On February 1, 1955, the fair market value of X Corporation stock is $110 per share. Under section 421(e), X Corporation is deemed to have granted an option to the employee on February 1, 1955, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1954, and on February 1, 1955. The exercise of such option by the employee is not the exercise of a restricted stock option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1955, before the date of the modification of the option. Any exercise of the option after February 1, 1955, the date of the modification, is not the exercise of a restricted stock option. See example (1) in this paragraph. The exercise of the option on January 15, 1955, pursuant to which 50 shares were acquired, is the exercise of a restricted stock option.

Example (4). On June 1, 1954, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1956. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1955, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1955, the fair market value of the X Corporation stock is $90 per share. Under these facts, the X Corporation has granted two options, one option (not a restricted stock option) with respect to 100 shares having been granted on June 1, 1954, and the other option (a restricted stock option) with respect to the additional 150 shares having been granted on February 1, 1955. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

[T.D. 6500, 25 FR 11694, Nov. 26, 1960]

§ 1.421–5 Operation of section 421.

(a) **Rules applicable to all restricted stock options—(1) In general.** If a share of stock is transferred to an individual pursuant to his timely exercise of a restricted stock option and is not disposed of by him within two years from the date

of the granting of the option nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him, then, under section 421(a)—

(i) No income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 shall be allowable at any time to the employer corporation of such individual or its parent or subsidiary corporation, or to a corporation which assumed or issued the option under section 421(g), with respect to the share so transferred; and

(iii) No amount other than the option price shall be considered as received by any of such corporations for the share so transferred.

For the purpose of subdivisions (i), (ii), and (iii) of this subparagraph, each share of stock transferred pursuant to a restricted stock option is treated separately. For example, if an individual, while employed by a corporation granting him a restricted stock option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(2) Holding period. The special rules provided in section 421(a) are not applicable if the individual disposes of the share of stock within two years from the date the option is granted or within six months after the transfer of such share to him. Section 421 is not made inapplicable by a transfer within the 2-year or 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) period if such transfer is not a disposition of the stock as defined in subparagraph (3) of this paragraph, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (d) of this section.

(3) Disposition of stock. (i) For the purpose of section 421, the term "disposition" includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(a) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(b) An exchange which occurs in a taxable year of the optionee beginning after December 31, 1953, and ending after August 16, 1954, and to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939; or

(c) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(ii) If an individual exercises a restricted stock option, a share of stock acquired pursuant to such exercise is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership is a disposition of such share, except to the extent that the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a restricted stock option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share.

(4) Examples. The rules of section 421(a) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase 100 shares of X Corporation stock at $95 per share. On that date, the fair market value of X Corporation stock is $100 per share. On June 1, 1955, while employed by X Corporation, E exercises the option in full and pays X Corporation $9,500, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Before June 1, 1956, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1955, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to

its transfer to E of the stock. E's basis for such 100 shares is $9,500.

Example (2). Assume, in example (1), that on August 1, 1956, two years and two months after the granting of the option and one year and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000, which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,500 ($13,000 minus E's basis of $9,500), which is treated as long-term capital gain.

Example (3). Assume, in example (2), that on August 1, 1956, E makes a gift of the 100 shares of X Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $9,500 becomes the donee's basis for determining gain or loss.

Example (4). Assume, in example (1), that on May 1, 1956, one year and 11 months after the granting of the option and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within two years from the date the option was granted. See paragraph (e) of this section for the effect of a disqualifying disposition.

Example (5). Assume, in example (1), that E dies on September 1, 1955, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1955, of the restricted stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is $12,500.

(b) Additional rules applicable where the option price is between 85 percent and 95 percent of the value of the stock—(1) In general. (i) If all the conditions necessary for the application of section 421(a) exist, section 421(b) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 1-year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If the option qualified under section 421(d)(1)(A)(i) (see paragraph (d)(2)(i)(a) of § 1.421–1), such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, if the option qualified under section 421(d)(1)(A)(ii) (see paragraph (d)(2)(i)(b) of § 1.421–1), such amount shall be whichever of the following amounts is lesser:

(a) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(b) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 421(b).

(ii) The application of the special rules provided in section 421(b) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 421(b), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) Basis. If the special rules provided in section 421(b) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). However, in the case of a share of stock acquired by the exercise of a restricted stock option after the death of the employee to whom the option was granted, the basis of such share shall be determined in accordance with the rules of paragraph (d)(4) of this section. If the special rules provided in section 421(b) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of

the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 421(b). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) **Examples.** The operation of section 421(b) may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation grants to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1955, E exercises the restricted stock option and on that date the X Corporation transfers the share of stock to E. On January 1, 1957, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of $15 is includible in E's gross income for 1957, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) The X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume, in example (1), that E sells the share of X Corporation stock on January 1, 1958, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includible as compensation in E's gross income for 1958. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume, in example (1), that the option provides that the option price shall be 90 percent of the fair market value of a share of the stock on the day the option is exercised. On June 1, 1955, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of stock. Compensation in the amount of $10 is includible in E's gross income for 1957, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10 the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume, in example (1), that instead of selling the share on January 1, 1957, E makes a gift of the share on that day. In such case, $15 is includible as compensation in E's gross income for 1957. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume, in example (2), that instead of selling the share on January 1, 1958, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1958. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume, in example (1), that after acquiring the share of stock on June 1, 1955, E dies on August 1, 1956, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume, in example (6), that E dies on August 1, 1955, at which time the share has a fair market value of $150. Although E's death occurred within two years from the date of the granting of the option and within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E and his wife sold the share on June 15, 1956, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1956, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and except that E predeceased his wife on August 1, 1956, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume, in example (9), that E's wife predeceased him on July 1, 1956. Section 421(b) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1956, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1956 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) Acquisition of other stock. (1) Section 421(c) provides that the special rules stated in section 421 (a) and (b), if applicable with respect

to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which is applicable section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) or a corresponding provision of the Internal Revenue Code of 1939. Stock so acquired shall, for the purpose of section 421, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 421(c) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036). Section 421(c) is applicable only with respect to such acquisitions which occur in any taxable year of the shareholder which begins after December 31, 1953, and ends after August 16, 1954. As to acquisitions occurring in earlier taxable years, see section 130A(c) of the Internal Revenue Code of 1939.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If, with respect to stock transferred pursuant to the timely exercise of a restricted stock option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock within two years after the option was granted, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of within two years after the option was granted, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the old stock pursuant to the exercise of the option, section 421 is applicable.

(d) Exercise after death. (1) If a restricted stock option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, and if such exercise occurs in a taxable year of the estate or of such person beginning after December 31, 1953, and ending after August 16, 1954, section 421 applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421 become inapplicable if such executor, administrator, or person disposes of the stock so acquired within two years after the granting of such option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the stock pursuant to the exercise of such option. This exception as to the applicability of section 421 does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421 to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of § 1.421–4, relating to the modification, extension, or renewal of the option. Section 421 is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a parent or subsidiary thereof, either when the option is exercised or at any time. However, section 421 is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the requirements of paragraph (b) of § 1.421–3, relating to the employment of such individual, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421 is not applicable to the exercise. For example, if the option is sold by the estate, section 421 does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421 is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 421(b) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 421(b) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If under section 421(b) an amount is required to be included in the gross income of the estate or of such person, the estate or such person

shall be allowed a deduction as a result of the inclusion of the value of the restricted stock option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the restricted stock option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 421(b) as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 421(b). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)–1.

(ii) The application of subdivision (i) may be illustrated by the following example:

Example. On June 1, 1953, E was granted a restricted stock option to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 a share. E died on February 1, 1954, without having exercised such option. The option was, however, exercisable by his estate, and for purposes of the estate tax was valued at $30. On March 1, 1955, the estate exercised the option, and on March 15, 1955, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1955, the estate is required by section 421(b) to include in its gross income as compensation the amount of $15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(d)(6)(B), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the restricted stock option, $30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the restricted stock option in the estate of E is $10. Since $15, the amount includible in gross income by reason of section 421(b), is less than the value for estate tax purposes of the option, only $^{15}/_{30}$ of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, $^{15}/_{30}$ of $10, or $5. No deduction under section 421(d)(6)(B) is allowable with respect to any capital gain.

(4)(i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 421(b). The basis of the share shall not be increased by reason of the inclusion of the value of the restricted stock option in the estate for estate tax purposes.

(ii)(a) In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of the option under this paragraph, determined under section 1011, shall be increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a restricted stock option to acquire 10 shares of stock has a basis of $100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by $^{1}/_{10}$ of $100, or $10. The option acquires a basis, determined under section 1014(a), only if it is exercised in accordance with section 421. Therefore, to the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by (b) and (c) of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 421(b).

(b) If the amount which would have been includible in gross income under section 421(b) had the employee exercised the option and held the share at the time of his death exceeds the amount which is includible in gross income under section 421(b), the basis of the share, determined under (a) of this subdivision, shall be reduced by such excess. For example, if $15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only $10 is includible under section 421(b), the basis of the share, determined under (a) of this subdivision, would be reduced by $5. For purposes of determining the amount which would have been includible in gross income under section 421(b) if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(c) If the amount includible in gross income under section 421(b) exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under (a) of this subdivision, shall be increased by such excess. Thus, if $15 is includible in gross income under section 421(b), and the basis of the option with respect to the share is $10, the basis of the share, determined under (a) of this subdivision, will be increased by $5.

(iii) If a restricted stock option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right

to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1954, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date was $100 per share. On June 1, 1955, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1956, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $90. The estate is required by section 421(b) to include $5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is $90 (the $85 paid for the stock plus the $5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

Example (2). On June 1, 1956, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation stock for $85. The fair market value of X Corporation stock on such date was $100 per share. On June 1, 1957, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1958, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $120. The basis of the share is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since $15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(b) of this subparagraph does not apply. Moreover, since the $15 includible in the gross income of the estate does not exceed the basis of the option ($35), subdivision (ii)(c) of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example (3). Assume the same facts as in example (2), except that the fair market value of the share of stock at the time if its sale was $90. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $90, the estate is required to include $5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of this death, $15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by $10 the amount which the estate is required to include in its gross income, subdivision (ii)(b) of this subparagraph applies, and the basis of the share ($120), determined under subdivision (ii)(a) of this subparagraph is reduced by $10. Accordingly, the basis is $110, and a capital loss of $20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was $5, and that the fair market value of X Corporation stock on the date the employee died did not exceed $100. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since such amount exceeds by $10 the basis of the option, subdivision (ii)(c) of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)(a) of this subparagraph, is increased by $10. Accordingly, the basis is $100 and a capital gain of $20 is realized on the disposition of the share.

Example (5). Assume the same facts as in example (2), except that on June 1, 1957, the date the employee died, the fair market value of X Corporation stock was $98, and that on June 1, 1958, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was $5. On August 1, 1958, the estate of E exercised the option and sold the share when its fair market value was $92. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is $90 (the $85) paid for the stock plus the $5 basis of the option). When the share is sold for $92, the estate is required to include $7 in its gross income as compensation. Since $13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(b) of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)(a) of this subparagraph, is reduced by $6 to $84. Furthermore, since the $7 that the estate is required to include in its gross income when the share is sold for $92 exceeds by $2 the basis of the option, subdivision (ii)(c) of this subparagraph applies, and the basis of the share ($84), determined under subdivision (ii)(a) and (ii)(b) of this subparagraph, is increased by $2. Accordingly, the basis is $86 and a capital gain of $6 is realized on the disposition of the share.

(e) **Disqualifying disposition.** The disposition of a share of stock, acquired by the exercise of a restricted stock option, within two years after the granting of the option or within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of the share pursuant to such exercise makes section 421 inapplicable to such transfer of the share. If such disqualifying disposition occurs in a taxable year of the individual which begins after December 31, 1953, and ends after August 16, 1954, the income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, if such disposition occurs in a taxable year of the employer which begins after December 31, 1953, and ends after August 16, 1954, the deduction attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which occurs the disposition. However, if the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determined as if the employee had been paid com-

pensation at the time provided in paragraph (d) of § 1.421–6.

[T.D. 6500, 25 FR 11696, Nov. 26, 1960, as amended by T.D. 6527, 26 FR 411, Jan. 19, 1961; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.421–6 Options to which section 421 does not apply.

(a) Scope of section. (1) If an employer or other person grants to an employee or other person for any reason connected with the employment of such employee an option to purchase stock of the employer or other property, and if section 421 is not applicable, then this section shall apply. This section will apply, for example, when an option is not a qualified or restricted stock option at the time it is granted or an option granted under an employee stock purchase plan, or when an option is modified so that it no longer qualifies as such an option, or when there is a disqualifying disposition of stock acquired by the exercise of such an option so that section 421 does not apply. When an option is granted for any reason connected with the employment of an employee, this section applies, if section 421 does not apply, irrespective of whether the option is granted by the employer, by a parent or subsidiary of the employer, by a stockholder of any of such corporations, or by any other person, and irrespective of whether the option is granted to the employee, to a member of his family, or to any other person, and irrespective of whether the option is to purchase the stock of the employer, the stock of the parent or subsidiary of the employer, the stock of any other corporation, or to purchase any other property. In addition, § 1.61–15 makes the rules of this section applicable in determining the time when certain other options result in the realization of income and the amount of such income.

(2) This section is applicable to options granted on or after February 26, 1945, and before July 1, 1969 (and thereafter, to the extent that § 1.83–8(b) applies). For rules relating to options granted after June 30, 1969, see § 1.83–7. This section, however, is not applicable to—

(i) Property transferred pursuant to an option exercised before September 25, 1959, if the property is transferred subject to a restriction which has a significant effect on its value, or

(ii) Property transferred pursuant to an option granted before September 25, 1959, and exercised on or after such date, if, under the terms of the contract granting such option, the property to be transferred upon the exercise of the option is to be subject to a restriction which has a significant effect on its value and if such property is actually transferred subject to such restriction. However, if an option granted before September 25, 1959, and on or after February 26, 1945, is sold or otherwise disposed of before exercise, the provisions of this section shall be fully applicable to such disposition.

(3) If an option to which this section applies has a readily ascertainable fair market value when granted, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option, irrespective of whether such value was included in income for the taxable year in which the option was granted, and any deduction which is allowable as a result of the granting of such option is allowable only for the taxable year in which the option is granted. Thus, if an option having a readily ascertainable fair market value to which this section applies was granted in a taxable year for which an assessment of deficiency was barred at the time of the adoption of paragraph (c) of this section as a Treasury decision, no amount is includible in gross income under this section as compensation by reason of the transfer or exercise of such option. However, if there is a determination to which the rules of sections 1311–1314 apply, there may be an adjustment for the taxable year in which the option was granted.

(b) Meaning and use of certain terms. (1) For the purpose of this section, the term "option" includes the right or privilege of a person to purchase property from any person by virtue of an offer continuing for a stated period of time, whether or not irrevocable, to sell such property at a stated price, such person being under no obligation to purchase.

(2) As used in this section, the terms "employee", "employment", and "employer" have reference to the legal and bona fide relationship of employer and employee. For rules applicable to the determination whether the employer-employee relationship exists, see section 3401(c) and the regulations thereunder.

(3) For purposes of applying the rules of this section to the options which are made subject to such rules by § 1.61–15—

(i) The term "employee" includes the person who provided the consideration resulting in the grant of the option, the term "employer" includes the person to whom, or for whom, such consideration was provided, and the term "employment" includes the providing of such consideration;

(ii) Where a stock option is granted to an underwriter prior to a public offering and such grant is expressly or impliedly conditional upon the successful completion of the underwriting, the date on which the option shall be considered "granted" shall be the date of the successful completion of the underwriting.

(c) Options with a readily ascertainable fair market value. (1) If there is granted an option to which this section applies and which has a readily ascertainable fair market value (determined in accordance with subparagraphs (2) and (3) of this paragraph) at the time the option is granted, the employee in connection with whose employment such option is granted realizes compensation at such time in an amount equal to the excess, if any, of such fair market value over any amount paid for the option. If an option to which this section applies does not have a readily ascertainable fair market value at the time the option is granted, the time when the compensation is realized and the amount of such compensation shall be determined under paragraph (d) of this section.

(2) Although options may have a value at the time they are granted, that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031–2 of this chapter (the Estate Tax Regulations).

(3)(i) When an option is not actively traded on an established market, the fair market value of the option is not readily ascertainable unless the fair market value of the option can be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(a) The option is freely transferable by the optionee;

(b) The option is exercisable immediately in full by the optionee;

(c) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option or such property; and

(d) The fair market value of the option privilege is readily ascertainable in accordance with subdivision (ii) of this subparagraph.

(ii) The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of the property subject to the option, for example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so acquired for its higher fair market value. Irrespective of whether any such gain may be realized immediately at the time an option is granted, the fair market value of an option includes the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise period), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider—

(a) Whether the value of the property subject to the option can be ascertained; and

(b) The probability of any ascertainable value of such property increasing or decreasing; and (c) The length of the period during which the option can be exercised.

(d) Options without a readily ascertainable fair market value. If there is granted an option to which this section applies, and if the option does not have a readily ascertainable fair market value at the time it is granted, the employee in connection with whose employment the option is granted is considered to realize compensation includible in gross income under section 61 at the time and in

the amount determined in accordance with the following rules of this paragraph:

(1) Except as provided in subparagraph (2) of this paragraph, if the option is exercised by the person to whom it was granted, the employee realizes compensation at the time an unconditional right to receive the property subject to the option is acquired by such person, and the amount of such compensation is the difference between the amount payable for the property and the fair market value of the property at the time an unconditional right to receive the property is acquired. An individual has an unconditional right to receive the property subject to the option when his right to receive such property is not subject to any conditions, other than conditions that may be performed by him at any time. Thus, if an individual who has exercised an option has a right to make payment for the property at any time and to receive the property immediately after making such payment, such individual realizes compensation at the time he exercises the option. However, if an individual who has exercised an opinion is prevented by the terms of the option contract from making payment immediately of from receiving an immediate transfer of the property after making payment, such individual does not realize compensation at the time he exercises the option. Such individual will not realize compensation until he does acquire the right to make payment immediately and to receive an immediate transfer of the property. For purposes of this paragraph, an unconditional right to receive the property subject to the option shall not be considered to have been acquired before the date on which the option is exercised.

(2)(i) If the option is exercised by the person to whom it was granted but, at the time an unconditional right to receive the property subject to the option is acquired by such person, such property is subject to a restriction which has a significant effect on its value, the employee realizes compensation at the time such restriction lapses or at the time the property is sold or exchanged, in an arm's length transaction, whichever occurs earlier, and the amount of such compensation is the lesser of—

(a) The difference between the amount paid for the property and the fair market value of the property (determined without regard to the restriction) at the time of its acquisition, or

(b) The difference between the amount paid for the property and either its fair market value at the time the restriction lapses or the consideration received upon the sale or exchange, whichever is applicable.

If the property is sold or exchanged in a transaction which is not at arm's length before the time the employee realizes compensation in accordance with this subdivision, any amount of gain which the employee realizes as a result of such sale or exchange is includible in gross income at the time of such sale or exchange, but the amount includible in gross income under this subdivision at the time of the expiration of the restriction or the sale or exchange at arm's length shall be reduced by the amount of gain includible in gross income as a result of the sale or exchange not at arm's length.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). On November 1, 1959, X Corporation grants to E, an employee, an option to purchase 100 shares of X Corporation stock at $10 per share. Under the terms of the option, E will be subject to a binding commitment to resell the stock to X Corporation at the price he paid for it in the event that his employment terminates within 2 years after he acquires the stock, for any reason except his death. Evidence of this commitment will be stamped on the face of E's stock certificate. E exercises the option and acquires the stock at a time when the stock, determined without regard to the restriction, has a fair market value of $18 per share. Two years after he acquires the stock, at which time the stock has a fair market value of $30 per share, E is still employed by X Corporation. E realizes compensation upon the expiration of the 2-year restriction and the amount of the compensation is $800. The $800 represents the difference between the amount paid for the stock ($1,000) and the fair market value of the stock (determined without regard to the restriction) at the time of its acquisition ($1,800), since such value is less than the fair market value of the stock at the time the restriction lapsed ($3,000).

Example (2). Assume, in example (1), that E dies one year after he acquires the stock, at which time the stock has a fair market value of $25 per share. Since the restriction lapses upon E's death, he realizes compensation of $800 ($1,800 less $1,000) and this amount is includible in E's gross income for the taxable year closing with his death.

Example (3). Assume that, pursuant to the exercise of an option not having a readily ascertainable fair market value to which this section applies, an employee acquires stock subject to the sole condition that, if he desires to dispose of such stock during the period of his employment, he is obligated to offer to sell the stock to his employer at its fair market value at the time of such sale. Since this condition is not a restriction which has a significant effect on value, the employee realizes compensation upon acquisition of the stock.

Example (4). Assume, in example (3), that the employee is obligated to offer to sell the stock to his employer at its book value rather than at its fair market value. Since this condition amounts to a restriction which has a significant effect on value, the employee does not realize compensation upon acquisition of the stock, but he does realize such compensation upon the lapse of the restriction, such as, for example, his death or the termination of his employment.

(3) If the option is not exercised by the person to whom it was granted, but is transferred in an arm's length transaction, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting.

(4) If the option is not exercised by the person to whom it was granted, but is transferred in a transaction which is not at arm's length, the employee realizes compensation in the amount of the gain resulting from such transfer of the option, and such compensation is includible in his gross income in accordance with his method of accounting. Moreover, the employee realizes additional compensation at the time and in the amount determined under subparagraph (1), (2), or (3) of this paragraph, except that the amount of compensation determined under subparagraph (1), (2), or (3) of this paragraph shall be reduced by any amount previously includible in gross income as a result of such transfer of the option. For example, if in 1960 an employee is granted an option not having a readily ascertainable fair market value to buy a share of stock for $50 at a time when the stock has a fair market value of $100, and later in 1960 the employee transfers, in a transaction not at arm's length, the option to his wife for $10, the employee realizes compensation of $10 in 1960. If in 1961 the wife exercises the option at a time when the stock has a fair market value of $120, the employee realizes additional compensation in 1961 in the amount of $60 (the $70 bargain spread less the $10 taxed as compensation in 1960). For the purpose of this subparagraph if a person other than the employee dies holding an unexercised option at a time when the employee is still living, the transfer which results by reason of the death of such person is a transfer in a transaction which is not at arm's length.

(5) If there is granted an option to which this section applies, and the employee dies before realizing the compensation in accordance with the rules of this paragraph, income having the character of compensation is realized at the time and in the amount determined under this paragraph by the person who transfers or exercises the option, or the person who receives the property subject to a restriction which has a significant effect on its value. For example, this subparagraph is applicable:

(i) When an option not having a readily ascertainable fair market value is granted to an employee, and he dies before transferring or exercising the option,

(ii) When an option not having a readily ascertainable fair market value is granted to the employee, and he dies after the transfer of the option in a transaction which is not at arm's length, but before the option is exercised, or

(iii) When an option not having a readily ascertainable fair market value is granted to another person, and the employee dies before realizing all of the compensation which would result from any transfer or exercise of the option. If the option is one which was granted to the employee and he dies before transferring or exercising the option, the option shall be considered a right to receive income in respect of a decedent to which the rules of section 691 apply. In any such case, if the option is transferred, section 691 provides that the amount received for such transfer or the fair market value of the property transferred at the time of transfer, whichever is greater, is income realized at the time of such transfer. Moreover, if a transfer is subject to this rule, it will be treated as a transfer in an arm's length transaction for the purpose of this paragraph.

(6) If an option to which this section applies is exercised in part and transferred in part, the rules of this paragraph shall be applied as if there were two options—one exercised and one transferred.

(7) Notwithstanding the other provisions of this paragraph, if this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the taxable year of the employee for which he is required to include in his gross income the compensation resulting from such option is determined under section 421(b) and paragraph (b) of § 1.421–8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421–5) and, in the case of a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, the amount of such compensation shall be subject to the limitation provided by section 422(c)(4) and paragraph (b) of § 1.422–1.

(e) **Basis.** (1) If an option to which this section applies is exercised by the person to whom it was granted, such person's basis for the property so acquired shall be increased by any amount that is includible in the gross income of the employee under paragraph (d) of this section. If such person transfers such property to a person whose basis is the same as the transferor's basis, such

transferee's basis shall also reflect the adjustment made by this paragraph. However, if such property is transferred by either of such persons at death so that its basis is determined under section 1014, the basis so determined shall not be increased by reason of this paragraph.

(2) If an option to which this section applies is transferred in a transaction which is not at arm's length, the transferee who exercises the option shall increase his basis for the property so acquired by any amount that is includible in the gross income of the employee at the time such transferee acquires the property.

(3) If an option to which this section applies is transferred in a transaction which is at arm's length, the basis of the property acquired by an exercise of the option shall not be increased by reason of any amount that is includible in this gross income of the employee under this section.

(4) If an option to which this section applies has a readily ascertainable fair market value at the time it is granted, the basis of such option includes any amount includible in gross income of the employee under paragraph (c) of this section.

(f) Deductions. If the employer grants an option to which this section applies, the employer of the employee in connection with whose employment the option is granted is considered to have paid compensation to such employee at the same time and in the same amount as such employee is considered under paragraph (c) or (d) of this section to have realized compensation. The deductibility of the amount considered so paid is determined under section 162 or other provision of the Code which is applicable to such a payment. Whether such amount may be deducted in the taxable year considered so paid, or whether such amount is a capital expenditure which is not deductible or which may be amortized, depends upon the nature of the transaction involved and the facts and circumstances of each case. If this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a qualified or restricted stock option, or acquired by the exercise of an option granted under an employee stock purchase plan, the employer's taxable year for which such compensation is deductible is determined under section 421(b) and paragraph (b) of § 1.421–8 (or, in the case of taxable years ending before January 1, 1964, under section 421(f) and paragraph (e) of § 1.421–5).

[T.D. 6540, 26 FR 512, Jan. 20, 1961, as amended by T.D. 6696, 28 FR 13451, Dec. 12, 1963; T.D. 6887, 31 FR 8787, June 24, 1966; T.D. 7554, 43 FR 31926, July 24, 1978]

§ 1.421–7 Meaning and use of certain terms.

(a) Option. (1) For purposes of sections 421 through 425, the term "option" includes the right or privilege of an individual to purchase stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (e) of this section, such individual being under no obligation to purchase. Such right or privilege, when granted, must be evidenced in writing. The individual who has such right or privilege is referred to as the optionee and the corporation offering to sell stock under such an arrangement is referred to as the optionor. While no particular form of words is necessary, the written option should express, among other things, an offer to sell at the option price and the period of time during which the offer shall remain open.

(2) An option may be granted as part of or in conjunction with an employee stock purchase plan or subscription contract. See section 423.

(3) An arrangement between a corporation and an employee may involve more than one option. For example, if a corporation on June 1, 1964, grants to an employee the right to purchase 1,000 shares of its stock on or after June 1, 1965, another 1,000 shares on or after June 1, 1966, and a further 1,000 shares on or after June 1, 1967, all shares to be purchased before June 1, 1968, provided the employee at the time of exercise of any of the purchase rights is employed by the corporation, such an arrangement will be construed as the grant to the employee on June 1, 1964, of three options, each for the purchase of 1,000 shares. However, if a corporation grants to an employee on January 1, 1965, the right to purchase 1,000 shares of its stock at $65 per share during 1965, or at $75 per share during 1966, or at $85 per share during 1967, such an arrangement will be construed as the grant to the employee on January 1, 1965, of but one option for the purchase of 1,000 shares, which ceases to be outstanding when fully exercised at the price in effect at the time of exercise.

(b) Statutory options. (1) The term "statutory option", used for purposes of convenience hereinafter in this section and in §§ 1.421–8 through 1.425–1, means a qualified stock option, as defined by section 422(b) and § 1.422–2; an option granted under an employee stock purchase plan, as defined by section 423(b) and § 1.423–2; and a

restricted stock option, as defined in section 424(b) and § 1.424–2.

(2) An option may qualify as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom it is granted, and is exercisable, during the lifetime of such individual, only by him. See sections 422(b)(6), 423(b)(9), and 424(b)(2). Accordingly, an option which is transferable by the individual to whom it is granted during his lifetime, or is exercisable during such individual's lifetime by another person, is not a statutory option. However, in case the option or the plan under which the option was granted contains a provision permitting the individual to whom the option was granted to designate the person who may exercise the option after his death, neither such provision, nor a designation pursuant to such provision, disqualifies the option as a statutory option.

(3)(i) The determination of whether an option is a statutory option is made as of the date such option is granted. An option which is a statutory option when granted does not lose its character as such an option by reason of subsequent events, and an option which is not a statutory option when granted does not become such an option by reason of subsequent events. See, however, paragraph (e) of § 1.425–1, relating to modification, extension, or renewal of an option. For rules concerning options that are not statutory options, see § 1.83–7.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). S–1 Corporation is a subsidiary of S Corporation which, in turn, is a subsidiary of P Corporation. On June 1, 1964, P grants to an employee of P a statutory option to purchase a share of stock of S–1. On January 1, 1965, S sells a portion of the S–1 stock which it owns to an unrelated corporation and, as of that date, S–1 ceases to be a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. Section 421 applies to such exercise.

Example (2). Assume P grants an option to an employee under the same facts as in example (1) above, except that on June 1, 1964, S–1 is not a subsidiary of either S or P. Such option is not a statutory option on June 1, 1964. On January 1, 1965, S purchases from an unrelated corporation a sufficient number of shares of S–1 stock to make S–1, as of that date, a subsidiary of S. On May 1, 1965, while still employed by P, the employee exercises his option to purchase a share of S–1 stock. The employee has not exercised a statutory option.

(c) Time and date of granting option. (1) For purposes of sections 421 through 425, the words "the date of the granting of the option" and "the time such option is granted", and similar phrases refer to the date or time when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.

(2) If the corporation imposes conditions on the granting of an option (as distinguished from conditions governing the exercise of the option), such conditions shall be given effect in accordance with the intent of the corporation. However, under section 425(i), if the grant of an option is subject to approval by stockholders, the date of grant of the option shall be determined as if the option had not been subject to such approval. A condition which does not require corporate action, such as the approval of, or registration with, some regulatory or governmental agency, for example, a stock exchange or the Securities and Exchange Commission, is ordinarily considered a condition upon the exercise of the option unless the corporate action clearly indicates that the option is not to be granted until such condition is satisfied. If an option is granted to an individual upon the condition that such individual will become an employee of the corporation granting the option or of a related corporation, such option is not granted prior to the date the individual becomes such an employee.

(3) In general, conditions imposed upon the exercise of an option will not operate to make ineffective the granting of the option. For example, on June 1, 1964, the A Corporation grants to X, an employee, an option to purchase 5,000 shares of the corporation's stock, exercisable by X on or after June 1, 1965, provided he is employed by the corporation on June 1, 1965, and provided that A's profits during the fiscal year preceding the year of exercise exceed $200,000. Such an option is granted to X on June 1, 1964, and will be treated as outstanding as of such date.

(d) Stock and voting stock. For purposes of sections 421 through 425, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock. Except as

otherwise provided, the term includes both treasury stock and stock of original issue. Special classes of stock authorized to be issued to and held by employees are within the scope of the term "stock" as used in such sections, provided such stock otherwise possesses the rights and characteristics of capital stock. For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders or whether the limitations pertaining to voting power contained in sections 422(b)(7), 423(b)(3) and 424(b)(3) and the regulations thereunder have been met, stock which does not have voting rights until the happening of an event, such as the default in the payment of dividends on preferred stock, is not voting stock until the happening of the specified event. Moreover, stock which does not possess a general voting power, and may vote only on particular questions, is not voting stock. However, if such stock is entitled to vote on whether a stock option plan is to be adopted, it is voting stock for the purpose of ascertaining whether the plan has been approved by the shareholders.

(e) **Option price.** (1) For purposes of sections 421 through 425, the term "option price" or "price paid under the option" means the consideration in money or other property which, pursuant to the terms of the option, is the price at which the stock subject to the option is purchased. The term "option price" does not include amounts paid as interest under a deferred payment arrangement or treated as unstated interest under section 483 and the regulations thereunder. Thus, for example, section 483 is applicable in determining whether the pricing requirements of section 422(b)(4), 423(b)(6), 424(b)(1), or 424(c) are met and is applicable in determining the basis of any stock acquired pursuant to the exercise of a statutory option. However, with respect to statutory options granted prior to January 1, 1965, the determination of whether the applicable pricing requirements are met shall be made without regard to section 483, but section 483 shall be taken into consideration in determining basis for purposes of determining gain or loss.

(2) In the case of a statutory option, any reasonable valuation method may be used for the purpose of determining whether at the time the option is granted the option price satisfies the pricing requirements of section 442(b)(4) (relating to qualified stock options), section 423(b)(6) (relating to employee stock purchase plans), or section 424(b)(1) (relating to restricted stock options), whichever is applicable, with respect to the stock subject to the option. Such methods include the valuation methods described in § 20.2031-2 of this chapter (Estate Tax Regulations).

(f) **Exercise.** For purposes of sections 421 through 425, the term "exercise", when used in reference to an option, means the act of acceptance by the optionee of the offer to sell contained in the option. In general, the time of exercise is the time when there is a sale or a contract to sell between the corporation and the individual. A promise to pay the option price does not constitute an exercise of the option unless the optionee is subject to personal liability on such promise. An agreement or undertaking by the employee to make payments under an employee stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee.

(g) **Transfer.** For purposes of sections 421 through 425, the term "transfer", when used in reference to the transfer to an individual of a share of stock pursuant to his exercise of a statutory option, means the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation.

(h) **Employment relationship.** (1) Section 421 is applicable to the exercise of a statutory option only if at the time the option is granted, the optionee is an employee of the corporation granting the option, or a related corporation of such corporation, unless the option has been assumed or a new option has been issued in its place under section 425(a). In case of such an assumption or issuance, the optionee must, at the time of such assumption or issuance, be an employee of the corporation so assuming or issuing the option, or a related corporation of such corporation. The determination of whether the optionee is an employee at the time the option is granted (or at the time of the assumption or issuance under section 425(a)) will be made in accordance with the rules contained in section 3401(c) and the regulations thereunder. As to the granting of an option conditioned upon employment, see paragraph (c)(2) of this section. A statutory option must be granted for a reason connected with the individual's employment by the corporation or by its related corporation.

(2) In order to qualify for the special tax treatment of section 421, in addition to meeting the requirements of subparagraph (1) of this paragraph, an individual exercising a qualified stock option or an option granted under an employee

stock purchase plan must, at all times during the period beginning with the date of the granting of such option and ending at the time of such exercise or on the day 3 months before the date of such exercise, be an employee of either the corporation granting such option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. For this purpose, the employment relationship in respect of an option granted in accordance with the requirements of subparagraph (1) of this paragraph will be treated as continuing intact while the individual is on military, sick leave or other bona fide leave of absence (such as temporary employment by the Government) if the period of such leave does not exceed 90 days, or, if longer, so long as the individual's right to reemployment with the corporation granting the option (or a related corporation of such corporation, or a corporation, or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies) is guaranteed either by statute or by contract. Where the period of leave exceeds 90 days and where the individual's right to reemployment is not guaranteed either by statute or by contract, the employment relationship will be deemed to have terminated on the 91st day of such leave.

(3) For purposes of determining whether an individual meets the requirements of this paragraph, the term "employer corporation", as used in section 425 (e) and (f), shall be read as "grantor corporation" or "corporation issuing or assuming a stock option in a transaction to which section 425(a) is applicable", as the case may be. For purposes of the employment requirement, a corporation employing an optionee is considered a related corporation if it was a parent or subsidiary of the corporation granting or assuming the option during the entire portion of the requisite period of employment during which it was the employer of such optionee.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, X Corporation granted a statutory option to A, an employee of X Corporation, to purchase a share of X stock. On February 1, 1965, X sold the plant where A was employed to M Corporation, an unrelated corporation, and A was employed by M. If A exercises his statutory option on June 1, 1965, section 421 is not applicable to such exercise, because on June 1, 1965, A is not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within 3 months before June 1, 1965.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 425(a). If A exercises the option to purchase the share of M stock on June 1, 1965, section 421 is applicable for A is then employed by a corporation which issued an option under section 425(a).

Example (3). E is an employee of P Corporation. On June 1, 1964, P grants E a statutory option to purchase a share of P stock. On June 1, 1965, P acquires 100 percent of the stock of S Corporation; on such date S becomes a subsidiary of P. On July 1, 1965, E ceases to be employed by P and becomes employed by S. On October 10, 1965, while still employed by S, E exercises his option to buy P stock. Since E was at all times during the requisite period of employment an employee of either P, the corporation granting the option, or S, a subsidiary of the grantor during the period in which such corporation was E's employer, section 421 is applicable to the exercise of the option.

Example (4). Assume the same facts as in example (3) except assume that at the time E became an employee of S Corporation, S assumed E's option to purchase P stock under section 425(a). Section 421 is applicable to E's exercise of his option to buy P stock.

Example (5). M Corporation grants a qualified stock option to E, an employee of such corporation. E is an officer in a reserve Air Force unit. E goes on military leave with his unit for 3 weeks. Regardless of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder during such 3-week period, E's employment relationship with M is treated as uninterrupted during the period of E's military leave.

Example (6). Assume the same facts as in example (5) and assume further that E's active duty status is extended indefinitely, but that E has an employment contract with M which provides that upon the termination of any military duty E may be required to serve, E will be entitled to reemployment with M or a parent or subsidiary of M. E exercises his M option while on active military duty. Irrespective of whether E is an employee of M within the meaning of section 3401(c) and the regulations thereunder at the time of such exercise or within 3 months before such exercise, section 421 can apply to such exercise.

Example (7). X Corporation grants a qualified stock option to A, an employee of X Corporation, whose employment contract provides that in the event of illness, A's right to reemployment with X, or a parent or subsidiary of X, will continue for 1 year after the time A becomes unable to perform his duties for X. A falls ill for 90 days. For purposes of section 422(a)(2), A's employment relationship with X will be treated as uninterrupted during the 90-day period. If A's incapacity extends beyond 90 days, then, for purposes of section 422(a)(2), A's employment relationship with X will be treated as continuing uninterrupted until A's reemployment rights terminate. Under section 422(a)(2), A has 3 months in which to exercise his qualified stock option after his employment relationship with X (and its parent and subsidiary corporation) is terminated.

(i) **Related corporation.** The term "related corporation", used for purposes of convenience in this section and §§ 1.421–8 through 1.425–1, means a corporation which is a parent or subsidiary corpo-

ration (as defined by section 425(e) and (f) and the regulations thereunder).

[T.D. 6887, 31 FR 8787, June 24, 1966, as amended by T.D. 6975, 33 FR 14779, Oct. 3, 1968; T.D. 7554, 43 FR 31927, July 24, 1978]

§ 1.421–8 General rules.

(a) Effect of qualifying transfer. (1) If a share of stock is transferred to an individual pursuant to his exercise of a statutory option, and if the requirements of section 422(a) (relating to qualified stock options), section 423(a) (relating to employee stock purchase plans), or section 424(a) (relating to restricted stock option), whichever is applicable, are met, then—

(i) Except as provided in section 422(c)(1) (relating to exercise of option when price is less than value of stock), and paragraph (e)(2) of § 1.422–2, no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

(ii) No deduction under section 162 or the regulations thereunder (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a related corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 425(a) and paragraph (a) of § 1.425–1 (relating to corporate reorganizations, liquidations, etc.) applies, with respect to the share so transferred; and

(iii) No amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

(2) For the purpose of this paragraph, each share of stock transferred pursuant to a statutory option is treated separately. For example, if an individual, while employed by a corporation granting him a statutory option, exercises the option with respect to part of the stock covered by the option, and if such individual exercises the balance of the option more than three months after leaving such employment, the application of section 421 to the stock obtained upon the earlier exercise of the option is not affected by the fact that the income taxes of the employer and the individual with respect to the stock obtained upon the later exercise of the option are not determined under section 421.

(b) Effect of disqualifying disposition. (1) The disposition of a share of stock, acquired by the exercise of a statutory option before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), makes section 421 inapplicable to the transfer of such share. The income attributable to such transfer shall be treated by the individual as income received in the taxable year in which such disposition occurs. Similarly, a deduction under section 162 attributable to the transfer of the share of stock pursuant to the exercise of the option shall be allowable for the taxable year in which such disposition occurs to the employer corporation, its parent or subsidiary corporation or a corporation issuing or assuming a stock option in a transaction to which section 425(a) applies. In such cases, no amount shall be treated as income, and no amount shall be allowed as a deduction, for any taxable year other than the taxable year in which the disposition occurs. If the stock was transferred pursuant to the exercise of the option in a taxable year other than the taxable year of the disposition, the amount of the deduction shall be determined as if the employee had been paid compensation at the time provided in paragraph (d) of § 1.421–6.

(2) Section 421 is not made inapplicable by a transfer before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), if such transfer is not a disposition of the stock as defined in section 425(c) and paragraph (c) of § 1.425–1, for example, a transfer from the decedent to his estate or a transfer by bequest or inheritance. Similarly, a disposition by the executor, administrator, heir, or legatee is not a disposition by the decedent. In case a statutory option is exercised by the estate of the individual to whom the option was granted, or by a person who acquired the option by bequest or inheritance or by reason of the death of such individual, see paragraph (c) of this section.

(3) For special rules relating to a disqualifying disposition of a share of stock acquired by the exercise of a qualified stock option, see paragraph (b) of § 1.422–1.

(c) Exercise by estate. (1) If a statutory option is exercised by the estate of the individual to whom the option was granted, or by any person who acquired such option by bequest or inheritance or by reason of the death of such individual, section 421(a) applies to such exercise in the same manner as if such option had been exercised by such deceased individual. Consequently, except as provided by section 422(c)(1) and paragraph (e)(2) of § 1.422–2, neither the estate nor such person is required to include any amount in gross income as a result of a transfer of stock pursuant to such exercise of the option. Nor does section 421(a)

become inapplicable if such executor, administrator, or person disposes of the stock so acquired before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1). This special rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss. The executor, administrator, or such person need not exercise the option within three months after the death of the individual to whom the option was granted for section 421(a) to be applicable. However, the exercise of the option must be pursuant to the terms of the option, and any change in the terms of the option is subject to the rules of paragraph (e) of § 1.425–1, relating to the modification, extension, or renewal of the option. Section 421(a) is applicable even though such executor, administrator, or person is not employed by the corporation granting the option, or a related corporation, either when the option is exercised or at any time. However, section 421(a) is not applicable to an exercise of the option by the estate or by such person, unless the individual to whom the option was granted met the employment requirements of section 422(a)(2), 423(a)(2), or 424(a)(2), whichever is applicable, either at the time of his death or within three months before such time. If the option is exercised by a person other than the executor or administrator, or other than a person who acquired the option by bequest or inheritance or by reason of the death of such deceased individual, section 421(a) is not applicable to the exercise. For example, if the option is sold by the estate, section 421(a) does not apply to an exercise of the option by such buyer; but if the option is distributed by the administrator to an heir as part of the estate, section 421(a) is applicable to an exercise of the option by such heir.

(2) Any transfer by the estate, whether a sale, a distribution of assets, or otherwise, of the stock acquired by its exercise of the option under this paragraph is a disposition of the stock. Therefore, if section 423(c), or 424(c)(1) is applicable, the estate must include an amount as compensation in its gross income. Similarly, if section 423(c) or 424(c)(1) is applicable in case of an exercise of the option under this paragraph by a person who acquired the option by bequest or inheritance or by reason of the death of the individual to whom the option was granted, there must be included in the gross income of such person an amount as compensation, either when such person disposes of the stock, or when he dies owning the stock.

(3)(i) If, under section 422(c)(1), 423(c), or 424(c)(1), an amount is required to be included in the gross income of the estate or of such person, the estate or such person shall be allowed a deduction as a result of the inclusion of the value of the option in the estate of the individual to whom the option was granted. Such deduction shall be computed under section 691(c) by treating the option as an item of gross income in respect of a decedent under section 691 and by treating the amount required to be included in gross income under section 422(c)(1), 423(c), or 424(c)(1), as an amount included in gross income under section 691 in respect of such item of gross income. No such deduction shall be allowable with respect to any amount other than an amount includible under section 422(c)(1), 423(c), or 424(c)(1). For the rules relating to the computation of a deduction under section 691(c), see § 1.691(c)–1.

(ii) The application of subdivision (i) may be illustrated by the following example:

Example. On June 1, 1964, E was granted an option under an employee stock purchase plan to purchase for $85 one share of the stock of his employer. On such day, the fair market value of such stock was $100 per share. E died on February 1, 1966, without having exercised such option. The option was, however, exercisable by bis estate, and for purposes of the estate tax was valued at $30. On March 1, 1966, the estate exercised the option, and on March 15, 1966, sold for $150 the share of stock so acquired. For its taxable year including March 15, 1966, the estate is required by sections 421(c)(1)(B) and 423(c) to include in its gross income as compensation the amount of $15. During such taxable year, no amounts of income were properly paid, credited, or distributable to the beneficiaries of the estate. However, under section 421(c)(2), the estate is entitled to a deduction determined in the following manner. E's estate includes no other items of income in respect of a decedent referred to in section 691(a), and no deductions referred to in section 691(b), so that the value for estate tax purposes of the option, $30, is also the net value of all items of income in respect of the decedent. The estate tax attributable to the inclusion of the option in the estate of E is $10. Since $15, the amount includible in gross income by reason of sections 421(c)(1)(B) and 423(c), is less than the value for estate tax purposes of the option, only 15/30 of the estate tax attributable to the inclusion of the option in the estate is deductible; that is, 15/30 of $10, or $5. No deduction under section 421(c)(2) is allowable with respect to any capital gain.

(4)(i) In the case of an employee dying before January 1, 1957, the basis of any share of stock acquired by the exercise of a restricted stock option under this paragraph, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 424(c)(1). The basis of the share shall not be increased by reason of the inclusion of the value of the restricted stock option in the estate for estate tax purposes.

(ii)(a) In the case of an employee dying after December 31, 1956, the basis of any share of stock acquired by the exercise of an option under this paragraph, determined under section 1011, shall be

increased by an amount equal to the portion of the basis of the option attributable to such share. For example, if a statutory option to acquire 10 shares of stock has a basis of $100, the basis of one share acquired by a partial exercise of the option, determined under section 1011, would be increased by 1/10th of $100, or $10. The option acquires a basis, determined under section 1014(a), only if the transfer of the share pursuant to the exercise of such option qualifies for the special tax treatment provided by section 421(a). To the extent the option is so exercised, in whole or in part, it will acquire a basis equal to its fair market value at the date of the employee's death or, if an election is made under section 2032, its value at its applicable valuation date. In certain cases, the basis of the share is subject to the adjustments provided by (b) and (c) of this subdivision, but such adjustments are only applicable in the case of an option which is subject to section 422(c)(1), 423(c), or 424(c)(1).

(b) If the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1) had the employee exercised the option on the date of his death and held the share at the time of his death exceeds the amount which is includible in gross income under such section, the basis of the share, determined under (a) of this subdivision, shall be reduced by such excess. For example, if $15 would have been includible in the gross income of the employee had he exercised the option and held such share at the time of his death, and only $10 is includible under section 422(c)(1), 423(c), or 424(c)(1), the basis of the share, determined under (a) of this subdivision, would be reduced by $5. For purposes of determining the amount which would have been includible in gross income under section 422(c)(1), 423(c), or 424(c)(1), if the employee had exercised the option and held such share at the time of his death, the amount which would have been paid for the share shall be computed as if the option had been exercised on the date the employee died.

(c) If the amount includible in gross income under section 422(c)(1), 423(c), or 424(c)(1), exceeds the portion of the basis of the option attributable to the share, the basis of the share, determined under (a) of this subdivision, shall be increased by such excess. Thus, if $15 is includible in gross income under such section, and the basis of the option with respect to the share is $10, the basis of the share, determined under (a) of this subdivision, will be increased by $5.

(iii) If a statutory option is not exercised by the estate of the individual to whom the option was granted, or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual, the option shall be considered to be property which constitutes a right to receive an item of income in respect of a decedent to which the rules of sections 691 and 1014(c) apply.

(iv) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1955, the X Corporation granted to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date was $100 per share. On June 1, 1956, E died. The fair market value of the X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1964, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $90. The estate is required by section 424(c)(1) to include $5 in its gross income as compensation. Since E died before January 1, 1957, the basis of the share is $90 (the $85 paid for the stock plus the $5 includible in gross income as compensation), and the basis of the share is not increased by reason of the inclusion of the value of the option in the estate of E (see section 1014(d) (as in effect with respect to taxable years ending before January 1, 1957)). Thus, no gain or loss is realized on the disposition of the share since the basis of the share is equal to the sale price.

Example (2). On June 1, 1964, the X Corporation granted to E, an employee, an option under its employee stock purchase plan to purchase a share of X Corporation stock for $85. The fair market value of X Corporation stock on such date was $100 per share. On June 1, 1966, E died. The fair market value of X Corporation stock on such date exceeded $100 per share and the fair market value of the option on the applicable valuation date was $35. On August 1, 1966, the estate of E exercised the option and sold the share of X Corporation stock at a time when the fair market value of the share was $120. The basis of the share is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since $15 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(b) of this subparagraph does not apply. Moreover, since the $15 includible in the gross income of the estate does not exceed the basis of the option ($35), subdivision (ii)(c) of this subparagraph does not apply. Since the basis of the stock and the sale price are the same, no gain or loss is realized by the estate on the disposition of the share.

Example (3). Assume the same facts as in example (2), except that the fair market value of the share of stock at the time of its sale was $90. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is $120 (the $85 paid for the stock plus the $35 basis of the option). When the share is sold for $90, the estate is required to include $5 in its gross income as compensation. If the employee had exercised the option and held the share at the time of his death, $15 would have been includible in gross income as compensation for the taxable year ending with his death. Since such amount exceeds by $10 the amount which the estate is required to include in its gross income, subdivision (ii)(b) of this subparagraph applies, and the basis of the share ($120), determined under subdivision (ii)(a) of this subparagraph is reduced by

$10. Accordingly, the basis is $110, and a capital loss of $20 is realized on the disposition of the share.

Example (4). Assume the same facts as in example (2), except that the fair market value of the option on the applicable valuation date was $5, and that the fair market value of X Corporation stock on the date the employee died did not exceed $100. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $120, the estate is required to include $15 in its gross income as compensation. Since such amount exceeds by $10 the basis of the option, subdivision (ii)(c) of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)(a) of this subparagraph, is increased by $10. Accordingly, the basis is $100 and a capital gain of $20 is realized on the disposition of the share.

Example (5). Assume the same facts as in example (2), except that on June 1, 1966, the date the employee died, the fair market value of X Corporation stock was $98, and that on June 1, 1967, the alternate valuation date, the fair market value of the stock had declined substantially, and the fair market value of the option was $5. On August 1, 1967, the estate of E exercised the option and sold the share when its fair market value was $92. The basis of the share, determined under subdivision (ii)(a) of this subparagraph, is $90 (the $85 paid for the stock plus the $5 basis of the option). When the share is sold for $92, the estate is required to include $7 in its gross income as compensation. Since $13 would have been includible in E's gross income if he had exercised the option and held such share at the time of his death, subdivision (ii)(b) of this subparagraph applies, and the basis of the share ($90), determined under subdivision (ii)(a) of this subparagraph, is reduced by $6 to $84. Furthermore, since the $7 that the estate is required to include in its gross income when the share is sold for $92 exceeds by $2 the basis of the option, subdivision (ii)(c) of this subparagraph applies, and the basis of the share ($84), determined under subdivision (ii)(a) and (ii)(b) of this subparagraph, is increased by $2. Accordingly, the basis is $86 and a capital gain of $6 is realized on the disposition of the share.

(d) Exercise by deceased employee during lifetime. If a statutory option is exercised by an individual to whom the option was granted and the individual dies before the expiration of the applicable holding period as determined under section 422(a)(1), 423(a)(1), or 424(a)(1), section 421(a) does not become inapplicable if the executor or administrator of the estate of such individual, or any person who acquired such stock by bequest or inheritance or by reason of the death of such individual, disposes of such stock before the expiration of such applicable holding period. This rule does not affect the applicability of section 1222, relating to what constitutes a short-term and long-term capital gain or loss.

(e) Incorporation by reference. Any requirement that an option expressly contain or state a prescribed limitation or term will be considered met if such limitation or term is set forth in a statutory option plan and is incorporated by reference by the option. Thus, if a statutory option plan expressly provides that no option granted thereunder shall be exercisable after five years from the date of grant, and if an option granted thereunder expressly provides that the option is granted subject to the terms and limitations of such plan, the option will be regarded as being, by its terms, not exercisable after the expiration of 5 years from the date such option is granted.

[T.D. 6887, 31 FR 8789, June 24, 1966]

§ 1.422–1 Qualified stock options—general rules.

(a) Applicability of section 421(a). (1)(i) Subject to the provisions of section 422(c)(1), the special rules of income tax treatment provided in section 421(a) are applicable with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option provided that the following conditions are satisfied—

(a) The individual must make no disposition of such share before the expiration of the 3-year period beginning on the day after the day of the transfer of such share, and

(b) At all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, the individual was an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(ii) For rules relating to the requisite employment relationship, see paragraph (h) of § 1.421–7.

(2)(i) An exception to the holding period requirement of section 422(a)(1) is provided with respect to certain transfers by insolvent individuals. If an insolvent individual holds a share of stock acquired pursuant to his exercise of a qualified stock option, and if such share is transferred to a trustee, receiver, or other similar fiduciary in any proceeding under the Bankruptcy Act or any other similar insolvency proceeding (such as an assignment for the benefit of creditors, a composition, etc.), neither such transfer, nor any other transfer of such share for the benefit of the insolvent individual's creditors in such proceeding shall constitute a disposition of such share for the purpose of section 422(a)(1). For the purpose of this subparagraph, an individual is an insolvent only if his liabilities exceed his assets, or if he is unable to satisfy his liabilities as they become due.

(ii) Notwithstanding that a transfer by the trustee or other fiduciary is not treated as a disposition

for the purpose of section 422(a)(1), such transfer may constitute a sale or exchange for purposes of recognizing capital gain or loss with respect to the share so transferred. For example, if the trustee transfers the share to a creditor in the insolvency proceeding in complete or partial satisfaction of such creditor's claim against the insolvent individual, capital gain or loss must be recognized by the insolvent individual to the extent of the difference between the fair market value of the share on the date of such transfer and the adjusted basis of such share. To the extent any transfer by the trustee or other fiduciary (other than a transfer back to the insolvent individual) is not for the exclusive benefit of the creditors in such insolvency proceeding, such transfer will be treated as a disposition for purposes of section 422(a)(1). Similarly, if the trustee or other fiduciary transfers the share back to the insolvent individual, any subsequent disposition of the share which is not made in respect of the insolvency proceeding and for the exclusive benefit of the creditors in such proceeding will be treated as a disposition for purposes of section 422(a)(1).

(b) **Failure to satisfy holding period.** (1) The special tax treatment of section 421(a) is not applicable with respect to the transfer of a share of stock pursuant to the exercise of a qualified stock option if the individual disposes of the share before the expiration of the 3-year period beginning on the day after the day of the transfer of such share to him. For general rules relating to the effect of such a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421–8. For definition of the term "disposition", see section 425(c) and paragraph (c) of § 1.425–1.

(2) If an individual who has acquired a share of stock by the exercise of a qualified stock option makes a disqualifying disposition of such share, and if such disposition is a sale or exchange with respect to which a loss (if sustained) would be recognized to the individual, then, under section 422(c)(4), the amount includible in the gross income of such individual, and deductible from the income of his employer corporation, its parent or subsidiary corporation or a corporation issuing on assuming an option in a transaction to which section 425(a) applies, as compensation attributable to the exercise of such option, shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share. Thus, the limitation does not apply when the disqualifying disposition is a sale described in section 1091 (relating to loss from wash sales of stock or securities), a gift, or a sale described in section 267(a)(1) (relating to sales between related persons), since a loss sustained in any such transaction would not be recognized. Subject to the limitation provided by section 422(c)(4) and this subparagraph, the amount of compensation attributable to the exercise of the option is determined under § 1.421–6 and paragraph (b) of § 1.421–8.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, X Corporation grants a qualified stock option to A, an employee of X Corporation, entitling A to purchase one share of X Corporation stock. On June 1, 1965, A exercises his option and the share of X Corporation stock is transferred to him on June 10, 1965. In order to meet the 3-year holding period requirement of section 422(a)(1), A must not dispose of the share acquired by exercise of his qualified stock option before June 11, 1968.

Example (2). Assume the same facts as in example (1) and assume further that the option price was $100, the fair market value of X Corporation stock on June 1, 1964, and that the fair market value of X Corporation stock was $200 on June 1, 1965, the date of exercise. A makes a disposition by selling his share on June 1, 1967, for $250. Under § 1.421–6 (relating to options to which sec. 421 does not apply) the amount of compensation attributable to A's exercise is $100 (the difference between the fair market value of the share at the date of exercise, $200, and the amount paid for the share, $100). Because the amount realized, $250, is greater than the value of the stock at exercise, section 422(c)(4) does not apply and thus does not affect the amount includible as compensation in A's gross income and deductible by X. A must include in his gross income for the taxable year in which the sale occurred $100 as compensation and $50 as capital gain ($250, the amount realized from the sale, less A's basis of $200, the $100 paid for the share plus the $100 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option). For its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $100 for compensation attributable to A's exercise of the qualified stock option.

Example (3). Assume the same facts as in example (2), except that A sells the share for $150. Under section 422(c)(4), A must include only $50 (the excess of the amount realized on such sale, $150, over the adjusted basis of the share, $100) in his gross income as compensation attributable to the exercise of his qualified stock option instead of the $100 which otherwise would have been includible as compensation under § 1.421–6. A realizes no capital gain or loss as a result of the sale, since his basis for the share is $150 (the $100 which he paid for the share, plus the $50 increase in basis resulting from the inclusion of that amount in A's gross income as compensation attributable to the exercise of the option). For its taxable year in which the disqualifying disposition occurs, X Corporation is allowed a deduction of $50 for compensation attributable to A's exercise of the qualified stock option.

Example (4). Assume the same facts as in example (2), except that A sells the share for $50. The limitation of section 422(c)(4) applies and A is not required to include any amount in gross income as compensation attributable to the exercise of his qualified stock option. A is allowed a capital loss of $50 (the difference between the amount realized on the sale, $50, and the adjusted basis of the share, $100). X Corporation is not allowed any deduction for compensation attributable to A's exercise of the qualified stock option and disqualifying disposition.

Example (5). Assume the same facts as in example (3) except that A sells the share to his son for $150. Under section 267, a loss sustained in such a sale would not be recognized. Therefore, the limitation of section 422(c)(4) does not apply. Accordingly, under § 1.421–6, A must include $100 (the difference between the fair market value of the share at the date of exercise, $200, and the amount paid for the share, $100) in his gross income as compensation attributable to the exercise of his qualified stock option in the taxable year in which the disqualifying disposition occurred. A will recognize no capital gain or loss on the transaction. X Corporation will be allowed a $100 deduction for compensation paid to A in its taxable year in which the disqualifying disposition occurred.

Example (6). Assume the same facts as in example (3) except assume that, as a result of the failure of a good-faith attempt to set the option price at the fair market value of X Corporation stock on the date of grant, the option price was set at $90 instead of $100. Under section 422(c)(1), A includes $15 (the lesser of 150 percent of the difference between the option price, $90, and the fair market value of the share at grant, $100; or the difference between the option price, $90, and the fair market value of the share at exercise, $200) in his gross income as compensation in the year of exercise. Under section 421(a)(2), X Corporation is allowed no deduction at such time. Upon his sale of the share, A will include $45 (the excess of the amount realized on such sale, $150, over the adjusted basis of the share, $105 ($90, the option price, plus $15, the amount included in A's gross income as compensation at exercise)) in his gross income as compensation attributable to his exercise in the taxable year in which the disqualifying disposition occurs. A will have no capital gain or loss as a result of such sale. Under section 422(c)(4), X Corporation will be allowed a deduction of $45 as compensation attributable to A's exercise, in the taxable year of A's disqualifying disposition.

[T.D. 6887, 31 FR 8792, June 24, 1966]

§ 1.422–2 Qualified stock options defined.

(a) Qualified stock option defined. (1)(i) The term "qualified stock option" means an option that meets the requirements of section 422(b) and this section. Generally, section 422(b) requires a qualified stock option to be granted to an individual after December 31, 1963, and before May 21, 1976. However, a qualified stock option may be granted after May 20, 1976, if it meets the requirements of section 422(c)(7). See paragraph (i) of this section for rules relating to options granted after May 20, 1976. Section 422(b)(1) requires that a qualified stock option be granted pursuant to a plan which meets certain requirements. See paragraph (b) of this section. However, options granted after December 31, 1963, and before January 1, 1965, need not be granted under an option plan to be qualified stock options. See paragraph (b)(4) of this section. Section 422(b)(2) provides that in order for an option to be a qualified stock option it must be granted within 10 years of the adoption of the plan or the date of stockholder approval, whichever is earlier. In order to grant qualified stock options after the expiration of such 10-year period, a new plan must be adopted and approved. See paragraph (c) of this section. A new plan may retain all of the terms of the old plan or may include new terms. Paragraphs (3) through (6) of section 422(b) establish certain requirements which must be met by the terms of a qualified stock option. An option which, when granted, does not by its terms meet these requirements, cannot be a qualified stock option. See paragraphs (d) through (g) of this section. However, if the terms of an option granted after December 31, 1963, are amended before January 1, 1965, to permit the option to satisfy the requirements of section 422(b)(3), (4), or (5), such amendment will be given retroactive effect. See paragraphs (d)(2), (e)(3), and (f)(3)(ii) of this section. In addition, if the terms of an option are amended at any time to permit such option to meet the requirement of section 422(b)(6), such amendment will be given retroactive effect. See section 425(h)(3)(B) and paragraph (e)(5)(ii) of § 1.425–1. Section 422(b)(7) bars the grant of a qualified stock option to any employee whose stock ownership exceeds the limits provided by such section. To the extent the grant of an option entitles the employee to purchase stock in excess of such limitation, the option cannot be a qualified stock option. See paragraph (h) of this section.

(ii) The determination of whether a particular option is a qualified stock option is made at the time such option is granted. Accordingly, except as is otherwise specifically provided by sections 421 through 425 and the regulations thereunder, events subsequent to the grant of an option cannot affect the status of the option. For example, an option which is granted to an employee whose stock ownership exceeds the limitation provided by section 422(b)(7) is not a qualified stock option when granted and can never become a qualified stock option, irrespective of whether the individual's stock ownership is within such limitation at the time such option is exercised.

(2) Section 422 and this section do not apply to an option which is a restricted stock option.

(b) Option plan. (1) A qualified stock option granted after December 31, 1964, must be granted pursuant to a plan which is approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter and bylaws, and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in

person or by proxy at a duly held stockholders' meeting. Thus, if neither the charter, bylaws or applicable State law prescribes the degree of stockholder approval required for the granting of qualified options, the approval of stockholders holding a majority of the voting stock of the corporation voting at a duly held meeting will suffice. However, if the applicable law requires that stockholders holding two-thirds of the voting stock must approve the granting of such options, such two-thirds requirement must be met.

(2) The plan required by section 422 must be approved within 12 months before or after the date the plan is adopted. Ordinarily, a plan is adopted when approved by the board of directors and the date of such board action will be the reference point for determining whether stockholder approval comes within the 12-month period. However, if the board's action is subject to a condition, such as shareholder approval, or the happening of a particular event, the plan is adopted on the date the condition is met or the event occurs, unless the board's resolution fixes the date of approval as the date of the board's action.

(3) The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan and the employees or class of employees eligible to receive options under the plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. The requirement that the plan as adopted and approved must indicate the class of employees (or the employees) eligible to receive options will be considered satisfied by a general designation of the class of employees eligible to receive options under the plan. Thus, such designations as "key employees of the grantor corporation", "all salaried employees of the grantor corporation and its subsidiaries, including subsidiaries which become such after adoption of the plan" or "all employees of the corporation" will meet this requirement. Moreover, this requirement will be considered satisfied although the board of directors or another group is given authority to select the particular employees who are to receive options from a described class and to determine the number of shares to be optioned to each such employee. The provisions relating to the aggregate number of shares to be issued under the plan and the class of employees (or the employees) eligible to receive options under the plan, are the only provisions of a stock option plan which require stockholder approval for purposes of section 422(b)(1). Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up), or change in the designation of the employees or class of employees eligible to receive options under the plan will be considered as the adoption of a new plan requiring stockholder approval within the prescribed 12-month period. Any other changes in the terms of a qualified stock option plan may be made without such changes being considered the adoption of a new plan. An option intended by the grantor corporation to be a qualified option will be treated as having been issued pursuant to a plan notwithstanding that the terms of the option conflict with certain terms of the plan unless such option is issued to an employee not eligible to receive options under the plan or options have been issued on stock in excess of the aggregate number of shares which may be issued under the plan. A stock option plan which otherwise meets the requirements of section 422(b)(1) and this paragraph may be availed of for the granting of qualified stock options although the adoption and approval of such plan occurred before January 1, 1964.

(4) In the case of an option granted after December 31, 1963, and before January 1, 1965, section 422(b)(1) and (2), and this paragraph do not apply. Thus, an option granted during the calendar year 1964, which meets the requirements of section 422(b)(3) through (7), will be a qualified stock option irrespective of whether such option is granted pursuant to a plan; or, if granted pursuant to a plan, irrespective of whether such option was granted within 10 years from the date such plan was adopted or approved by shareholders, and irrespective of whether such plan specifies the employees or class of employees to whom options may be granted or the number of shares which may be granted under options.

(c) **Duration of plan.** A qualified stock option must be granted within 10 years from the date the option plan (required by section 422(b)(1) and paragraph (b) of this section) is adopted, or the date such plan is approved by the stockholders, whichever is earlier. Thus, a plan for the granting of qualified stock options expires 10 years after the adoption or approval of such plan, whichever is

earlier. This is equally true whether the adoption or approval occurred before January 1, 1964 (as in the case of a restricted stock option plan which met the requirement of section 422(b)(1) when adopted and approved), or after such date. For example, a restricted stock option plan which was adopted June 1, 1956, and approved August 1, 1956, and which otherwise met the requirements of section 422(b)(1) and paragraph (b) of this section may be availed of for the granting of qualified stock options only through May 31, 1966, after which date the plan will expire for purposes of section 422(b)(1) and (2).

(d) Period for exercising options. (1) A qualified stock option by its terms must not be exercisable after the expiration of 5 years from the date the option is granted. Except as provided by subparagraph (2) of this paragraph, an option which does not contain such a provision when granted cannot be a qualified stock option.

(2) An exception to the requirement of section 422(b)(3) and this paragraph is provided in the case of options granted after December 31, 1963, and before January 1, 1965. If, at the time of grant, such an option did not contain the provision required by section 422(b)(3) and this paragraph, the option may be amended before January 1, 1965, to add such a provision and such amendment will not be treated as a modification under section 425(h)(1) or § 1.425–1. Furthermore, the amendment will be considered as retroactive to the date of grant of the option and will in no way affect such grant.

(e) Option price. (1) In general, the option price of a qualified stock option must not be less than the fair market value of the stock subject to the option at the time the option is granted. For general rules relating to the option price see paragraph (e) of § 1.421–7. For rules relating to the determination of when an option is granted, see paragraph (c) of § 1.421–7. The option price may be determined in any manner so long as the minimum price possible under the terms of the option cannot (except as provided by section 422(c)(1) and subparagraph (2) of this paragraph) be less than the fair market value of the stock at the date of grant.

(2)(i) Under section 422(c)(1), if a share of stock is transferred to an individual pursuant to his exercise of an option which fails to qualify as a qualified stock option because there was a failure of an attempt, made in good faith, to meet the requirements of section 422(b)(4) and subparagraph (1) of this paragraph, the requirements of such section and subparagraph shall be considered to have been met. However, in such a case there shall be included as compensation (and not as gain upon the sale or exchange of a capital asset) in the gross income of the individual for his taxable year in which such option is exercised, an amount equal to the lesser of—(a) 150 percent of the difference between the option price and the fair market value of the stock at the time the option was granted, or (b) the difference between the option price and the fair market value of the stock at the time of such exercise. The basis of the stock acquired shall be increased by an amount equal to the amount included in the gross income of the individual.

(ii) Whether there was a good-faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time the option was granted depends on the facts and circumstances surrounding the case. For example, in the case of a publicly held stock which was actively traded in an established market at the time the option was granted, determining the fair market value of such stock by any reasonable method using market quotations would establish that a good-faith attempt to meet the requirements of section 422(b)(4) and this paragraph was made. On the other hand, in the case of a stock which is not publicly traded, if it is shown, for example, that the fair market value of the stock at the date of grant was based upon an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a showing will establish that there was a good-faith attempt to meet the requirements of section 422(b)(4) and this paragraph. However, amounts treated as unstated interest under section 483 and the regulations thereunder, if attributable to the exercise of options granted after December 31, 1964, and amounts paid as interest under a deferred payment arrangement are not includible as part of the "option price". See paragraph (e)(1) of § 1.421–7. In the case of an option granted after July 1, 1966, an attempt to set the option price at not less than fair market value will not be regarded as made in good faith where an adjustment of the option price to allow for the application of section 483 results in the option price being lower than the fair market value on which the option price was based.

(3) A further exception to the requirement of section 422(b)(4) and subparagraph (1) of this paragraph is provided in the case of options granted after December 31, 1963, and before January 1, 1965. An amendment to the terms of such an option made before January 1, 1965, to satisfy the requirements of section 422(b)(4) and subpara-

graph (1) of this paragraph will not be considered a modification for purposes of section 425(h) and § 1.425–1. Furthermore, the amendment will be considered as retroactive to the date of grant of the option, and will in no way affect such grant.

(f) Prior outstanding options. (1)(i) Section 422(b)(5) provides that a qualified stock option must, by its terms, not be exercisable while there is outstanding any qualified or restricted stock option which was granted, before the granting of the new qualified stock option, to the individual to purchase stock in his employer corporation, or in a corporation which, at the time of the granting of the new qualified stock option, is a parent or subsidiary corporation of the employer corporation, or a predecessor corporation of any of such corporations. Thus, in general, under section 422(b)(5), a qualified stock option must not be exercisable until all qualified and restricted stock options which were previously granted to the individual by the grantor corporation, or by related or predecessor corporations, have been exercised in full or have expired solely by reason of the lapse of time. The limitation of section 422(b)(5) applies irrespective of whether the transfer of stock pursuant to such prior outstanding restricted or qualified stock options can qualify for the special tax treatment of section 421. The exercisability of a qualified stock option is not affected by options which are not qualified or restricted stock options.

(ii) If the new qualified stock option being granted to the individual, and all the outstanding qualified and restricted stock options previously granted to the individual, are to purchase stock of the same class in the same corporation, section 422(c)(6) provides that the requirement of section 422(b)(5) will be considered to have been met if the new option by its term is not exercisable while there is outstanding (within the meaning of section 422(c)(2)) any such previously granted option with an option price (determined as of the date of grant of the new option) higher than the option price of the new option. Thus, a qualified stock option to which section 422(c)(6) applies may be exercisable without regard to a prior outstanding option to purchase stock of the same class in the same corporation, if the option price payable under such prior outstanding option is not greater than the price of the new option.

(iii) The restriction imposed by section 422(b)(5) (or sec. 422(c)(6)(B)) must be set forth in the terms of the option unless the individual in fact has no prior outstanding qualified or restricted stock options (or restricted stock options previously granted which will become outstanding at a future time) to purchase stock of the grantor corporation, a related corporation, or a predecessor corporation of any of such corporations, at the time the new qualified stock option is granted. An option which incorporates by reference the provision of a plan containing the restrictions required by section 422(b)(5) (or 422(c)(6)(B)) will be treated as an option which by its terms sets forth such restrictions. Except as provided by this subdivision, if an option is granted which does not contain the restriction imposed by section 422(b)(5), either expressly or by incorporation by reference, such option cannot be a qualified stock option, irrespective of whether such restriction is in fact complied with at the time the option is exercised, and irrespective of whether the plan under which the option is granted contains the restriction required by section 422(b)(5). If the terms of an option granted after December 31, 1963, and before January 1, 1965, are amended before January 1, 1965, to satisfy the requirements of this subdivision, the amendment will not be considered a modification for purposes of section 425(h) and § 1.425–1, the amendment will be considered as retroactive to the date of grant of the option, and the amended option will be treated as an outstanding qualified stock option as of the date of the original grant.

(2) For purposes of section 422(b)(5) and this paragraph, the term "predecessor corporation" means a corporation which was a party to a transaction described in section 425(a) (irrespective of whether a substitution or assumption under such section was in fact effected) with the grantor corporation, or a corporation which, at the time the new qualified stock option is granted, is a related corporation of the grantor corporation, or a predecessor corporation of any of such corporations.

(3)(i) Except as is otherwise provided by this subparagraph, for purposes of section 422(b)(5), a qualified or restricted stock option is treated as outstanding according to its original terms until such option is exercised in full or expires by reason of the lapse of time. Thus, for example, if an option outstanding according to its terms for 5 years is revised to shorten to 1 year the period during which it may be exercised, such option is treated as outstanding for 5 years from the original date of grant for purposes of section 422(b)(5), notwithstanding the revision. If any portion of such an option is not exercised, such portion will be treated as outstanding until the expiration of the maximum period for which such portion, according to the terms of the option when granted,

could have been exercised under any circumstances. A qualified or restricted stock option previously held by an individual and replaced in a transaction to which section 425(a) applies will not thereafter be treated as outstanding. However, if a qualified or restricted stock option is modified and under section 425(h) such modification is considered as the granting of a new option (even though for other purposes only one option is regarded as being in existence), the original qualified or restricted stock option continues for the purposes of section 422(b)(5) to be outstanding, and may prevent an exercise of the new qualified or restricted stock option until the original option has, by its original terms, expired.

(ii) A restricted stock option granted before January 1, 1964, will not be treated as outstanding for any period before the first day on which (under the terms of such option) it may be exercised. If such an option is exercisable in installments, each installment will be treated as a separate option for purposes of this rule, with each installment becoming outstanding as of the first day it becomes exercisable under the terms of the option. However, this special rule does not affect the date on which the option is treated as granted. Thus, such a restricted stock option affects the exercise of a qualified stock option granted subsequent to the grant of such a restricted stock option to the extent the qualified stock option is not exercised before the restricted stock option becomes outstanding. See example (7) under subparagraph (4) of this paragraph.

(iii) A restricted stock option terminated before January 1, 1965, will not be treated as outstanding irrespective of the reason for which such option was terminated. If, under this subdivision, the number of shares subject to a restricted stock option is reduced, such option will be treated as outstanding for purposes of section 422(b)(5) only with respect to such reduced number of shares.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). S Corporation is a subsidiary of P Corporation. In 1963 E was an employee of S Corporation and was granted a restricted stock option by S to buy S stock. In June of 1964 E left S and became an employee of X Corporation, where he was granted a qualified stock option to purchase X stock. X Corporation is neither a related nor predecessor corporation of P or S. On June 1, 1965, E leaves X to become an employee of P Corporation, and on such date E is granted a qualified stock option by P to purchase P stock. E's restricted stock option to buy S stock was not cancelled during 1964, and both his restricted stock option on S stock and his qualified stock option on X stock are outstanding on June 1, 1965, when E is granted a qualified stock option to purchase P stock. In order to meet the requirement of section 422(b)(5), E's qualified stock option on P stock must, by its terms, not be exercisable until E's restricted stock option on S stock is exercised in full or expires solely by reason of the lapse of time.

Example (2). E is an employee of P Corporation. E holds a restricted stock option granted June 1, 1963, and a qualified stock option granted June 1, 1965. Both options were granted to him by P to purchase P stock. E has been granted no other qualified or restricted stock options by P, a related corporation, or a predecessor corporation of any of such corporations. The price payable under E's restricted stock option as of June 1, 1965, is $100; the option price of E's qualified stock option is $90. On June 1, 1966, P grants another qualified stock option to E to purchase P stock at $95. Under section 422(b)(5) and (c)(6), neither of E's qualified stock options may be exercisable until E's restricted stock option is exercised in full or expires solely by reason of the lapse of time. Assuming the restricted stock option is fully exercised on June 1, 1967, E will be free to exercise either his 1965 or 1966 qualified stock option.

Example (3). Assume the same facts as in example (2). On November 30, 1964, P cancels E's restricted stock option and in exchange therefor issues a qualified stock option to E in place of the cancelled restricted stock option. For purposes of section 422(b)(5), E's restricted stock option is treated as terminated and no longer outstanding as of such date, and will not affect the exercise of E's 1964, 1965, or 1966 qualified stock options. The qualified stock option issued in place of E's restricted stock option will be treated as outstanding for purposes of section 422(b)(5) as of November 30, 1964.

Example (4). Assume the same facts as in example (3) except assume that the cancellation of the restricted stock option takes place on November 30, 1965, and that the new option is a qualified stock option as of such date. Assume further that the option prices are as follows:

Restricted stock option	$100
Qualified stock option (granted June 1, 1965)	90
Qualified stock option (granted November 30, 1965, upon cancellation of restricted stock option)	85
Qualified stock option (granted June 1, 1966)	95

and that each qualified stock option runs 5 years from grant, and that the restricted stock option, according to its terms when granted, would have expired solely by reason of the lapse of time at the close of business on May 31, 1969. Under section 422(b)(5), and (c)(2) and (6), E's restricted stock option is treated as outstanding according to its original terms when granted, and E cannot exercise any of his qualified stock options until June 1, 1969 (the first day after the expiration of the original period for which E's restricted stock option was granted). On June 1, 1969, E's June 1, 1965, qualified stock option will be fully exercisable. E's November 30, 1965, qualified stock option will not be exercisable until after the full exercise or expiration of E's June 1, 1965, qualified stock option. The exercise of E's June 1, 1966, qualified stock option is barred only by E's restricted stock option. Thus, upon the expiration of E's restricted stock option, E is free to exercise either his June 1965 qualified stock option, or his June 1966 qualified stock option, while the exercise of his November 1965 qualified stock option must await the full exercise or expiration of his June 1965 qualified stock option.

Example (5). Assume the same facts as in example (4). On June 1, 1968, P Corporation sells all of its assets to M Corporation, and on such date E becomes an employee of M Corporation. Assume further that M Corporation substitutes new options to purchase M stock for the P options held by E, in a transaction to which section 425(a) applies. For purposes of section 422(b)(5), each M Corporation option received by E

in substitution of a P Corporation option will be treated as outstanding to the same extent and in the same manner as the P option which it replaces. Thus, none of the M options received by E in substitution for his qualified stock options of P stock may be exercisable before June 1, 1969, and the M option issued in substitution for E's November 1965, qualified stock option may be exercisable only after the full exercise or expiration of the M option issued in substitution for E's June 1, 1965, option on P stock. If, in 1969, E is granted another qualified stock option by M Corporation, such qualified stock option will be subject to the qualified stock options granted by M to E in 1968 in substitution for E's qualified stock options to purchase P stock. The qualified stock options to purchase P stock which were replaced by M in the transaction to which section 425(a) applied will not be treated as outstanding for any purpose under section 422(b)(5).

Example (6). Assume the same facts as in example (5) except assume that M does not effect a substitution or assumption of E's P Corporation qualified stock options under section 425(a). Although P is neither a parent nor subsidiary of M, for purposes of section 422(b)(5), P is a predecessor corporation of M Corporation. Accordingly, any qualified stock options granted to E by M (or its parent or subsidiary corporations, or a predecessor corporation of any of such corporations) must, by their terms, not be exercisable until the expiration of the option periods for all of E's qualified and restricted stock options granted to E by P Corporation. Section 422(c)(6) cannot apply to permit E to exercise his M options before the expiration of the option periods of his P options because not all of E's qualified and restricted stock options which are outstanding (within the meaning of section 422(c)(2)) are to purchase stock of the same class in the same corporation.

Example (7). F is an employee of N Corporation. Prior to January 1, 1964, N granted a restricted stock option to F to purchase 100 shares of N Corporation stock at a price of $100 per share. The option is exercisable in installments as follows: 20 shares on or after June 1, 1965; another 40 shares on or after June 1, 1967; and the last 40 shares on or after June 1, 1969. Under section 422(c)(2), each installment of F's restricted stock option will be treated as becoming outstanding as of the first day on which such installment may be exercised. Thus, under the facts given, any qualified stock options granted to F by N Corporation to purchase N stock at less than $100 per share will be affected by F's restricted stock option as follows: Before June 1, 1965, F may exercise such qualified stock options without regard to his restricted stock option; between May 31, 1965, and June 1, 1967, F may exercise such qualified stock options only after the full exercise of the first installment of his restricted stock option; between May 31, 1967, and June 1, 1969, F may exercise such qualified stock options only after the full exercise of the first and second installments of his restricted stock option; after May 31, 1969, F may exercise such qualified stock options only after the full exercise or expiration of all installments of his restricted stock option.

Example (8). F is an employee of N Corporation. On January 1, 1966, N grants F a qualified option to purchase 100 shares of N Corporation stock at a price of $100 a share at any time prior to January 1, 1971. The stock is then selling at $100 a share. On January 1, 1967, when the stock was selling at $95 a share, N modified the option to permit F to exercise the option at any time prior to January 1, 1972. Under section 425(h) N's modification is treated as the granting of a new option to F. Although for other purposes F, after the modification, has one option to purchase 100 shares of N Corporation stock at a price of $100 a share at any time prior to January 1, 1972, for purposes of section 422(b)(5), F is regarded as having two options, an "original" option to purchase 100 shares at $100 a share prior to January 1, 1971, and a modified option to purchase 100 shares at $100 a share prior to January 1, 1972. If the terms of the modified option include the language of section 422(c)(6)(B), so that section 422(b)(5) does not apply, the modified option will be exercisable immediately as there is no prior outstanding option to purchase stock at a higher price.

Example (9). F is an employee of N Corporation. On January 1, 1966, N grants F a qualified option to purchase 100 shares of N Corporation stock at a price of $100 a share at any time prior to January 1, 1971. The stock is then selling at $100 a share. On January 1, 1967, when the stock was selling at $95 a share, N modified the option to permit F to purchase 100 shares of N Corporation stock at a price of $95 a share and to exercise the option at any time prior to January 1, 1972. Under section 425(h) N's modification is treated as the granting of a new option to F. Although for other purposes F, after the modification, has one option to purchase 100 shares of N Corporation at a price of $95 a share at any time prior to January 1, 1972, for purposes of section 422(b)(5), F is regarded as having two options. Thus, F may not exercise the modified option until January 1, 1971, as until that date, the original option is regarded as outstanding. If the option period had not been extended, F would never have been able to exercise the modified option because of the limitation of section 422(b)(5) and the existence, for the purposes of that section, of a prior outstanding option having the same expiration date as the new option.

(g) Restriction on transferability. A qualified stock option must, by its terms, not be transferable by the individual to whom it is granted otherwise than by will or the laws of descent and distribution, and must be exercisable, during the lifetime of such individual, only by him. For general rules relating to the restriction on transferability required by section 422(b)(6), see paragraph (b)(2) of § 1.421–7. For a limited exception to the requirement of section 422(b)(6), see section 425(h)(3).

(h) Options granted to certain shareholders. (1)(i) In general, an option is not a qualified stock option to the extent that, immediately after such option is granted, the optionee owns stock possessing more than 5 percent of the total combined voting power or value of all classes of stock of the employer corporation, or a related corporation of such corporation. Selection 422(c)(3) provides that, in applying the limitation of section 422(b)(7), the rules of section 425(d) (relating to attribution of stock ownership) shall apply in determining the stock ownership of the individual, and stock which the individual may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the individual. An option is outstanding for purposes of sections 422(b)(7) and 422(c)(3) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. The rules of section 422(c)(2) which are applied in determining whether an option is outstanding for purposes of section

422(b)(5) do not apply with respect to section 422(b)(7) and paragraph (c)(3).

(ii) The determination of the percentage of the total combined voting power or value of all classes of stock of his employer corporation (or a related corporation of such corporation) that is owned by the individual is made by comparing the voting power or value of the shares owned (or treated as owned) by the individual to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to such individual. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(2) If an individual is granted an option which permits him to purchase stock in excess of the limitation of section 422(b)(7) (determined by applying the rules of section 422(c)(3) and this paragraph), such option shall be treated as meeting the requirement of section 422(b)(7) to the extent that such individual could, if the option were exercised in full at the time of grant, purchase stock under such option without exceeding such limitation. If shares in excess of the number allowable under section 422(b)(7) are transferred to the individual under an option, such shares will not be treated as transferred pursuant to the exercise of a qualified stock option, irrespective of whether the stock ownership of the individual at the time of such transfer exceeds the limitation of section 422(b)(7). The shares purchased under an option described in this subparagraph which will be treated as shares transferred pursuant to the exercise of a qualified stock option will be the first shares acquired under the option. If more shares are acquired in any one exercise of the option than can qualify as being transferred pursuant to the exercise of a qualified stock option under the rules of section 422(b)(7) and this paragraph, the individual must designate which shares are to be treated as having been transferred pursuant to the exercise of a qualified stock option.

(3)(i) If at the time the option is granted the combined equity capital of the employer corporation and its related corporations does not exceed $2,000,000, the 5-percent limitation of section 422(b)(7) is increased by adding to such 5 percent the percentage (not higher than 5 percent) which bears the same ratio to 5 percent as the difference between such combined equity capital and $2,000,000 bears to $1,000,000. Thus, if the employer corporation and its related corporations have combined equity capital of $1,000,000 or less, an employee may be granted a qualified stock option so long as the value of voting power of the stock owned (or treated as owned) by such employee does not exceed 10 percent of the total combined voting power or value of all classes of stock of any of such corporations.

(ii)(a) Section 422(c)(3) provides that the term "equity capital" means, in the case of one corporation, the sum of its money and other property (in an amount equal to the adjusted basis of such property for determining gain), less the amount of its indebtedness (other than indebtedness to shareholders). In the case of a group of corporations consisting of a parent and its subsidiary corporations, the term "equity capital" means the sum of the equity capital of each of such corporations adjusted in the manner provided by (b) of this subdivision.

(b) In determining the equity capital of a corporation which is a member of a group of corporations consisting of a parent and its subsidiary corporations, the following adjustments shall be made:

(i) The sum of the money and other property (in an amount equal to the adjusted basis of such property for determining gain) of such corporation shall be reduced by the amount included in the equity capital of such corporation in respect of: stock owned by such corporation in any other corporation in the group; cash, property, or services due such corporation by any other corporation in the group; inventory owned by such corporation, to the extent the adjusted basis (for determining gain) of such inventory includes profits realized by any other corporation in the group; and fixed assets owned by such corporation, to the extent the adjusted basis (for determining gain) of such fixed assets includes profits realized by any other corporation in the group; and

(ii) The total indebtedness of such corporation which is taken into account in determining its equity capital shall be reduced by the amount of such indebtedness which is owed to any other corporation in the group.

In making the reductions required by this subdivision, no adjustments shall be made to reflect any minority interest in intercompany profits, indebtedness, or stock ownership; and no reduction is required to be made in respect of amounts representing profits in the inventory or fixed assets of a corporation arising from intercompany transac-

tions which occurred before such corporation became a member of the group.

(4) The application of this paragraph may be illustrated by the following examples:

Example (1). E, an employee of M Corporation, owns 6,000 shares of the common stock of M Corporation, the only class of M stock outstanding. M has 100,000 shares of its common stock outstanding. M's equity capital (as defined by section 422(c)(3) and this paragraph) exceeds $2,000,000. Since E owns 6 percent of the combined voting power or value of all classes of M Corporation stock, M cannot grant a qualified stock option to E. Any option granted to E which purports to be a qualified stock option will be treated as a compensatory option, and as such, subject to the rules of § 1.421–6 of the regulations. If E's father and brother each owned 3,000 shares of M stock, and E owned no M stock in his own name, the result in this case would be the same, since under section 425(d) a person is treated as owning stock held by his father and his brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, E merely held an option on 6,000 shares of M stock, irrespective of whether the transfer of stock under such option could qualify for the special tax treatment of section 421, since section 422(c)(3)(C) provides that stock which the individual may purchase under outstanding options shall be treated as stock owned by such individual.

Example (2). Assume the same facts as in example (1) and assume further that M is a subsidiary corporation of P Corporation. Irrespective of whether E owns any P stock, and irrespective of the amount of P's equity capital or number of P shares outstanding, E cannot receive a qualified stock option from P. This results from E's ownership of more than 5 percent of the total combined voting power of all classes of stock of a subsidiary of P Corporation, *i.e.*, M Corporation. Thus, an individual who owns (or is treated as owning) stock in excess of the limitation of section 422(b)(7), in any corporation in a group of corporations, consisting of a parent and its subsidiary corporations, cannot receive a qualified stock option from any corporation in the group.

Example (3). F is an employee of R Corporation. R's equity capital is in excess of $2,000,000. R has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming F owns no stock in R or in any parent or subsidiary of R for purposes of section 422(b)(7), R can grant a qualified stock option to F for 5,000 shares, since immediately after the grant of the option F will be treated as owning 5,000 shares of a total of 100,000 shares actually issued and outstanding at such time. The 5,000 shares which F will be treated as owning by reason of section 422(c)(3)(C) will not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether F's stock ownership exceeds the limitation of section 422(b)(7).

Example (4). Assume the same facts as in example (3) and assume further that on June 1, 1965, R grants F an option, purporting to be a qualified stock option, for 5,200 shares at an option price of $100 per share, the fair market value of R stock on such date. This option will only be a qualified stock option to the extent of 5,000 shares. Assume R transfers 5,000 shares to F pursuant to F's partial exercise of the option. Such transfer can qualify for the special tax treatment of section 421. However, no further transfer of shares pursuant to an exercise of this option can qualify for the special tax treatment of section 421, since the option was not a qualified stock option when granted to the extent it covered more than 5,000 shares. This is true although F's stock ownership immediately after the transfer of the 5,000 shares to him does not exceed the 5-percent limitation of section 422(b)(7), since F owns only 5,200 shares (5,000 shares outright, plus 200 shares by reason of section 422(c)(3)(C)) of a total 105,000 shares actually issued and outstanding (the 100,000 shares issued and outstanding when the option was granted to F, plus an additional 5,000 shares issued and outstanding as a result of F's exercise).

Example (5). E is an employee of P Corporation. P owns 60 percent in value of the stock of S Corporation, and P and S have combined equity capital (as defined by section 422(c)(3)(A)(ii) and subparagraph (3) of this paragraph) of $1,600,000. Since the combined equity capital of P and S is less than $2,000,000, there may be added to the 5-percent limitation of section 422(b)(7) the additional percentage which bears the same proportion to 5 percent as the difference between the combined equity capital of P and S and $2,000,000 ($2,000,000 minus $1,600,000, or $400,000) bears to $1,000,000. Accordingly, there may be added to the 5-percent limitation of section 422(b)(7) an additional 2 percent ($400,000 is to $1,000,000, as 2 percent is to 5 percent), resulting in a limitation of 7 percent (5 percent plus 2 percent) for purposes of section 422(b)(7). Thus, an option which otherwise meets the requirements of section 422(b) and which is granted to E by P or S to purchase the stock of either of such corporations will meet the requirement of section 422(b)(7) to the extent that, immediately after such option is granted. E will not own (or be treated as owning) stock in either P or S possessing more than 7 percent of the total combined voting power or value of all classes of the stock of either of such corporations which is actually issued and outstanding at such time. If, at the time the option is granted, E owns stock possessing more than 7 percent of the total combined voting power or value of the stock of either P or S, the option could not qualify as a qualified stock option, irrespective of which corporation's stock was the subject of the option.

(i) Certain options granted after May 20, 1976—(1) In general. An option granted to an individual after May 20, 1976 is not a qualified stock option unless the option meets the requirements of section 422(c)(7) and this paragraph. Generally, an option meets the requirements of section 422(c)(7) if it either is granted under a written plan adopted before May 21, 1976, or is substituted for a qualified stock option described in paragraph (i)(3) of this section. An option meeting the requirements of section 422(c)(7) and this paragraph that is exercised after May 20, 1981, will be treated under § 1.83–7(a) as if it were a nonqualified stock option without a readily ascertainable fair market value at the time of its grant.

(2) Options granted under a written plan adopted before May 21, 1976. (i) An option granted after May 20, 1976, is a qualified stock option if it otherwise meets the requirements of section 422(b) and this section and if the option is granted under a written plan that was adopted before May 21, 1976. A plan will be treated as having been adopted as of the date all actions needed for adoption have been completed. Ordinarily, a plan is adopted when approved by the board of directors of the granting corporation. However, if the board's action is subject to a condition or the happening of a particular event,

the plan is adopted on the date the condition is met or the event occurs unless the board's resolution fixes the date of approval as the date of the board's action. For purposes of determining the date of the adoption of a plan, the date of the approval of the plan by the shareholders of the granting corporation is disregarded. Thus, it is immaterial whether the shareholders approved the plan before, on, or after May 21, 1976, although the plan must satisfy the requirements of paragraph (b) of this section, which requires that the shareholders approve the plan within 12 months before or after its adoption by the board. The authorization of specific grants of options to specific individuals under the plan is not required in order for options granted under the plan to be qualified stock options.

(ii) A corporation that merely changes its identity or place of incorporation may continue to grant qualified stock options under a written plan adopted before May 21, 1976, to the extent permissible had the change not occurred. In all other reorganizations a written option plan will be treated as being adopted after May 20, 1976, unless the corporation that adopted the plan before May 21, 1976, survives the reorganization. Of course, the surviving corporation may continue to grant options under the plan only to the extent it would have been able to do so had the reorganization not occurred.

(3) Substituted stock options. An option granted after May 20, 1976, is a qualified stock option if the option is an option that has been substituted, in a transaction to which section 425(a) applies (relating to certain corporate reorganizations, liquidations, etc.), for a qualified stock option granted before May 21, 1976 (or any option that is a qualified stock option under the requirements section 422(c)(7)(A) or (B) and paragraph (i)(2) or (3) of this section).

(4) Modifications to option plans. An option plan adopted before May 21, 1976, may be modified after May 20, 1976, and options granted under such a plan, as modified, will be considered options granted under a plan adopted before May 21, 1976, unless the modification is considered the adoption of a new plan. See paragraph (b) of this section for rules relating to modifications that will be considered the adoption of a new plan. If a plan is modified after May 20, 1976, such that the modification is considered under paragraph (b) of this section to be the adoption of a new plan any option granted as a result of such modification will not be a qualified stock option. An option will be considered to have been granted as a result of such modification if it could not have been granted but for such modification of the plan. For example, if the modification changes the terms of the options to be granted in such a way that the modification is considered the adoption of a new plan, then no option granted with such terms is a qualified stock option since it could not have been granted but for the modification. If a plan is modified to increase the number of shares that can be transferred upon exercise of the options granted under the plan, any option granted after the modification will be a qualified stock option only if the option could have been granted without the modification to the plan. For example, if the number of shares authorized under a plan is increased from 4,000 shares to 10,000 shares at a time when options have already been granted under the plan to purchase 3,000 of the previously authorized shares, an option granted after the modification will be a qualified stock option if it is not an option to purchase any of the additional 6,000 shares authorized by the modification. In determining for this purpose which shares are subject to a particular option, the first option granted after the modification will be considered an option to buy originally authorized shares to the extent there are any such shares not subject to a previously granted option. If options to buy originally authorized shares and options to buy additional shares are granted, the granting corporation may designate which options are options to buy originally authorized shares to the extent there are originally authorized shares not subject to a previously granted option. In the previous example, absent such a designation, if ten options were granted on different days after the plan modification, each option for the purchase of 700 shares, the first option would be a qualified stock option since 1,000 originally authorized shares are not subject to any previously granted option. The second option would not be a qualified stock option because it includes an option to buy 400 shares that were not originally authorized and therefore could not have been granted without the modification. If the order in which the ten options were granted could not be determined and no such designation were made under this paragraph, none of the options would be a qualified stock option. If the modification enlarges the class of employees eligible to receive options, any option granted to a newly eligible employee would not be a qualified stock option.

(5) Exercise of certain options after May 20, 1981. If a qualified stock option granted after May 20, 1976, is exercised after May 20, 1981, the option will be treated as if it were a nonqualified stock option that did not have a readily ascertain-

able fair market value at the time it was granted. Thus, if such a qualified stock option is exercised after May 20, 1981, section 421(a) will not apply to the transfer of stock pursuant to the exercise of the option, and such transfer will be taxed under section 83. See § 1.83–7(a) for rules relating to the treatment of nonqualified stock options under section 83.

[T.D. 6887, 31 FR 8793, June 24, 1966, as amended by T.D. 7680, 45 FR 13453, Feb. 29, 1980]

§ 1.423–1 Applicability of section 421(a).

(a) General rule. Subject to the provisions of section 423(c) and paragraph (k) of this section, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan provided that the following conditions are satisfied—

(1) The individual must make no disposition of such share within 2 years from the date of the granting of the option, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him; and

(2) At all times during the period beginning with the date of the granting of the option and ending on the day three months before the date of such exercise, the individual must be an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(b) Cross-references. For rules relating to the employment relationship, see paragraph (h) of § 1.421–7. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421–8. For definition of the term "disposition", see section 425(c) and paragraph (c) of § 1.425–1.

[T.D. 6887, 31 FR 8798, June 24, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.423–2 Employee stock purchase plan defined.

(a) In general. (1) The term "employee stock purchase plan" means a plan which meets the requirements of paragraphs (1) through (9) of section 423(b). If the terms of the plan do not satisfy the requirements of paragraphs (3) through (9) of section 423(b), such requirements may be satisfied by the terms of an offering made under such plan. However, in such a case, such requirements will be treated as satisfied only with respect to options exercised under such offering.

(2) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time such option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under such a plan, the option will not be treated as granted under an employee stock purchase plan. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4). If such an option is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, such option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the plan or the options granted under such plan or offering. For example, an option granted to an individual who is ineligible to receive an option under an employee stock purchase plan by reason of his ownership of 5 percent or more of the voting power or value of the stock of the grantor corporation (or a related corporation of such corporation), will not be treated as an option granted under an employee stock purchase plan, and the grant of such an option will not disqualify options granted under such plan from the special tax treatment of section 421. If all the options granted under an offering do not give the respective optionees the same rights and privileges, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. If, at the time an option is granted, it qualifies as an option granted under an employee stock purchase plan, but the terms of the option are not in fact met, the option will not qualify for the special tax treatment of section 421. However, the failure of such an option to qualify for the special tax treatment of section 421, will not disqualify other options granted under the plan.

(b) Options restricted to employees. An employee stock purchase plan must provide that options are to be granted only to employees of the employer corporation or of its related corporations

to purchase stock in any such corporation. If such a provision is not included in the terms of the plan, the plan will not be an employee stock purchase plan and options granted under such plan will not qualify for the special tax treatment of section 421. For rules relating to the employment requirement, see paragraph (h) of § 1.421–7.

(c) Stockholder approval. (1) An employee stock purchase plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter and bylaws, and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting. Thus, if neither the charter, bylaws or applicable State law prescribes the degree of stockholder approval required for the granting of qualified options, the approval of stockholders holding a majority of the voting stock of the corporation voting at a duly held meeting will suffice. However, if the applicable State law requires that stockholders holding two-thirds of the voting stock must approve the granting of such options, such two-thirds requirement must be met.

(2) The plan required by section 423 must be approved within 12 months before or after the date the plan is adopted. Ordinarily, a plan is adopted when approved by the board of directors and the date of such board action will be the reference point for determining whether stockholder approval comes within the 12-month period.

(3) The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan, and the corporations or class of corporations whose employees will be offered options under such plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. The provisions relating to the aggregate number of shares to be issued under the plan and the employees (or class of employees) eligible to receive options under the plan, are the only provisions of a stock option plan which require stockholder approval for purposes of section 423(b)(1).

(4) Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up) will be treated as the adoption of a new plan requiring approval of the stockholders within 12 months of such adoption. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be treated as the adoption of a new plan requiring stockholder approval unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the grantor corporation and its parent or subsidiary corporations. The group from among which such changes and designations are permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the grantor after the adoption and approval of the plan. Any other changes in the terms of an employee stock purchase plan may be made without such changes being considered the adoption of a new plan.

(5) A plan which otherwise meets the requirements of section 423(b) and this section may be used as an employee stock purchase plan although the adoption and approval of such plan occurred before January 1, 1964.

(d) Options granted to certain shareholders. (1) An employee stock purchase plan must by its terms provide that no employee can be granted an option if such employee, immediately after the option is granted, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or its parent or subsidiary corporation. In determining whether the stock ownership of an employee equals or exceeds this 5 percent limit, the rules of section 425(d) (relating to attribution of stock ownership) shall apply, and stock which the employee may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the employee. An option is outstanding for purposes of section 423(b)(3) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. If an option is granted to an individual whose stock ownership (as determined under this paragraph for purposes of section 423(b)(3)) exceeds the limitation of section 423(b)(3), no portion of such option will be

treated as having been granted under an employee stock purchase plan.

(2) The determination of the percentage of the total combined voting power or value of all classes of stock of his employer corporation (or a related corporation of such corporation) that is owned by the individual is made by comparing the voting power or value of the shares owned (or treated as owned) by the individual to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to such individual. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). E, an employee of M Corporation, owns 6,000 shares of the common stock of M Corporation, the only class of M stock outstanding. M has 100,000 shares of its common stock outstanding. Since E owns 6 percent of the combined voting power or value of all classes of M Corporation stock, M cannot grant an option to E under M's employee stock purchase plan. If E's father and brother each owned 3,000 shares of M stock and E owned no M stock in his own name, the result in this case would be the same, since under section 425(d) a person is treated as owning stock held by his father and his brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, E merely held an option on 6,000 shares of M stock, irrespective of whether the transfer of stock under such option could qualify for the special tax treatment of section 421, since section 423(b)(3) provides that stock which the employee may purchase under outstanding options shall be treated as stock owned by such employee.

Example (2). Assume the same facts as in example (1) and assume further that M is a subsidiary corporation of P Corporation. Irrespective of whether E owns any P stock, E cannot receive an option from P under P's employee stock purchase plan since he owns 5 percent of the total combined voting power of all classes of stock of a subsidiary of P Corporation, *i.e.*, M Corporation. Thus, an individual who owns (or is treated as owning) stock in excess of the limitation of section 423(b)(3), in any corporation in a group of corporations, consisting of a parent and its subsidiary corporations, cannot receive an option under an employee stock purchase plan from any corporation in the group.

Example (3). F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming F owns no stock in R or in any parent or subsidiary of R for purposes of section 423(b)(3), R can grant an option to F under its employee stock purchase plan for 4,999 shares, since immediately after the grant of the option, F would not own 5 percent or more of the combined voting power or value of all classes of R stock actually issued and outstanding at such time. The 4,999 shares which F would be treated as owning under section 423(b)(3) would not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether F's stock ownership exceeds the limitation of section 423(b)(3).

Example (4). Assume the same facts as in example (3) and assume further that on June 1, 1965, R grants F an option, purportedly under its employee stock purchase plan, for 5,000 shares. No portion of this option will be treated as granted under an employee stock purchase plan.

(e) **Employees covered by plan.** (1) Subject to the limitations of section 423(b)(3), (5) and (8), an employee stock purchase plan must, by its terms, provide that options are to be granted to all employees of any corporation which grants options to any of its employees by reason of their employment by such corporation except that one or more of the following categories of employees may be excluded from the coverage of the plan:

(i) Employees who have been employed less than 2 years;

(ii) Employees whose customary employment is 20 hours or less per week;

(iii) Employees whose customary employment is for not more than 5 months in any calendar year;

(iv) Officers;

(v) Persons whose principal duties consist of supervising the work of other employees; and

(vi) Highly compensated employees.

No option granted under a plan or offering which excludes from participation any employees, other than those who may be excluded under section 423(b)(4) and this paragraph, and those barred from participation by reason of section 423(b)(3), (5), and (8) and paragraphs (d), (f) and (i) of this section, can be regarded as having been granted under an employee stock purchase plan. If an option is not granted to any employee who is entitled to the grant of an option under the terms of the plan or offering, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. Furthermore, no option will be considered as having been granted under an employee stock purchase plan if the option was granted in connection with an offering made after September 28, 1979 with respect to which employees, otherwise eligible, are denied participation to any extent because of their continuing participation or eligibility for participation in a prior plan or offering (including a prior plan or offering of a related corporation). However, a plan which, by its terms, permits all eligible employees to elect to participate in an offering will not violate the requirements of this paragraph solely because eligible employees who elect not to participate in the offering are not granted options pursuant to such offering.

(2) For purposes of section 423(b)(3) the existence of the employment relationship between an individual and the corporation participating under the plan will be determined under paragraph (h) of § 1.421–7 (relating to employment relationship).

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation has a stock purchase plan which meets all the requirements of section 423(b) except that by its terms, options are not required to be granted to employees whose weekly rate of pay is less than $100. As a matter of corporate practice, M grants options under its plan to all employees, irrespective of their weekly rate of pay. M's plan is not an employee stock purchase plan.

Example (2). Assume the same facts as in example (1) and assume further that the first offering under M's plan provides by its terms that options will be granted to all employees of M Corporation. With respect to options exercised under such offering the terms of such offering will be treated as part of the terms of M's plan. Accordingly, stock transferred pursuant to options exercised under such offering will be treated as stock transferred pursuant to the exercise of options granted under an employee stock purchase plan for purposes of section 421.

(f) **Equal rights and privileges.** (1) An employee stock purchase plan must, by its terms, provide that all employees granted options under such plan shall have the same rights and privileges; however, a plan will not fail to satisfy this requirement merely because the amount of stock which may be purchased by any employee under such plan is determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation of employees, or because the plan provides that no employee may purchase more than a maximum amount of stock fixed under the plan. Thus, the provisions applying to one option under an offering (such as the provisions relating to the method of payment for the stock and the determination of the purchase price per share) must apply to all other options under such offering in the same manner. If all the options granted under a plan or offering do not, by their terms, give the respective optionees the same rights and privileges, none of such options shall be treated as having been granted under an employee stock purchase plan for purposes of section 421.

(2) The requirements of section 423(b)(5) and this paragraph do not prevent the maximum amount of stock which an employee may purchase from being determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees. For example, if an employee stock purchase plan provides that the maximum amount of stock which each employee may purchase under the offering is one share for each $100 of annual gross pay, options granted under such offering will be treated as meeting the requirement of section 423(b)(5). However, such a provision must not exclude employees from participation under the plan or offering. For example, a plan which provides for the grant of options based on one share for each $100 of annual gross pay in excess of $10,000 will not meet the requirements of section 423(b)(5).

(3)(i) Except as provided in paragraph (f)(3)(ii) of this section, a plan permitting one or more employees to apply sums which were withheld under an earlier plan or offering towards the purchase of additional stock under the current plan or offering will be a violation of equal rights and privileges unless all employees in the current plan or offering are permitted to make payments in an amount not less than that which any employee is allowed to carry over, to be applied to the purchase of shares under the current plan or offering.

(ii) A plan will not fail to satisfy the requirements of this section merely because one or more employees are permitted to apply sums, in an amount representing a fractional share, which were withheld under an earlier plan or offering toward the purchase of additional stock under the current plan or offering.

(4)(i) Section 423(b)(5) does not prohibit the delaying of the grant of an option to any employee who is barred from being granted an option solely by reason of such employee's failing to meet a minimum service requirement until such employee meets such requirement.

(ii) The provision of this paragraph (4) may be illustrated by the following example:

Example. N Corporation has an employee stock purchase plan which provides that options to purchase stock in an amount equal to ten percent of an employee's annual salary at a price equal to 85 percent of the fair market value at the time the option is granted will be granted to all employees other than those who have been employed less than 18 months. In addition, the plan provides that employees who have not yet met the minimum service requirements on the date the options are initially granted will be granted similar options on the date such employment has been attained. Such plan meets the requirements of section 423(b)(5).

(g) **Option price.** (1) An employee stock purchase plan must, by its terms, provide that the option price will not be less than the lesser of—

(i) An amount equal to 85 percent of the fair market value of the stock at the time such option is granted, or

(ii) An amount which under the terms of the option may not be less than 85 percent of the fair

market value of the stock at the time such option is exercised.

For definition of the term "option price", and general rules relating to such term, see paragraph (e) of § 1.421–7. For rules relating to the determination of when an option is granted, see paragraph (c) of § 1.421–7. Any option which does not meet the minimum pricing requirements of section 423(b)(6) and this paragraph will not be treated as granted under an employee stock purchase plan irrespective of whether the plan itself or the offering satisfies such requirements. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4).

(2) The option price may be stated either as a percentage or as a dollar amount. If the option price is stated as a dollar amount, the requirement of section 423(b)(6) and this paragraph can only be met by a plan or offering in which the price is fixed at not less than 85 percent of the fair market value of the stock at the time the option is granted. If the fixed price is less than 85 percent of the fair market value of the stock at grant, the option cannot meet the requirement of section 423(b)(6) even if a decline in the fair market value of the stock results in such fixed price being not less than 85 percent of the fair market value of the stock at the time the option is exercised, since such a result was not certain to occur under the terms of the option.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation has an employee stock purchase plan which provides that the option price will be 85 percent of the fair market value of the stock at grant, or 85 percent of the stock at exercise, whichever amount is the lesser. Upon the exercise of an option issued under M's plan, M agrees to accept an amount which is less than the minimum amount allowable under the terms of such plan. Notwithstanding that the option was issued under an employee stock purchase plan, the transfer of stock pursuant to the exercise of such option does not satisfy the requirement of section 423(b)(6) and cannot qualify for the special tax treatment of section 421.

Example (2). Assume the same facts as in example (1) and assume further that at the time of grant, the fair market value of M Corporation stock is $100 per share and that the option price is set at 85 percent of the fair market value of M stock at exercise, but not less than $80 per share. The option satisfies the requirement of section 422(b)(6), and can qualify for the special tax treatment of section 421.

Example (3). Assume the same facts as in example (2), except assume that the option price is set at 85 percent of the fair market value of M stock at exercise, but not more than $80 per share. This option cannot satisfy the requirement of section 423(b)(6) irrespective of whether, at the time the option is exercised, 85 percent of the fair market value of M stock is $80 or less.

(h) **Option period.** An employee stock purchase plan must, by its terms, provide that options granted under such plan cannot be exercised after the expiration of 27 months from the date of grant unless, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of the stock at the time of the exercise of the option. If the option price is to be not less than 85 percent of the fair market value of the stock at the time the option is exercised, then the option period provided under the plan must not exceed 5 years from the date of grant. If the requirement of section 423(b)(7) is not met by the terms of the plan or offering, options issued under such plan or offering will not be treated as options granted under an employee stock purchase plan irrespective of whether such options, by their terms, are exercisable beyond the period allowable under section 423(b)(7) and this paragraph. An option which provides that the option price is to be not less than 85 percent of the fair market value of the stock at exercise may have an option period of 5 years irrespective of whether the fair market value of the stock at exercise is more or less than the fair market value of such stock at grant. However, if the option provides that the option price is to be 85 percent of the fair market value of the stock at exercise, but not more than some other fixed amount, then irrespective of the price paid on exercise, the option period must not be more than 27 months.

(i) **Restriction on amount of optioned stock.** (1) Under section 423(b)(8), an employee stock purchase plan must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of his employer corporation and its related corporations at a rate which exceeds $25,000 in fair market value of such stock (determined at the time the option is granted) for each calendar year in which any such option granted to such individual is outstanding at any time. In applying the limitation of section 423(b)(8)—

(i) The right to purchase stock under an option is deemed to accrue when the option (or any portion thereof) first becomes exercisable during the calendar year;

(ii) The right to purchase stock under an option accrues at the rate provided in the option, but in

no case may such rate exceed $25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

(iii) A right to purchase stock which has accrued under one option granted pursuant to the plan may not be carried over to any other option.

If an option is granted under an employee stock purchase plan which satisfies the requirement of section 423(b)(8), but such option gives the optionee the right to buy stock in excess of the maximum rate allowable under such section and this paragraph, no portion of such option will be treated as having been granted under an employee stock purchase plan. Furthermore, if the option was granted to an employee entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 421.

(2) The limitation of section 423(b)(8) and this paragraph applies only to options granted under employee stock purchase plans and does not limit the amount of stock which an employee may purchase under qualified stock options (as defined in section 422(b)), restricted stock options (as defined in section 424(b)), or any other stock options (except those to which section 423 applies). Stock purchased under options to which section 423 does not apply will not limit the amount which an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of section 423(b)(3).

(3) Under the limitation of section 423(b)(8), an individual may purchase up to $25,000 of stock (based on the fair market value of such stock at the time the option was granted) in each calendar year during which an option granted to such individual under an employee stock purchase plan is outstanding. Alternatively, an individual may purchase more than $25,000 of stock (based on the fair market value of such stock at the time the option was granted) in a calendar year, so long as the total amount of stock which he purchases does not exceed $25,000 in fair market value of such stock (determined at the time the option was granted) for each calendar year in which the option was outstanding. If in any calendar year the individual holds two or more outstanding options granted under employee stock purchase plans of his employer corporation, or a related corporation of such corporation, his purchases of stock attributable to such year under all such options must not exceed $25,000 in fair market value of such stock (determined at the time such options were granted). Under an employee stock purchase plan, an individual may not purchase stock in anticipation that the option will be outstanding for some future year. Thus, the individual may purchase only the amount of stock which does not exceed the limitation of section 423(b)(8) for the year of the purchase and for preceding years during which the option was outstanding. Thus, the amount of stock which may be purchased under an option depends on the number of years in which the option is actually outstanding. The amount of stock which may be purchased under an employee stock purchase plan may not be increased by reason of the failure to grant an option in an earlier year under such plan, or by reason of the failure to exercise an earlier option. For example, if an option is granted to an individual and expires without having been exercised at all, the failure to exercise the option does not increase the amount of stock which such individual may be permitted to purchase under an option granted in a year following the year of such expiration. If an option granted under an employee stock purchase plan is outstanding in more than one calendar year, stock purchased pursuant to the exercise of such an option will be applied first, to the extent allowable under section 423(b)(8) and this paragraph, against the $25,000 limitation for the earliest year in which such option was outstanding, then, against the $25,000 limitation for each succeeding year, in order. For example, if an individual purchases $60,000 in fair market value of stock (determined at the time the option was granted) by the exercise of an option granted under an employee stock purchase plan of his employer corporation, and if such option was outstanding in 3 calendar years, then $25,000 in fair market value of such stock (determined at the time the option was granted) will be attributed to the first calendar year in which such option was outstanding, another $25,000 in fair market value of such stock will be attributed to the second calendar year in which such option was outstanding, and the remaining $10,000 in fair market value of such stock will be attributed to the last calendar year in which such option was outstanding. Thus, the individual may receive a right under another option granted under such employee stock purchase plan (or under an employee stock purchase plan of a parent or subsidiary corporation of his employer corporation) entitling him to purchase

another $15,000 in fair market value of such stock (determined as of the date such option is granted) for such last calendar year.

(4) The application of section 423(b)(8) and this paragraph may be illustrated by the following examples:

Example (1). Assume that P Corporation maintains an employee stock purchase plan and that E is employed by P. On June 1, 1964, P grants E an option under the plan to purchase a total of 750 shares of P stock at $85 per share. On such date, the fair market value of P stock is $100 per share. The option provides that it cannot be exercised after May 31, 1966. Under section 423(b)(8), the option must not permit E to purchase more than 250 shares of P stock during the calendar year 1964, since 250 shares are equal to $25,000 in fair market value of P stock determined at the time of grant. During the calendar year 1965, E may purchase under such option an amount of P stock equal to the difference between $50,000 in fair market value of P stock (determined at the time the option was granted) and the fair market value of P stock (determined at the time of grant of the option) purchased during 1964. During the calendar year 1966, E may purchase an amount of P stock equal to the difference between $75,000 in fair market value of such stock (determined at the time of grant of the option) and the total amount of the fair market value of such stock (determined at the time of grant of the option) purchased under such option during the calendar years 1964 and 1965. E may purchase $25,000 of stock for the year 1964 and $25,000 of stock for the year 1966, although the option was outstanding for only a part of each of such years. However, E may not be granted another option under an employee stock purchase plan of P or a related corporation to purchase stock of any of such corporations during the calendar years 1964, 1965, and 1966, so long as the option granted June 1, 1964, is outstanding. If this option permitted E to purchase only $15,000 of P's stock for each year it is outstanding, then E could be granted another option by P, or by a related corporation, in 1964, permitting him to purchase an additional $10,000 of stock for each year it is outstanding.

Example (2). Assume the same facts as in example (1), and assume further that the option granted to E in 1964 is terminated in 1965 without any part of such option having been exercised, and that subsequent to such termination and during 1965, E is granted another option under P's employee stock purchase plan. Under such option, E may be permitted to purchase $25,000 of stock for 1965. On the other hand, if, in 1966, E exercised the option granted to him in 1964 and purchased 600 shares of P stock, 500 shares, the maximum amount of stock which could have been purchased in 1965 under the option, is treated as having been purchased for the years 1964 and 1965. Thus, only 100 shares of the stock are treated as having been purchased for 1966, and E may be permitted under the new option to purchase for 1966 stock having a fair market value of $15,000 at the time the new option is granted.

(j) Restriction on transferability. An employee stock purchase plan must, by its terms, provide that options granted under such plan are not transferable by the optionee otherwise than by will or the laws of descent and distribution, and must be exercisable, during his lifetime, only by him. For general rules relating to the restriction on transferability required by section 423(b)(9), see paragraph (b)(2) of § 1.421–7. For a limited exception to the requirement of section 423(b)(9), see section 425(h)(3).

(k) Special rule where option price is between 85 percent and 100 percent of value of stock. (1)(i) If all the conditions necessary for the application of section 421(a) exist, section 423(c) provides additional rules which are applicable in cases where, at the time the option is granted, the option price per share is less than 100 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) holding periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) the lesser of—

(a) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted, or

(b) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of such disposition or death.

For purposes of applying the rules of section 423(c) and this paragraph, if the option price is not fixed or determinable at the time the option is granted, the option price will be computed as if the option had been exercised at such time. The amount of compensation resulting from the application of section 423(c) and this paragraph shall be included in the individual's gross income for the taxable year in which the disposition occurs, or for the taxable year closing with his death, whichever event results in the application of section 423(c).

(ii) The application of the special rules provided in section 423(c) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 423(c), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If, during his lifetime, the individual exercises an option granted under an employee stock purchase plan, but such individual dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of sections 421 and 423, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) If the special rules provided in section 423(c) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 423(c). However, the basis of a share of stock acquired after the death of an employee by the exercise of an option granted to such employee under an employee stock purchase plan shall be determined in accordance with the rules of section 421(c) and paragraph (c) of § 1.421–8. If the special rules provided in section 423(c) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 423(c). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, an option under X's employee stock purchase plan to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1965, E exercises the option and on that date the X Corporation transfers the share of stock to E. On January 1, 1967, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporations are as follows: (i) compensation in the amount of $15 is includible in E's gross income for 1967, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) the X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume the same facts as in example (1), except assume that E sells the share of X Corporation stock on January 1, 1968, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includable as compensation in E's gross income for 1968. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume the same facts as in example (1), except assume that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 1965, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of the stock. Compensation in the amount of $10 is includible in E's gross income for 1967, the year of the disposition of the share. This is determined in the following manner: The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10, the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume the same facts as in example (1), except assume that instead of selling the share on January 1, 1967, E makes a gift of the share on that day. In such case $15 is includible as compensation in E's gross income for 1967. E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1968. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume the same facts as in example (6), except assume that E dies on August 1, 1965, at which time the share has a fair market value of $150. Although E's death occurred within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1966, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 423(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1966 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

[T.D. 6887, 31 FR 8799, June 24, 1966, as amended by T.D. 7645, 44 FR 55836, Sept. 28, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.424–1 Applicability of section 421(a).

(a) In general. (1) Subject to the provisions of section 424(c), the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise after 1949 of a restricted stock option provided that—

(i) The individual makes no disposition of such share within 2 years from the date of the granting of the option, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him; and

(ii) At the time he exercised such option—

(a) The individual is an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies, or

(b) The individual ceased to be an employee of such corporations within the 3-month period preceding the time of such exercise.

(2) For general rules relating to the employment relationship, see paragraph (h) of § 1.421–7. For rules relating to the employment relationship when there has been a transaction described in section 425(a) (relating to corporate reorganizations, liquidations, etc.) see § 1.425–1. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421–8. For definition of the term "disposition", see section 425(c) and paragraph (c) of § 1.425–1.

(b) Examples. The application of this section may be illustrated by the following examples:

Example (1). On June 1, 1958, X Corporation grants a restricted stock option to A, an employee of X Corporation, to purchase a share of X stock. A continues to be employed by X Corporation until February 1, 1964, when X sells the plant where A is employed to M Corporation, an unrelated corporation. On such date, A becomes employed by M. A continues to be employed by M Corporation until June 1, 1964, when A exercises his option on X Corporation. Section 421 is not applicable to this exercise, because on June 1, 1964, A was not employed by the corporation which granted the option or by a related corporation of such corporation, nor was he employed by any of such corporations within three months before June 1, 1964.

Example (2). Assume the facts to be the same as in example (1), except that when A was employed by M Corporation, the option to purchase X stock was terminated, and was replaced by an option to buy M stock in such circumstances that M Corporation is treated as a corporation issuing an option under section 425(a). If A exercises the option to purchase the share of M stock on June 1, 1964, section 421 is applicable, for A is then employed by a corporation which issued an option under section 425(a).

Example (3). Assume that P Corporation owns all of the stock of S Corporation and grants a restricted stock option to E, an employee of S Corporation. If E exercises the option, section 421 is applicable since E is employed by a corporation which is a subsidiary of the corporation which granted the restricted stock option.

[T.D. 6887, 31 FR 8803, June 24, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.424–2 Restricted stock option.

(a) Restricted stock option defined. (1) A "restricted stock option" is an option granted after February 26, 1945, and before January 1, 1964 (or, if it meets the requirements of section 424(c)(3), an option granted after December 31, 1963), to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or a related corporation, to purchase stock of any such corporations, but, except in the case of options described in subparagraph (2) of this paragraph, only if—

(i) At the time such option is granted the option price is at least 85 percent of the fair market value at such time of the stock subject to the option;

(ii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him;

(iii) Such individual, at the time the option is granted, does not own stock possessing more than 10 percent of the total combined voting power of all classes of stock either of the employer corporation or of its parent or subsidiary corporation; and

(iv) In the case of options granted after June 21, 1954, such option by its terms is not exercisable after the expiration of ten years from the date on which such option was granted.

For purposes of applying the rule of subdivision (i) of this subparagraph to a variable price option (as defined by section 424(c)(2) and paragraph (c) of this section) under which the option price is determined by a formula described in paragraph (c) of this section, the option price shall, notwithstanding any provision of the option, be computed as if such option is exercised on the day when it is granted. For example, if on June 15, 1959, an option is granted providing that the option price shall be $10 under the average fair market value of the stock during the month in which the option is exercised or the average fair market value of the stock during the preceding month, whichever is lower, and if on June 15, 1959, the value of the stock subject to the option is $100 a share, to determine if the option meets the requirement of subdivision (i) of this subparagraph, it is necessary to determine the average fair market value of the stock during the months of May and June 1959. If such lower average fair market value is $95 or more, the option meets the requirement of subdivision (i) of this subparagraph.

(2) Regardless of the extent to which the individual to whom the option is granted owns stock of either the employer corporation, or of a related corporation, an option is a restricted stock option if—

(i) Such option is granted after February 26, 1945, to such individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or a related corporation, to purchase stock of any of such corporations;

(ii) At the time such option is granted the option price is at least 110 percent of the fair market value at such time of the stock subject to the option;

(iii) Such option by its terms is not transferable by such individual otherwise than by will or by the laws of descent and distribution, and is exercisable, during his lifetime, only by him; and

(iv) Such option by its terms is not exercisable after the expiration of 5 years from the date on which such option was granted or is exercised within 1 year after August 16, 1954.

(3) In determining the amount of stock owned by an individual for the purpose of applying the 10 percent test of section 424(b)(3), the rules of section 425(d) (relating to attribution of stock ownership) shall apply. See § 1.425–1.

(4) For general rules relating to the employment relationship, see paragraph (h) of § 1.421–7. For general rules relating to the restriction on transferability required by section 424(b)(2) and this paragraph, see paragraph (b)(2) of § 1.421–7. For modification of certain options so as to conform to the requirement of section 424(b)(2), see section 425(h)(3).

(b) Special rule where option price is between 85 percent and 95 percent of value of stock. (1)(i) If all the conditions necessary for the application of section 421(a) exist, section 424(c)(1) provides additional rules which are applicable in cases where, at the time the restricted stock option is granted, the option price per share is less than 95 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) holding periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) an amount determined in the following manner. If, at the time the option was granted, the option price was fixed or determinable, and was at least 85 percent of the fair market value of the stock subject to such option, such amount shall be the amount, if any, by which the option price is exceeded by the lesser of the fair market value of the share at the time the option was granted or the fair market value of the share at the time of such disposition or death. However, in the case of a variable price option (as defined by section 424(c)(2) and paragraph (c) of this section) under which the option price (computed as if the option had been exercised when granted) at the time the option was granted was at least 85 percent of the fair market value of the stock subject to

such option, such amount shall be whichever of the following amounts is the lesser:

(a) The excess of the fair market value of the share at the time of such disposition or death over the price paid under the option, or

(b) The excess of the fair market value of the share at the time the option was granted over the option price, computed as if the option had been exercised at such time.

The amount of such compensation shall be included in the individual's gross income for the taxable year in which the disposition occurs or for the taxable year closing with his death, whichever event results in the application of section 424(c)(1) and this paragraph.

(ii) The application of the special rules provided in section 424(c) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or a related corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 424(c)(1), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or a related corporation with respect to such amount.

(iii) If the individual exercises a restricted stock option during his lifetime and dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of section 421, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) If the special rules provided in section 424(c) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 424(c)(1). However, in the case of a share of stock acquired by the exercise of a restricted stock option after the death of the employee to whom the option was granted, the basis of such share shall be determined in accordance with the rules of section 421(c) and paragraph (c) of § 1.421–8. If the special rules provided in section 424(c)(1) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section 1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 424(c)(1). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1959, the X Corporation grants to E, an employee, a restricted stock option to purchase a share of X Corporation's stock for $85. The fair market value of the X Corporation stock on such date is $100 per share. On June 1, 1965, E exercises the option and on that date the X Corporation transfers the share of stock to E. On January 1, 1967, E sells the share for $150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) Compensation in the amount of $15 is includible in E's gross income for 1967, the year of the disposition of the share. The $15 represents the difference between the option price ($85) and the fair market value of the share on the date the option was granted ($100), since such value is less than the fair market value of the share on the date of disposition ($150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100. Since the share was sold for $150, E realizes a gain of $50, which is treated as long-term capital gain; (ii) the X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

Example (2). Assume the same facts as in example (1), except assume that E sells the share of X Corporation stock on January 1, 1968, for $75, its fair market value on that date. Since $75 is less than the option price ($85), no amount in respect of the sale is includible as compensation in E's gross income for 1968. E's basis for determining gain or loss on the sale is $85. Since E sold the share for $75, E realized a loss of $10 on the sale, which loss is treated as a long-term capital loss.

Example (3). Assume the same facts as in example (1), except assume that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 1965, when the option is exercised, the fair market value of the stock is $120 per share so that E pays $108 for the share of stock. Compensation in the amount of $10 is includible in E's gross income for 1967, the year of the disposition of the share. This is determined in the following manner. The excess of the fair market value of the stock at the time of the disposition ($150) over the price paid for the share ($108) is $42; and the excess of the fair market value of the stock at the time the option was granted ($100) over the option price, computed as if the option had been exercised at such time ($90), is $10. Accordingly, $10, the lesser, is includible in gross income. In this situation, E's cost basis of $108 is increased by $10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $118. Since the share was sold for $150, E realizes a gain of $32, which is treated as long-term capital gain.

Example (4). Assume the same facts as in example (1), except assume that instead of selling the share on January 1, 1967, E makes a gift of the share on that day. In such case, $15 is includible as compensation in E's gross income for 1967.

E's cost basis of $85 is increased by $15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is $100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

Example (5). Assume the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, E makes a gift of the share on that date. Since the fair market value of the share on that day ($75) is less than the option price ($85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1968. E's basis for the share is $85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is $75 (fair market value of the share at the date of gift).

Example (6). Assume the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, at which time the share has a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death, such $15 being the difference between the option price ($85) and the fair market value of the share when the option was granted ($100), since such value is less than the fair market value at date of death ($150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (7). Assume the same facts as in example (6), except assume that E dies on August 1, 1965, at which time the share has a fair market value of $150. Although E's death occurred within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

Example (8). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for $150, its fair market value on that date. Compensation in the amount of $15 is includible in E's gross income for 1966, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is $100, that is, the cost of $85 increased by the amount of $15 includible as compensation in E's gross income. The gain of $50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

Example (9). Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966, at which time the share had a fair market value of $150. Compensation in the amount of $15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the $15 includible in the decedent's gross income.

Example (10). Assume the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 424(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1966 (after the death of his wife), for $150, its fair market value at that time, the income tax consequences would be the same as in example (1).

(c) Variable price option defined. (1) For purposes of section 424 and this section, the term "variable price option" means an option under which the option price is determined by a formula in which the only variable is the fair market value of the stock at any time during a period of six consecutive months which includes the day on which such option is exercised. Except as provided in subparagraph (2) of this paragraph, such formula may provide for determining such price by reference to such value on any particular day in such 6-month period, or by reference to an average value of the stock over either the whole of such 6-month period or over any shorter period included in such 6-month period. Such 6-month period may begin with, end with, or in any other manner span the day on which such option is exercised. Such formula may also depend upon factors other than such value of the stock, but such other factors must not be variable and must be fixed in the option when granted. For example, such formula may provide that the option price shall be 85 percent of the value of the stock on the day the option is exercised, but such price shall not be less than $85, nor more than $110. Another example of a formula which meets the requirements of this paragraph is a provision that the option price shall be 95 percent of the fair market value of the stock on the day the option is exercised but not more than $95. However, the requirements of this paragraph are not met by a formula which provides that if the profits of the employer for the year do not exceed $100,000, the option price shall be $15 under the fair market value of the stock the option is exercised, but if such profits exceed $100,000, the option price shall be $20 under such value of the stock. For an example of how to determine whether an option which contains a formula meeting the requirements of this paragraph also meets the requirement that the option price must be at least 85 percent of the fair market value of the stock at the time the option is granted, see paragraph (a)(1) of § 1.424–2.

(2) In the case of an option granted after September 30, 1958, the term "variable price option" does not include any option in which the formula provides for determining the option price by reference to the fair market value of the stock at any time before the option is exercised if such value may be greater than the average fair market value of the stock during the calendar month in which the option is exercised. Whether an option meets the requirement of this paragraph shall be determined solely by reference to the terms of the option, and the circumstances existing at the time the option is granted or exercised are immaterial.

Thus, an option, granted after September 30, 1958, and containing a pricing formula which takes into consideration the value of the stock at any time before the option is exercised, is subject to the new limitation and does not meet the requirement of this paragraph, even though the option price is not actually based upon such prior fair market value either at the time the option is exercised or at the time the option price is computed as if it were exercised for the purpose of applying the 85 percent test of section 424(b)(1). For example, a formula which provides that the option price is to be 45 percent of the fair market value of the stock 30 days before the date on which the option is exercised, but not more than $85, will not qualify under this paragraph since under this formula the price may be determinable by reference to a higher prior value. On the other hand, a formula which provides that the option price is to be 90 percent of the average value of the stock during the month the option is exercised or the average value of the stock during the preceding month, whichever is lower, will qualify. In the case of an option granted after September 30, 1958, the only way that a formula which provides for determining the option price by reference to the fair market value of the stock at a time before the option is exercised can come within the requirement of this paragraph is to provide that the option price is to be determined by reference to such fair market value only if such fair market value is not greater than the average fair market value of the stock during the month in which the option is exercised. If under the terms of an option the price is to be determined by reference to the fair market value of the stock at a time before the option is exercised, whether such value is higher or lower than the average fair market value of the stock during the month the option is exercised, such option will not be considered a restricted stock option since the option price may be based upon the prior value of the stock when such value exceeds the average fair market value of the stock during the month the option is exercised. However, if an option provides for determining the option price by reference to a prior fair market value of the stock only when such value is lower than such average value of the stock, such option can qualify as a restricted stock option. The average fair market value of the stock during the month in which the option is exercised means such value during the calendar month the option is exercised and not merely during a 30- or 31-day period including the time the option is exercised. To compute the average fair market value of the stock for the month, it will be necessary to ascertain the fair market value of the stock for each day during the month, including those days which are not business days. In ascertaining the fair market value of the stock for each day, the generally accepted principles for ascertaining such value will be applied.

(d) Certain options granted after December 31, 1963. (1) In general, the term "restricted stock option" means only a stock option which is granted after February 26, 1945, and before January 1, 1964, and which meets the requirements of section 424(b) and paragraph (a) of this section. However, section 424(c)(3) provides that if an option is granted after December 31, 1963, and such option meets the requirements of section 424(b) and this section, the option will be treated as a restricted stock option, provided such option is granted pursuant to—

(i) A binding written contract entered into before January 1, 1964, or

(ii) A written plan adopted and approved before January 1, 1964, which (as of January 1, 1964, and as of the date of the granting of the option)—

(a) Met the requirements of section 423(b)(4) and (5) and paragraphs (e) and (f) of § 1.423–2 (relating to employees covered by the plan, and equal rights and privileges, respectively), or

(b) Was being administered in a way which did not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. In determining whether an option is granted pursuant to a plan described in subdivision (ii) of this subparagraph, the terms of any written offering that was made on or before January 1, 1964, will be treated as a part of the terms of the plan.

(2) For purposes of section 424(c)(3)(A) and this paragraph, a binding written contract means only a written contract under which the employee has an enforceable right to compel the grant or modification (as defined by section 425(h) and paragraph (e) of § 1.425–1) of a restricted stock option, or to obtain damages upon the breach of such contract. A contract which provides that the individual's right to a restricted stock option is contingent upon the happening of an event (including the passage of time) may satisfy the requirements of section 424(c)(3)(A). However, if the event itself, or the determination of whether the event has occurred, rests with the board of directors or any other individual or group (other than an arbitrator), the contract will not be treated as giving the employee an enforceable right for purposes of section 424(c)(3)(A) or this paragraph.

(3)(i) For purposes of applying section 424(c)(3)(B) with respect to options granted after December 31, 1963, and before October 1, 1967, the adoption and approval of a plan required by such section and this paragraph will be deemed to have occurred if the plan was adopted and approved on or before December 31, 1963, in the manner required by the applicable law of the State of incorporation. Thus, an option granted within such period pursuant to a restricted stock option plan which was not approved by the stockholders of the grantor corporation, but which was adopted by an authorized executive committee and approved by the board of directors of the grantor corporation before January 1, 1964, will meet the requirements of section 424(c)(3)(B) relating to adoption and approval, provided that the granting of options pursuant to such a plan is not contrary to the applicable State law. However, with respect to options granted on or after October 1, 1967, the approval required by section 424(c)(3)(B) must comply with all applicable provisions of the corporate charter and bylaws and the law of the State of incorporation and must represent the express consent of stockholders holding at least a majority of the voting stock of the corporation voting in person or by proxy at a duly held stockholders' meeting. The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan, and the corporations or class of corporations whose employees may be offered options under such plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up) will be treated as the adoption of a new plan requiring stockholder approval. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be treated as the adoption of a new plan requiring stockholder approval unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the grantor corporation and its parent or subsidiary corporations. The group from among which such changes and designations are permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the grantor after the adoption and approval of the plan. Any other changes in the terms of a restricted stock option plan may be made without such changes being considered the adoption of a new plan.

(ii) A plan may qualify under section 424(c)(3)(B)(ii) and paragraph (1)(ii)(b) of this paragraph even though coverage thereunder is limited to employees who have either reached a designated age or have been employed for a designated number of years, or who are employed in certain designated departments or are in other classifications, provided that the effect of coverage of such employees does not discriminate in favor of officers, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. Furthermore, a plan (which is not otherwise discriminatory) will not be considered discriminatory merely because options are granted only to fulltime employees (rather than employees working 20 hours per week or more), or because employees with less than 6 months employment per taxable year are omitted (rather than employees whose annual employment is for not more than 5 months per taxable year).

(4) An option issued or assumed in a transaction to which section 425(a) applies is treated as a continuation of the option previously held by such individual. Accordingly, if the option previously held by the individual was a restricted stock option (whether or not such restricted stock option was granted before, on, or after December 31, 1963), the option received in the transaction to which section 425(a) applies will be treated as a restricted stock option irrespective of whether such option meets the requirements of section 424(c)(3).

(5) An option granted after December 31, 1963, that is treated as a restricted stock option under section 424(c)(3) and this paragraph must be exercised before May 21, 1981, in order for section 421(a) to apply to the transfer of stock pursuant to such exercise. If such an option is exercised after May 20, 1981, section 421(a) will not apply to the transfer of stock pursuant to such exercise, and section 83 will apply to such transfer as if the option were a nonqualified stock option without a readily ascertainable fair market value at the time of its grant. See § 1.83–7(a) for rules relating to the treatment of nonqualified stock options under section 83.

[T.D. 6887, 31 FR 8804, June 24, 1966, as amended by T.D. 7680, 45 FR 13454, Feb. 29, 1980; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.425–1 Definitions and special rules applicable to statutory options.

(a) *Corporate reorganizations, liquidations, etc.* (1)(i) The term "issuing or assuming a stock option in a transaction to which section 425(a) applies" means, for purposes of sections 421 through 425, a substitution of a new option for an old option, or an assumption of such old option, by an employer corporation, or a related corporation of such corporation, by reason of a corporate transaction (as defined by subdivision (ii) of this subparagraph), if—

(*a*) The excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(*b*) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

(ii) For purposes of this section, the term "corporate transaction" means any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any purchase or acquisition of property or stock by any corporation, any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation, if such action by such corporation results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-subsidiary relationship.

(2)(i) A change in the terms of an option attributable to the issuance or assumption of an option by reason of a corporate transaction (as defined under section 425(a) and subparagraph (1)(ii) of this paragraph) is not a modification of such option. See section 425(h)(3) and paragraph (e) of this section. Thus, section 425(a), in effect, provides rules under which a new employer, or a parent or subsidiary of a new employer, may by reason of a corporate transaction assume a statutory option granted by the former employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution being considered as a modification of the option. For example, section 425(a) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume statutory options which had been granted to them by their former employer, X Corporation. Another example is where X Corporation forms a new subsidiary, Y Corporation, and transfers to it certain assets and employees, and where Y Corporation wishes to grant to such employees a statutory option to purchase its stock in place of the statutory option which they had to purchase stock of X Corporation.

(ii) Section 425(a) also provides rules under which a new parent or subsidiary corporation of the employer corporation may by reason of a corporate transaction assume a statutory option granted by the employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the employer or parent or subsidiary thereof, without having such assumption or substitution considered a modification of the option. Section 425(a) may apply, for example, where X Corporation acquires a new subsidiary, Y Corporation, by purchase of stock and desires to grant to the employees of Y Corporation a statutory option to buy stock of X Corporation in place of a statutory option which they have to purchase the stock of Y Corporation.

(iii) Section 425(a) applies only when the assumption or substitution occurs by reason of a corporate transaction as defined in this paragraph. Thus, section 425(a) may apply where as a result of a corporate transaction a statutory option can no longer be exercised, or if exercised, section 421 would not apply (see the first example in subdivision (i) of this subparagraph). Moreover, section 425(a) may apply in any case where the reason for the assumption or substitution grows out of a corporate transaction even though there could have been a valid exercise under section 421 of the original option (see the second example in subdivision (i) of this subparagraph and the example in subdivision (ii) of this subparagraph). However, a corporation which has issued an option may not substitute a new option for such option under section 425(a). See, however, paragraph (e) of this section.

(3) For section 425(a) to apply, it is not necessary to show that the corporation assuming or substituting the option is under any obligation to do so. In fact, section 425(a) may apply where the option which is being assumed or replaced

expressly provides that it will terminate upon the occurrence of certain corporate transactions. However, section 425(a) cannot be applied to revive a statutory option which, for reasons not related to the corporate transaction, expires before it can properly be assumed or replaced under section 425(a). For section 425(a) to apply, the assumed or substituted option must qualify as a statutory option.

(4)(i) Section 425(a) does not apply if the terms of the assumed or substituted option confer on the employee more favorable benefits than he had under the old option. Section 425(a) can apply to a corporate transaction only if, on a share by share comparison, the ratio of the option price to the fair market value of the stock subject to the option immediately after the substitution or assumption is no more favorable to the optionee than the ratio of the option price to the fair market value of the stock subject to the old option immediately before such substitution or assumption. The number of shares subject to an option issued or assumed may be adjusted to compensate for any change in the aggregate spread between the aggregate option price and the aggregate fair market value of the stock subject to the option immediately after the substitution or assumption as compared to the aggregate spread between the option price and the aggregate fair market value of the stock subject to the option immediately before such substitution or assumption. Such an adjustment will not prevent section 425(a) from applying to such substitution or assumption.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). On June 1, 1965, P Corporation acquires 100 percent of the stock of S Corporation and on such date S becomes a subsidiary of P Corporation. Also on such date, P Corporation substitutes a qualified stock option to purchase P stock for a qualified stock option to purchase S stock held by E, an employee of S. Assume that E's S option had 3 years to run on the date of the substitution. If the P option granted to E in substitution for his S option runs for more than 3 years from the date of the substitution, section 425(a) cannot apply, since the effect of such an option would be to give E an additional benefit which he did not enjoy under his S option.

Example (2). E is an employee of S Corporation. E holds a qualified stock option which was granted to him by S to purchase 60 shares of S stock at $12 per share. On June 1, 1967, S Corporation is merged into P Corporation, and on such date P substitutes a qualified stock option to purchase P stock for E's qualified stock option to purchase S stock. Immediately before the substitution, the fair market value of S stock was $32 per share; immediately after the substitution, the fair market value of P stock is $24 per share. The new option entitles E to buy P stock at $9 per share. Since on a share by share comparison the ratio of the new option price ($9 per share) to the fair market value of P stock immediately after the substitution ($24 per share) is not more favorable to E than the ratio of the old option price ($12 per share) to the fair market value of S stock immediately before the substitution ($32 per share) ($9/24=12/32$) the requirement of subparagraph (4)(i) of this paragraph is met. The number of shares subject to E's option to purchase P stock is set at 80. Since the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's new option to purchase P stock, $1,200 (80×$24 minus 80×$9), is not greater than the excess of the aggregate fair market value over the aggregate option price of the stock subject to E's old option to purchase S stock, $1,200 (60×$32 minus 60×$12), the requirement of subparagraph (1)(i)(a) of this paragraph is met. Thus, section 425(a) may apply to the substitution.

Example (3). Assume the same facts as in example (2), except assume that the fair market value of S stock immediately before the substitution was $8 per share and that the option price was $10 per share, and that the fair market value of P stock immediately after the substitution is $12 per share. P sets the new option price at $15 per share. Since on a share by share comparison the ratio of the new option price ($15 per share) to the fair market value of P stock immediately after the substitution ($12 per share) is not more favorable to E than the ratio of the old option price ($10 per share) to the fair market value of S stock immediately before the substitution ($8 per share) (15/12=10/8), the requirement of subparagraph (4)(i) of this paragraph is met. Assume further that the number of shares subject to E's P option is set at 20 as compared to 60 shares under E's old option to buy S stock. Immediately after the substitution, 2 shares of P stock are worth $24, which is what 3 shares of S stock were worth immediately before the substitution (2×$12=3×$8). Thus, to completely replace E's S option, E should have received an option to purchase 40 shares of P stock, *i.e.*, 2 shares of P for each 3 shares of S which E could have purchased under his old option (2/3=40/60). Since E's new option covers 20 shares of P stock, it is clear that P has replaced only ½ of E's stock option. The portion of E's stock option which was not replaced by P is an outstanding stock option to purchase stock of a predecessor corporation of P Corporation for purposes of section 422(b)(5) and (c)(2).

(5) For the purpose of applying section 425(a), the assumption or substitution shall be considered to occur at the time that the optionee would, except for section 425(a), be considered to have been granted the option which the employer corporation, or parent or subsidiary thereof, is issuing or assuming. An assumption or substitution which occurs by reason of a corporate transaction may occur before or after the corporate transaction.

(6) In order to have a substitution of an option under section 425(a) the optionee must, in connection with the corporate transaction, lose his rights under the old option. There cannot be a substitution of a new option for an old option within the meaning of section 425(a) if it is contemplated that the optionee may exercise both the old option and the new option. It is not necessary, however, to have a complete substitution of a new option for the old option. However, if the old option was a qualified or restricted stock option, any portion of such option which is not substituted or assumed in a transaction to which section 425(a) applies will

be treated as an outstanding option to purchase stock of a predecessor corporation of the new employer or grantor corporation. See section 422(b)(5) and (c)(2) and paragraph (f) of § 1.422–2. For example, assume that X Corporation forms a new corporation, Y Corporation, by a transfer of certain assets and distributes the stock of Y Corporation to the shareholders of X Corporation. Assume further that E, an employee of X Corporation, is thereafter an employee of both X Corporation and Y Corporation. Y Corporation wishes to substitute an option to purchase some of its stock for the statutory option which E has, entitling him to purchase 100 shares of the stock of X Corporation. The option to purchase the stock of X Corporation, at $50 a share, was granted when the stock had a fair market value of $50 a share, and the stock was worth $100 a share just before the distribution of the new corporation's stock to the shareholders of X Corporation. The stock of X Corporation and of Y Corporation is worth $50 a share just after such distribution, which also is the time of the substitution. On these facts an option to purchase 200 shares of stock of Y Corporation at $25 a share could be given to the employee in complete substitution for the old option. It would also be permissible to give the employee an option to purchase 100 shares of stock of Y Corporation at $25 a share in substitution for his right to purchase 50 of the shares covered by the old option. However, if the option to purchase X stock was a qualified or restricted stock option, then to the extent the old option is not assumed or a new option issued in substitution therefor in a transaction to which section 425(a) applies, such old option will be treated as an outstanding option under section 422(c)(2) for purposes of section 422(b)(5). See paragraph (f) of § 1.422–2.

(7) Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in § 20.2031–2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. In the case of a merger, consolidation, or other reorganization which is arrived at by arm's-length negotiations, the fair market value of the stocks subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.

(8) For the purpose of applying section 425(a) and this paragraph, the determination of whether the parent-subsidiary relationship exists shall be based upon circumstances existing immediately after the corporate transaction.

(b) Acquisition of new stock. (1) Section 425(b) provides that the rules provided by sections 421 through 425 which are applicable with respect to stock transferred to an individual upon his exercise of an option, shall likewise be applicable with respect to stock acquired by a distribution or an exchange to which section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036) applies. Stock so acquired shall, for purposes of sections 421 through 425, be considered as having been transferred to the individual upon his exercise of the option. A similar rule shall be applied in the case of a series of such acquisitions. With respect to such acquisitions, section 425(b) does not make inapplicable any of the provisions of section 305, 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036).

(2) The application of this paragraph may be illustrated by the following example:

Example. If, with respect to stock transferred pursuant to the timely exercise of a statutory option, there is a distribution of new stock to which section 305(a) is applicable, and if there is a disposition of such new stock before the expiration of the applicable holding period required with respect to the stock originally acquired pursuant to the exercise of such option, such disposition makes section 421 inapplicable to the transfer of the original stock pursuant to the exercise of the option to the extent that the disposition effects a reduction of the individual's total interest in the old and new stock. However, if the new stock, as well as the old stock, is not disposed of before the expiration of the holding period required with respect to the original stock acquired pursuant to the exercise of the option, the special tax treatment provided by section 421 is applicable

to both the original shares and the shares acquired by virtue of the distribution to which section 305(a) applies.

(c) Disposition of stock. (1) For purposes of sections 421 through 425, the term "disposition" includes a sale, exchange, gift, or any transfer of legal title, but does not include—

(i) A transfer from a decedent to his estate or a transfer by bequest or inheritance; or

(ii) An exchange to which is applicable section 354, 355, 356, or 1036 (or so much of section 1031 as relates to section 1036); or

(iii) A mere pledge or hypothecation. However, a disposition of the stock pursuant to a pledge or hypothecation is a disposition by the individual, even though the making of the pledge or hypothecation is not such a disposition.

(2) A share of stock acquired by an individual pursuant to the exercise of a statutory option is not considered disposed of by the individual if such share is taken in the name of the individual and another person jointly with right of survivorship, or is subsequently transferred into such joint ownership, or is retransferred from such joint ownership to the sole ownership of the individual. However, any termination of such joint ownership (other than a termination effected by the death of a joint owner) is a disposition of such share, except to the extent the individual reacquires ownership of the share. For example, if such individual and his joint owner transfer such share to another person, the individual has made a disposition of such share. Likewise, if a share of stock held in the joint names of such individual and another person is transferred to the name of such other person, there is a disposition of such share by the individual. If an individual exercises a statutory option and a share of stock is transferred to another or is transferred to such individual in his name as trustee for another, the individual has made a disposition of such share. However, a termination of joint ownership resulting from the death of one of the owners is not a disposition of such share. For determination of basis in the hands of the survivor where joint ownership is terminated by the death of one of the owners, see section 1014.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to E, an employee, a qualified stock option to purchase 100 shares of X Corporation stock at $100 per share, the fair market value of X Corporation stock on that date. On June 1, 1965, while employed by X Corporation, E exercises the option in full and pays X Corporation $10,000, and on that day X Corporation transfers to E 100 shares of its stock having a fair market value of $12,000. Before June 1, 1968, E makes no disposition of the 100 shares so purchased. E realizes no income on June 1, 1965, with respect to the transfer to him of the 100 shares of X Corporation stock. X Corporation is not entitled to any deduction at any time with respect to its transfer to E of the stock. E's basis for such 100 shares is $10,000.

Example (2). Assume the same facts as in example (1), except assume that on August 1, 1968, three years and two months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000 which is the fair market value of the stock on that date. For the taxable year in which the sale occurs, E realizes a gain of $3,000 ($13,000 minus E's basis of $10,000), which is treated as long-term capital gain.

Example (3). Assume the same facts as in example (2), except assume that on August 1, 1968, E makes a gift of the 100 shares of Y Corporation stock to his son. Such disposition results in no realization of gain to E either for the taxable year in which the option is exercised or the taxable year in which the gift is made. E's basis of $10,000 becomes the donee's basis for determining gain or loss.

Example (4). Assume the same facts as in example (1), except assume that on May 1, 1968, two years and 11 months after the transfer of the shares to him, E sells the 100 shares of X Corporation stock for $13,000. The special rules of section 421(a) are not applicable to the transfer of the stock by X Corporation to E, because disposition of the stock was made by E within three years from the date the shares were transferred to him.

Example (5). Assume the same facts as in example (1), except assume that E dies on September 1, 1965, owning the 100 shares of X Corporation stock acquired by him pursuant to his exercise on June 1, 1965, of the qualified stock option. On the date of death, the fair market value of the stock is $12,500. No income is realized by E by reason of the transfer of the 100 shares to his estate. If the stock is valued as of the date of E's death for estate tax purposes, the basis of the 100 shares in the hands of the executor is $12,500.

Example (6). Assume the same facts as in example (1), except assume that on June 1, 1965, when the option is exercised by E the 100 shares are transferred by X to E and his wife W, as joint owners with right of survivorship, and that E dies on July 1, 1965. Neither the transfer into joint ownership nor the termination of such joint ownership by E's death is a disposition. Because E has made no disqualifying disposition of the shares, section 421(a) is applicable and E realizes no income at death with respect to the shares even though he held the stock less than 3 years after the transfer of the shares to him pursuant to his exercise of a qualified stock option. See paragraph (b)(2) of § 1.421–8.

(d) Attribution of stock ownership. Section 425(d) provides that in determining the amount of stock owned by an individual for purposes of applying the percentage limitations of section 422(b)(7), 423(b)(3), and 424(b)(3), stock of the employer corporation or of a related corporation which is owned (directly or indirectly) by or for such individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants, shall be considered as owned by such individual. Also, for such purpose, if a domestic or foreign corporation, partnership, estate, or trust owns (directly or indirectly) stock of

the employer corporation or of its parent or subsidiary, such stock shall be considered as being owned proportionately by or for the shareholders, partners, or beneficiaries of the corporation, partnership, estate, or trust.

(e) **Modification, extension, or renewal of option.** (1) Section 425(h) provides the rules for determining whether a share of stock transferred to an individual upon his exercise of an option, after the terms thereof have been modified, extended, or renewed, is transferred pursuant to the exercise of a statutory option. Such rules and the rules of this section are applicable to modifications, extensions, or renewals (or to changes which are not treated as modifications) of an option in any taxable year of the optionee which begins after December 31, 1963, except that section 425(h)(1) and this paragraph shall not apply to any change made before January 1, 1965, in the terms of an option granted after December 31, 1963, to permit such option to meet the requirements of section 422(b)(3), (4), or (5), and the regulations thereunder. See paragraphs (d), (e), and (f), of § 1.422–2, relating to period for exercising options, option price, and prior outstanding options, respectively, in the case of qualified stock options.

(2) Any modification, extension, or renewal of the terms of an option to purchase stock shall be considered as the granting of a new option.

(3) Except as otherwise provided in subparagraph (4) of this paragraph, in case of a modification, extension, or renewal of an option, the highest of the following values shall be considered to be the fair market value of the stock at the time of the granting of such option for purposes of applying the rules of sections 423(b)(6), and 424(b)(1)—

(i) The fair market value on the date of the original granting of the option,

(ii) The fair market value on the date of the making of such modification, extension, or renewal, or

(iii) The fair market value at the time of the making of any intervening modification, extension, or renewal.

(4)(i) In the case of a modification, extension, or renewal of a restricted stock option before January 1, 1964 (or after December 31, 1963, if made pursuant to a binding written contract entered into before January 1, 1964), the rules of subparagraph (3) of this paragraph do not apply if the aggregate of the monthly average fair market values of the stock subject to the option for the 12 consecutive calendar months preceding the month in which the modification, extension, or renewal occurs, divided by 12, is an amount less than 80 percent of the fair market value of such stock on the date of the original granting of the option or the date of the making of any intervening modification, extension, or renewal, whichever is the highest. In such case, any modification, extension, or renewal of the option is treated as the granting of a new option but only the fair market value of the stock subject to the option at the time of the modification, extension, or renewal is considered in determining whether the option is a restricted stock option. In the case of stocks listed on a stock exchange, the average fair market value of the stock for any month may be determined by adding the highest and lowest quoted selling prices during such month and dividing the sum by two. The method used for determining the average fair market value of the stock for any month must be used for all twelve months, except where it is shown that such method cannot be used for any month or does not clearly reflect the average fair market value of the stock for any such month.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On June 1, 1962, a restricted stock option was granted to purchase before July 1, 1965, a share of stock for $85. The fair market value of such stock on June 1, 1962, was $100. On June 15, 1963, when the fair market value of the stock is $60, such option is extended so that it is exercisable at any time before July 1, 1966, at $55 a share. The average fair market value of the stock subject to the option for each of the 12 calendar months preceding June 1963, is as follows:

1962	
June	$100
July	90
August	80
September	70
October	80
November	80
December	90
1963	
January	90
February	80
March	70
April	60
May	60

The aggregate of such values is $950. When this sum is divided by 12, the result is $79.17, which is an amount less than 80 percent of the fair market value of the stock ($100) when the option was granted. Accordingly, when the option is extended on June 15, 1963, the option price could have been reduced as low as $51 (85 percent of the fair market value of the stock on such day) without disqualifying the option as a restricted stock option. If the aggregate fair market values of the stock so ascertained had amounted to $960 or more, the rules of subparagraph (3) of this paragraph would have been

applicable with the result that any reduction in the option price would have disqualified the option as a restricted stock option.

(5)(i) The time or date when an option is modified, extended, or renewed shall be determined, insofar as applicable, in accordance with the rules governing determination of the time or date of granting an option provided in paragraph (c) of § 1.421–7. For purposes of sections 421 through 425, the term "modification" means any change in the terms of the option which gives the optionee additional benefits under the option. For example, a change in the terms of the option, which shortens the period during which the option is exercisable, is not a modification. However, a change which provides more favorable terms for the payment for the stock purchased under the option, is a modification. Where an option is amended solely to increase the number of shares subject to the option, such increase shall not be considered as a modification of the option, but shall be treated as the grant of a new option for the additional shares.

(ii)(a) A change in the number or price of the shares of stock subject to an option merely to reflect a stock dividend, or stock split-up, is not a modification of the option.

(b) A change in the number or price of the shares of stock subject to an option to reflect a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) is not a modification of the option provided that the excess of the aggregate fair market value (determined immediately after such corporate transaction) of the shares subject to the option immediately after such change over the aggregate new option price of such shares is not more than the excess of the aggregate fair market value of the shares subject to the option immediately before the transaction over the aggregate former option price of such shares, and provided that the option after such change does not give the employee additional benefits which he did not have before such change. The ratio of the option price immediately after the change to the fair market value of the stock subject to the option immediately after the corporate transaction must not be more favorable to the optionee on a share by share comparison than the ratio of the old option price to the fair market value of the stock subject to the option immediately before such a transaction. A reduction in the option price of an option, other than as specifically provided for in this section, is a modification of such option.

(c) The application of (b) of this subdivision may be illustrated by the following example:

Example. E, an employee of P Corporation, holds a qualified stock option granted to him by P to buy 90 shares of P stock at $36 per share. P Corporation is a party to a corporate transaction (as defined by paragraph (a)(1)(ii) of this section) which results in a decline in the fair market value of P stock. Immediately before such transaction the fair market value of P stock was $64 per share. Immediately after such transaction, the fair market value of P stock is $48 per share. Two weeks after such transaction, P proposes to amend E's option in order to reflect the decline in the fair market value of P stock attributable to the transaction. At such time, the fair market value of P stock is $50 per share. However, since the change was not made at the time of the transaction, the fair market value of P stock at the time of the change is irrelevant for purposes of determining whether the change comes under the rule of (b) of this subdivision. P changes the terms of E's option to lower the option price to $27 per share and to increase the number of shares subject to the option to 120. No other terms of the option are changed. The aggregate fair market value (determined immediately after the corporate transaction) of the shares subject to the option immediately after the change is $5,760 ($48 × 120). The aggregate option price of the shares subject to the option immediately after the change is $3,240 ($27 × 120). Thus, the excess of such fair market value over such option price is $2,520 ($5,760-$3,240). The aggregate fair market value of the stock subject to the option immediately before the corporate transaction is $5,760 ($64 × 90). The aggregate option price for the stock subject to the option immediately before the change is $3,240 ($36 × 90). Thus, the excess of such fair market value over such option price is $2,520 ($5,760-$3,240). Accordingly, the excess after the change does not exceed the excess before the corporate transaction. Moreover, the ratio of the option price immediately after the change ($27 per share) to the fair market value of P stock immediately after the transaction ($48 per share) is not more favorable to E on a share by share comparison than the ratio of the old option price ($36 per share) to the fair market value of P stock immediately before the transaction ($64) ($\frac{27}{48} = \frac{36}{64}$). For purposes of section 425(h), the changes made do not confer additional benefits on E which he did not have before the change. Accordingly, the changes do not constitute a modification of E's option.

(iii) Any change in the terms of an option for the purpose of qualifying the option as a statutory option grants additional benefits and, therefore, is a modification. However, if the terms of an option are changed to provide that the optionee cannot transfer the option except by will or by the laws of descent and distribution in order to meet the requirements of section 422(b)(6), 423(b)(9), or 424(b)(2), such change is not a modification, provided that in any case where the purpose of the change is to meet the requirements of section 424(b)(2) the option is at the same time changed so that it is not exercisable after the expiration of ten years from the date the option was granted. Where an option is not immediately exercisable in full, a change in the terms of such option to accelerate the time at which the option (or any portion thereof) may be exercised is not a modification for purposes of section 425(h) and this section. A modification results where an option is

revised to insert the language required by section 422(c)(6)(B).

(iv) An extension of an option refers to the granting by the corporation to the optionee of an additional period of time within which to exercise the option beyond the time originally prescribed. A renewal of an option is the granting by the corporation of the same rights or privileges contained in the original option on the same terms and conditions. The rules of this paragraph apply as well to successive modifications, extensions, and renewals.

(6) A statutory option may, as a result of a modification, extension, or renewal, thereafter cease to be a statutory option, or any option may, by modification, extension, or renewal, thereafter become a statutory option. Moreover, a qualified option after a modification may not be exercisable in accordance with its terms because of the requirements of section 422(b)(5) and section 422(c)(6). See paragraph (f)(3)(i) of § 1.422–2 and examples (8) and (9) of paragraph (f)(4) of § 1.422–2.

(7) The application of this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of the stock of X Corporation at $90 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, X Corporation modifies the option to provide that the price at which the employee may purchase the stock shall be $80 per share. On February 1, 1965, the fair market value of the X Corporation stock is $90 per share. Under section 425(h), the X Corporation is deemed to have granted an option to the employee on February 1, 1965. Such option shall be treated as an option to purchase at $80 per share 100 shares of stock having a fair market value of $100 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee after February 1, 1965, is not the exercise of a statutory option.

Example (2). On June 1, 1964, the X Corporation grants to an employee an option under X's employee stock purchase plan to purchase 100 shares of X Corporation stock at $90 per share, exercisable after December 31, 1965, and on or before June 1, 1966. On June 1, 1964, the fair market value of X Corporation's stock is $100 per share. On February 1, 1965, X Corporation modifies the option to provide that the option shall be exercisable on or before September 1, 1966. On February 1, 1965, the fair market value of X Corporation stock is $110 per share. Under section 425(h), X Corporation is deemed to have granted an option to the employee on February 1, 1965, to purchase at $90 per share 100 shares of stock having a fair market value of $110 per share, that is, the higher of the fair market value of the stock on June 1, 1964, or on February 1, 1965. The exercise of such option by the employee is not the exercise of a statutory option.

Example (3). The facts are the same as in example (1), except that the employee exercised the option to the extent of 50 shares on January 15, 1965, before the date of the modification of the option. Any exercise of the option after February 1, 1965, the date of the modification, is not the exercise of a statutory option. See example (1) in this subparagraph. The exercise of the option on January 15, 1965, pursuant to which 50 shares were acquired, is the exercise of a statutory option.

Example (4). On June 1, 1964, the X Corporation grants to an employee an option to purchase 100 shares of the stock of X Corporation at $80 per share, such option to be exercised on or before June 1, 1966. At the time the option is granted, the fair market value of the X Corporation stock is $100 per share. On February 1, 1965, before the employee exercises the option, the X Corporation modifies the option to provide that the number of shares of stock which the employee may purchase at $80 per share will be 250. On February 1, 1965, the fair market value of X Corporation stock is $80 per share. Under these facts, the X Corporation has granted two options, one option (not a statutory option) with respect to 100 shares having been granted on June 1, 1964, and the other option (a qualified stock option) with respect to the additional 150 shares having been granted on February 1, 1965. In the absence of facts identifying which option is exercised first, the employee will be deemed to have exercised the options in the order in which they were granted.

[T.D. 6887, 31 FR 8808, June 24, 1966]

Accounting Periods And Methods Of Accounting

Accounting Periods

§ 1.441–1T Period for computation of taxable income (temporary).

(a) Computation of taxable income. Taxable income shall be computed and a return shall be made for a period known as the "taxable year." For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see parts II and III (section 446 and following), subchapter E, chapter 1 of the Code, and the regulations thereunder.

(b) Taxable year—(1) Definition of taxable year—(i) In general. Except as otherwise provided in this paragraph (b)(1), the term "taxable year" means—

(A) The taxpayer's annual accounting period if it is a calendar year or a fiscal year; or

(B) The calendar year if section 441(g) (relating to taxpayers who keep no books or have no accounting period) applies. Except as provided in administrative provisions of the Internal Revenue

laws, a taxable year may not cover a period of more than 12 calendar months. If a return is made under section 443 for a period of less than 12 months (a "short period"), the taxable year is the short period for which the return is made.

(ii) Special rules for certain entities. The general rule provided in paragraph (b)(1)(i) of this section may be modified by the Internal Revenue laws or regulations. For example, special rules are provided for the following taxpayers—

(A) In the case of personal service corporations, the applicable rules are contained in § 1.441–4T.

(B) In the case of partnerships, the applicable rules are contained in § 1.706–1T.

(C) In the case of S corporations, the applicable rules are contained in section 1378.

(D) In the case of members of an affiliated group which makes a consolidated return, the applicable rules are contained in § 1.1502–76 and paragraph (d) of § 1.442–1.

(E) In the case of trusts, the applicable rules are contained in section 645.

(F) In the case of real estate investment trusts, the applicable rules are contained in section 859.

(G) In the case of real estate mortgage investment conduits, the applicable rules are contained in section 860D(a)(5).

(H) In the case of FSCs or DISCs, the applicable rules are contained in section 441(h).

(2) Adoption of taxable year. A new taxpayer adopts a taxable year on or before the time prescribed by law (not including extensions) for the filing of the taxpayer's first return and may adopt, without prior approval, any taxable year that satisfies the requirements of section 441 and this section.

(3) Change in taxable year—(i) General rule. After a taxpayer has adopted a taxable year, such year must be used in computing taxable income and making returns for all subsequent years unless prior approval is obtained from the Commissioner to make a change or unless a change is otherwise permitted or required under the Internal Revenue laws or regulations. See section 442 and § 1.442–1. Also see paragraph (b)(4) of this section.

(ii) Change in taxable year required by the Tax Reform Act of 1986. Procedures for entities (certain personal service corporations, partnerships and S corporations) required to change their taxable year under section 806 of the Tax Reform Act of 1986, Pub. L. 99–514, 100 Stat. 2362, are provided in Rev. Proc. 87–32, 1987–28 I.R.B. 14, or successor revenue procedures.

(4) Retention of taxable year—(i) In general. In certain cases, taxpayers will be required under the Internal Revenue laws or regulations to change their taxable year unless they establish a business purpose for retaining their current taxable year. For example, corporations electing to be S corporations, corporations that are personal service corporations for the first time, and certain partnerships with new partners may be required to change their taxable year unless they establish a business purpose for retaining their current taxable year.

(ii) Section 806 of the Tax Reform Act of 1986. Rev.Proc. 87–32 provides (and any successor revenue procedure would provide) procedures for certain entities (i.e., personal service corporations, partnerships and S corporations) requesting the Commissioner's approval to retain a fiscal year when such entity would otherwise be required to change its taxable year under section 806 of the Tax Reform Act of 1986. In addition, personal service corporations should see Announcement 87–82, 1987–37 I.R.B. 30, for modifications to Rev.Proc. 87–32 extending the due date for personal service corporations requesting the Commissioner's approval to establish a business purpose.

(c) Annual accounting period. The term "annual accounting period" means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes his income in keeping his books.

(d) Calendar year. The term "calendar year" means a period of 12 months ending on December 31. A taxpayer who has not established a fiscal year must make his return on the basis of a calendar year.

(e) Fiscal year. (1) The term "fiscal year" means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52–53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the taxpayer are kept in accordance with such fiscal year.

(f) Election of year consisting of 52–53 weeks. For rules relating to the 52–53-week taxable year, see §§ 1.441–2T, 1.441–3T, and 1.441–4T.

(g) No books kept; no accounting period. Except as otherwise provided in the Internal Revenue laws or regulations, the taxpayer's taxable year shall be the calendar year if—

(1) The taxpayer keeps no books;

(2) The taxpayer does not have an annual accounting period (as defined in section 441(c) and paragraph (c) of this section); or

(3) The taxpayer has an annual accounting period, but such period does not qualify as a fiscal year (as defined in section 441(e) and paragraph (e) of this section).

For the purposes of paragraph (g)(1) of this section, the keeping of books does not require that records be bound. Records which are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. A taxpayer whose taxable year is required to be a calendar year under section 441(g) and this paragraph (g) may not adopt a fiscal year without obtaining prior approval from the Commissioner. See section 442 and § 1.442–1T(a)(2).

(h) Effective date. This section is effective for taxable years beginning after December 31, 1986. See 26 CFR 1.441–1 (revised as of April 1, 1987) for rules applicable to taxable years beginning before January 1, 1987.

[T.D. 6500, 25 FR 11701, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7767, 46 FR 11264, Feb. 6, 1981; T.D. 7936, 49 FR 2104, Jan. 18, 1984; T.D. 8167, 52 FR 48526, Dec. 23, 1987]

§ 1.441–2T Election of year consisting of 52–53 weeks (temporary).

(a) General rule. Section 441(f) provides, in general, that a taxpayer may elect to compute his taxable income on the basis of a fiscal year which—

(1) Varies from 52 to 53 weeks,

(2) Ends always on the same day of the week, and

(3) Ends always on—

(i) Whatever date this same day of the week last occurs in a calendar month, or

(ii) Whatever date this same day of the week falls which is nearest to the last day of the calendar month.

For example, if the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 1956, the taxable year would end on November 24, 1956. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 1956, the taxable year would end on December 1, 1956. Thus, in the case of a taxable year described in subparagraph (3)(i) of this paragraph, the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described in subparagraph (3)(ii) of this paragraph, the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(b) Application of effective dates. (1) For purposes of determining the effective date or the applicability of any provision of this title which is expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, a 52–53-week taxable year is deemed to begin on the first day of the calendar month beginning nearest to the first day of the 52–53-week taxable year, and is deemed to end or close on the last day of the calendar month ending nearest to the last day of the 52–53-week taxable year, as the case may be. Examples of provisions of this title the applicability of which is expressed in terms referred to in the preceding sentence include the provisions relating to the time for filing returns and other documents, paying tax, or performing other acts, and the provisions of part II (section 1561 and following), subchapter B, chapter 6, relating to surtax exemptions of certain controlled corporations. The provisions of this subparagraph do not apply to the computation of the tax if subparagraph (2) of this paragraph, relating to the computation under section 21 of the effect of changes in rates of tax during a taxable year, applies. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 1957. For that purpose, a 52–53–week taxable year beginning on any day within the period December 26, 1956, to January 4, 1957, inclusive, shall be treated as beginning on January 1, 1957.

Example (2). Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52–53–week taxable year ending on any day during the period May 25 to June 3, inclusive, shall be treated as ending on May 31, the last day of the month ending nearest to

the last day of the taxable year, and the return, therefore, must be made on or before August 15.

Example (3). X, a corporation created on January 1, 1966, elects a 52–53–week taxable year ending on the Friday nearest the end of December. Thus, X's first taxable year begins on Saturday, January 1, 1966, and ends on Friday, December 30, 1966; its next taxable year begins on Saturday, December 31, 1966, and ends on Friday, December 29, 1967; and its next taxable year begins on Saturday, December 30, 1967, and ends on Friday, January 3, 1969. For purposes of applying the provisions of Part II, subchapter B, chapter 6 of the Code, X's first taxable year is deemed to begin on January 1, 1966, and end on December 31, 1966; its next taxable year is deemed to begin on January 1, 1967, and end on December 31, 1967; and its next taxable year is deemed to begin on January 1, 1968, and end on December 31, 1968. Accordingly, each such taxable year is treated as including one and only one December 31st.

(2) If a change in the rate of tax is effective during a 52–53-week taxable year (other than on the first day of such year as determined under subparagraph (1) of this paragraph), the tax for the 52–53-week taxable year shall be computed in accordance with section 21, regulating to effect of changes, and the regulations thereunder. For the purpose of the computation under section 21, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of subparagraph (1) of this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Assume a change in the rate of tax is effective for taxable years beginning after June 30, 1956. For a 52–53–week taxable year beginning on Wednesday, November 2, 1955, the tax must be computed on the basis of the old rates for the actual number of days, from November 2, 1955, to June 30, 1956, inclusive, and on the basis of the new rates for the actual number of days from July 1, 1956, to Tuesday, October 30, 1956, inclusive.

Example (2). Assume a change in the rate of tax for taxable years beginning after June 30. For this purpose, a 52–53–week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 21 will be required for such year because of the change in rate.

(c) Adoption of or change to or from 52–53-week taxable year. (1) A new taxpayer may adopt the 52–53-week taxable year for his first taxable year if he keeps his books and computes his income on that basis, or if he conforms his books accordingly in closing them. The taxpayer must thereafter keep his books and report his income on the basis of the 52–53-week taxable year so adopted unless prior approval for a change is obtained from the Commissioner. See subparagraph (4) of this paragraph. The taxpayer shall file with his return for his first taxable year a statement containing the information required in subparagraph (3) of this paragraph. A newly-formed partnership may adopt a 52–53–week taxable year without the permission of the Commissioner only if such a year ends either with reference to the same month in which the taxable years of all its principal partners end or with reference to the month of December. See paragraph (b)(1) of § 1.706–1.

(2) A taxpayer, including a partnership, may change to a 52–53-week taxable year without the permission of the Commissioner if the 52–53-week taxable year ends with reference to the end of the same calendar month as that in which the former taxable year ended, and if the taxpayer keeps his books and computes his income for the year of change on the basis of such 52–53-week taxable year, or if he conforms his books accordingly in closing them. The taxpayer must continue to keep his books and compute his income on the basis of such 52–53-week taxable year unless prior approval for a change is obtained. See subparagraph (4) of this paragraph. The taxpayer shall indicate his election to change to such 52–53-week taxable year by a statement filed with his return for the first taxable year for which the election is made. This statement shall contain the information required in subparagraph (3) of this paragraph.

(3) The statement referred to in subparagraphs (1) and (2) of this paragraph shall contain the following information:

(i) The calendar month with reference to which the new 52–53-week taxable year ends;

(ii) The day of the week on which the 52–53-week taxable year always will end; and

(iii) Whether the 52–53-week taxable year will always end on (a) the date on which such day of the week falls in the calendar month, or (b) on the date on which such day of the week last occurs which is nearest to the last day of such calendar month.

(4) Where a taxpayer wishes to change to a 52–53-week taxable year and, in addition, wishes to change the month with reference to which the taxable year ends, or where a taxpayer wishes to change from a 52–53-week taxable year, he must obtain prior approval from the Commissioner, as provided in section 442 and § 1.442–1.

(5) If a change from or to a 52–53-week taxable year results in a short period (within the meaning of section 443) of 359 days or more, or six days or less, the tax computation under section 443(b) shall not apply. If the short period is 359 days or more, it shall be treated as a full taxable year. If

the short period is six days or less, such short period is not a separate taxable year but shall be added to and deemed a part of the following taxable year. (In the case of a change from or to a 52–53-week taxable year not involving a change of the month with reference to which the taxable year ends, the tax computation under section 443(b) does not apply since the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days, but less than 359 days, taxable income for the short period shall be placed on an annual basis for the purpose of section 443(b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period shall be the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless section 443(b)(2) and paragraph (b)(2) of § 1.443–1, relating to the alternative tax computation, apply). For adjustment in deduction for personal exemption, see section 443(c) and paragraph (b)(1)(v) of § 1.443–1.

(6) The provisions of subparagraph (5) of this paragraph are illustrated by the following examples:

Example (1). A taxpayer having a fiscal year ending April 30 elects for years beginning after April 30, 1955, a 52–53–week taxable year ending on the last Saturday in April. This election involves a short period of 364 days, from May 1, 1955, to April 28, 1956, inclusive. Since this short period is 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

Example (2). Assume the same conditions as in example (1), except that the taxpayer elects for years beginning after April 30, 1955, a taxable year ending on the Tuesday nearest to April 30. This election involves a short period of three days, from May 1 to May 3, 1955. Since this short period is less than seven days, tax is not separately computed for it. This short period is added to and deemed part of the following 52–week taxable year which would otherwise begin on May 4, 1955, and end on May 1, 1956. Thus, that taxable year is deemed to begin on May 1, 1955, and end on May 1, 1956.

(d) **Computation of taxable income.** The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, are generally applicable to 52–53-week taxable years. Thus, items of income and deductions are determined on the basis of a 52–53-week taxable year, except that such items may be determined as though the 52–53-week taxable year were a taxable year consisting of 12 calendar months if such practice is consistently followed by the taxpayer and if income is clearly reflected thereby. In the case of depreciation, unless some other practice is consistently followed, the allowance shall be determined as though the 52–53-week year were a taxable year consisting of 12 calendar months. Amortization deductions for the taxable year shall be determined as though the 52–53-week year were a taxable year consisting of 12 calendar months.

(e) **Partnerships, S corporations, and personal service corporations—(1) In general.** Paragraph (e) of this section applies if a partnership, partner, S corporation, S corporation shareholder, personal service corporation (within the meaning of § 1.441–4T(d)), or employee-owner (within the meaning of § 1.441–4T(h)) uses a 52–53-week taxable year.

(2) **Treatment of taxable years ending with reference to the same calendar month—(i) Timing of partners taking into account partnership items.** If the taxable year of a partnership and a partner end with reference to the same calendar month, then for purposes of determining the taxable year in which a partner takes into account—

(A) Items described in section 702, and

(B) Items that are deductible by the partnership (including items described in section 707(c)) and includible in the income of the partner, the partner's taxable year will be deemed to end on the last day of the partnership's taxable year.

(ii) **Timing of S shareholders taking into account S corporation items.** If the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which a shareholder takes into account—

(A) Items described in section 1366(a), and

(B) Items that are deductible by the S corporation and includible in the income of the shareholder, the shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

(iii) **Personal service corporations and employee-owners.** If the taxable year of a personal service corporation and an employee-owner end with reference to the same calendar month, then for purposes of determining the taxable year in which an employee-owner takes into account items that are deductible by the personal service corporation and includible in the income of the employee-owner, the employee-owner's taxable year will be deemed to end on the last day of the personal service corporation's taxable year.

(3) **Automatic approval for partnerships and S corporations.** If a partnership or S corporation is

required to use a taxable year ending with respect to the last day of a particular month and the partnership or S corporation desires to use a 52–53-week taxable year with reference to such month, the partnership or S corporation is granted automatic approval to use such 52–53-week taxable year. See § 1.441–4T(b)(2)(ii) for a similar rule for personal service corporations.

(4) Examples. The provisions of paragraph (e)(2) of this section may be illustrated by the following examples.

Example (1). ABC Partnership uses a 52–53–week taxable year that ends on the Sunday nearest to December 31, and its partners, A, B, and C, are individual calendar year taxpayers. Assume that, for ABC's taxable year ending January 3, 1988, each partner's distributive share of ABC's taxable income is $10,000. Under section 706(a) and paragraph (e)(2)(i) of this section, for the taxable year ending December 31, 1987, A, B, and C each must include $10,000 in income with respect to the ABC year ending January 3, 1988. Similarly, if ABC makes a guaranteed payment to A on January 2, 1988, A must include the payment in income for his or her taxable year ending December 31, 1987.

Example (2). X, a personal service corporation, uses a 52–53–week taxable year that ends on the Sunday nearest to December 31, and all of the employee-owners of X are individual calendar year taxpayers. Assume that, for its taxable year ending January 3, 1988, X pays a bonus of $10,000 to each employee-owner. Under paragraph (e)(2)(iii) of this section, each employee-owner must include the bonus in income for the taxable year ending December 31, 1987.

(5) Effective date. Paragraph (e) of this section applies to taxable years beginning after December 31, 1986.

(f) Special rules for 1986 and subsequent years. For special rules relating to certain adoptions of, or changes to or from, a 52–53–week taxable year ending in 1986 or 1987, see § 1.441–3T. For special rules relating to a 52–53–week taxable year beginning after December 31, 1986, see § 1.441–2T(e).

[T.D. 6500, 25 FR 11702, Nov. 26, 1960, as amended by T.D. 6845, 30 FR 9739, Aug. 5, 1965; T.D. 8123, 52 FR 3617, Feb. 5, 1987; T.D. 8167, 52 FR 48527, Dec. 23, 1987]

§ 1.441–3T Special rules for certain adoptions of, retentions of, or changes to or from a 52-53-week taxable year (temporary).

(a) Applicability. This section applies to any partnership, partner, S corporation, S corporation shareholder, personal service corporation, or employee-owner that wishes to adopt or change to or from a 52-53-week taxable year. This section also applies to a corporation seeking S status that wishes to adopt, retain, or change to or from a 52-53-week taxable year. This section applies in the case of a change to or from a 52-53-week taxable year whether or not the taxpayer also wishes to change the month with reference to which its taxable year ends. Paragraph (c) (2) of this section applies to any taxpayer (including, for example, a corporation that is not seeking S status) that wishes to adopt or change to or from a 52-53-week taxable year.

(b) Definitions—(1) Personal service corporation. For purposes of this section only, the term "personal service corporation" means any corporation (other than an S corporation) if—

(i) The principal activity of that corporation is the performance of personal services, and

(ii) Such services are substantially performed by employee-owners.

A corporation shall not be treated as a personal service corporation, however, unless more than 10 percent of the fair market value of the outstanding stock of the corporation is held by employee-owners.

(2) Employee-owner. For purposes of this section, the term "employee-owner" means an employee who owns, on any day of the corporation's taxable year, any outstanding stock of the personal service corporation. Section 318 will apply to determine stock ownership for purposes of this paragraph (b), except that "any" is to be substituted for "50 percent or more in value" in section 318(a)(2)(C).

(3) Performance of a substantial portion of services. For purposes of paragraph (b)(1) of this section, personal services are substantially performed by employee-owners if the total time spent by employee-owners in performing those services is 10 percent or more of the total time spent by all employees (including employee-owners) in performing those services. In determining time spent in performing personal services of a corporation, time spent on matters that do not relate directly and intrinsically to the performance of services for or on behalf of clients or customers of the corporation shall not be taken into account. Thus, for example, in the case of a corporation performing accounting services, time spent in performing secretarial services, managerial work of a purely administrative nature, or janitorial services shall not be taken into account in determining either the time spent by employee-owners in performing accounting services or the total time spent by all employees in performing accounting services. Managerial time shall be taken into account, however, to the extent that it consists of the supervi-

sion of accounting services performed by employees for or on behalf of clients or customers of the corporation.

(c) **General rule—(1) Satisfaction of applicable conditions.** A taxpayer to which this section applies may not adopt, retain, or change to or from a 52-53-week taxable year under § 1.441-2(c) (1) or (2), § 1.442-1, or 26 CFR 18.1378-1 unless each of the applicable conditions set forth in paragraph (d) of this section is satisfied with respect to the taxpayer seeking the adoption, retention, or change. For additional requirements applicable to certain taxpayers that wish to adopt, retain, or change to or from a 52-53-week taxable year, see §§ 1.442-2T and 1.442-3T.

(2) **Evasion or avoidance of tax—(i) General rule.** A taxpayer may not adopt or change to or from a 52-53-week taxable year if the principal purpose for such action is the evasion or avoidance of Federal income tax.

(ii) **Example.** The provisions of this paragraph (c)(2) may be illustrated by the following example.

Example. Assume that X, a calendar year corporation, wishes to elect, for taxable years beginning after December 31, 1985, a 52-53-week taxable year that ends on the Tuesday nearest to December 31. Assume that such election allows the corporation to sell a substantial portion of its assets on Wednesday, December 31, 1986, and to report the income from such sale in the taxable year beginning on December 31, 1986, and ending on December 29, 1987. By electing the 52-53-week taxable year, the corporation obtains the advantages of the lower Federal income tax rates applicable for the period beginning December 31, 1986. Moreover, the sale of the assets on December 31 allows the buyer of the assets, a calendar year taxpayer, to obtain certain Federal income tax advantages that are not available with respect to purchases of assets in 1987 and later years. Given the above facts, it is presumed that the principal purpose for such action is the evasion or avoidance of Federal income tax. Thus, X may not adopt a 52-53-week taxable year.

(d) **Conditions applicable to certain taxpayers—(1) Conditions.** (i) If the taxpayer seeking the adoption or change is a partnership, all of the partners (determined at the close of the first taxable year of the partnership for which the election to use the 52-53-week taxable year is made or, if applicable, the short period involved in the change) must agree to treat the current and all subsequent 52-53-week years of the partnership (and of any partner) as ending on the last day of the calendar month that ends nearest to the last day of the 52-53-week year for purposes of determining the taxable year in which the inclusions required by sections 702 and 707(c) are taken into account.

(ii) If the taxpayer seeking the adoption or change is a partner, the partner must agree to treat the current and all subsequent 52-53-week years of the partner (and the 52-53-week years of any partnership in which such taxpayer is a partner) as ending on the last day of the calendar month that ends nearest to the last day of the 52-53-week year for purposes of determining the taxable year in which the inclusions required by sections 702 and 707(c) are taken into account.

(iii) If the taxpayer seeking the adoption, retention, or change is an S corporation or a corporation seeking S status, all of the shareholders (determined at the close of the first taxable year of the S corporation for which the election to use or retain the 52-53-week year is made or, if applicable, the short period involved in the change) must agree to treat the current and all subsequent 52-53-week taxable years of the corporation (and of any shareholder) as ending on the last day of the calendar month that ends nearest to the last day of the 52-53-week year for purposes of determining the taxable year in which the inclusions required by section 1366 are taken into account.

(iv) If the taxpayer seeking the adoption or change is an S corporation shareholder, the shareholder must agree to treat the current and all subsequent 52-53-week taxable years of the shareholder (and the 52-53-week years of any S corporation in which such taxpayer is a shareholder) as ending on the last day of the calendar month that ends nearest to the last day of the 52-53-week year for purposes of determining the taxable year in which the inclusions required by section 1366 are taken into account.

(v) If the taxpayer seeking the adoption or change is a personal service corporation, all of the employee-owners (determined at the close of the first taxable year of the corporation for which the election to use the 52-53-week taxable year is made or, if applicable, the short period involved in the change) must agree to treat the current and all subsequent taxable years of an employee-owner and the corporation that end with or with reference to the same calendar month as if both such taxable years ended on the last day of the taxable year of the corporation for purposes of determining the taxable year in which payments (whether or not in cash) that are deductible by the corporation are taken into account by the employee-owner.

(vi) If the taxpayer seeking the adoption or change is an employee-owner of a personal service corporation, the employee-owner must agree to treat the current and all subsequent taxable years of the employee-owner and the corporation that

end with or with reference to the same calendar month as if both such taxable years ended on the last day of the taxable year of the corporation for purposes of determining the taxable year in which payments (whether or not in cash) that are deductible by the corporation are taken into account by the employee-owner.

(2) **Examples.** The provisions of paragraph (d)(1) of this section may be illustrated by the following examples.

Example (1). Assume that ABC, a calendar year partnership, wishes to elect, for taxable years beginning after December 31, 1985, a 52-53-week taxable year that ends on the Friday nearest to December 31. Assume that A, B, and C, who are individual calendar year taxpayers, are equal partners in ABC. Assume also that A, B, and C agree to treat each of the 52-53-week taxable years of ABC as ending on December 31 for purposes of determining the taxable year in which guaranteed payments and their distributive shares of income, gains, losses, deductions, and credits are taken into account. Assume that, for its taxable year ending January 2, 1987, ABC has net income of $30,000, and that ABC has no other items of income, gain, loss, deduction, or credit for that taxable year. Under paragraph (d)(1)(i) of this section, A, B, and C each must include $10,000 in income for their taxable years ending on December 31, 1986. Similarly, if ABC makes a guaranteed payment to A on January 2, 1987, A must include the payment in income for the taxable year ending December 31, 1986.

Example (2). Assume that X, a calendar year personal service corporation, wishes to elect, for taxable years beginning after December 31, 1985, a 52-53-week taxable year that ends on the Friday nearest to December 31. Assume that all of the employer-owners of X are individual calendar year taxpayers. Assume further that all of the employee-owners agree to treat their taxable year as ending on the last day of X's taxable year for purposes of determining the year in which payments by X are taken into income. Assume that on January 2, 1987, X makes a payment of bonuses of $10,000 to each employee-owner. Under paragraph (d)(1)(v) of this section, each employee-owner must include $10,000 in income for the taxable year ending December 31, 1986.

(e) **Procedural requirements.** In the case of an adoption of or change to a 52-53-week taxable year under § 1.441-2(c) (1) or (2), a taxpayer to which any condition in paragraph (d) of this section applies must indicate on the statement required under § 1.441-2(c) (1) or (2), or on a separate statement that is attached to the income tax return for the year of adoption or change, that all of the applicable conditions are satisfied. If the due date for that return is before March 9, 1987, the statement required under § 1.441-2(c) (1) or (2) (or an amended statement) indicating that the applicable conditions are satisfied must be filed by the later of March 9, 1987 or the due date for the return (determined with regard to extensions). If § 1.442-2T or § 1.442-3T applies to an adoption of, retention of, or change to or from a 52-53-week taxable year, the procedures set forth in § 1.442-2T or § 1.442-3T (whichever is applicable) must be followed and the rules set forth in § 1.442-2T(f)(3) or § 1.442-3T(d) shall apply.

(f) **Effective date—(1) In general.** This section shall apply to adoptions of, retentions of, or changes to or from a 52-53-week taxable year if—

(i) The income tax return for the first taxable year for which the election to use or retain the 52-53-week year is made (or, if applicable, the income tax return for the short period involved in the change) is filed after September 29, 1986, and

(ii) The first taxable year for which the election to use or retain the 52-53-week year is made (or the short period involved in the change) ends before January 5, 1987.

(2) **Exceptions.** This section shall not apply if the application required to effect or request the adoption, retention, or change was timely filed before September 30, 1986. In the case of an adoption or change that is effected by filing an income tax return for the first taxable year for which the election is made, this section shall not apply if an application for extension of time for filing that return was filed before September 30, 1986, the application clearly stated the taxpayer's intention to adopt or change to a 52-53-week taxable year, and the income tax return for that taxable year is timely filed (determined with regard to extensions).

[T.D. 8123, 52 FR 3617, Feb. 5, 1987]

§ 1.441–4T Taxable year of a personal service corporation (temporary).

(a) **Taxable year.** The taxable year of a personal service corporation (as defined in paragraph (d) of this section) is—

(1) The calendar year, or a "short period" (as provided in § 1.441–1T(b)(1)(i)) ending December 31; or

(2) A fiscal year, or a short period (other than a short period provided in paragraph (a)(1) of this section), if the corporation obtains the approval of the Commissioner (in accordance with paragraph (c) of this section) for using such fiscal year.

(b) **Change in taxable year required—(1) In general.** For any taxable year beginning after December 31, 1986, a taxpayer that is a personal service corporation for such taxable year must—

(i) Use a taxable year described in paragraph (a) of this section; or

(ii) Change to such a taxable year by using a short taxable year that ends on the last day of a

taxable year described in paragraph (a) of this section.

(2) **Approval not required for change to a calendar year**—(i) **In general.** A personal service corporation may change its taxable year to the calendar year without the approval of the Commissioner. In such cases, however, the taxpayer should notify the Internal Revenue Service of the change in accordance with the provisions of the applicable revenue procedure. See, for example, section 5.02(1) of Rev.Proc. 87–32, 1987–28 I.R.B. 14.

(ii) **Special rule for 52–53–week taxable year ending with reference to the month of December.** For purposes of this section, a 52–53–week taxable year of a personal service corporation ending with reference to the month of December shall be treated as the calendar year. In order to assist in the processing of the retention or change in taxable year, taxpayers should refer to this special rule by either typing or legibly printing the following statement at the top of page 1 of the income tax return: "FILED UNDER § 1.441–4T(b)(2)(ii)." See § 1.441–2T(e) for special rules regarding 52–53–week taxable years for personal service corporations.

(3) **Examples.** The provisions of paragraph (b) of this section may be illustrated by the following examples.

Example (1). X corporation's last taxable year beginning before January 1, 1987, ends on January 31, 1987. In addition, X is a personal service corporation for its taxable year beginning February 1, 1987, and does not obtain the approval of the Commissioner for using a fiscal year. Thus, under paragraph (b)(1) of this section, X is required to change its taxable year to the calendar year by using a short taxable year that begins on February 1, 1987, and ends on December 31, 1987. Under paragraph (b)(2)(i) of this section, X may change its taxable year without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with section 5.02(1) of Rev.Proc. 87–32.

Example (2). Assume the same facts as in example (1), except that for its taxable year beginning February 1, 1987, X obtains the approval of the Commissioner to change its annual accounting period to a fiscal year ending September 30. Under paragraph (b)(1) of this section, X must file a tax return for the short period from February 1, 1987, through September 30, 1987.

Example (3). Assume the same facts as in example (1), except that the first taxable year for which X is a personal service corporation is the taxable year that begins on February 1, 1990. Thus, for taxable years ending before that date, this section does not apply with respect to X. For its taxable year beginning on February 1, 1990, however, X will be required to comply with paragraph (b) of this section. If X does not obtain the approval of the Commissioner to use a fiscal year, X will be required to change its taxable year to the calendar year by using a short taxable year that ends on December 31, 1990.

Example (4). Assume the same facts as in example (1), except that X desires to change to a 52–53–week taxable year ending with reference to the month of December. Pursuant to paragraphs (b)(2)(i) and (b)(2)(ii) of this section, X may change its taxable year to a 52–53–week taxable year ending with reference to the month of December without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with paragraph (b)(2)(ii) of this section.

(c) **Approval of a fiscal year.** A personal service corporation must establish to the satisfaction of the Commissioner a business purpose for using a fiscal year under paragraph (a)(2) of this section. Business purpose is established to the satisfaction of the Commissioner in the case of a personal service corporation that—

(1) Requests to use, or is using, a fiscal year that coincides with its natural business year, as defined in section 4.01(1) of Rev.Proc. 87–32, or successor revenue procedures, or

(2) Receives permission from the Commissioner to use the fiscal year by establishing a business purpose for the fiscal year under section 6.01 of Rev.Proc. 87–32, or successor revenue procedures. See also Rev.Rul. 87–57, 1987–28 I.R.B. 7. See Announcement 87–82 for modifications to Rev. Proc. 87–32 regarding due dates for personal service corporations filing applications and income tax returns for certain short taxable years beginning after December 31, 1986.

(d) **Personal service corporation for a taxable year**—(1) **In general.** For purposes of this section, a taxpayer is a personal service corporation for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period for the taxable year is the performance of personal services;

(iii) During the testing period for the taxable year, such services are substantially performed by employee-owners; and

(iv) Employee-owners, as defined in paragraph (h) of this section, own (as determined under the attribution rules of section 318, except that "any" shall be substituted for "50 percent" in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period for the taxable year.

(2) **Testing period**—(i) **In general.** Except as otherwise provided in paragraph (d)(2)(ii) of this section, the testing period for a taxable year is the taxable year preceding such taxable year.

(ii) New corporations. The testing period for a taxpayer's first taxable year is the period beginning on the first day of such taxable year and ending on the earlier of—

(A) The last day of such taxable year; or

(B) The last day of the calendar year in which such taxable year begins.

(3) Examples. The provisions of paragraph (d)(2) of this section may be illustrated by the following examples.

Example (1). Corporation A has been in existence since 1980 and has used a January 31 taxable year for all taxable years beginning before 1987. For purposes of determining whether A is a personal service corporation for the taxable year beginning February 1, 1987, A's testing period under paragraph (d)(2)(i) of this section is the taxable year ending January 31, 1987.

Example (2). B corporation's first taxable year begins on June 1, 1987, and B desires to use a September 30 taxable year. However, if B is a personal service corporation, it must obtain the Commissioner's approval to use a September 30 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987 through September 30, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a September 30 taxable year.

Example (3). The facts are the same as in Example (2), except that B desires to use a March 31 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987, through December 31, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a March 31 fiscal year.

(e) Determination of whether an activity during the testing period is treated as the performance of personal services—(1) Activities described in section 448(d)(2)(A). For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in the regulations interpreting section 448) will be treated as the performance of personal services for purposes of this section.

(2) Activities not described in section 448(d)(2)(A). For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(f) Principal activity—(1) General rule. For purposes of this section, the principal activity of a corporation for any testing period will be considered to be the performance of personal services if the cost of the corporation's compensation (the "compensation cost") for such testing period that is attributable to its activities that are treated as the performance of personal services under paragraph (e) of this section exceeds 50 percent of the corporation's total compensation cost for such testing period.

(2) Compensation cost. For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(i) Wages and salaries, and

(ii) Any other amounts attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (h)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation includible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

However, for purposes of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a), or to a simplified employee pension plan defined in section 408(k).

(3) Attribution of compensation cost to personal service activity—(i) Employees involved only in the performance of personal services. The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (e) of this section, or employees involved only in supporting the work of such employees, shall be considered to be attributable to the corporation's personal service activity.

(ii) Employees involved only in activities that are not treated as the performance of personal services. The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (e) of this section, or for employees involved only in supporting the work of such employees, shall not be considered to be attributable to the corporation's personal service activity.

(iii) **Other employees.** The compensation cost for any employee who is not described in either paragraph (f)(3)(i) or paragraph (f)(3)(ii) of this section ("a mixed activity employee") shall be allocated as follows—

(A) Compensation cost attributable to personal service activity. That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity equals the compensation cost for such employee multiplied by the percentage of the total time worked for the corporation by such employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (e) of this section. Such percentage shall be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) Compensation cost not attributable to personal service activity. That portion of the compensation cost for a mixed activity employee that shall not be considered to be attributable to the corporation's personal service activity is the compensation cost for such employee less the amount determined in paragraph (f)(3)(iii)(A) of this section.

(g) **Services substantially performed by employee-owners—(1) General rule.** Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for such period attributable to its activities that are treated as the performance of personal services (within the meaning of paragraph (e) of this section), is attributable to personal services performed by employee-owners.

(2) **Compensation cost attributable to personal services.** For purposes of paragraph (g)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services shall be determined under paragraph (f)(3) of this section; and

(ii) The portion of the amount determined under paragraph (g)(2)(i) of this section that is attributable to personal services performed by employee-owners shall be determined by the taxpayer in any reasonable and consistent manner.

(3) **Examples.** The provisions of paragraph (g) of this section may be illustrated by the following examples.

Example (1). For its taxable year beginning February 1, 1987, Corporation A's testing period is the taxable year ending January 31, 1987. During such testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was $1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was $210,000. Pursuant to paragraph (g)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

Example (2). Corporation B has the same facts as corporation A in example (1), except that during the taxable year ending January 31, 1987, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was $1,500,000 ($1,000,000 attributable to B's personal service activity and $500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was $250,000 ($210,000 attributable to B's personal service activity and $40,000 attributable to B's other activity). Pursuant to paragraph (g)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners ($210,000).

(h) **Employee-owner defined—(1) General rule.** For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period, and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) **Special rule for independent contractors who are owners.** Any person who is an owner of the corporation within the meaning of paragraph (h)(1)(ii) of this section and who performs personal services for or on behalf of the corporation shall be treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that he or she would be considered an independent contractor for other purposes.

(i) **Special rules for affiliated group filing consolidated return—(1) In general.** For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group shall be treated as a single corporation;

(ii) The employees of the members of the affiliated group shall be treated as employees of such single corporation; and

(iii) All of the stock, of the members of the affiliated group, that is not owned by any other member of the affiliated group shall be treated as the outstanding stock of such corporation.

(2) Examples. The provisions of this paragraph (i) may be illustrated by the following examples.

Example (1). The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 1987, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 1987. During the testing period (i.e., the taxable year ending January 31, 1987), A did not perform personal services while B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A while some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (i)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated Federal income tax return. Since the only employee-owners of AB are the employees of B and since B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, (a) its principal activity is the providing of personal services, or (b) the personal services are substantially performed by employee-owners.

Example (2). The facts are the same as in example (1), except that on the last day of the testing period A owns only 80 percent of B. The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is $1,000,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is $5,000 as of the last day of the testing period. Pursuant to paragraph (d)(1)(iv) and paragraph (i)(1) of this section, AB must determine whether the employee-owners of A and B (*i.e.,* B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Since the $14,000 [($100,000.09) + $5,000] fair market value of the stock held by B's employees is greater than 10 percent of the $105,000 ($100,000 + $5,000) aggregate fair market value of A and B as of the last day of the testing period, AB may be subject to this section if, on a consolidated basis during the testing period, (a) the principal activity of AB is the performance of personal services and (b) the personal services are substantially performed by employee-owners.

(j) Effective date. This section applies to taxable years beginning after December 31, 1986.
[T.D. 8167, 52 FR 48528, Dec. 23, 1987]

§ 1.442–1 Change of annual accounting period.

(a) Manner of effecting such change—(1) In general. If a taxpayer wishes to change his annual accounting period (as defined in section 441(c)) and adopt a new taxable year (as defined in section 441(b)), he must obtain prior approval from the Commissioner by application, as provided in paragraph (b) of this section, or the change must be authorized under the Income Tax Regulations. A new taxpayer who adopts an annual accounting period as provided in section 441 and §§ 1.441–1 or 1.441–2 need not secure the permission of the Commissioner under section 442 and this section. However, see subparagraph (2) of this paragraph. For adoption of and changes to or from a 52–53-week taxable year, see section 441(f) and § 1.441–2; for adoption of and changes in the taxable years of partners and partnerships, see paragraph (b)(2) of this section, section 706(b) and paragraph (b) of § 1.706–1; for special rules relating to certain corporations, subsidiary corporations, and newly married couples, see paragraphs (c), (d), and (e), respectively, of this section. For special rules relating to real estate investment trusts, see section 859.

(2) Taxpayers to whom section 441(g) applies. Section 441(g) provides that if a taxpayer keeps no books, does not have an annual accounting period, or has an accounting period which does not meet the requirements for a fiscal year, his taxable year shall be the calendar year. If section 441(g) applies to a taxpayer, the adoption of a fiscal year will be treated as a change in his annual accounting period under section 442. Therefore, such fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. Approval of any such change will be denied unless the taxpayer agrees in his application to establish and maintain accurate records of his taxable income for the short period involved in the change and for the fiscal year proposed. The keeping of records which adequately and clearly reflect income for the taxable year constitutes the keeping of books within the meaning of section 441(g) and paragraph (g) of § 1.441–1.

(b) Prior approval of the Commissioner—(1) In general. In order to secure prior approval of a change of a taxpayer's annual accounting period, the taxpayer must file an application on Form 1128 with the Commissioner of Internal Revenue, Washington, D. C. 20224, to effect the change of accounting period. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period. Approval will not be granted unless the taxpayer and the

Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. In general, a change of annual accounting period will be approved where the taxpayer established a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration will be given to all the facts and circumstances relating to the change, including the tax consequences resulting therefrom. Among the nontax factors that will be considered in determining whether a substantial business purpose has been established is the effect of the change on the taxpayer's annual cycle of business activity. The agreement between the taxpayer and the Commissioner under which the change will be effected shall, in appropriate cases, provide terms, conditions, and adjustments necessary to prevent a substantial distortion of income which otherwise would result from the change. The following are examples of effects of the change which would substantially distort income: (i) Deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one year to another so as to reduce substantially the taxpayer's tax liability; (ii) causing a similar deferral or shifting in the case of any other person, such as a partner, a beneficiary, or a shareholder in an electing small business corporation as defined in section 1371(b); or (iii) creating a short period in which there is either (a) a substantial net operating loss, or (b) in the case of an electing small business corporation, a substantial portion of amounts treated as long-term capital gain. Even though a substantial business purpose is not established, the Commissioner in appropriate cases may permit a husband or wife to change his or her taxable year in order to secure the benefits of section 1(a) (relating to tax in case of a joint return). See paragraph (e) of this section for special rule for newly married couples.

(2) Partnerships and partners. (i) A newly-formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or is the same taxable year to which its principal partners who do not have such taxable year concurrently change) without securing prior approval from the Commissioner. If all its principal partners are not on the same taxable year, a newly-formed partnership may adopt a calendar year without securing prior approval from the Commissioner. If a newly-formed partnership wishes to adopt a taxable year that does not qualify under the preceding two sentences, the adoption of such year requires the prior approval of the Commissioner in accordance with section 706(b)(1) and paragraph (b) of § 1.706–1. An existing partnership may change its taxable year without securing prior approval from the Commissioner if all its principal partners have the same taxable year to which the partnership changes, or if all its principal partners who do not have such a taxable year concurrently change to such taxable year. In any other case, an existing partnership may not change its taxable year unless it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section and section 706(b)(1) and paragraph (b) of § 1.706–1.

(ii) A partner may change his taxable year only if he secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section.

(3) Certain foreign corporations. Application for approval to change such taxable year of either a controlled foreign corporation (as defined in section 957 or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company (as defined in section 552) shall be made by filing an application in accordance with paragraph (b)(1) of this section. The application shall be made by one or more of such controlled foreign corporation's United States shareholders (as defined in section 951(b)), by one or more individuals who comprise a foreign corporation's "United States group" (as defined in section 552(a)(2)), or by the respective corporations. In general, a change of such a taxable year will be approved if the annual accounting period of such controlled foreign corporation or foreign corporation meeting the stock ownership requirements of a foreign personal holding company is changed to conform to the requirements of foreign law or because bona fide foreign business reasons make such a change necessary or desirable and the other applicable provisions of paragraph (b)(1) of this section are satisfied.

(c) Special rule for certain corporations. **(1)** Except as otherwise provided in paragraph (c)(4) and (5) of this section and under section 859, a corporation may change its annual accounting period without the prior approval of the Commissioner if all the conditions in subparagraph (2) of this paragraph are met, and if the corporation files a statement with the district director with whom the returns of the corporation are filed at or before the time (including extension) for filing the return for the short period required by such change. This statement shall indicate that the corporation is changing its annual accounting period under paragraph (c) of this section and shall contain

information indicating that all of the conditions in subparagraph (2) of this paragraph have been met.

(2) The provisions of this paragraph do not apply unless all of the following conditions are met:

(i) The corporation has not changed its annual accounting period at any time within the ten calendar years ending with the calendar year which includes the beginning of the short period required to effect the change of annual accounting period;

(ii) The short period required to effect the change of annual accounting period is not a taxable year in which the corporation has a net operating loss as defined in section 172;

(iii) The taxable income of the corporation for the short period required to effect the change of annual accounting period is, if placed on an annual basis (see paragraph (b)(1)(i) and (ii) of § 1.443–1), 80 percent or more of the taxable income of the corporation for the taxable year immediately preceding such short period;

(iv) If a corporation had a special status either for the short period or for the taxable year immediately preceding such short period, it must have the same special status for both the short period and such taxable year (for the purpose of this subdivision, special status includes only: a personal holding company, a corporation that is an exempt organization, a foreign corporation not engaged in a trade or business within the United States, a Western Hemisphere trade corporation, and a China Trade Act corporation); and

(v) The corporation does not attempt to make an election under section 1372(a) that purports to initially become effective with respect to a taxable year which (a) would immediately follow the short period required to effect the change of annual accounting period, and (b) would begin after August 23, 1972.

(3) If the Commissioner finds upon examination of the returns that the corporation, because of subsequent adjustments in establishing tax liability, did not in fact meet all the conditions in subparagraph (2) of this paragraph, the statement filed under subparagraph (1) of this paragraph shall be considered as a timely application for permission to change the corporation's annual accounting period to the taxable year indicated in the statement.

(4) A corporation which is an electing small business corporation (as defined in section 1371(b)) or a DISC (as defined in section 992(a)(1)) during the short period required to effect the change of annual accounting period may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) of this section. This subparagraph shall apply only if such short period ends after February 28, 1959. See subparagraphs (3)(ii) and (4) of § 1.991–1(b) for special rules relating to the change of a DISC's annual accounting period during 1972.

(5) A controlled foreign corporation (as defined in section 957) or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company (as defined in section 552) may change its taxable year only if it secures the prior approval of the Commissioner in accordance with paragraph (b)(1) and (3) of this section. A controlled foreign corporation or a foreign corporation that meets the stock ownership requirements of a foreign personal holding company that is not subject to United States income tax shall be treated for the purposes of this section as a taxpayer within the meaning of section 7701(a)(14).

(d) **Special rule for change of annual accounting period by subsidiary corporation.** A subsidiary corporation which is required to change its annual accounting period under § 1.1502–76, relating to the taxable year of members of an affiliated group which file a consolidated return, need not file an application on Form 1128 with respect to such change.

(e) **Special rule for newly married couples.** (1) A newly married husband or wife may change his or her annual accounting period in order to adopt the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of such spouse ending after the date of marriage, provided that the newly married husband or wife adopting the annual accounting period of the other spouse files a return for the short period required by such change on or before the 15th day of the 4th month following the close of such short period. See section 443 and the regulations thereunder. (If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be adopted under this paragraph.) The short-period return shall contain a statement that it is filed under authority of this paragraph. For a change of annual accounting period by a husband or wife which does not qualify under this subparagraph, see paragraph (b) of this section.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. H & W marry on September 25, 1956. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 1956. H may not change to a calendar year for 1956 since, under paragraph (e) of § 1.442–1, he would have had to file a return for the short period from July 1 to December 31, 1955, by April 15, 1956. Since the date of marriage occurred subsequent to this due date, the return could not be filed under paragraph (e) of § 1.442–1. Therefore, H cannot change to a calendar year for 1956. However, H may change to a calendar year for 1957 by filing a return under paragraph (e) of § 1.442–1 by April 15, 1957, for the short period from July 1 to December 31, 1956. If H files such a return, H and W may file a joint return for calendar year 1957 (which is W's second taxable year ending after the date of marriage).

(f) **Effective date.** The provisions of this section (other than paragraphs (c)(4) and (e) thereof) are effective for any change of annual accounting period where the last day of the short period required to effect the change ends on or after March 1, 1957. For special rules applicable to certain changes of annual accounting period that result in a short period ending in 1986 or 1987, see § 1.442–2T. For special rules applicable to certain adoptions and retentions of a taxable year ending in 1986 or 1987, see § 1.442–3T.

[T.D. 6500, 25 FR 11703, Nov. 26, 1960, as amended by T.D. 6614, 27 FR 10098, Oct. 13, 1962; T.D. 7235, 37 FR 28624, Dec. 28, 1972; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7286, 38 FR 26911, Sept. 27, 1973; T.D. 7323, 39 FR 34409, Sept. 25, 1974; T.D. 7470, 42 FR 12178, March 3, 1977; T.D. 7767, 45 FR 11265, Feb. 6, 1981; T.D. 7936, 49 FR 2106, Jan. 18, 1984; T.D. 8123, 52 FR 3619, Feb. 5, 1987]

§ 1.442–2T Special limitations on certain changes of annual accounting period (temporary).

(a) **Applicability.** This section applies to any taxpayer that wishes to change its annual accounting period, or that wishes to adopt an annual accounting period described in paragraph (h) of this section. This section shall not apply, however, to:

(1) Any taxpayer to which the provisions of § 1.1502–76 apply (other than a taxpayer to which the provisions of paragraph (h) of this section apply);

(2) Any taxpayer to which the provisions of § 1.442–1(e) apply;

(3) Any taxpayer that wishes to change its annual accounting period to a calendar year (including a change under 26 CFR 18.1378–1(b)) or to a 52-53-week taxable year that ends with reference to the month of December (see, however, § 1.441-3T);

(4) Any partnership that wishes to change its annual accounting period under § 1.706-1(b)(1) to the same taxable year as that of all of its principal partners or to which all of its principal partners are concurrently changing;

(5) Any corporation seeking S status that wishes to change its annual accounting period under section 4.02 of Rev. Proc. 83-25, 1983-1 C.B. 689, to the same taxable year as that of shareholders holding more than 50 percent of the shares of stock of the corporation or to which such shareholders are concurrently changing;

(6) Any corporation seeking S status that wishes to change its annual accounting period under section 4.04 of Rev. Proc. 83-25, 1983-1 C.B. 689;

(7) Any taxpayer that wishes to change to a 52-53-week taxable year that ends with reference to the same calendar month as that in which the former taxable year ended (see, however, § 1.441–3T); or

(8) Any organization exempt under section 501(a), and any plan meeting the requirements for qualification under section 401(a) and which is exempt under section 501 (a), except those organizations and plans required to file a Form 990-T for the short period involved in the change of annual accounting period.

(b) **General rule.** A taxpayer to which this section applies may not change its annual accounting period under the provisions of—

(1) Paragraph (c) of § 1.442-1,

(2) Paragraph (b) of § 1.706-1,

(3) 26 CFR 18.1378-1(b),

(4) Rev. Proc. 72-51, 1972-2 C.B. 832, or

(5) Any revenue procedure issued before September 18, 1986, that, without regard to this section, would permit a taxpayer to change its taxable year either under a procedure that does not require the prior approval of the Commissioner or under expedited procedures for obtaining that approval.

Examples of procedures suspended by paragraph (b)(5) of this section include Rev. Proc. 84-34, 1984-1 C.B. 508, and those portions of Rev. Proc. 83-25, 1983-1 C.B. 689, that apply to changes of annual accounting period. In addition, the Commission will not consider a request by a taxpayer to which this section applies for approval of a

change of annual accounting period under § 1.442-1(b)(1) unless the requirements of paragraph (e) of this section are satisfied. A taxpayer to which this section applies may, however, change its annual accounting period without securing the prior approval of the Commissioner if the taxpayer can establish a substantial business purpose for the change under paragraph (c) of this section and agrees to all of the applicable conditions set forth in paragraph (d) of this section.

(c) Substantial business purpose—(1) General rule. Except as provided in paragraph (c)(4) of this section, a taxpayer generally can establish a substantial business purpose under this paragraph (c) for a change of annual accounting period to any taxable year that meets the requirements of paragraph (c)(2) of this section. If more than one taxable year meets the requirements of paragraph (c)(2), however, a taxpayer can establish a substantial business purpose under this paragraph (c) only for a change to the year that yields the highest percentage when the percentages (rounded to the nearest 1/100 of a percent) obtained under paragraph (c)(2) of this section are averaged.

(2) Mechanical test. A taxable year meets the requirements of this paragraph (c)(2) only if, for the most recent 12-month period (determined at the time the statement or application required to effect or request the change is filed) ending with the last month of the requested taxable year and for each of the two preceding 12-month periods ending with the corresponding month—

(i) The gross receipts from sales or services for the last two months of such 12-month period equal or exceed 25 percent of—

(ii) The gross receipts from sales or services for such 12-month period.

(3) Special rules—(i) Gross receipts. For purposes of this section, gross receipts from sales or services shall be determined using the taxpayer's method of accounting.

(ii) 52-53-week taxable year. If the requested year is a 52-53-week taxable year, the calendar month ending nearest to the last day of the 52-53-week taxable year shall be treated for purposes of paragraph (c)(2) of this section as the last month of the requested year.

(iii) Taxpayers not in existence for three 12-month periods. If a taxpayer has not been in existence for the three 12-month periods described in paragraph (c)(2) of this section, the requirements of paragraph (c)(2) of this section may be satisfied by taking into account the gross receipts from sales and services of a predecessor organization (within the meaning of section 4.04 of Rev. Proc. 83-25) that was actively engaged in a trade or business at all times during the portion of the three applicable 12-month periods prior to the inception of the taxpayer. Thus, a taxpayer in existence for only the most recent applicable 12-month period may use the gross receipts of a predecessor organization for the two preceding 12-month periods.

(4) Exceptions. The following taxpayers cannot establish a substantial business purpose for a change of annual accounting period under this section solely by satisfying the requirements of this paragraph (c), and, thus, must secure the prior approval of the Commissioner to the change:

(i) A partner of a partnership;

(ii) A partnership in which any partner is a partnership or S corporation;

(iii) A beneficiary of a trust or estate;

(iv) A United States shareholder of a controlled foreign corporation; and

(v) A shareholder of a DISC or former DISC.

(5) Examples. The provisions of this paragraph (c) may be illustrated by the following examples.

Example (1). Assume that X, a calendar year corporation that is not described in paragraph (c)(4) of this section, wishes to change its annual accounting period to a fiscal year that ends on November 30. If the change is permitted under this section, the short period involved in the change would end on November 30, 1986. Under paragraph (f) of this section, X must attach a statement to its income tax return for the short period ending November 30, 1986, in order to effect the change. For purposes of paragraph (c)(2) of this section, the most recent 12-month period ending with the last month of the requested taxable year (November), determined as of the time the statement required to effect the change is filed, is the period that begins on December 1, 1985, and ends on November 30, 1986. The two preceding 12-month periods ending with the corresponding month are the periods from December 1, 1984, through November 30, 1985, and from December 1, 1983, through November 30, 1984.

Example (2). Assume that X, a calendar year corporation that is not described in paragraph (c)(4) of this section, wishes to change its annual accounting period to a fiscal year that ends on September 30. Assume that the most recent 12-month period determined under paragraph (c)(2) of this section is the period from October 1, 1985, through September 30, 1986, and that the two preceding 12-month periods are the periods from October 1, 1984, through September 30, 1985, and from October 1, 1983, through September 30, 1984.

Assume that the gross receipts from sales or services for the last two months of the 12-month periods ending on September 30, 1986, September 30, 1985, and September 30, 1984, are $3,500, $3,125, and $2,500, respectively. Assume further that the total gross receipts for the 12-month periods ending on September 30, 1986, September 30, 1985, and September 30,

1984, are $12,500, $12,000, and $10,000, respectively. The following percentages are obtained for the 12-month periods ending on September 30, 1986, September 30, 1985, and September 30, 1984, when the gross receipts for the last two months of each period are divided by the total gross receipts for that 12-month period: 28.00% ($3,500/$12,500), 26.04% ($3,125/$12,000), and 25.00% ($2,500/$10,000). Thus, the requirements of paragraph (c)(2) of this section are satisfied since each of those percentages equals or exceeds 25%.

Example (3). Assume the same facts as in example (2) except that X wishes to change its annual accounting period to a fiscal year that ends on July 31. In addition, assume that the percentages obtained for purposes of paragraph (c)(2) of this section with respect to a fiscal year that ends on July 31 are 26.00%, 25.00%, and 25.00%. Under paragraph (c)(1) of this section, X can establish a substantial business purpose only for a fiscal year that ends on September 30 since the average of the percentages obtained under paragraph (c)(2) of this section with respect to that year (26.35%) exceeds the average of the percentages obtained with respect to a fiscal year that ends on July 31 (25.33%).

(d) **Conditions.** The requirements of this section are in addition to any applicable conditions under sections 441, 442, 443, 706, and 1378. Thus, for example, a taxpayer must annualize income for the short period involved in a change of annual accounting period to which this section applies if required to do so under section 443(b). The following additional conditions apply under this section to any change of annual accounting period made by a corporation (other than an S corporation) without the prior approval of the Commissioner:

(1) If the taxpayer has a net operating loss as defined in section 172 for the short period involved in the change, that net operating loss must be deducted ratably over a six-year period beginning with the first taxable year after the short period unless—

(i) The net operating loss resulting from the short period is $10,000 or less, or

(ii) The net operating loss results from a short period of nine months or longer and is less than the net operating loss for a full 12-month period beginning with the first day of the short period.

(2) If the taxpayer has an unused credit for the short period, the taxpayer must carry the unused credit forward. Unused credits from the short period may not be carried back.

(3) The taxpayer may not make an election to be treated as an S corporation that would be effective for the taxable year immediately following the short period.

(e) **Prior approval of the Commissioner—(1) In general.** The Commissioner will not consider a request for approval to a change of annual accounting period under this section unless—

(i) The taxpayer is described in paragraph (c)(4) of this section and the taxable year to which the taxpayer wishes to change meets the requirements of paragraph (c)(1) of this section, or

(ii) The taxpayer has experienced a substantial acquisition or divestiture, as defined in paragraph (e)(2) of this section.

(2) **Substantial acquisition or divestiture—(i) In general.** For purposes of this paragraph (e), a taxpayer has not experienced a substantial acquisition or divestiture unless—

(A) The taxpayer has acquired or disposed of a block of assets on or after the first day of the taxable year immediately proceeding the short period involved in the change of annual accounting period,

(B) At all times during the applicable 12-month periods (as defined in paragraph (e)(2)(iii) of this section), including any period during which the assets were not held by the taxpayer, the assets were segregated, whether in a separate branch or division or otherwise, so that the gross receipts attributable to those assets can be identified, and

(C) The requirements of paragraph (e)(2)(ii) of this section are satisfied.

If a taxpayer has experienced a substantial acquisition or divestiture it is anticipated that the Commissioner will usually approve a change of annual accounting period to a taxable year that would meet the requirements of paragraph (c)(1) of this section if pro-forma gross receipts (i.e., gross receipts that would have resulted if the acquisition or divestiture had taken place at the beginning of the earliest applicable 12-month period) were substituted for the gross receipts described in paragraph (c)(2) of this section. The failure of a requested taxable year to meet the requirements of paragraph (c)(1) when pro-forma gross receipts are used, however, will not prevent the Commissioner from approving the change.

(ii) **Mechanical test.** A taxpayer has experienced a substantial acquisition or divestiture for purposes of this paragraph (e) only if—

(A) The aggregate of the gross receipts from sales and services (within the meaning of paragraph (c)(3)(i) of this section) for the applicable 12-month periods attributable to the acquired or divested assets (including receipts for any period during which the assets were not held by the taxpayer), exceeds 80 percent of—

(B) The aggregate of the gross receipts from sales and services (within the meaning of paragraph (c)(3)(i) of this section) of the taxpayer for the applicable 12-month periods, determined without taking into account the gross receipts from sales and services attributable to the acquired or divested assets.

(iii) Applicable 12-month periods. For purposes of this paragraph (e)(2), the term "applicable 12-month periods" means—

(A) In the case of an acquisition, the 12-month period described in paragraph (c)(2) of the section; and

(B) In the case of divestiture, the 12-month periods described in paragraph (c)(2) of this section that end before the date of the divestiture.

(iv) Example. The provisions of this paragraph (e) may be illustrated by the following example.

Example. Assume that X, a calendar year corporation, wishes to change its annual accounting period to a fiscal year ending October 31, 1986. Assume that on January 1, 1986, X acquired from corporation Y a block of assets that Y held in a separate division and that X also holds in a separate division. Assume that the most recent 12-month period described in paragraph (c)(2) of this section is the period that begins on November 1, 1985, and ends on October 31, 1986, and that the two preceding 12-month periods are the periods from November 1, 1984 through October 31, 1985, and from November 1, 1983, through October 31, 1984. Assume that the gross receipts attributable to the assets acquired from Y for the 12-month period ending October 31, 1986 (including the receipts attributable to the period from November 1, 1985, through December 31, 1985, when the assets were held by Y, and the receipts attributable to the period from January 1, 1986, through October 31, 1986, when the assets were held by X), are $8,000. In addition, assume that the gross receipts attributable to the assets acquired from Y for the 12-month periods ending October 31, 1985, and October 31, 1984, when the assets were held by Y, are $7,500, and $7,000, respectively. Assume further that X's gross receipts from sales and services for the 12-month period ending October 31, 1986, October 31, 1985, and October 31, 1984, without taking into account gross receipts attributable to the assets acquired from Y, are $10,000, $9,000, and $8,000, respectively. The requirements of paragraph (e)(2)(ii) of this section are satisfied since $22,500 ($8,000 + $7,500 + $7,000) exceeds 80 percent of $27,000 ($10,00 + $9,000 + $8,000). Thus, the Commissioner will consider X's request to change its taxable year to a fiscal year ending October 31, 1986.

(f) Procedures—(1) Changes not requiring the prior approval of the Commissioner. In order to effect a change that does not require the prior approval of the Commissioner under this section, a taxpayer must indicate that the requirements of this section are satisfied in a statement setting forth the computations required to establish a substantial business purpose under paragraph (c) of this section. The statement also must indicate that the taxpayer has agreed to all of the applicable conditions to the change, including any applicable conditions contained in § 1.441-3T. A taxpayer (other than an corporations seeking S status) must attach the statement to the income tax return for the short period involved in the change and, in addition, must type or legibly print the following caption at the top of page 1 of the return; "FILED UNDER § 1.442-2T (f)(1)." In the case of a corporation seeking S status, the statement must be attached to Form 2553 and the caption "FILED UNDER § 1.442-2T (f) (1)" must be typed or printed legibly at the top of page 1 of Form 2553.

(2) Changes requiring the prior approval of the Commissioner. In the case of a change of annual accounting period that requires the prior approval of the Commissioner under this section, a taxpayer must file Form 1128 or Form 2553, whichever is applicable. (See paragraph (e)(1) of this section for situations in which a request for approval will be considered.) The taxpayer must indicate that the application is filed under this paragraph (f)(2) by typing or printing legibly the following caption at the top of page 1 of the Form 1128 or Form 2553: "FILED UNDER § 1.442-2T (f)(2)." The taxpayer also must attach a statement to the applicable form setting forth the computations described in paragraph (c) of this section. In addition, a taxpayer described in paragraph (e)(1) (ii) of this section must attach a statement setting forth the computations described in paragraph (e) (2) of this section.

(3) Time for filing. (i) Except as otherwise provided in paragraph (f)(3) (ii) of this section, a taxpayer cannot change its annual accounting period under this section unless the return or form required to effect or request the change is filed by its due date (with extensions if the change is effected by filing an income tax return for the short period involved in the change).

(ii) A taxpayer may change its annual accounting period under this section if the due date (without regard to extensions) for the return or form required to effect or request the change is on or after September 30, 1986, and before March 9, 1987 and the return or form is filed before March 9, 1987 (or, in the case of a change effected by filing an income tax return for the short period involved in the change, if an application for extension is filed before March 9, 1987. This paragraph only extends the time for changing an annual accounting period and does not extend the time for making a S election. An S election that is timely filed before March 9, 1987, however, will not be denied or rendered ineffective solely by

reason of the need for the taxpayer to submit the information required by paragraph (f)(1) or (f)(2) of this section.

(iii) In the case of a change of annual accounting period under this section that is effected by filing an income tax return for the short period involved in the change, any failure to file a return or to pay tax on or before the due date for the return or the date prescribed for payment will be treated as due to reasonable cause and will not give rise to any addition to tax under section 6651 if—

(A) The due date for the return (without regard to extensions) or the date prescribed for payment is on or after September 30, 1986, and before March 9, 1987, and

(B) The return (or application for extension) is filed and the tax is paid before March 9, 1987.

(g) Effective date—(1) In general. This section shall apply to a change of annual accounting period (other than a change described in paragraph (g)(2) of this section) if—

(i) The income tax return for the short period involved in the change is filed after September 29, 1986, and

(ii) The short period involved in the change ends before January 5, 1987.

(2) Exceptions. This section shall not apply to a change of annual accounting period if the application required to effect or request the change was timely filed before September 30, 1986. In the case of a change that is effected by filing an income tax return for the short period involved in the change, this section shall not apply if an application for extension to file that return was filed before September 30, 1986, the application clearly stated the year to which the taxpayer intended to change, and the income tax return for the short period is timely filed (determined with regard to extensions).

(3) Hardship rule. A taxpayer can request a waiver from the provisions of this section if the taxpayer can demonstrate, to the satisfaction of the Commissioner, that the taxpayer would sustain a substantial hardship from the application of this section, and if the short period involved in the change ends on or before October 5, 1986. A waiver ordinarily will not be granted unless the taxpayer can show that, by October 5, 1986, the taxpayer had closed its books in a manner that indicates that the period in question was intended to be the end of the short period, taken a physical inventory (if applicable), and incurred substantial costs in modifying its accounting systems (including,) for example, costs of reprogramming applicable computer systems) in order to change its year. A request for a waiver under this paragraph (g)(3) must be filed with the Commissioner of Internal Revenue, 1111 Constitution Avenue, NW, Room 5040, Washington, DC 20224 by March 9, 1987. Any information submitted with the request for waiver shall be submitted under penalties of perjury.

(h) Anti-abuse rule—(1) In general. A taxpayer may not adopt any taxable year that has the effect of circumventing the provisions of this section. The provisions of this section are deemed to be circumvented if, for example, a taxpayer that is unable to change its taxable year under this section transfers a substantial portion of its net assets to a related person and the related person purportedly adopts the desired taxable year. In that case, purported adoption of the desired taxable year will not be given effect and the related person must adopt the same taxable year as that of the taxpayer that is unable to change its taxable year under this section. For this purpose, the term "related person" has the same meaning as in section 168(e)(4)(D) (as in effect prior to the enactment of the Tax Reform Act of 1986), except that the second sentence thereof (relating to the substitution of 10 percent for 50 percent in applying sections 267(b) and 707(b)(1)) shall be disregarded.

(2) Example. The provisions of paragraph (h)(1) of this section may be illustrated with the following example.

Example. Assume that X, a calendar year corporation, is subject to the restrictions on changes in annual accounting period under this section. Assume that X wishes to change its taxable year to a fiscal year ending November 30, 1986, but cannot do so because it does not meet the requirements of this section. Assume further that X creates corporation Y, a wholly-owned subsidiary of X, which purportedly adopts a taxable year ending November 30, 1986. In addition, assume that X transfers a substantial portion of its net assets to Y before November 30, 1986, in a transaction described in section 351 or 368. Under these facts, Y may not adopt a November 30 taxable year and instead must adopt a taxable year that ends on December 31, which is the taxable year of X.

[T.D. 8123, 52 FR 3619, Feb. 5, 1987]

§ 1.442–3T Special limitations on certain adoptions and retentions of a taxable year (temporary).

(a) Applicability. This section generally applies to—

(1) Any partnership that wishes to adopt a taxable year other than the calendar year, the

taxable year of its principal partners, or the taxable year to which all of its principal partners are concurrently changing, and

(2) Any corporation seeking S status that wishes to adopt or retain a taxable year other than the calendar year or a taxable year that meets the requirements of § 4.02 or 4.04 of Rev. Proc. 83-25, 1983-1 C.B. 689.

(b) General rule. A taxpayer to which this section applies may not adopt or retain a taxable year that results in any deferral of income to its partners or shareholders unless the taxpayer—

(1) Secures the prior approval of the Commissioner by establishing a substantial business purpose under paragraph (c)(2) of this section for the adoption or retention, or

(2) Is permitted to adopt or retain the taxable year without securing the prior approval of the Commissioner under paragraph (c)(1) of this section.

Thus, a taxpayer to which this section applies may not adopt or retain a taxable year that results in a deferral of income to its partners or shareholders under Rev. Proc. 72-51, 1972-2 C.B. 832, or § 4.03 of Rev. Proc. 83-25, 1983-1 C.B. 689.

(c) Substantial business purpose—(1) Prior approval of the Commissioner not needed. Notwithstanding § 1.706-1(b), § 1.442-1(b)(2), and 26 CFR 18.1378-1(a), a taxpayer to which this section applies may adopt or retain a taxable year that results in a deferral of income to its partners or shareholders without the prior approval of the Commissioner if the taxpayer can establish a substantial business purpose under § 1.442-2T(c). Thus, a taxpayer described in § 1.442-2T(c)(4) must secure the prior approval of the Commissioner to the adoption or retention even if the requirements of § 1.442-2T(c)(1) are satisfied. A taxpayer shall effect an adoption or retention permitted under this paragraph (c)(1) in the manner prescribed by § 1.442-2T(f)(1), except that the taxpayer's first income tax return shall be treated as the return for the short period involved in a change of annual accounting period.

(2) Prior approval of the Commissioner. In any case where the taxpayer was in existence for the three 12-month periods described in § 1.442-2T(c)(2), or where a predecessor organization (within the meaning of § 4.04 of Rev. Proc. 83-25) was actively engaged in a trade or business at all times during the portion of those three 12-month periods prior to the inception of the taxpayer, the Commissioner will consider a request for prior approval of an adoption or retention of a taxable year that results in a deferral of income to its partners or shareholders only if the taxpayer is described in § 1.442-2T(e). In such a case, the application for approval shall be filed in the manner prescribed by § 1.442-2T(f)(2). In any other case, the taxpayer must establish a substantial business purpose in order to obtain the prior approval of the Commissioner, and must file an application for approval in accordance with § 1.706-1(b) or 26 CFR 18.1378-1(a) (whichever is applicable) and § 1.442-1T(b)(1). For this purpose, the following factors generally will not be sufficient to establish a substantial business purpose:

(i) The use of a particular year for regulatory or financial accounting purposes;

(ii) The hiring patterns of a particular business (e.g., the fact that a firm typically hires staff during certain times of the year);

(iii) The use of a particular year for administrative purposes, such as for the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement arrangements with staff, partners, or shareholders; and

(iv) The fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis.

(d) Time for filing. (1) Except as otherwise provided in paragraph (d)(2) of this section, a taxpayer cannot adopt or retain a taxable year under this section unless the return or form required to effect or request the adoption or retention is filed by its due date (with extensions if the adoption is effected by filing an income tax return for the taxpayer's first taxable year).

(2) A taxpayer may adopt or retain a taxable year under this section if the due date (without regard to extensions) for the return or form required to effect or request the adoption or retention is on or after November 6, 1986, and before March 9, 1987, and the return or form is filed before March 9, 1987 (or, in the case of an adoption effected by filing an income tax return for the taxpayer's first taxable year, if an application for extension is filed before March 9, 1987). This paragraph (d)(2) only extends the time for adopting or retaining a taxable year and does not extend the time for making an S election. An S election that is timely filed before March 9, 1987, however, will not be denied or rendered ineffective solely by reason of the need for the taxpayer to

submit the information required by paragraph (c) of this section.

(3) In the case of an adoption or retention of a taxable year under this section that is effected by filing an income tax return for the taxpayer's first taxable year, any failure to file a return or to pay tax on or before the due date for the return or the date prescribed for payment will be treated as due to reasonable cause and will not give rise to any addition to tax under section 6651 if—

(i) The due date for the return (without regard to extensions) or the date prescribed for payment is on or after November 6, 1986, and before March 9, 1987, and

(ii) The return (or application for extension) is filed and the tax is paid before March 9, 1987.

(e) **Effective date.** This section generally applies if the first taxable year of the partnership or the first taxable year for which the election to be an S corporation is effective begins before January 1, 1987, unless the application necessary to effect or request the adoption or retention was timely filed before November 6, 1986. This section shall not apply, however, to an adoption by a partnership of a taxable year that begins before January 1, 1986.

[T.D. 8123, 52 FR 3622, Feb. 5, 1987]

§ 1.443–1 Returns for periods of less than 12 months.

(a) **Returns for short period.** A return for a short period, that is, for a taxable year consisting of a period of less than 12 months, shall be made under any of the following circumstances:

(1) **Change of annual accounting period.** In the case of a change in the annual accounting period of a taxpayer, a separate return must be filed for the short period of less than 12 months beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year. However, such a return is not required for a short period of six days or less, or 359 days or more, resulting from a change from or to a 52–53-week taxable year. See section 441(f) and § 1.441–2. The computation of the tax for a short period required to effect a change of annual accounting period is described in paragraph (b) of this section. In general, a return for a short period resulting from a change of annual accounting period shall be filed and the tax paid within the time prescribed for filing a return for a tax day of the short period. For rules applicable to a subsidiary corporation which becomes a member of an affiliated group which files a consolidated return, see § 1.1502–76.

(2) **Taxpayer not in existence for entire taxable year.** If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a corporation organized on August 1 and adopting the calendar year as its annual accounting period is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, a dissolving corporation which files its returns for the calendar year is required to file a return for the short period from January 1 to the date it goes out of existence. Income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year, and, in the case of a taxpayer other than a corporation, the deduction under section 151 for personal exemptions (or deductions in lieu thereof) need not be reduced under section 443(c). In general, the requirements with respect to the filing of returns and the payment of tax for a short period where the taxpayer has not been in existence for the entire taxable year are the same as for the filing of a return and the payment of tax for a taxable year of 12 months ending on the last day of the short period. Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year.

(b) **Computation of tax for short period on change of annual accounting period—(1) General rule.** (i) If a return is made for a short period resulting from a change of annual accounting period, the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. Unless section 443(b)(2) and subparagraph (2) of this paragraph apply, the tax for the short period shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(ii) If a return is made for a short period of more than 6 days, but less than 359 days, resulting from a change from or to a 52–53-week taxable year, the taxable income for the short period shall be annualized and the tax computed on a daily basis, as provided in section 441(f)(2)(B)(iii) and paragraph (c)(5) of § 1.441–2.

(iii) For method of computation of income for a short period in the case of a subsidiary corporation required to change its annual accounting period to conform to that of its parent, see § 1.1502–76(b).

(iv) An individual taxpayer making a return for a short period resulting from a change of annual accounting period is not allowed to take the standard deduction provided in section 141 in computing his taxable income for the short period. See section 142(b)(3).

(v) In computing the taxable income of a taxpayer other than a corporation for a short period (which income is to be annualized in order to determine the tax under section 443(b)(1)) the personal exemptions allowed individuals under section 151 (and any deductions allowed other taxpayers in lieu thereof, such as the deduction under section 642(b)) shall be reduced to an amount which bears the same ratio to the full amount of the exemptions as the number of months in the short period bears to 12. In the case of the taxable income for a short period resulting from a change from or to a 52–53-week taxable year to which section 441(f)(2)(B)(iii) applies, the computation required by the preceding sentence shall be made on a daily basis, that is, the deduction for personal exemptions (or any deduction in lieu thereof) shall be reduced to an amount which bears the same ratio to the full deduction as the number of days in the short period bears to 365.

(vi) If the amount of a credit against the tax (for example, the credits allowable under section 34 (for dividends received on or before December 31, 1964), and 35 (for partially tax-exempt interest)) is dependent upon the amount of any item of income or deduction, such credit shall be computed upon the amount of the item annualized separately in accordance with the foregoing rules. The credit so computed shall be treated as a credit against the tax computed on the basis of the annualized taxable income. In any case in which a limitation on the amount of a credit is based upon taxable income, taxable income shall mean the taxable income computed on the annualized basis.

(vii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A taxpayer with one dependent who has been granted permission under section 442 to change his annual accounting period files a return for the short period of 10 months ending October 31, 1956. He has income and deductions as follows:

Income			
Interest income			$10,000.00
Partially tax-exempt interest with respect to which a credit is allowable under section 35			500.00
Dividends to which sections 34 and 116 are applicable			750.00
			11,250.00
Deductions			
Real estate taxes			200.00
2 personal exemptions at $600 on an annual basis			1,200.00
The tax for the 10-month period is computed as follows:			
Total income as above			11,250.00
Less:			
Exclusion for dividends received		$50.00	
2 personal exemptions ($1,200 × 10/12)		1,000.00	
Real estate taxes		200.00	
			1,250.00
Taxable income for 10-month period before annualizing			10,000.00
Taxable income annualized (10,000 × 12/10)			12,000.00
Tax on $12,000 before credits			3,400.00
Deduct credits:			
Dividends received for 10-month period	$750.00		
Less: Excluded portion	50.00		
Included in gross income	700.00		
Dividend income annualized ($700 × 12/10)	840.00		
Credit (4 percent of $840)		33.60	
Partially tax-exempt interest included in gross income for 10-month period	500.00		
Partially tax-exempt interest (annualized) ($500 × 12/10)	600.00		
Credit (3 percent of $600)		18.00	
			51.60
Tax on $12,000 (after credits)			3,348.40
Tax for 10-month period ($3,348.40 × 10/12)			2,790.33

Example (2). The X Corporation makes a return for the one-month period ending September 30, 1956, because of a change in annual accounting period permitted under section 442. Income and expenses for the short period are as follows:

Gross operating income	$126,000
Business expenses	130,000
Net loss from operations	(4,000)
Dividends received from taxable domestic corporations	30,000
Gross income for short period before annualizing	26,000
Dividends received deduction (85 percent of $30,000, but not in excess of 85 percent of $26,000)	22,100
Taxable income for short period before annualizing	3,900
Taxable income annualized ($3,900 × 12)	46,800

Tax on annual basis:

$46,800 at 52 percent	$24,336	
Less surtax exemption	5,500	
		$18,836
Tax for 1-month period ($18,836 × 1/12)		1,570

Example (3). The Y Corporation makes a return for the six-month period ending June 30, 1957, because of a change in annual accounting period permitted under section 442. Income for the short period is as follows:

Taxable income exclusive of net long-term capital gain		$40,000
Net long-term capital gain		10,000
Taxable income for short period before annualizing		50,000
Taxable income annualized ($50,000 × 12/6)		100,000
Regular tax computation		
Taxable income annualized		100,000
Tax on annual basis:		
$100,000 at 52 percent	$52,000	
Less surtax exemption	5,500	
		46,500
Tax for 6-month period ($46,500 × 6/12)		23,250
Alternative tax computation		
Taxable income annualized		100,000
Less annualized capital gain ($10,000 × 12/6)		20,000
Annualized taxable income subject to partial tax		80,000
Partial tax on annual basis		
$60,000 at 52 percent	$41,600	
Less surtax exemption	5,500	
		36,100
25 percent of annualized capital gain ($20,000)		5,000
Alternative tax on annual basis		41,100
Alternative tax for 6-month period ($41,100 × 6/12)		20,550

Since the alternative tax of $20,550 is less than the tax computed in the regular manner ($23,250), the corporation's tax for the 6-month short period is $20,550.

(2) Exception: computation based on 12-month period. (i) A taxpayer whose tax would otherwise be computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year) for the short period resulting from a change of annual accounting period may apply to the district director to have his tax computed under the provisions of section 443(b)(2) and this subparagraph. If such application is made, as provided in subdivision (v) of this subparagraph, and if the taxpayer establishes the amount of his taxable income for the 12-month period described in subdivision (ii) of this subparagraph, then the tax for the short period shall be the greater of the following—

(a) An amount which bears the same ratio to the tax computed on the taxable income which the taxpayer has established for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for such 12-month period; or

(b) The tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

However, if the tax computed under section 443(b)(2) and this subparagraph is not less than the tax for the short period computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year), then section 443(b)(2) and this subparagraph do not apply.

(ii) The term "12-month period" referred to in subdivision (i) of this subparagraph means the 12-month period beginning on the first day of the short period. However, if the taxpayer is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has disposed of substantially all of its assets before the end of such 12-month period, the term "12-month period" means the 12-month period ending at the close of the last day of the short period. For the purposes of the preceding sentence, a corporation which has ceased business and distributed so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, will be considered to have disposed of substantially all of its assets. In the case of a change from a 52–53-week taxable year, the term "12-month period" means the period of 52 or 53 weeks (depending on the taxpayer's 52–53-week taxable year) beginning on the first day of the short period.

(iii)(a) The taxable income for the 12-month period is computed under the same provisions of law as are applicable to the short period and is computed as if the 12-month period were an actual annual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, his taxable income for the 12-month period shall include his distributive share of partnership income for any taxable year of the partnership ending within or with such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending before or after such 12-month period. If any other item partially applicable to such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period in such manner as will most clearly reflect income for the 12-month period.

(b) In the case of a taxpayer permitted or required to use inventories, the cost of goods sold during a part of the 12-month period included in a taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such part of the 12-month period is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation engaged in the sale of merchandise, which has a short period from January 1, 1956, to September 30, 1956, is the calendar year 1956. The three-month period, October 1, 1956, to December 31, 1956, is part of the taxpayer's taxable year ending September 30, 1957. The cost of goods sold during the three-month period, October 1, 1956, to December 31, 1956, is such part of the cost of goods sold during the entire fiscal year ending September 30, 1957, as the gross receipts from sales for such three-month period are of the gross receipts from sales for the entire fiscal year.

(c) The Commissioner may, in granting permission to a taxpayer to change his annual accounting period, require, as a condition to permitting the change, that the taxpayer must take a closing inventory upon the last day of the 12-month period if he wishes to obtain the benefits of section 443(b)(2). Such closing inventory will be used only for the purposes of section 443(b)(2), and the taxpayer will not be required to use such inventory in computing the taxable income for the taxable year in which such inventory is taken.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). The taxpayer in example (1) under paragraph (b)(1)(vii) of this section establishes his taxable income for the 12-month period from January 1, 1956, to December 31, 1956. The taxpayer has a short period of 10 months, from January 1, 1956, to October 31, 1956. The taxpayer files an application in accordance with subdivision (v) of this subparagraph to compute his tax under section 443(b)(2). The taxpayer's income and deductions for the 12-month period, as so established, follow:

Income

Interest income	$11,000
Partially tax-exempt interest with respect to which a credit is allowable under section 35	600
Dividends to which sections 34 and 116 are applicable	850
	12,450

Deductions

Real estate taxes	200
2 personal exemptions at $600	1,200

Tax computation for short period under section 443(b)(2)(A)(i)

Total income as above		$12,450
Less:		
Deductions		
Exclusion for dividends received	$50	
Personal exemptions	1,200	
Deduction for taxes	200	
		1,450
Taxable income for 12-month period		11,000
Tax before credits		3,020
Credit for partially tax-exempt interest (3 percent of $600)	18	
Credit for dividends received (4 percent of ($850–50))	32	
		50
Tax under section 443(b)(2)(A)(i) for 12-month period		2,970
Taxable income for 10-month short period from example (1) of paragraph (b)(1)(vii) of this section before annualizing		10,000
Tax for short period under section 443(b)(2)(A)(i) ($2,970 × $10,000 (taxable income for short period)/$11,000 (taxable income for 12-month period))		2,700

Tax computation for short period under section 443(b)(2)(A)(ii)

Total income for 10-month short period		$11,250
Less:		
Exclusion for dividends received	50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	15	
Dividends received (4 percent of ($750 – 50))	28	
		43
Tax for short period under section 443(b)(2)(A)(ii)		2,529

The tax of $2,700 computed under section 443(b)(2)(A)(i) is greater than the tax of $2,529, computed under section 443(b)(2)(A)(ii), and is, therefore, the tax under section 443(b)(2). Since the tax of $2,700 (computed under section 443(b)(2)) is less than the tax of $2,790.33 (computed under section 443(b)(1)) on the annualized income of the short period (see example (1) of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,700.

Example (2). Assume the same facts as in example (1) of this subdivision, except that, during the month of November 1956, the taxpayer suffered a casualty loss of $5,000. The tax computation for the short period under section 443(b)(2) would be as follows:

Tax computation for short period under section 443(b)(2)(A)(i)

Taxable income for 12-month period from example (1)		$11,000
Less: Casualty loss		5,000
Taxable income for 12-month period		6,000
Tax before credits	$1,360	
Credits from example (1)	50	

Tax under section 443(b)(2)(A)(i) for 12-month period	1,310	
Tax for short period ($1,310 × $10,000/$6,000) under section 443(b)(2)(A)(i)	2,183	

Tax computotion for short period under section 443(b)(2)(A)(ii)

Total income for the short period	11,250	
Less:		
Exclusion for dividends received	50	
2 personal exemptions	1,200	
Real estate taxes	200	
		1,450
Taxable income for short period without annualizing and without proration of personal exemptions		$9,800
Tax before credits		2,572
Less credits:		
Partially tax-exempt interest (3 percent of $500)	15	
Dividends received (4 percent of ($750 − 50))	28	
		43
Tax for short period under section 443(b)(2)(A)(ii)		2,529

The tax of $2,529, computed under section 443(b)(2)(A)(ii) is greater than the tax of $2,183 computed under section 443(b)(2)(A)(i) and is, therefore, the tax under section 443(b)(2). Since this tax is less than the tax of $2,790.33, computed under section 443(b)(1) (see example (1) of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is $2,529.

(v)(a) A taxpayer who wishes to compute his tax for a short period resulting from a change of annual accounting period under section 443(b)(2) must make an application therefor. Except as provided in (b) of this subdivision, the taxpayer shall first file his return for the short period and compute his tax under section 443(b)(1). The application for the benefits of section 443(b)(2) shall subsequently be made in the form of a claim for credit or refund. The claim shall set forth the computation of the taxable income and the tax thereon for the 12-month period and must be filed not later than the time (including extensions) prescribed for filing the return for the taxpayer's first taxable year which ends on or after the day which is 12 months after the beginning of the short period. For example, assume that a taxpayer changes his annual accounting period from the calendar year to a fiscal year ending September 30, and files a return for the short period from January 1, 1956, to September 30, 1956. His application for the benefits of section 443(b)(2) must be filed not later than the time prescribed for filing his return for his first taxable year which ends on or after the last day of December 1956, the twelfth month after the beginning of the short period. Thus, the taxpayer must file his application not later than the time prescribed for filing the return for his fiscal year ending September 30, 1957. If he obtains an extension of time for filing the return for such fiscal year, he may file his application during the period of such extension. If the district director determines that the taxpayer has established the amount of his taxable income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 443(b)(2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

(b) If at the time the return for the short period is filed, the taxpayer is able to determine that the 12-month period ending with the close of the short period (see section 443(b)(2)(B)(ii) and subparagraph (2)(ii) of this paragraph) will be used in the computations under section 443(b)(2), then the tax on the return for the short period may be determined under the provisions of section 443(b)(2). In such case, a return covering the 12-month period shall be attached to the return for the short period as a part thereof, and the return and attachment will then be considered as an application for the benefits of section 443(b)(2).

(c) Adjustment in deduction for personal exemption. For adjustment in the deduction for personal exemptions in computing the tax for a short period resulting from a change of annual accounting period under section 443(b)(1) (or under section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52–53-week taxable year), see paragraph (b)(1)(v) of this section.

(d) Adjustments in exclusion of computing minimum tax for tax preferences. (1) If a return is made for a short period on account of any of the reasons specified in subsection (a) of section 443, the $30,000 amount specified in section 56 (relating to minimum tax for tax preferences), modified as provided by section 58 and the regulations thereunder, shall be reduced to the amount which bears the same ratio to such specified amount as the number of days in the short period bears to 365.

(2) **Example.** The provisions of this paragraph may be illustrated by the following example:

Example. A taxpayer who is an unmarried individual has been granted permission under section 442 to change his annual accounting period files a return for the short period of 4 months ending April 30, 1970. The $30,000 amount specified in section 56 is reduced as follows:

$$(^{120}/_{365}) \times \$30{,}000 = \$9{,}835.89.$$

(e) Cross references. For inapplicability of section 443(b) and paragraph (b) of this section in computing—

(1) Accumulated earnings tax, see section 536 and the regulations thereunder;

(2) Personal holding company tax, see section 546 and the regulations thereunder;

(3) Undistributed foreign personal holding company income, see section 557 and the regulations thereunder;

(4) The taxable income of a regulated investment company, see section 852(b)(2)(E) and the regulations thereunder; and

(5) The taxable income of a real estate investment trust, see section 857(b)(2)(C) and the regulations thereunder.

[T.D. 6500, 25 F.R. 11705, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4093, April 28, 1962; T.D. 6777, 29 FR 17808, Dec. 16, 1964; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7564, 43 FR 40494, Sept. 12, 1978; T.D. 7575, 43 FR 58816, Dec. 18, 1978; T.D. 7767, 45 FR 11265, Feb. 6, 1981]

§ 1.444–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 444.

[T.D. 8208, 53 FR 19693, May 27, 1988]

§ 1.444–1T Election to use a taxable year other than the required taxable year (temporary).

(a) General rules—(1) Year other than required year. Except as otherwise provided in this section and § 1.444-2T, a partnership, S corporation, or personal service corporation (as defined in § 1.441-4T(d)) may make or continue an election (a "section 444 election") to have a taxable year other than its required taxable year. See paragraph (b) of this section for limitations on the taxable year that may be elected. See § 1.444-2T for rules that generally prohibit a partnership, S corporation, or personal service corporation that is a member of a tiered structure from making or continuing a section 444 election. See § 1.444-3T for rules explaining how and when to make a section 444 election.

(2) Effect of section 444 election—(i) In general. A partnership or S corporation that makes or continues a section 444 election shall file returns and make payments as required by §§ 1.7519-1T and 1.7519-2T. A personal service corporation that makes or continues a section 444 election is subject to the deduction limitation of § 1.280H-1T.

(ii) Duration of section 444 election. A section 444 election shall remain in effect until the election is terminated pursuant to paragraph (a)(5) of this section.

(3) Section 444 election not required for certain years. A partnership, S corporation, or personal service corporation is not required to make a section 444 election to use—

(i) A taxable year for which such entity establishes a business purpose to the satisfaction of the Commissioner (i.e., approved under section 4 or 6 of Rev. Proc. 87-32, 1987-28 I.R.B. 14, or any successor revenue ruling or revenue procedure), or

(ii) A taxable year that is a "grandfathered fiscal year," within the meaning of section 5.01(2) of Rev. Proc. 87-32 or any successor revenue ruling or revenue procedure.

Although a partnership, S corporation or personal service corporation qualifies to use a taxable year described in paragraph (a)(3) (i) or (ii) of this section, such entity may, if otherwise qualified, make a section 444 election to use a different taxable year. Thus, for example, assume that a personal service corporation that historically used a January 31 taxable year established to the satisfaction of the Commissioner, under section 6 of Rev. Proc. 87-32, a business purpose to use a September 30 taxable year for its taxable year beginning February 1, 1987. Pursuant to this paragraph (a)(3), such personal service corporation may use a September 30 taxable year without making a section 444 election. However, the corporation may, if otherwise qualified, make a section 444 election to use a year ending other than September 30 for its taxable year beginning February 1, 1987.

(4) Required taxable year. For purposes of this section, the term "required taxable year" means the taxable year determined under section 706(b), 1378, or 441(i) without taking into account any taxable year which is allowable either—

(i) By reason of business purpose (i.e., approved under section 4 or 6 of Rev. Proc. 87-32 or any successor revenue ruling or procedure), or

(ii) As a "grandfathered fiscal year" within the meaning of section 5.01(2) of Rev. Proc. 87-32, or any successor revenue ruling or procedure.

(5) Termination of section 444 election—(i) In general. A section 444 election is terminated when—

(A) A partnership, S corporation, or personal service corporation changes to its required taxable year; or

(B) A partnership, S corporation, or personal service corporation liquidates (including a deemed liquidation of a partnership under § 1.708-1 (b)(1)(iv)); or

(C) A partnership, S corporation, or personal service corporation willfully fails to comply with the requirements of section 7519 or 280H, whichever is applicable; or

(D) A partnership, S corporation, or personal service corporation becomes a member of a tiered structure (within the meaning of § 1.444-2T), unless it is a partnership or S corporation that meets the same taxable year exception under § 1.444-2T (e); or

(E) An S corporation's S election is terminated; or

(F) A personal service corporation ceases to be a personal service corporation.

However, if a personal service corporation, that has a section 444 election in effect, elects to be an S corporation, the S corporation may continue the section 444 election of the personal service corporation. Similarly, if an S corporation that has a section 444 election in effect terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation. If a section 444 election is terminated under this paragraph (a)(5), the partnership, S corporation, or personal service corporation may not make another section 444 election for any taxable year.

(ii) Effective date of termination. A termination of a section 444 election shall be effective—

(A) In the case of a change to the required year, on the first day of the short year caused by the change;

(B) In the case of a liquidating entity, on the date the liquidation is completed for tax purposes;

(C) In the case of willful failure to comply, on the first day of the taxable year (determined as if a

section 444 election had never been made) determined in the discretion of the District Director;

(D) In the case of membership in a tiered structure, on the first day of the taxable year in which the entity is considered to be a member of a tiered structure, or such other taxable year determined in the discretion of the District Director;

(E) In the case of termination of S status, on the first day of the taxable year for which S status no longer exists;

(F) In the case of a personal service corporation that changes status, on the first day of the taxable year, for which the entity is no longer a personal service corporation.

In the case of a termination under this paragraph (a)(5) that results in a short taxable year, an income tax return is required for the short period. In order to allow the Service to process the affected income tax return in an efficient manner, a partnership, S corporation, or personal service corporation that files such a short period return should type or legibly print at the top of the first page of the income tax return for the short taxable year—"SECTION 444 ELECTION TERMINATED." In addition, a personal service corporation that changes its taxable year to the required taxable year is required to annualize its income for the short period.

(iii) Example. The provisions of paragraph (a)(5)(ii) of this section may be illustrated by the following example.

Example. Assume a partnership that is 100 percent owned, at all times, by calendar year individuals has historically used a June 30 taxable year. Also assume the partnership makes a valid section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. However, for its taxable year beginning July 1, 1988, the partnership changes to a calendar year, its required year. Based on these facts, the partnership's section 444 election is terminated on July 1, 1988, and the partnership must file a short period return for the period July 1, 1988-December 31, 1988. Furthermore, pursuant to § 1.702-3T(a)(1), the partners in such partnership are not entitled to a 4-year spread with respect to partnership items of income and expense for the taxable year beginning July 1, 1988 and ending December 31, 1988.

(iv) Special rule for entity that liquidates or is sold prior to making a section 444 election, required return, or required payment. A partnership, S corporation, or personal service corporation that is liquidated or sold for tax purposes before a section 444 election, required return, or required payment is made for a particular year may, nevertheless, make or continue a section 444 election, if otherwise qualified. (See §§ 1.7519-2T (a)(2) and 1.7519-1T (a)(3), respectively, for a description of the required return and a definition of the term "required payment.") However, the partnership, S corporation, or personal service corporation (or a trustee or agent thereof) must comply with the requirements for making or continuing a section 444 election. Thus, if applicable, required payments must be made and a subsequent claim for refund must be made in accordance with § 1.7519-2T(a)(6). The following examples illustrate the application of this paragraph (a)(5)(iv).

Example (1). Assume an existing S corporation historically used a June 30 taxable year and desires to make a section 444 election for its taxable year beginning July 1, 1987. Assume further that the S corporation is liquidated for tax purposes on February 15, 1988. If otherwise qualified, the S corporation (or a trustee or agent thereof) may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 15, 1988. However, if the S corporation makes a section 444 election, it must comply with the requirements for making a section 444 election, including making required payments.

Example (2). The facts are the same as in example (1), except that instead of liquidating on February 15, 1988, the shareholders of the S corporation sell their stock to a corporation on February 15, 1988. Thus, the corporation's S election is terminated on February 15, 1988. If otherwise qualified, the corporation may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 14, 1988.

Example (3). The facts are the same as in example (2), except that the new shareholders are individuals. Furthermore, the corporation's S election is not terminated. Based on these facts, the S corporation, if otherwise qualified, may make a section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. Furthermore, the S corporation may, if otherwise qualified, continue its section 444 election for subsequent taxable years.

(6) Re-activating certain S elections—(i) Certain corporations electing S status that did not make a back-up calendar year request. If a corporation that timely filed Form 2553, Election by a Small Business Corporation, effective for its first taxable year beginning in 1987—

(A) Requested a fiscal year based on business purpose,

(B) Did not agree to use a calendar year in the event its business purpose request was denied, and

(C) Such business purpose request is denied or withdrawn,

such corporation may retroactively re-activate its S election by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(ii) Certain corporations that revoked their S status. If a corporation that used a fiscal year revoked its S election (pursuant to section 1362(d)(1)) for its first taxable year beginning in 1987, such corporation may retroactively re-activate its S election (i.e. rescind its revocation) by

making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(iii) Procedures for re-activating an S election. A corporation re-activating its S election pursuant to paragraph (a)(6) (i) or (ii) of this section must—

(A) Obtain the consents of all shareholders who have owned stock in the corporation since the first day of the first taxable year of the corporation beginning after December 31, 1986,

(B) Include the following statement at the top of the first page of the corporation's Form 1120S for its first taxable year beginning in 1987—"SECTION 444 ELECTION—RE-ACTIVATES S STATUS," and

(C) Include the following statement with Form 1120S—RE-ACTIVATION CONSENTED TO BY ALL SHAREHOLDERS WHO HAVE OWNED STOCK AT ANY TIME SINCE THE FIRST DAY OF THE FIRST TAXABLE YEAR OF THIS CORPORATION BEGINNING AFTER DECEMBER 31, 1986."

(iv) Examples. The provisions of this paragraph (a)(6) may be illustrated by the following examples.

Example (1). Assume a corporation historically used a June 30 taxable year and such corporation timely filed Form 2553, Election by a Small Business Corporation, to be effective for its taxable year beginning July 1, 1987. On its Form 2553, the corporation requested permission to retain its June 30 taxable year based on business purpose. However, the corporation did not agree to use a calendar year in the event its business purpose request was denied. On April 1, 1988, the Internal Revenue Service notified the corporation that its business purpose request was denied and therefore the corporation's S election was not effective. Pursuant to paragraph (a)(6)(i) of this section, the corporation may re-activate its S election by making a valid section 444 election and complying with the procedures in paragraph (a)(6)(iii) of this section.

Example (2). The facts are the same as in example (1), except that as of July 26, 1988, the Internal Revenue Service has not yet determined whether the corporation has a valid business purpose to retain a June 30 taxable year. Based on these facts, the corporation may, if otherwise qualified, make a back-up section 444 election as provided in § 1.444-3T(b)(4). If the corporation's business purpose request is subsequently denied, the corporation should follow the procedures in §1.444-3T(b)(4)(iii) for activating a back-up section 444 election rather than the procedures provided in this paragraph (a)(6 for re-activating an S election.

Example (3). Assume a corporation has historically been an S corporation with a March 31 taxable year. However, for its taxable year beginning April 1, 1987, the corporation revoked its S election pursuant to section 1362 (d)(1). Pursuant to paragraph (a)(6)(ii) of this section, such corporation may retroactively rescind its S election revocation by making a valid section 444 election for its taxable year beginning April 1, 1987, and complying with the procedures provided in paragraph (a)(6)(iii) of this section. If the corporation retroactively rescinds its S revocation, the corporation shall file a Form 1120S for its taxable year beginning April 1, 1987.

(b) Limitation on taxable years that may be elected—(1) General rule. Except as provided in paragraphs (b)(2) and (3) of this section, a section 444 election may be made only if the deferral period (as defined in paragraph (b)(4) of this section) of the taxable year to be elected is not longer than three months.

(2) Changes in taxable year—(i) In general. In the case of a partnership, S corporation, or personal service corporation changing its taxable year, such entity may make a section 444 election only if the deferral period of the taxable year to be elected is not longer than the shorter of—

(A) Three months, or

(B) The deferral period of the taxable year that is being changed, as defined in paragraph (b)(2)(iii) of this section.

(ii) Special rule for certain existing corporations electing S status. If a corporation with a taxable year other than the calendar year—

(A) Elected after September 18, 1986, and before January 1, 1988, under section 1362 of the Code to be an S corporation, and

(B) Elected to have the calendar year as the taxable year of the S corporation,

then, for taxable years beginning before 1989, paragraph (b)(2)(i) of this section shall be applied by taking into account the deferral period of the last taxable year of the corporation prior to electing to be an S corporation, rather than the deferral period of the taxable year that is being changed. Thus, the provisions of the preceding sentence do not apply to a corporation that elected to be an S corporation for its first taxable year.

(iii) Deferral period of the taxable year that is being changed. For purposes of paragraph (b)(2)(i)(B) of this section, the phrase "deferral period of the taxable year that is being changed" means the deferral period of the taxable year immediately preceding the taxable year for which the taxpayer desires to make a section 444 election. Furthermore, the deferral period of such year will be determined by using the required taxable year of the taxable year for which the taxpayer desires to make a section 444 election. For example, assume P, a partnership that has historically used a March 31 taxable year, desires to change to a September 30 taxable year by making a section 444 election for its taxable year

beginning April 1, 1987. Furthermore, assume that pursuant to paragraph (a)(4) of this section, P's required taxable year for the taxable year beginning April 1, 1987 is a year ending December 31. Based on these facts the deferral period of the taxable year being changed is nine months (the period from March 31 to December 31).

(iv) Examples. See paragraph (d)(1) of this section for examples that illustrate the provisions of this paragraph (b)(2).

(3) Special rule for entities retaining 1986 taxable year. Notwithstanding paragraph (b)(2) of this section, a partnership, S corporation, or personal service corporation may, for its first taxable year beginning after December 31, 1986, if otherwise qualified, make a section 444 election to have a taxable year that is the same as the entity's last taxable year beginning in 1986. See paragraph (d)(2) of this section for examples that illustrate the provisions of this paragraph (b)(3).

(4) Deferral period—(i) Retentions of taxable year. For a partnership, S corporation, or personal service corporation that desires to retain its taxable year by making a section 444 election, the term "deferral period" means the months between the beginning of such year and the close of the first required taxable year (as defined in paragraph (a)(4) of this section). The following example illustrates the application of this paragraph (b)(4)(i).

Example. AB partnership has historically used a taxable year ending July 31. AB desires to retain its July 31 taxable year by making a section 444 election for its taxable year beginning August 1, 1987. Calendar year individuals, A and B, each own 50 percent of the profits and capital of AB; thus, under paragraph (a)(4) of this section AB's required taxable year is the year ending December 31. Pursuant to this paragraph (b)(4)(i), if AB desires to retain its year ending July 31, the deferral period is five months (the months between July 31 and December 31).

(ii) Adoptions of and changes in taxable year—(A) In general. For a partnership, S corporation, or personal service corporation that desires to adopt or change its taxable year by making a section 444 election, the term "deferral period" means the months that occur after the end of the taxable year desired under section 444 and before the close of the required taxable year.

(B) Special rule. If a partnership, S corporation or personal service corporation is using the required taxable year as its taxable year, the deferral period is deemed to be zero.

(C) Examples. The provisions of this paragraph (b)(4)(ii) may be illustrated by the following examples.

Example (1). Assume that CD partnership has historically used the calendar year and that CD's required taxable year is the calendar year. Under the special rule provided in paragraph (b)(4)(ii)(B) of this section, CD's deferral period is zero. See paragraph (b)(2)(i) of this section for rules that preclude CD from making a section 444 election to change its taxable year.

Example (2). E, a newly formed partnership, began operations on December 1, 1987, and is owned by calendar year individuals. E desires to make a section 444 election to adopt a September 30 taxable year. E's required taxable year is December 31. Pursuant to paragraph (b)(4)(ii)(A) of this section E's deferral period for the taxable year beginning December 1, 1987, is three months (the number of months between September 30 and December 31).

Example (3). Assume that F, a personal service corporation, has historically used a June 30 taxable year. F desires to make a section 444 election to change to an August 31 taxable year, effective for its taxable year beginning July 1, 1987. For purposes of determining the availability of a section 444 election for changing to the taxable year ending August 31, the deferral period of an August 31 taxable year is four months (the number of months between August 31 and December 31). The deferral period for F's existing June 30 taxable year is six months (the number of months between June 30 and December 31). Pursuant to § 1.444-1T(b)(2)(i), F may not make a section 444 election to change to an August 31 taxable year.

(5) Miscellaneous rules—(i) Special rule for determining the taxable year of a corporation electing S status. For purposes of this section, and only for purposes of this section, a corporation that elected to be an S corporation for a taxable year beginning in 1987 or 1988 and which elected to be an S corporation prior to September 26, 1988, will not be considered to have adopted or changed its taxable year by virtue of information included on Form 2553, Election by a Small Business Corporation. See example (8) in paragraph (d) of this section.

(ii) Special procedure for cases where an income tax return is superseded—(A) In general. In the case of a partnership, S corporation, or personal service corporation that filed an income tax return for its first taxable year beginning after December 31, 1986, but subsequently makes a section 444 election that would result in a different year end for such taxable year, the income tax return filed pursuant to the section 444 election will supersede the original return. However, any payments of income tax made with respect to such superseded return will be credited to the taxpayer's superseding return and the taxpayer may file a claim for refund for such payments. See examples (5) and (7) in paragraph (d)(2) of this section.

(B) Procedure for superseding return. In order to allow the Service to process the affected income tax returns in an efficient manner, a partnership, S corporation, or personal service corporation that desires to supersede an income tax return in ac-

cordance with paragraph (b)(5)(ii)(A) of this section, should type or legibly print at the top of the first page of the income tax return for the taxable year elected—"SECTION 444 ELECTION—SUPERSEDES PRIOR RETURN."

(iii) Anti-abuse rule—If an existing partnership, S corporation or personal service corporation ("predecessor entities"), or the owners thereof, transfer assets to a related party and the principal purpose of such transfer is to—

(A) Create a deferral period greater than the deferral period of the predecessor entity's taxable year, or

(B) Make a section 444 election following the termination of the predecessor entity's section 444 election, then such transfer will be disregarded for purposes of section 444 and this section, even if the deferral created by such change is effectively eliminated by a required payment (within the meaning of section 7519) or deferral of a deduction (to a personal service corporation under section 280H). The following example illustrates the application of this paragraph (b)(5)(iii).

Example. Assume that P1 is a partnership that historically used the calendar year and is owned by calendar year partners. Assume that P1 desires to make a section 444 election to change to a September year for the taxable year beginning January 1, 1988. P1 may not make a section 444 election to change taxable years under section 444(b)(2) because its current deferral period is zero. Assume further that P1 transfers a substantial portion of its assets to a newly-formed partnership (P2), which is owned by the partners of P1. Absent paragraph (b)(5)(iii) of this section, P2 could, if otherwise qualified, make a section 444 election under paragraph (b)(1) of this section to use a taxable year with a three month or less deferral period (i.e., a September 30, October 31, or November 30 taxable year). However, if the principal purpose of the asset transfer was to create a one-, two-, or three-month deferral period by P2 making a section 444 election, the section 444 election shall not be given effect, even if the deferral would be effectively eliminated by P2 making a required payment under section 7519.

(iv) Special rules for partial months and 52-53-week taxable years. Except as otherwise provided in § 1.280H-1T(c)(2)(i)(A), for purposes of this section and §§ 1.7519-1T, 1.7519-2T and 1.280H-1T—

(A) A month of less than 16 days is disregarded, and a month of more than 15 days is treated as a full month; and

(B) A 52-53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(c) Effective date. This section is effective for taxable years beginning after December 31, 1986.

(d) Examples—(1) Changes in taxable year. The following examples illustrate the provisions of paragraph (b)(2) of this section.

Example (1). A is a personal service corporation that historically used a June 30 taxable year. A desires to make a section 444 election to change to an August 31 taxable year, effective with its taxable year beginning July 1, 1987. Under paragraph (b)(4)(ii) of this section, the deferred period of the taxable year to be elected is four months (the number of months between August 31 and December 31). Furthermore, the deferral period of the taxable year that is being changed is six months (the number of months between June 30 and December 31). Pursuant to paragraph (b)(2)(i) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferred period of the taxable year being changed. Since the deferral period of the taxable year to be elected (August 31) is greater than three months, A may not make a section 444 election to change to the taxable year ending August 31, However, since the deferral period of the taxable year that is being changed is three months or more, A may, if otherwise qualified, make a section 444 election to change to a year ending September 30, 1987 (three-month deferral period), a year ending October 31, 1987 (two-month deferral period), or a year ending November 30, 1987 (one-month deferral period). In addition, instead of making a section 444 election to change its taxable year, A could, if otherwise qualified, make a section 444 election to retain its June end, pursuant to paragraph (b)(3) of this section.

Example (2). B, a corporation that historically used an August 31 taxable year, elected on November 1, 1986 to be an S corporation for its taxable year beginning September 1, 1986. As a condition to having the S election accepted, B agreed on Form 2553 to use calendar year. Pursuant to the general effective date provided in paragraph (c) of this section, B may not make a section 444 election for its taxable year beginning in 1986. Thus, B must file a short period income tax return for the period September 1 to December 31, 1986.

Example (3). The facts are the same as in example (2), except that B desires to make a section 444 election for its taxable year beginning January 1, 1987. Absent paragraph (b)(2)(ii) of this section, B would not be allowed to change its taxable year because the deferral period of the taxable year being changed (i.e., the calendar year) is zero. However, pursuant to the special rule provided in paragraph (b)(2)(ii) of this section, B shall apply paragraph (b)(2)(i) of this section by taking into account the deferral period of the last taxable year of B prior to B's election to be an S corporation (four months), rather than the deferral period of B's taxable year that is being changed (zero months). Thus, if otherwise qualified, B may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30, for its taxable year beginning January 1, 1987.

Example (4). The facts are the same as in example (3), except that B files a calendar year income tax return for 1987 rather than making a section 444 election. However, for its taxable year beginning January 1, 1988, B desires to change its taxable year by making a section 444 election. Given that the special rule provided in paragraph (b)(2)(ii) of this section applies to section 444 elections made in taxable years beginning before 1989, B may, if otherwise qualified, make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning January 1, 1988.

Example (5). C, a corporation that historically used a June 30 taxable year, elected on December 15, 1986 to be an S corporation for its taxable year beginning July 1, 1987. As a condition to having the S election accepted, C agreed on Form 2553 to use a calendar year. Although pursuant to paragraph (b)(3) of this section, C would, if otherwise qualified, be allowed to retain its June 30 taxable year, C desires to change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (b)(2) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferral period of the taxable year being changed. Given these facts, the deferral period of the taxable year to be elected is 3 months (September 30 to December 31) while the deferral period of the taxable year being changed is 6 months (June 30 to December 31). Thus, C may, if otherwise qualified, change to a September 30 taxable year for its taxable year beginning July 1, 1987, by making a section 444 election. The fact that C agreed on Form 2553 to use a calendar year is not relevant.

Example (6). D, a corporation that historically used a March 31 taxable year, elects on June 1, 1988 to be an S corporation for its taxable year beginning April 1, 1988. D desires to change to a June 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1988. Pursuant to paragraph (b)(2)(i) of this section, D may not change to a June 30 taxable year because such year would have a deferral period greater than 3 months. However, if otherwise qualified, D may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning April 1, 1988.

Example (7). E, a corporation that began operations on November 1, 1986, elected to be an S corporation on December 15, 1986, for its taxable year beginning November 1, 1986. E filed a short period income tax return for the period November 1 to December 31, 1986. E desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning January 1, 1987. Although E elected to be an S corporation after September 18, 1986, and before January 1, 1988, paragraph (b)(2)(ii) of this section does not apply to E since E was not a C corporation prior to electing S status. Thus, E may not change its taxable year for the taxable year beginning January 1, 1987, by making a section 444 election.

Example (8). The facts are the same as in example (7), except that E began operations on April 15, 1987, and elected to be an S corporation on June 1, 1987, for its taxable year beginning April 15, 1987. As a condition to being an S corporation, E agreed on Form 2553 to use a calendar year. E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987. Pursuant to paragraph (b)(5)(i) of this section, E's agreement to use a calendar year on Form 2553 does not mean that E has adopted a calendar year. Thus, E's desire to make a section 444 election to use a September 30 taxable year will not be considered a change in taxable year and thus paragraph (b)(2) of this section will not apply. Instead, E will be subject to paragraph (b)(1) of this section. Since a September 30 taxable year would result in only a three-month deferral period (September 30 to December 31), E may, if otherwise qualified, make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987.

(2) Special rule for entities retaining their 1986 taxable year. The following examples illustrate the provisions of paragraph (b)(3) of this section.

Example (1). F, an S corporation that elected to be an S corporation several years ago, has historically used a June 30 taxable year. F desires to retain its June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Pursuant to paragraph (b)(4)(i) of this section, the deferral period of the taxable year being retained is 6 months (June 30 to December 31, F's required taxable year). Absent the special rule provided in paragraph (b)(3) of this section, F would be subject to the general rule provided in paragraph (b)(1) of this section which limits the deferral period of the taxable year elected to three months or less. However, pursuant to paragraph (b)(3) of this section, F may, if otherwise qualified, make a section 444 election to retain its year ending June 30 for its taxable year beginning July 1, 1987.

Example (2). The facts are the same as in example (1), except that F received permission from the Commissioner to change its taxable year to the calendar year, and filed a short period income tax return for the period July 1 to December 31, 1986. F desires to make a section 444 election to use a year ending June 30 for its taxable year beginning January 1, 1987. Given that F had a December 31 taxable year for its last taxable year beginning in 1986, the special rule provided in paragraph (b)(3) of this section does not allow F to use a June 30 taxable year for its taxable year beginning January 1, 1987. Furthermore, pursuant to paragraph (b)(2)(i) of this section, F is not allowed to change its taxable year from December 31 to June 30 because the deferral period of the taxable year being changed is zero months.

Example (3). G, a corporation that historically used an August 31 taxable year, elected be an S corporation on November 15, 1986, for its taxable year beginning September 1, 1986. As a condition to obtaining S status, G agreed to use a calendar year. Thus, G filed its first S corporation return for the period September 1 to December 31, 1986. G desires to make a section 444 election to use a year ending August 31 for its taxable year beginning January 1, 1987. Since G's last taxable year beginning in 1986 was a calendar year, G cannot use paragraph (b)(3) of this section, relating to retentions of taxable years, to elect an August 31 taxable year. Thus, G is subject to paragraph (b)(2)(i) of this section, relating to changes in taxable year. Although G, if otherwise qualified, may use the special rule provided in paragraph (b)(2)(ii) of this section, G may only change from its current taxable year (i.e., the calendar year) to a taxable year that has no more than a three-month deferral period (i.e., September 30, October 31, or November 30).

Example (4). The facts are the same as in example (3), except that G elected to be an S corporation for its taxable year beginning September 1, 1987, rather than its taxable year beginning September 1, 1986. As a condition to making its S election, G agreed, on Form 2553, to use the calendar year. However, G has not yet filed a short period income tax return for the period September 1 to December 31, 1987. Given these facts, paragraph (b)(3) of this section would allow G, if otherwise qualified, to make a section 444 election to retain an August 31 taxable year for its taxable year beginning September 1, 1987.

Example (5). The facts are the same as in example (4), except that G has already filed a short period income tax return for the period September 1 to December 31, 1987. Pursuant to paragraph (b)(5)(ii)(A) of this section, G may supersede the return it filed for the period September 1 to December 31, 1987. Thus, pursuant to paragraph (b)(3) of this section, G may, if otherwise qualified, make a section 444 election to retain an August 31 taxable year for the taxable year beginning September 1, 1987. In addition, G should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

Example (6). H, a corporation that historically used a May 31 taxable year, elects to be an S corporation on June 15, 1988

for its taxable year beginning June 1, 1988. H desires to make a section 444 election to use a taxable year other than the calendar year. Since the taxable year in issue is not H's first taxable year beginning after December 31, 1986, H may not use the special rule provided in paragraph (b)(3)(i) and thus may not retain its May 31 year. However, H may, if otherwise qualified, make a section 444 election under paragraph (b)(2)(i) of this section, to change to a taxable year that has no more than a three-month deferral period (i.e., September 30, October 31, or November 30) for its taxable year beginning June 1, 1988.

Example (7). I is a partnership that has historically used a calendar year. Sixty percent of the profits and capital of I are owned by Q, a corporation (that is neither an S corporation nor a personal service corporation) that has a June 30 taxable year, and 40 percent of the profits and capital are owned by R, a calendar year individual. Since the partner that has more than a fifty percent interest in I has a June 30 taxable year, I's required taxable year is June 30. Accordingly, I filed an income tax return for the period January 1 to June 30, 1987. Based on these facts, I may, pursuant to paragraph (b)(5)(ii)(A) of this section, disregard the income tax return filed for the period January 1 to June 30, 1987. Thus, if otherwise qualified, I may make a section 444 election under paragraph (b)(2)(i) of this section to use a calendar year for its taxable year beginning January 1, 1987. If I makes such a section 444 election, I should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

[T.D. 8205, 53 FR 19694, May 27, 1988]

§ 1.444–2T Tiered structure (temporary).

(a) General rule. Except as provided in paragraph (e) of this section, no section 444 election shall be made or continued with respect to a partnership, S corporation, or personal service corporation that is a member of a tiered structure on the date specified in paragraph (d) of this section. For purposes of this section, the term "personal service corporation" means a personal service corporation as defined in § 1.441-4T (d).

(b) Definition of a member of a tiered structure— (1) In general. A partnership, S corporation, or personal service corporation is considered a member of a tiered structure if—

(i) The partnership, S corporation, or personal service corporation directly owns any portion of a deferral entity, or

(ii) A deferral entity directly owns any portion of the partnership, S corporation, or personal service corporation.

However, see paragraph (c) of this section for certain de minimis rules, and see paragraph (b)(3) of this section for an anti-abuse rule. In addition, for purposes of this section, a beneficiary of a trust shall be considered to own an interest in the trust.

(2) Deferral entity—(i) In general. For purposes of this section, the term "deferral entity" means an entity that is a partnership, S corporation, personal service corporation, or trust. In the case of an affiliated group of corporations filing a consolidated income tax return that is treated as a personal service corporation pursuant to § 1.441-4T (i), such affiliated group is considered to be a single deferral entity.

(ii) Grantor trusts. The term "deferral entity" does not include a trust (or a portion of a trust) which is treated as owned by the grantor or beneficiary under Subpart E, part I, subchapter J, chapter 1, of the Code (relating to grantor trusts), including a trust that is treated as a grantor trust pursuant to section 1361(d)(1)(A) of the Code (relating to qualified subchapter S trusts). Thus, any taxpayer treated under subpart E as owning a portion of a trust shall be treated as owning the assets of the trust attributable to that ownership. The following examples illustrate the provisions of this paragraph (b)(2)(ii).

Example (1). A, an individual, is the sole beneficiary of T. T is a trust that owns 50 percent of the profits and capital of X, a partnership that desires to make a section 444 election. Furthermore, pursuant to Subpart E, Part I, subchapter J, chapter 1 of the Code, A is treated as an owner of X. Based upon these facts, T is not a deferral entity and 50 percent of X is considered to be directly owned by A.

Example (2). The facts are the same as in example (1), except that A is a personal service corporation rather than an individual. Given these facts, 50 percent of X is considered to be directly owned by A, a deferral entity. Thus, X is considered to be a member of a tiered structure.

(3) Anti-abuse rule. Notwithstanding paragraph (b)(1) of this section, a partnership, S corporation, or personal service corporation is considered a member of a tiered structure if the partnership, S corporation, personal service corporation, or related taxpayers have organized or reorganized their ownership structure or operations for the principal purpose of obtaining a significant unintended tax benefit from making or continuing a section 444 election. For purposes of the preceding sentence, a significant unintended tax benefit results when a partnership, S corporation, or personal service corporation makes a section 444 election and, as a result, a taxpayer (not limited to the entity making the election) obtains a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519. See examples (15) through (19) in paragraph (f) of this section.

(c) De minimis rules—(1) In general. For rules relating to a de minimis exception to paragraph (b)(1)(i) of this section (the "downstream de minimis rule"), see paragraph (c)(2) of this section. For rules relating to a de minimis exception to paragraph (b)(1)(ii) of this section (the "upstream de minimis rule"), see paragraph (c)(3) of this

section. For rules relating to the interaction of the de minimis rules provided in this paragraph (c) and the "same taxable year exception" provided in paragraph (e) of this section, see paragraph (e)(5) of this section.

(2) Downstream de minimis rule—(i) General rule. If a partnership, S corporation, or personal service corporation directly owns any portion of one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(i) of this section if, in the aggregate, all such deferral entities accounted for—

(A) Not more than 5 percent of the partnership's, S corporation's, or personal service corporation's adjusted taxable income for the testing period ("5 percent adjusted taxable income test"), or

(B) Not more than 2 percent of the partnership's, S corporation's, or personal service corporation's gross income for the testing period ("2 percent gross income test"). See section 702 (c) for rules relating to the determination of gross income of a partner in a partnership.

See examples (3) through (5) in paragraph (f) of this section.

(ii) Definition of testing period. For purposes of this paragraph (c)(2), the term "testing period" means the taxable year that ends immediately prior to the taxable year for which the partnership, S corporation, or personal service corporation desires to make or continue a section 444 election. However, see the special rules provided in paragraph (c)(2)(iv) of this section for certain special cases (e.g., the partnership, S corporation, personal service corporation or deferral entity was not in existence during the entire testing period). The following example illustrates the application of this paragraph (c)(2)(ii).

Example. A partnership desires to make a section 444 election for its taxable year beginning November 1, 1987. The testing period for purposes of determining whether deferral entities owned by such partnership are de minimis under paragraph (c)(2) of this section is the taxable year ending October 31, 1987. If either the partnership or the deferral entities were not in existence for the entire taxable year ending October 1, 1987, see the special rules provided in paragraph (c)(2)(iv) of this section.

(iii) Definition of adjusted taxable income—(A) Partnership. In the case of a partnership, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(1) Aggregate amount of the partnership items described in section 702(a) (other than credits and tax-exempt income),

(2) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(1) of this section, and

(3) Guaranteed payments defined in section 707(c) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(1) of this section and are not otherwise included in paragraph (c)(2)(iii)(A)(2) of this section. For purposes of determining the aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(1) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has $1,000 of ordinary taxable income, $500 of specially allocated deductions, and $300 of capital loss, the partnership's aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(1) of this section is $200 ($1,000-$500-$300).

(B) S corporation. In the case of an S corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(1) Aggregate amount of the S corporation items described in section 1366(a) (other than credits and tax-exempt income), and

(2) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(B)(1) of this section.

For purposes of determining the aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(1) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 1366(a) an S corporation has $2,000 of ordinary taxable income, $1,000 of deductions described in section 1366(a)(1)(A) of the Code, and $500 of capital loss, the S corporation's aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(1) of this section is $500 ($2,000-$1,000-$500).

(C) Personal service corporation. In the case of a personal service corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(1) Taxable income of the personal service corporation, and

(2) Applicable amounts defined in section 280H(f)(1) that are deducted in determining the amount described in paragraph (c)(2)(iii)(C)(1) of this section.

(iv) Special rules—(A) Pro-forma rule. Except as provided in paragraph (c)(iv)(C)(2) of this section, if a partnership, S corporation, or personal service corporation directly owns any interest in a deferral entity as of the date specified in paragraph (d) of this section and such ownership interest is different in amount from the partnership's, S corporation's, or personal service corporation's interest on any day during the testing period, the 5 percent adjusted taxable income test and the 2 percent gross income test must be applied on a pro-forma basis (i.e., adjusted taxable income and gross income must be calculated for the testing period assuming that the partnership, S corporation, or personal service corporation owned the same interest in the deferral entity that it owned as of the date specified in paragraph (d) of this section). The following example illustrates the application of this paragraph (c)(2)(iv)(A).

Example. A personal service corporation desiring to make a section 444 election for its taxable year beginning October 1, 1987, acquires a 25 percent ownership interest in a partnership on or after October 1, 1987. Furthermore, the partnership has been in existence for several years. The personal service corporation must modify its calculations of the 5 percent adjusted taxable income test and the 2 percent gross income test for the testing period ended September 30, 1987, by assuming that the personal service corporation owned 25 percent of the partnership during such testing period and the personal service corporation's adjusted taxable income and gross income were correspondingly adjusted.

(B) Reasonable estimates allowed. If the information necessary to complete the pro-forma calculation described in paragraph (c)(2)(iv)(A) of this section is not readily available, the partnership, S corporation, or personal service corporation may make a reasonable estimate of such information.

(C) Newly formed entities—(1) Newly formed deferral entities. If a partnership, S corporation, or personal service corporation owns any portion of a deferral entity on the date specified in paragraph (d) of this section and such deferral entity was not in existence during the entire testing period (hereinafter referred to as a "newly formed deferral entity"), both the 5 percent adjusted taxable income test and the 2 percent gross income test are modified as follows. First, the partnership, S corporation, or personal service corporation shall calculate the percentage of its adjusted taxable income or gross income that is attributable to deferral entities, excluding newly formed deferral entities. Second, the partnership, S corporation, or personal service corporation shall calculate (on the date specified in paragraph (d) of this section) the percentage of the tax basis of its assets that are attributable to its tax basis with respect to its ownership interests in all newly formed deferral entities. If the sum of the two percentages is 5 percent or less, the deferral entities are considered de minimis and are disregarded for purposes of paragraph (b)(1)(i) of this section. If the sum of the two percentages is greater than 5 percent, the deferral entities do not qualify for the de minimis rule provided in paragraph (c)(2) of this section and thus the partnership, S corporation, or personal service corporation is considered to be a member of a tiered structure for purposes of this section.

(2) Newly formed partnership, S corporation, or personal service corporation desiring to make a section 444 election. If a partnership, S corporation, or personal service corporation desires to make a section 444 election for the first taxable year of its existence, the 5 percent adjusted taxable income test and the 2 percent gross income test are replaced by a 5 percent of assets test. Thus, if on the date specified in paragraph (d) of this section, 5 percent or less of the assets (measured by reference to the tax basis of the assets) of the newly formed partnership, S corporation, or personal service corporation are attributable to the tax basis with respect to its ownership interests in the deferral entities, the deferral entities will be considered de minimis and will be disregarded for purposes of paragraph (b)(1)(i) of this section.

(3) Upstream de minimis rule. If a partnership, S corporation, or personal service corporation is directly owned by one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(ii) of this section if on the date specified in paragraph (d) of this section the deferral entities directly own, in the aggregate, 5 percent or less of—

(i) An interest in the current profits of the partnership, or

(ii) The stock (measured by value) of the S corporation or personal service corporation.

See examples (6) and (7) in paragraph (f) of this section.

(d) Date for determining the existence of a tiered structure—(1) General rule. For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will be considered a member of a tiered structure for a particular taxable year if the partnership, S corporation, or personal service corporation is a member of a tiered structure on the last day of the required taxable year (as defined in section 444 (e) of the Code) ending within such year. If a particular taxable year does not include the last day of the

required taxable year for such year, the partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for such year. The following examples illustrate the application of this paragraph (d)(1).

Example (1). Assume that a newly formed partnership whose first taxable year begins November 1, 1988, desires to adopt a September 30 taxable year by making a section 444 election. Furthermore, assume that for its taxable year beginning November 1, 1988, the partnership's required taxable year is December 31. If the partnership is a member of a tiered structure on December 31, 1988, it will not be eligible to make a section 444 election for a taxable year beginning November 1, 1988, and ending September 30, 1989.

Example (2). Assume an S corporation that historically used a June 30 taxable year desires to make a section 444 election to change to a year ending September 30 for its taxable year beginning July 1, 1987. If the S corporation can make the section 444 election, it will have a short taxable year beginning July 1, 1987, and ending September 30, 1987. Given these facts, the short taxable year beginning July 1, 1987, does not include the last day of the S corporation's required taxable year for such year (i.e., December 31, 1987). Thus, pursuant to paragraph (d)(1) of this section, the S corporation will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987, and ending September 30, 1987.

(2) Special rule for taxable years beginning in 1987. For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for a taxable year beginning in 1987 if the partnership, S corporation, or personal service corporation is not a member of a tiered structure on the day the partnership, S corporation, or personal service corporation timely files its section 444 election for such year. The following examples illustrate the application of this paragraph (d)(2).

Example (1). Assume that a partnership desires to retain a June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Furthermore, assume that the partnership's required taxable year for such year is December 31 and that the partnership was a member of a tiered structure on such date. Also assume that the partnership was not a member of a tiered structure as of the date it timely filed its section 444 election for its taxable year beginning July 1, 1987. Based upon the special rule provided in this paragraph (d)(2), the partnership will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987.

Example (2). Assume the same facts as in example (1), except that the partnership was a member of a tiered structure on the date it filed its section 444 election for its taxable year beginning July 1, 1987, but was not a member of a tiered structure on December 31, 1987. Paragraph (d)(1) of this section would still apply and thus the partnership would not be considered part of a tiered structure for its taxable year beginning July 1, 1987. However, the partnership would be considered a member of a tiered structure for its taxable year beginning July 1, 1988, if the partnership was a member of a tiered structure on December 31, 1988.

(e) Same taxable year exception—(1) In general. Although a partnership or S corporation is a member of a tiered structure as of the date specified in paragraph (d) of this section, the partnership, S corporation may make or continue a section 444 election if the tiered structure (as defined in paragraph (e)(2) of this section) consists entirely of partnerships or S corporations (or both), all of which have the same taxable year as determined under paragraph (e)(3) of this section. However, see paragraph (e)(5) of this section for the interaction of the de minimis rules provided in paragraph (c) of this section with the same taxable year exception. For purposes of this paragraph (e), two or more entities are considered to have the same taxable year if their taxable years end on the same day, even though they begin on different days. See examples (8) through (14) in paragraph (f) of this section.

(2) Definition of tiered structure—(i) General rule. For purposes of the same taxable year exception, the members of a tiered structure are defined to include the following entities—

(A) The partnership or S corporation that desires to qualify for the same taxable year exception,

(B) A deferral entity (or entities) directly owned (in whole or in part) by the partnership or S corporation that desires to qualify for the same taxable year exception,

(C) A deferral entity (or entities) directly owning any portion of the partnership or S corporation that desires to qualify for the same taxable year exception, and

(D) A deferral entity (or entities) directly owned (in whole or in part) by a "downstream controlled partnership," as defined in paragraph (e)(2)(ii) of this section.

(ii) Special flow-through rule for downstream controlled partnerships. If more than 50 percent of a partnership's profits and capital are owned by a partnership or S corporation that desires to qualify for the same taxable year exception, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section. Furthermore, if more than 50 percent of a partnership's profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section.

(3) Determining the taxable year of a partnership or S corporation. The taxable year of a partnership or S corporation to be taken into account for purposes of paragraph (e)(1) of this

section is the taxable year ending with or prior to the date specified in paragraph (d) of this section. Furthermore, the determination of such taxable year will take into consideration any section 444 elections made by the partnership or S corporation. See examples (10) and (11) in paragraph (f) of this section.

(4) Special rule for 52-53-week taxable years. For purposes of this paragraph (e), a 52-53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(5) Interaction with de minimis rules—(i) Downstream de minimis rule—(A) In general. If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and directly owns any member (or members) of the tiered structure with a taxable year different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(2) of this section is satisfied with respect to such owned member (or members). The following example illustrates the application of this paragraph (e)(5)(i)(A).

Example. P, a partnership with a June 30 taxable year, owns 60 percent of P1, another partnership with a June 30 taxable year. P also owns 1 percent of P2 and P3, calendar year partnerships. If, in the aggregate, P's ownership interests in P2 and P3 are considered de minimis under paragraph (c)(2) of this section, P meets the same taxable year exception and may make a section 444 election to retain its June 30 taxable year.

(B) Special rule for members of a tiered structure directly owned by a downstream controlled partnership. For purposes of paragraph (e)(5)(i)(A) of this section, a partnership or S corporation desiring to make or continue a section 444 election is considered to directly own any member of the tiered structure (as defined in paragraph (e)(2) of this section) directly owned by a downstream controlled partnership (as defined in paragraph (e)(2)(ii) of this section). The adjusted taxable income or gross income of the partnership or S corporation that is attributable to a member of a tiered structure directly owned by a downstream controlled partnership equals the adjusted taxable income or gross income of such member multiplied by the partnership's or S corporation's indirect ownership percentage of such member. The following example illustrates the application of this paragraph (e)(5)(i)(B).

Example. P, a partnership, desires to retain its June 30 taxable year by making a section 444 election. However, as of the date specified in paragraph (d) of this section, P owns 75 percent of P1, a June 30 partnership, and P1 owns 40 percent of P2, a calendar year partnership. P also owns 25 percent of P3, a calendar year partnership. Pursuant to paragraphs (e)(5)(i) (A) and (B) of this section, P may only qualify to use the same taxable year exception if, in the aggregate, P2 and P3 are de minimis with respect to P. Pursuant to paragraph (e)(5)(i)(B) of this section, P's adjusted taxable income or gross income attributable to P2 equals 30 percent (75 percent times 40 percent) of P2's adjusted taxable income or gross income.

(ii) Upstream de minimis rule. If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and is owned directly by a member (or members) of the tiered structure with taxable years different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(3) of this section is satisfied with respect to such owning member (or members). See example (12) of paragraph (f) of this section.

(f) Examples. The provisions of this section may be illustrated by the following examples.

Example (1). A, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, A is owned by a combination of individuals and S corporations. The S corporations are deferral entities, as defined in paragraph (b)(2) of this section. Thus, pursuant to paragraph (b)(1)(ii) of this section, A will be a member of a tiered structure unless under paragraph (c)(3) of this section, the S corporations, in the aggregate, own a de minimis portion of A. If the S corporations' ownership in A is not considered de minimis under paragraph (c)(3) of this section, A is a member of a tiered structure and will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example (2). B, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, B is a partner in two partnerships, B1 and B2. B1 and B2 are deferral entities, as defined in paragraph (b)(2) of this section. Thus, under paragraph (b)(1)(i) of this section, B will be a member of a tiered structure unless B's aggregate ownership interests in B1 and B2 are considered de minimis under paragraph (c)(2) of this section. If B is a member of a tiered structure on the date specified in paragraph (d) of this section, B will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

Example (3). C, a partnership with a September 30 taxable year, is 100 percent owned by calendar year individuals. C desires to make a section 444 election for its taxable year beginning October 1, 1987. However, on the date specified in paragraph (d) of this section, C owns a 1 percent interest in C1, a partnership. C does not own any other interest in a deferral entity. For the taxable year ended September 30, 1987, 10 percent of C's adjusted taxable income (as defined in paragraph (c)(2)(iii) of this section) was attributable to C's partnership

interest in C1. Furthermore, 4 percent of C's gross income for the taxable year ended September 30, 1987, was attributable to C's partnership interest in C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is not de minimis because during the testing period more than 5 percent of C's adjusted taxable income is attributable to C1 and more than 2 percent of C's gross income is attributable to C1. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (4). The facts are the same as example (3), except that for the taxable year ended September 30, 1987, only 2 percent of C's adjusted taxable income was attributable to C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is considered de minimis for purposes of determining whether C is a member of a tiered structure because not more than 5 percent of C's adjusted taxable income during the testing period is attributable to C1. Thus, C is not a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (5). The facts are the same as example (4), except that in addition to owning C1, C also owns 15 percent of C2, another partnership. For the taxable year ended September 30, 1987, 2 percent of C's adjusted taxable income is attributable to C1 and an additional 4 percent is attributable to C2. Furthermore, for the taxable year ended September 30, 1987, 4 percent of C's gross income is attributable to C1 while 3 percent is attributable to C2. Under paragraph (c)(2) of this section, C1 and C2 must be aggregated for purposes of determining whether C meets either the 5 percent adjusted taxable income test or the 2 percent gross income test. Since C's adjusted taxable income attributable to C1 and C2 is 6 percent (2 percent + 4 percent) and C's gross income attributable to C1 and C2 is 7 percent (4 percent + 3 percent), C does not meet the downstream de minimis rule provided in paragraph (c)(2) of this section. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

Example (6). The facts are the same as example (3), except that instead of determining whether C is part of a tiered structure, the issue is whether C1 is part of a tiered structure. In addition, assume that on the date specified in paragraph (d) of this section, the remaining 99 percent of C1 is owned by calendar year individuals and C1 does not own an interest in any deferral entity. Although C in Example (3) was considered to be a part of a tiered structure by virtue of its ownership interest in C1, C1 must be tested separately to determine whether it is part of a tiered structure. Since C's interest in C1 is 5 percent or less, C's interest in C1 is de minimis with respect to C1. See paragraph (c)(3) of this section. Thus, based upon these facts, C1 is not part of a tiered structure.

Example (7). The facts are the same as example (6), except that the remaining 99 percent of C1 is owned 94 percent by calendar year individuals and 5 percent by C3, another partnership. Thus, deferral entities own 6 percent of C1 (1 percent owned by C and 5 percent owned by C3). Under paragraph (c)(3) of this section, deferral entities own more than a de minimis interest (i.e., 5 percent) of C1, and thus C1 is part of a tiered structure.

Example (8). D, a partnership with a September 30 taxable year, desires to make a section 444 election for its taxable year beginning October 1, 1987. On December 31, 1987, and the date D plans to file its section 444 election, D is 10 percent owned by D1, a personal service corporation with a September 30 taxable year, and 90 percent owned by calendar year individuals. Furthermore, D1 will retain its September 30 taxable year because it previously established a business purpose for such year. Since D is owned in part by D1, a personal service corporation, and the ownership interest is not de minimis under paragraph (c)(3) of this section, D is considered a member of a tiered structure for its taxable year beginning October 1, 1987. Furthermore, although D and D1 have the same taxable year, D does not qualify for the same taxable year exception provided in paragraph (e) of this section because D1 is a personal service corporation rather than a partnership or S corporation. Thus, pursuant to paragraph (a) of this section, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (9). The facts are the same as example (8), except that D1 is a partnership rather than a personal service corporation. Based upon these facts, D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (10). The facts are the same as example (9), except that D1 has not established a business purpose for a September 30 taxable year. In addition, D1 does not desire to make a section 444 election and, under section 706(b), D1 will be required to change to a calendar year for its taxable year beginning October 1, 1987. Pursuant to paragraph (e)(3) of this section, D and D1 do not have the same taxable year for purposes of the same taxable year exception provided in paragraph (e) of this section. Thus, D may not make a section 444 election for its taxable year beginning October 1, 1987.

Example (11). The facts are the same as example (8), except that D1 is a partnership with a March 31 taxable year. Furthermore, for its taxable year beginning April 1, 1987, D1 will change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (e)(3) of this section, D1 is considered to have a September 30 taxable year for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (12). The facts are the same as example (11), except that instead of the remaining 90 percent of D being owned by calendar year individuals, it is owned 86 percent by individuals and 4 percent by D2, a calendar year partnership. Thus, D, a September 30 partnership, is 10 percent owned by D1, a September 30 partnership, 86 percent owned by calendar year individuals, and 4 percent owned by D2, a calendar year partnership. Under paragraph (e)(5)(ii) of this section, D2's ownership interest in D is considered de minimis for purposes of the same taxable year exception. Since D2's ownership interest in D is considered de minimis, it is disregarded for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

Example (13). E, a partnership with a June 30 taxable year, desires to make a section 444 election for its taxable year beginning July 1, 1987. On the date specified in paragraph (d) of this section, E is 100 percent owned by calendar year individuals; E owns 99 percent of the profits and capital of E1, a partnership with a June 30 taxable year; and E1 owns 30 percent of the profits and capital of E2, a partnership with a September 30 taxable year. E owns no other deferral entities. Pursuant to paragraph (b)(1)(i) of this section, E is considered to be a member of a tiered structure. Furthermore, pursuant to paragraph (e) of this section, E does not qualify for the same taxable year exception because E2 does not have the same taxable year as E and E1.

Example (14). The facts are the same as example (13), except that E owns only 49 percent (rather than 99 percent) of the profits and capital of E1. Pursuant to paragraph (e) of this section, E qualifies for the same taxable year exception because E and E1 have the same taxable year. Pursuant to paragraph (e) of this section, E1's ownership interest in E2 is disregarded since E does not own more than 50 percent of E1's profits and capital.

Example (15). Prior to consideration of the anti-abuse rule provided in paragraph (b)(3) of this section, H, a partnership that commenced operations on October 1, 1987, is eligible to make a section 444 election for its taxable year beginning October 1, 1987. Although H may obtain a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519 (since there will be no required payment for H's first taxable year), the anti-abuse rule of paragraph (b)(3) will not apply unless the principal purpose of organizing H was the attainment of a significant deferral of income that would result from making a section 444 election.

Example (16). F, a partnership with a January 31 taxable year, desires to make a section 444 election to retain its January 31 taxable year for the taxable year beginning February 1, 1987. F is 100 percent owned by calendar year individuals. Prior to the date specified in paragraph (d) of this section, F contributes substantially all of its assets to F1, a partnership, in exchange for a 51 percent interest in F1. The remaining 49 percent of F1 is owned by the calendar year individuals owning 100 percent of F. If F is allowed to make a section 444 election to retain its January 31 taxable year, F1's required taxable year will be January 31 since a majority of F1's partners use a January 31 taxable year (see § 1.706-3T). F's principal purpose for creating F1 and contributing its assets to F1 is to obtain an 11-month deferral on 49 percent of the income previously earned by F and now earned by F1. Pursuant to paragraph (b)(3) of this section, F is not allowed to make a section 444 election for its taxable year beginning February 1, 1987.

Example (17). The facts are the same as in example (16), except that F does not create F1 and contribute its assets to F1 until immediately after F makes its section 444 election for the taxable year beginning February 1, 1987. Thus, F is allowed to make a section 444 election for its taxable year beginning February 1, 1987. However, pursuant to paragraph (b)(3) of this section, F will have its section 444 election terminated for subsequent years unless the tax deferral inherent in the structure is eliminated (e.g., F1 is liquidated or the individual owners of F contribute their interests in F1 to F) prior to the date specified in paragraph (d) of this section for subsequent taxable years beginning on or after February 1, 1988.

Example (18). The facts are the same as in example (16), except that F1 is 99 percent owned by F and none of the individual owners of F own any portion of F1. Furthermore, F obtained no tax benefit from creating and contributing assets to F1. Given these facts paragraph (b)(3) of this section does not apply and thus, F may make a section 444 election for its taxable year beginning February 1, 1987.

Example (19). G, a partnership with an October 31 taxable year, desires to retain its October 31 taxable year for its taxable year beginning November 1, 1987. However, as of December 31, 1987, G owns a 30 percent interest in G1, a calendar year partnership. G owns no other deferral entity, and G is 100 percent owned by calendar year individuals. Furthermore, G's interest in G1 does not meet the de minimis rule provided in paragraph (c)(3) of this section. Thus, in order to avoid being a tiered structure, G sells its interest in G1 to an unrelated third party prior to the date G timely makes it section 444 election for its taxable year beginning November 1, 1987. Although the sale of G1 allows G to qualify to make a section 444 election, and therefore to obtain a significant tax benefit, such benefit is not unintended. Thus, paragraph (b)(3) of this section does not apply, and G may make a section 444 election for its taxable year beginning November 1, 1987.

(g) Effective date. This section is effective for taxable years beginning after December 31, 1986.
[T.D. 8205, 53 FR 19698, May 27, 1988]

§ 1.444–3T Manner and time of making section 444 election (temporary).

(a) In general. A section 444 election shall be made in the manner and at the time provided in this section.

(b) Manner and time of making election—(1) General rule. A section 444 election shall be made by filing a properly prepared Form 8716, "Election to Have a Tax Year Other Than a Required Tax Year," with the Service Center indicated by the instructions to Form 8716. Except as provided in paragraphs (b) (2) and (4) of this section, Form 8716 must be filed by the earlier of—

(i) The 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or

(ii) The due date (without regard to extensions) of the income tax return resulting from the section 444 election.

In addition, a copy of Form 8716 must be attached to Form 1065 or Form 1120 series form, whichever is applicable, for the first taxable year for which the section 444 election is made. Form 8716 shall be signed by any person who is authorized to sign Form 1065 or Form 1120 series form, whichever is applicable. (See sections 6062 and 6063, relating to the signing of returns.) The provisions of this paragraph (b)(1) may be illustrated by the following examples.

Example (1). A, a partnership that began operations on September 10, 1988, is qualified to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 10, 1988. Pursuant to paragraph (b)(1) of this section, A must file Form 8716 by the earlier of the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective (i.e., February 15, 1989) or the due date (without regard to extensions) of the partnership's tax return for the period September 10, 1988 to September 30, 1988 (i.e., January 15, 1989). Thus, A must file Form 8716 by January 15, 1989.

Example (2). The facts are the same as in example (1), except that A began operations on October 20, 1988. Based upon these facts, A must file Form 8716 by March 15, 1989, the 15th day of the fifth month following the month that

includes the first day of the taxable year for which the election will first be effective.

Example (3). B is a corporation that first becomes a personal service corporation for its taxable year beginning September 1, 1988. B qualifies to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 1, 1988. Pursuant to this paragraph (b)(1), B must file Form 8716 by December 15, 1988, the due date of the income tax return for the short period September 1 to September 30, 1988.

(2) **Special extension of time for making an election.** If, pursuant to paragraph (b)(1) of this section, the due date for filing Form 8716 is prior to July 26, 1988, such date is extended to July 26, 1988. The provisions of this paragraph (b)(2) may be illustrated by the following examples.

Example (1). B, a partnership that historically used a June 30 taxable year, is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Absent paragraph (b)(2) of this section, B would be required to file Form 8716 by December 15, 1987. However, pursuant to paragraph (b)(2) of this section, B's due date for filing Form 8716 is extended to July 26, 1988.

Example (2). C, a partnership that began operations on January 20, 1988, is qualified to make a section 444 election to use a year ending September 30 for its taxable year beginning January 20, 1988. Absent paragraph (b)(2) of this section, C is required to file Form 8716 by June 15, 1988 (the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective). However, pursuant to paragraph (b)(2) of this section, the due date for filing Form 8716 is July 26, 1988.

(3) **Corporation electing to be an S corporation—(i) In general.** A corporation electing to be an S corporation is subject to the same time and manner rules for filing Form 8716 as any other taxpayer making a section 444 election. Thus, a corporation electing to be an S corporation that desires to make a section 444 election is not required to file Form 8716 with its Form 2553, "Election by a Small Business Corporation." However, a corporation electing to be an S corporation after September 26, 1988, is required to state on Form 2553 its intention to—

(A) Make a section 444 election, if qualified, or

(B) Make a "back-up section 444 election" as described in paragraph (b)(4) of this section.

If a corporation electing to be an S corporation fails to state either of the above intentions, the District Director may, at his discretion, disregard any section 444 election for such taxpayer.

(ii) **Examples.** The provisions of this paragraph (b)(3) may be illustrated by the following examples.

Example (1). D is a corporation that commences operations on October 1, 1988, and elects to be an S corporation for its taxable year beginning October 1, 1988. All of D's shareholders use the calendar year as their taxable year. D desires to adopt a September 30 taxable year. D does not believe it has a business purpose for a September 30 taxable year and thus it must make a section 444 election to use such year. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 that, if qualified, it will make a section 444 election to adopt a year ending September 30 for its taxable year beginning October 1, 1988. If D is qualified (i.e., D is not a member of a tiered structure on December 31, 1988) to make a section 444 election for its taxable year beginning October 1, 1988, D must file Form 8716 by March 15, 1989. If D ultimately is not qualified to make a section 444 election for its taxable year beginning October 1, 1988, D's election to be an S corporation will not be effective unless, pursuant to the instructions to Form 2553, D made a back-up calendar year election (i.e., an election to adopt the calendar year in the event D ultimately is not qualified to make a section 444 election for such year).

Example (2). The facts are the same as in example (1), except that D believes it can establish, to the satisfaction of the Commissioner, a business purpose for adopting a September 30 taxable year. However, D desires to make a "back-up section 444 election" (see paragraph (b)(4) of this section) in the event that the Commissioner does not grant permission to adopt a September 30 taxable year based upon business purpose. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 its intention, if qualified, to make a back-up section 444 election to adopt a September 30 taxable year. If, by March 15, 1989, D has not received permission to adopt a September 30 taxable year and D is qualified to make a section 444 election, D must make a back-up election in accordance with paragraph (b)(4) of this section.

(4) **Back-up section 444 election—(i) General rule.** A taxpayer that has requested (or is planning to request) permission to use a particular taxable year based upon business purpose, may, if otherwise qualified, file a section 444 election (referred to as a "back-up section 444 election"). If the Commissioner subsequently denies the business purpose request, the taxpayer will, if otherwise qualified, be required to activate the back-up section 444 election. See examples (1) and (2) in paragraph (b)(4)(iv) of this section.

(ii) **Procedures for making a back-up section 444 election.** In addition to following the general rules provided in this section, a taxpayer making a back-up section 444 election should, in order to allow the Service to process the affected returns in an efficient manner, type or legibly print the words "BACK-UP ELECTION" at the top of Form 8716, "Election to Have a Tax Year Other Than a Required Tax Year." However, if such Form 8716 is filed on or after the date a Form 1128, Application for Change in Accounting Period, is filed with respect to a period that begins on the same date, the words "FORM 1128 BACK-UP ELECTION"

should be typed or legibly printed at the top of Form 8716.

(iii) Procedures for activating a back-up section 444 election—(A) Partnerships and S corporations—(1) In general. A back-up section 444 election made by a partnership or S corporation is activated by filing the return required in § 1.7519-2T (a)(2)(i) and making the payment required in § 1.7519-1T. The due date for filing such return and payment will be the later of—

(i) The due dates provided in § 1.7519-2T, or

(ii) 60 days from the date the Commissioner denies the business purpose request.

However, interest will be assessed (at the rate provided in section 6621 (a)(2)) on any required payment made after the due date (without regard to any extension for a back-up election) provided in § 1.7519-2T (a)(4)(i) or (a)(4)(ii), whichever is applicable, for such payment. Interest will be calculated from such due date to the date such amount is actually paid. Interest assessed under this paragraph will be separate from any required payments. Thus, interest will not be subject to refund under § 1.7519-2T.

(2) Special rule if Form 720 used to satisfy return requirement. If, pursuant to § 1.7519-2T (a)(3), a partnership or S corporation must use Form 720, "Quarterly Federal Excise Tax Return," to satisfy the return requirement of § 1.7519-2T (a)(2), then in addition to following the general rules provided in § 1.7519-2T, the partnership or S corporation must type or legibly print the words "ACTIVATING BACK-UP ELECTION" on the top of Form 720. A partnership or S corporation that would otherwise file a Form 720 on or before the date specified in paragraph (b)(4)(iii)(A)(1) of this section may satisfy the return requirement by including the necessary information on such Form 720. Alternatively, such partnership or S corporation may file an additional Form 720 (i.e., a Form 720 separate from the Form 720 it would otherwise file). Thus, for example, if the due date for activating an S corporation's back-up election is November 15, 1988, and the S corporation must file a Form 720 by October 31, 1988, to report manufacturers excise tax for the third quarter of 1988, the S corporation may use that Form 720 to activate its back-up election. Alternatively, the S corporation may file its regular Form 720 that is due October 31, 1988, and file an additional Form 720 by November 15, 1988, activating its back-up election.

(B) Personal service corporations. A back-up section 444 election made by a personal service corporation is activated by filing Form 8716 with the personal service corporation's original or amended income tax return for the taxable year in which the election is first effective, and typing or legibly printing the words—"ACTIVATING BACK-UP ELECTION" on the top of such income tax return.

(iv) Examples. The provisions of this paragraph (b)(4) may be illustrated by the following examples. Also see example (2) in paragraph (b)(3) of this section.

Example (1). E, a partnership that historically used a June 30 taxable year, requested (pursuant to section 6 of Rev. Proc. 87-32, 1987-28 I.R.B. 14) permission from the Commissioner to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Furthermore, E is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. However, as of the date specified in paragraph (b)(2) of this section, the Commissioner has not determined whether E has a valid business purpose for retaining its June 30 taxable year. Based on these facts, E may, by the date specified in paragraph (b)(2) of this section, make a back-up section 444 election to retain its June 30 taxable year.

Example (2). The facts are the same as in example (1). In addition, on August 12, 1988, the Internal Revenue Service notifies E that its business purpose request is denied. E asks for reconsideration of the Service's decision, and the Service sustains the original denial on September 30, 1988. Based on these facts, E must activate its back-up section 444 election within 60 days after September 30, 1988.

Example (3). The facts are the same as in example (1), except that E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning July 1, 1987. Although E qualifies to make a section 444 election to retain its June 30 taxable year, E may make a back-up section 444 election for a September 30 taxable year.

(c) Administrative relief—(1) Extension of time to file income tax returns—(i) Automatic extension. If a partnership, S corporation, or personal service corporation makes a section 444 election (or does not make a section 444 election, either because it is ineligible or because it decides not to make the election, and therefore changes to its required taxable year) for its first taxable year beginning after December 31, 1986, the due date for filing its income tax return for such year shall be the later of—

(A) The due date established under—

(1) Section 6072, in the case of Form 1065,

(2) § 1.6037-1 (b), in the case of Form 1120S,

(3) Section 6072 (b), in the case of other Form 1120 series form; or

(B) August 15, 1988.

The words "SECTION 444 RETURN" should, in order to allow the Service to process the affected returns in an efficient manner, be typed or legibly printed at the top of the Form 1065 or Form 1120 series form, whichever is applicable, filed under this paragraph (c)(1)(i).

(ii) **Additional extensions.** If the due date of the income tax return for the first taxable year beginning after December 31, 1986, extended as provided in paragraph (c)(1)(i)(B) of this section, occurs before the date that is 6 months after the date specified in paragraph (c)(1)(i)(A) of this section, the partnership, S corporation, or personal service corporation may request an additional extension or extensions of time (up to 6 months after the date specified in paragraph (c)(1)(i)(A) of this section) to file its income tax return for such first taxable year. The request must be made by the later of the date specified in paragraph (c)(1)(i)(A) or (c)(1)(i)(B) of this section and must be made on Form 7004, "Application for Automatic Extension of Time To File Corporation Income Tax Return", or Form 2758, "Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Other Returns," whichever is applicable, in accordance with the form and its instructions. In addition, the following words should be typed or legibly printed at the top of the form—"SECTION 444 REQUEST FOR ADDITIONAL EXTENSION."

(iii) **Examples.** The provisions of paragraph (c)(1) of this section may be illustrated by the following examples.

Example (1). G, a partnership that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. Absent paragraph (c)(1)(i) of this section, G's Form 1065 for the taxable year ending January 31, 1988, is due on or before May 15, 1988. However, if G types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

Example (2). The facts are the same as in example (1), except that G desires to extend the due date of its income tax return for the year ending January 31, 1988, to a date beyond August 15, 1988. Pursuant to paragraph (c)(1)(ii) of this section, G may extend such return to November 15, 1988 (i.e., the date that is up to 6 months after May 15, 1988, the normal due date of the return). However, in order to obtain this additional extension, G must file Form 2758 pursuant to paragraph (c)(1)(i) of this section on or before August 15, 1988.

Example (3). H, a partnership that historically used a May 31 taxable year, makes a section 444 election to use a year ending September 30 for its taxable year beginning on June 1, 1987. Absent paragraph (c)(1)(i) of this section, H's Form 1065 for the taxable year beginning June 1, 1987, and ending September 30, 1987, is due on or before January 15, 1988. However, if H types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends to due date of such return to August 15, 1988.

Example (4). The facts are the same as in example (3), except H desires to further extend (i.e., extend beyond August 15, 1988) the due date of its income tax return for its taxable year beginning June 1, 1987, and ending September 30, 1987. Since August 15, 1988, is 6 months or more after the due date (without extensions) of such return, paragraph (c)(1)(ii) of this section prevents H from further extending the time for filing such return.

Example (5). I, a partnership that historically used a June 30 taxable year, considered making a section 44 election to retain such taxable year, but eventually decided to change to a December 31, taxable year (I's required taxable year). Absent paragraph (c)(1)(i) of this section, I's Form 1065 for the taxable year beginning July 1, 1987, and ending December 31, 1987, is due on or before April 15, 1988. Pursuant to paragraph (c)(1)(i) of this section, if I types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988. In addition, I may further extend such return pursuant to paragraph (c)(1)(ii) of this section.

(2) **No penalty for certain late payments—(i) In general.** In the case of a personal service corporation or S corporation described in paragraph (c)(1)(i) of this section, no penalty under section 6651 (a)(2) will be imposed for failure to pay income tax (if any) for the first taxable year beginning after December 31, 1986, but only for the period beginning with the last date for payment and ending with the later of the date specified in paragraph (c)(1)(i) or paragraph (c)(1)(ii) of this section.

(ii) **Example.** The provisions of paragraph (c)(2)(i) of this section may be illustrated by the following example.

Example. J, a personal service corporation that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. The last date (without extension) for payment of J's income tax (if any) for its taxable year beginning February 1, 1987, is April 15, 1988. However, under paragraph (c)(2)(i) of this section, no penalty under section 6651(a)(2) will be imposed on any underpayment of income tax for the period beginning April 15, 1988 and ending August 15, 1988.

(d) **Effective date.** This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19703, May 27, 1988]

Methods Of Accounting

Methods of Accounting in General

§ 1.446–1 General rule for methods of accounting.

(a) General rule. (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 263A, 471, and 472, and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) Exceptions. (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish

the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) **Permissible methods—(1) In general.** Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) **Cash receipts and disbursements method.** Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451–2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and paragraph (a)(1) of § 1.461–1.

(ii) **Accrual method.** Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, under an accrual method, a taxpayer engaged in manufacturing may account for the sale of an item when the item is shipped, when the item is delivered, when the item is accepted, or when title to the item passes to the purchaser, whether or not billed, depending upon the method regularly employed in keeping the taxpayer's books; however, see § 1.451–5 relating to advance payments. The determination of when an item is shipped, delivered or accepted, or when title passes, does not depend upon when any other item in the contract is shipped, delivered or accepted, or when title passes.

(iii) **Other permissible methods.** Special methods of accounting are described elsewhere in chapter 1 of the Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 451, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) **Combinations of the foregoing methods.** (a) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(b) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) **Special rules.** (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by

the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(d) Taxpayer engaged in more than one business. (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) Requirement respecting the adoption or change of accounting method. (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii)(*a*) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451–3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(*b*) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but which are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with

respect to the addition to a reserve for bad debts or an adjustment in the useful life of a depreciable asset. Although such adjustments may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustments in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve, see the regulations under section 166 of the Code; for the treatment of a change in the useful life of a depreciable asset, see the regulations under section 167(b) of the Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. On the other hand, for example, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which has been consistently treated as an expense in the year of purchase involves the question of the proper timing of an item, and is to be treated as a change in method of accounting.

(c) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(iii) A change in the method of accounting may be illustrated by the following examples:

Example (1). Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example (2). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example (3). A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example (4). From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example (5). A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change of method of accounting for inventories.

Example (6). A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations thereunder. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example (7). A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations thereunder, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example (8). A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

(3)(i) Except as otherwise provided under the authority of subdivision (ii) of this subparagraph, in order to secure the Commissioner's consent to a change of a taxpayer's method of accounting, the taxpayer must file an application on Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within 180 days after the beginning of the taxable year in which it is desired to make the change. The taxpayer shall, to the extent applicable, furnish (a) all information requested on such form, disclosing in detail all classes of items which would be treated differently under the new method of accounting and showing all amounts which would be duplicated or omitted as a result of the proposed change and (b) the taxpayer's computation of the adjustments to take into account such duplications or omissions. The Commissioner may require such other information

as may be necessary in order to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. See section 481 and the regulations thereunder, relating to certain adjustments required by such changes, section 472 and the regulations thereunder, relating to changes to and from the last-in, first-out method of inventorying goods, and section 453 and the regulations thereunder, relating to certain adjustments required by a change from an accrual method to the installment method.

(ii) Notwithstanding the provisions of subdivision (i) of this subparagraph, the Commissioner may prescribe administrative procedures, subject to such limitations, terms, and conditions as he deems necessary to obtain his consent, to permit taxpayers to change their accounting practices or methods to an acceptable treatment consistent with applicable regulations. Limitations, terms, and conditions, as may be prescribed in such administrative procedures by the Commissioner, shall include those necessary to prevent the omission or duplication of items includible in gross income or deductions.

[T.D. 6500, 25 FR 11708, Nov. 26, 1960, as amended by T.D. 7073, 35 FR 17710, Nov. 18, 1970; T.D. 7285, 38 FR 26184, Sept. 19, 1973; T.D. 8067, 51 FR 378, Jan. 6, 1986; T.D. 8131, 52 FR 10084, March 30, 1987]

§ 1.448–1T Limitation on the use of the cash receipts and disbursements method of accounting (temporary).

(a) Limitation on accounting method—(1) In general. This section prescribes regulations under section 448 relating to the limitation on the use of the cash receipts and disbursements method of accounting (the cash method) by certain taxpayers.

(2) Limitation rule. Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a—

(i) C corporation,

(ii) Partnership with a C corporation as a partner, or

(iii) Tax shelter.

A partnership is described in paragraph (a)(2)(ii) of this section, if the partnership has a C corporation as a partner at any time during the partnership's taxable year beginning after December 31, 1986.

(3) **Meaning of C corporation.** For purposes of this section, the term "C corporation" includes any corporation that is not an S corporation. For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511 (b) shall be treated, for purposes of this section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from federal income taxes under section 501 (a) shall be treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as a C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, partnership ABC is treated as a partnership with a C corporation partner.

(4) **Treatment of a combination of methods.** For purposes of this section, the use of a method of accounting that records some, but not all, items on the cash method shall be considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(b) Tax shelter defined—(1) In general. For purposes of this section, the term "tax shelter" means any—

(i) Enterprise (other than a C corporation) if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale,

(ii) Syndicate (within the meaning of paragraph (b)(3) of this section), or

(iii) Tax shelter within the meaning of section 6661 (b)(2)(C)(ii) (relating to (A) a partnership or other entity, (B) any investment plan or arrangement, or (C) any other plan or arrangement, whose principal purpose is the avoidance or evasion of Federal income tax).

(2) **Requirement of registration.** For purposes of paragraph (b)(1)(i) of this section, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to register the offering would result in a violation of the applicable federal or state law (regardless of whether the offering is in fact registered). In addition, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law (regardless of whether the notice is in fact filed).

(3) **Meaning of syndicate.** For purposes of paragraph (b)(1)(ii) of this section, the term "syndicate" means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(3), the term "limited entrepreneur" has the same meaning given such term in section 464 (e)(2). In addition, in determining whether an interest in a partnership is held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 464 (c)(2) shall apply in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256 (e)(3)(C) shall apply in any other case. Moreover, for purposes of this paragraph (b) (3), the losses of a partnership, entity, or enterprise (the enterprise) means the excess of the deductions allowable to the enterprise over the amount of income recognized by such enterprise under the enterprise's method of accounting used for federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or section 1221 (2) assets are not taken into account.

(4) **Presumed tax avoidance.** For purposes of paragraph (b)(1)(iii) of this section, marketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (e.g., payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).

(5) **Taxable year tax shelter must change accounting method.** A partnership, entity, or enterprise that is a tax shelter must change from the cash method for the later of (i) the first taxable year beginning after December 31, 1986, or (ii) the taxable year that such partnership, entity, or enterprise becomes a tax shelter.

(c) **Effect of section 448 on other provisions.** Nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of § 1.446-1(c)(2) that an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects that taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the taxpayer secures the consent of the Commissioner under section 446(e), and, in the opinion of the Commissioner, the use of the cash method clearly reflects that taxpayer's income under section 446(b).

(d) **Exception for farming business—(1) In general.** Except in the case of a tax shelter, this section shall not apply to any farming business. A taxpayer engaged in a farming business and a separate nonfarming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the nonfarming business.

(2) **Meaning of farming business.** For purposes of paragraph (d) of this section, the term "farming business" means—

(i) The trade or business of farming as defined in section 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees), or

(ii) The raising, harvesting, or growing of trees described in section 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i) of this section).

Thus, for purposes of this section, the term "farming business" includes the raising of timber. For purposes of this section, the term "farming business" does not include the processing of commodities or products beyond those activities normally incident to the growing, raising or harvesting of such products. For example, assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce food products which the taxpayer sells to customers. Similarly, assume that a taxpayer is in the business of raising poultry or other livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation. However, under this section the term "farming business" does include processing activities which are normally incident to the growing, raising or harvesting of agricultural products. For example, assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(e) Exception for qualified personal service corporation—(1) In general. Except in the case of a tax shelter, this section does not apply to a qualified personal service corporation.

(2) Certain treatment for qualified personal service corporation. For purposes of paragraph (a)(2)(ii) of this section (relating to whether a partnership has a C corporation as a partner), a qualified personal service corporation shall be treated as an individual.

(3) Meaning of qualified personal service corporation. For purposes of this section, the term "qualified personal service corporation" means any corporation that meets—

(i) The function test paragraph (e)(4) of this section, and

(ii) The ownership test of paragraph (e)(5) of this section.

(4) Function test—(i) In general. A corporation meets the function test if substantially all the corporation's activities for a taxable year involve the performance of services in one or more of the following fields—

(A) Health,

(B) Law,

(C) Engineering (including surveying and mapping),

(D) Architecture,

(E) Accounting,

(F) Actuarial science,

(G) Performing arts, or

(H) Consulting.

Substantially all of the activities of a corporation are involved in the performance of services in any field described in the preceding sentence (a qualifying field), only if 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field. For purposes of determining whether this 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing services to clients, and the performance of administrative and support services incident to such activities.

(ii) Meaning of services performed in the field of health. For purposes of paragraph (e)(4)(i)(A) of this section, the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipi-

ent. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.

(iii) **Meaning of services performed in the field of performing arts.** For purposes of paragraph (e)(4)(i)(G) of this section, the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (e.g., persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performances of such artists to members of the public (e.g., employees of a radio station that broadcasts the performances of musicians and singers). Finally, the performance of services in the field of the performing arts does not include the provision of services by athletes.

(iv) **Meaning of services performed in the field of consulting**—(A) In general. For purposes of paragraph (e)(4)(i)(H) of this section, the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (e.g., whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect).

(B) Examples. The following examples illustrate the provisions of paragraph (e)(4)(iv)(A) of this section. The examples do not address all types of services that may or may not qualify as consulting. The determination of whether activities not specifically addressed in the examples qualify as consulting shall be made by comparing the service activities in question to the types of service activities discussed in the examples. With respect to a corporation which performs services which qualify as consulting under this section, and other services which do not qualify as consulting, see paragraph (e)(4)(i) of this section which requires that substantially all of the corporation's activities involve the performance of services in a qualifying field.

Example (1). A taxpayer is in the business of providing economic analyses and forecasts of business prospects for its clients. Based on these analyses and forecasts, the taxpayer advises its clients on their business activities. For example, the taxpayer may analyze the economic conditions and outlook for a particular industry which a client is considering entering. The taxpayer will then make recommendations and advise the client on the prospects of entering the industry, as well as on other matters regarding the client's activities in such industry. The taxpayer provides similar services to other clients, involving, for example, economic analyses and evaluations of business prospects in different areas of the United States or in other countries, or economic analyses of overall economic trends and the provision of advice based on these analyses and evaluations. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (2). A taxpayer is in the business of providing services that consist of determining a client's electronic data processing needs. The taxpayer will study and examine the client's business, focusing on the types of data and information relevant to the client and the needs of the client's employees for access to this information. The taxpayer will then make recommendations regarding the design and implementation of data processing systems intended to meet the needs of the client. The taxpayer does not, however, provide the client with additional computer programming services distinct from the recommendations made by the taxpayer with respect to the design and implementation of the client's data processing systems. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (3). A taxpayer is in the business of providing services that consist of determining a client's management and business structure needs. The taxpayer will study the client's organization, including, for example, the departments assigned to perform specific functions, lines of authority in the managerial hierarchy, personnel hiring, job responsibility, and personnel evaluations and compensation. Based on the study, the taxpayer will then advise the client on changes in the client's management and business structure, including, for example, the restructuring of the client's departmental systems or its lines of managerial authority. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (4). A taxpayer is in the business of providing financial planning services. The taxpayer will study a particular client's financial situation, including, for example, the client's present income, savings and investments, and anticipated future economic and financial needs. Based on this study, the taxpayer will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example (5). A taxpayer is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer provides its clients

with economic analyses and forecasts of conditions in various industries and businesses. Based on these analyses, the taxpayer makes recommendations regarding transactions in securities and commodities. Clients place orders with the taxpayer to trade securities or commodities based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the trade orders. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of trade orders for its clients).

Example (6). A taxpayer is in the business of studying a client's needs regarding its data processing facilities and making recommendations to the client regarding the design and implementation of data processing systems. The client will then order computers and other data processing equipment through the taxpayer based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the equipment orders made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of equipment orders for its clients).

Example (7). A taxpayer is in the business of assisting businesses in meeting their personnel requirements by referring job applicants to employers with hiring needs in a particular area. The taxpayer may be informed by potential employers of their need for job applicants, or, alternatively, the taxpayer may become aware of the client's personnel requirements after the taxpayer studies and examines the client's management and business structure. The taxpayer's compensation for its services is typically based on the job applicants, referred by the taxpayer to the clients, who accept employment positions with the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is involved in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the hiring of a job applicant by the client).

Example (8). The facts are the same as in example (7), except that the taxpayer's clients are individuals who use the services of the taxpayer to obtain employment positions. The taxpayer is typically compensated by its clients who obtain employment as a result of the taxpayer's services. For the reasons set forth in example (7), the taxpayer is not considered to be engaged in the performance of services in the field of consulting.

Example (9). A taxpayer is in the business of assisting clients in placing advertisements for their goods and services. The taxpayer analyzes the conditions and trends in the client's particular industry, and then makes recommendations to the client regarding the types of advertisements which should be placed by the client and the various types of advertising media (e.g., radio, television, magazines, etc.) which should be used by the client. The client will then purchase, through the taxpayer, advertisements in various media based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the particular orders for advertisements which the client makes. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the placing of advertisements by clients).

Example (10). A taxpayer is in the business of selling insurance (including life and casualty insurance), annuities, and other similar insurance products to various individual and business clients. The taxpayer will study the particular client's financial situation, including, for example, the client's present income, savings and investments, business and personal insurance risks, and anticipated future economic and financial needs. Based on this study, the taxpayer will then make recommendations to the client regarding the desirability of various insurance products. The client will then purchase these various insurance products through the taxpayer. The taxpayer's compensation for its services is typically based on the purchases made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of brokerage or sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the purchase of insurance products by its clients).

(5) Ownership test—(i) In general. A corporation meets the ownership test, if at all times during the taxable year, substantially all the corporation's stock, by value, is held, directly or indirectly, by—

(A) Employees performing services for such corporation in connection with activities involving a field referred to in paragraph (e)(4) of this section,

(B) Retired employees who had performed such services for such corporation,

(C) The estate of any individual described in paragraph (e)(5)(i) (A) or (B) of this section, or

(D) Any other person who acquired such stock by reason of the death of an individual described in paragraph (e)(5)(i) (A) or (B) of this section, but only for the 2-year period beginning on the date of the death of such individual.

For purposes of this paragraph (e)(5) of this section, the term "substantially all" means an amount equal to or greater than 95 percent.

(ii) Definition of employee. For purposes of the ownership test of this paragraph (e)(5) of this section, a person shall not be considered an employee of a corporation unless the services performed by that person for such corporation, based on the facts and circumstances, are more than de minimis. In addition, a person who is an employee of a corporation shall not be treated as an employee of another corporation merely by reason of the employer corporation and the other corporation being members of the same affiliated group or otherwise related.

(iii) Attribution rules. For purposes of this paragraph (e)(5) of this section, a corporation's stock is considered held indirectly by a person if, and to the extent, such person owns a proportionate interest in a partnership, S corporation, or qualified personal service corporation that owns such stock. No other arrangement or type of ownership shall constitute indirect ownership of a corporation's stock for purposes of this paragraph (e)(5) of this section. Moreover, stock of a corporation held by a trust is considered held by a person if, and to the extent, such person is treated under subpart E, part I, subchapter J, chapter 1 of the Code as the owner of the portion of the trust that consists of such stock.

(iv) Disregard of community property laws. For purposes of this paragraph (e) (5) of this section, community property laws shall be disregarded. Thus, in determining the stock ownership of a corporation, stock owned by a spouse solely by reason of community property laws shall be treated as owned by the other spouse.

(v) Treatment of certain stock plans. For purposes of this paragraph (e)(5) of this section, stock held by a plan described in section 401 (a) that is exempt from tax under section 501 (a) shall be treated as held by an employee described in paragraph (e)(5)(i)(A) of this section.

(vi) Special election for certain affiliated groups. For purposes of determining whether the stock ownership test of this paragraph (e)(5) of this section has been met, at the election of the common parent of an affiliated group (within the meaning of section 1504 (a)), all members of such group shall be treated as one taxpayer if substantially all (within the meaning of paragraph (e)(4)(i) of this section) the activities of all such members (in the aggregate) are in the same field described in paragraph (e)(4)(i)(A)-(H) of this section. For rules relating to the making of the election, see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(vii) Examples. The following examples illustrate the provisions of paragraph (e) of this section:

Example (1). (i) X, a Corporation, is engaged in the business of providing accounting services to its clients. These services consist of the preparation of audit and financial statements and the preparation of tax returns. For purposes of section 448, such services consist of the performance of services in the field of accounting. In addition, for purposes of section 448, the supervision of employees directly preparing the statements and returns, and the performance of all administrative and support services incident to such activities (including secretarial, janitorial, purchasing, personnel, security, and payroll services) are the performance of services in the field of accounting.

(ii) In addition, X owns and leases a portion of an office building. For purposes of this section, the following types of activities undertaken by the employees of X shall be considered as the performance of services in a field other than the field of accounting: (A) services directly relating to the leasing activities, e.g., time spent in leasing and maintaining the leased portion of the building; (B) supervision of employees engaged in directly providing services in the leasing activity; and (C) all administrative and support services incurred incident to services described in (A) and (B). The leasing activities of X are considered the performance of services in a field other than the field of accounting, regardless of whether such leasing activities constitute a trade or business under the Code. If the employees of X spend 95% or more of their time in the performance of services in the field of accounting, X satisfies the function test of paragraph (e)(4) of this section.

Example (2). Assume that Y, a C corporation, meets the function test of paragraph (e)(4) of this section. Assume further that all the employees of Y are performing services for Y in a qualifying field as defined in paragraph (e)(4) of this section. P, a partnership, owns 40%, by value, of the stock of Y. The remaining 60% of the stock of Y is owned directly by employees of Y. Employees of Y have an aggregate interest of 90% in the capital and profits of P. This, 96% of the stock of Y is held directly, or indirectly, by employees of Y performing services in a qualifying field. Accordingly, Y meets the ownership test of paragraph (e)(5) of this section and is a qualified personal service corporation.

Example (3). The facts are the same as in example (2), except that 40% of the stock of Y is owned by Z, a C corporation. The remaining 60% of the stock is owned directly by the employees of Y. Employees of Y own 90% of the stock, by value, of Z. Assume that Z independently qualifies as a personal service corporation. The result is the same as in example (2), i.e., 96% of the stock of Y is held, directly or indirectly, by employees of Y performing services in a qualifying field. Thus, Y is a qualified personal service corporation.

Example (4). The facts are the same as in example (3), except that Z does not independently qualify as a personal service corporation. Because Z is not a qualified personal service corporation, the Y stock owned by Z is not treated as being held indirectly by the Z shareholders. Consequently, only 60% of the stock of Y is held, directly or indirectly, by employees of Y. Thus, Y does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example (5). Assume that W, a C corporation, meets the function test of paragraph (e)(4) of this section. In addition, assume that all the employees of W are performing services for W in a qualifying field. Nominal legal title to 100% of the stock of W is held by employees of W. However, due solely to the operation of community property laws, 20% of the stock of W is held by spouses of such employees who themselves are not employees of W. In determining the ownership of the stock, community property laws are disregarded. Thus, Y meets the ownership test of paragraph (e)(5) of this section, and is a qualified personal service corporation.

Example (6). Assume that 90% of the stock of T, a C corporation, is directly owned by the employees of T. Spouses of T's employees directly own 5% of the stock of T. The spouses are not employees of T, and their ownership does not occur solely by operation of community property laws. In addition, 5% of the stock of T is held by trusts (other than a trust described in section 401(a) that is exempt from tax under section 501(a)), the sole beneficiaries of which are employees of

T. The employees are not treated as owners of the trusts under subpart E, part I, subchapter J, chapter 1 of the Code. Since a person is not treated as owning the stock of a corporation owned by that person's spouse, or by any portion of a trust that is not treated as owned by such person under subpart E, only 90% of the stock of T is treated as held, directly or indirectly, by employees of T. Thus, T does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example (7). Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and H. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, G, and H. Y is not engaged in the performance of services in a qualifying field. Instead, Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F involve the performance of services in the field of engineering. In addition, a majority of (but not substantially all) the activities of G involve the performance of services in the field of engineering; the remainder of G's services involve the performance of services in a nonqualifying field. Moreover, a majority of (but not substantially all) the activities of H involve the performance of services in the field of engineering; the remainder of H's activities involve the performance of services in the field of architecture. Nevertheless, substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, involve the performance of services in the field of engineering. Accordingly, Y elects under paragraph (e)(5)(vi) of this section to be treated as one taxpayer for determining the ownership test of paragraph (e)(5) of this section. Assume that substantially all the stock of Y (by value) is held by employees of F, G, or H who perform services in connection with a qualifying field (engineering or architecture). Thus, for purposes of determining whether any member corporation is a qualified personal service corporation, the ownership test of paragraph (e)(5) of this section has been satisfied. Since F and H satisfy the function test of paragraph (e)(4) of this section, F and H are qualified personal service corporations. However, since Y and G each fail the function test of paragraph (e)(4) of this section, neither corporation is a qualified personal service corporation.

Example (8). The facts are the same as in example (7), except that less than substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, are performed in the field of engineering. Substantially all the activities of the group consisting of Y, F, G, and H, are, in the aggregate, performed in two fields, the fields of engineering and architecture. Y may not elect to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section. The election is available only if substantially all the activities of the group, in the aggregate, involve the performance of services in only one qualifying field. Moreover, none of the group members are qualified personal service corporations. Y fails the function test of paragraph (e)(4) of this section because less than substantially all the activities of Y are performed in a qualifying field. In addition, F, G, and H fail the ownership test of paragraph (e)(5) of this section because substantially all their stock is owned by Y and not by their employees. The owners of Y are not deemed to indirectly own the stock owned by Y because Y is not a qualified personal service corporation.

Example (9). (i) The facts are the same as in example (8), except Y itself satisfies the function tests of paragraph (e)(4) of this section because substantially all the activities of Y involve the performance of services in the field of engineering. In addition, assume that all employees of Y are involved in the performance of services in the field of engineering, and that all such employees own 100% of Y's stock. Moreover, assume that one-third of all the employees of Y are separately employed by F. Similarly, another one-third of the employees of Y are separately employed by G and H, respectively. None of the employees of Y are employed by more than one of Y's subsidiaries. Also, no other persons except the employees of Y are employed by any of the subsidiaries.

(ii) Y is a personal service corporation under section 448 because Y satisfies both the function and the ownership test of paragraphs (e) (4) and (5) of this section. As in example (8), Y is unable to make the election to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section because less than substantially all the activities, in the aggregate, of the group members are performed in one of the qualifying fields. However, because Y is a personal service corporation, the stock owned by Y is treated as indirectly owned, proportionately, by the owners of Y. Thus, the employees of F are collectively treated as owning one-third of the stock of F, G, and H. The employees of G and H are similarly treated as owning one-third of each subsidiary's stock.

(iii) F, G, and H each fail the ownership test of paragraph (e)(5) of this section because less than substantially all of each corporation's stock is owned by the employees of the respective corporation. Only one-third of each corporation's stock is owned by employees of that corporation. Thus, F, G, and H are not qualified personal service corporations.

Example (10). (i) Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and Z. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, and G. Z is a foreign corporation and is excluded from the affiliated group under section 1504. Assume that Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F, G, and Z involve the performance of services in the field of engineering. Assume that employees of Z own one-third of the stock of Y and that none of these employees are also employees of Y, F, or G. In addition, assume that Y elects to be treated as one taxpayer for determining whether group members meet the ownership tests of paragraph (e)(5) of this section. Thus, Y, F, and G are treated as one taxpayer for purposes of the ownership test.

(ii) None of the members of the group are qualified personal service corporations. Y, F, and G fail the ownership test of paragraph (e)(5) of this section because less than substantially all the stock of Y is owned by employees of either Y, F, or G. Moreover, Z fails the ownership test of paragraph (e)(5) of this section because substantially all its stock is owned by Y and not by its employees.

(6) Application of function and ownership tests. A corporation that fails the function test of paragraph (e)(4) of this section for any taxable year, or that fails the ownership test of paragraph (e)(5) of this section at any time during any taxable year, shall change from the cash method effective for the year in which the corporation fails to meet the function test or the ownership test. For example, if a personal service corporation fails the function test for taxable year 1987, such corporation must change from the cash method effective for taxable year 1987. A corporation that fails the function or ownership test for a taxable year shall not be treated as a qualified personal service corporation for any part of that taxable year.

(f) Exception for entities with gross receipts of not more than $5 million—(1) In general. Except in the case of a tax shelter, this section shall not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if, for all prior taxable years beginning after December 31, 1985, such corporation or partnership (or any predecessor thereof) meets the $5,000,000 gross receipts test of paragraph (f)(2) of this section.

(2) The $5,000,000 gross receipts test—(i) In general. A corporation meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence) ending with such prior taxable year does not exceed $5,000,000. In the case of a C corporation exempt from federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (a)(3) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the $5,000,000 gross receipts test is satisfied. A partnership with a C corporation as a partner meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence) ending with such prior year does not exceed $5,000,000. The gross receipts of the corporate partner are not taken into account in determining whether the partnership meets the $5,000,000 gross receipts test.

(ii) Aggregation of gross receipts. For purposes of determining whether the $5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52 (a) or (b), or section 414 (m) or (*o*) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the $5,000,000 gross receipts test is satisfied.

(iii) Treatment of short taxable year. In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.

(iv) Determination of gross receipts—(A) In general. The term "gross receipts" means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade or business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221 (1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221 (2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (e.g., a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.

(3) Examples. The following examples illustrate the provisions of paragraph (f) of this section:

Example (1). X, a calendar year C corporation, was formed on January 1, 1986. Assume that in 1986 X has gross receipts of $15 million. For taxable year 1987, this section applies to X because in 1986, the period during which X was in existence, X has average annual gross receipts of more than $5 million.

Example (2). Y, a calendar year C corporation that is not a qualified personal service corporation, has gross receipts of $10 million, $9 million, and $4 million for taxable years 1984, 1985, and 1986, respectively. In taxable year 1986, X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7.67 million ($10 million + 9 million + 4 million '3). Thus, for taxable year 1987, this section applies and Y must change from the cash method for such year.

Example (3). Z, a C corporation which is not a qualified personal service corporation, has a 5% partnership interest in ZAB partnership, a calendar year cash method taxpayer. All other partners of ZAB partnership are individuals. Z corporation has average annual gross receipts of $100,000 for the 3-taxable-year period ending with 1986 (i.e., 1984, 1985 and 1986). The ZAB partnership has average annual gross receipts of $6 million for the same 3-taxable-year period. Since ZAB fails to meet the $5,000,000 gross receipts test for 1986, this section applies to ZAB for its taxable year beginning January 1, 1987. Accordingly, ZAB must change from the cash method for its 1987 taxable year. The gross receipts of Z corporation are not relevant in determining whether ZAB is subject to this section.

Example (4). The facts are the same as in example (3), except that during the 1987 taxable year of ZAB, the Z corporation transfers its partnership interest in ZAB to an individual. Under paragraph (a)(1) of this section, ZAB is treated as a partnership with a C corporation as a partner. Thus, this section requires ZAB to change from the cash method effective for its taxable year 1987. If ZAB later desires to change its method of accounting to the cash method for its taxable year beginning January 1, 1988 (or later), ZAB must comply with all requirements of law, including sections 446(b), 446(e), and 481, to effect the change.

Example (5). X, a C corporation that is not a qualified personal service corporation, was formed on January 1, 1986, in a transaction described in section 351. In the transaction, A, an individual, contributed all of the assets and liabilities of B, a trade or business, to X, in return for the receipt of all the outstanding stock of X. Assume that in 1986 X has gross receipts of $4 million. In 1984 and 1985, the gross receipts of B, the trade or business, were $10 million and $7 million respectively. The gross receipts test is applied for the period during which X and its predecessor trade or business were in existence. X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7 million ($10 million + $7 million + $4 million'3). Thus, for taxable year 1987, this section applies and X must change from the cash method for such year.

(g) Treatment of accounting method change and timing rules for section 481(a) adjustment—(1) Treatment of change in accounting method. In the case of any taxpayer required by this section to change its method of accounting for any taxable year, such change shall be treated as initiated by the taxpayer and made with the consent of the Commissioner. Thus, the adjustments required under section 481(a) with respect to the change in method of accounting of such a taxpayer shall not be reduced to amounts attributable to taxable years preceding the Internal Revenue Code of 1954. See paragraph (h) of this section for rules to effect the change in accounting method.

(2) Timing rules for section 481(a) adjustment—(i) In general. Except as otherwise provided in paragraph (g)(2)(ii) and (g)(3) of this section, a taxpayer required by this section to change from the cash method shall take the section 481(a) adjustment into account ratably (beginning with the year of change) over a shorter of—

(A) The number of taxable years the taxpayer uses the cash method, or

(B) 4 taxable years.

(ii) Hospital timing rules—(A) In general. In the case of a hospital required by this section to change from the cash method, the section 481(a) adjustment shall be taken into account ratably (beginning with the year of change) over 10 years.

(B) Definition of hospital. For purposes of paragraph (g) of this section, a hospital is an institution—

(1) Accredited by the Joint Commission of Accreditation of Hospitals (the JCAH) (or accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAH);

(2) Used primarily to provide, by or under the supervision of physicians, to inpatients diagnostic services and therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons;

(3) Requiring every patient to be under the care and supervision of a physician; and

(4) Providing 24-hour nursing services rendered or supervised by a registered professional nurse and having a licensed practical nurse or registered nurse on duty at all times.

For purposes of this section, an entity need not be owned by or on behalf of a governmental unit or by a section 501(c)(3) organization, or operated by a section 501(c)(3) organization, in order to be considered a hospital. In addition, for purposes of this section, a hospital does not include a rest or nursing home, continuing care facility, daycare center, medical school facility, research laboratory, or ambulatory care facility.

(C) Dual function facilities. With respect to any taxpayer whose operations consist both of a hospital, and other facilities not qualifying as a hospital, the portion of the adjustment required by section 481(a) that is attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section relating to hospitals. The portion of the adjustment required by section 481(a) that is not attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section not relating to hospitals.

(3) Special timing rules for section 481(a) adjustment—(i) One-third rule. If, during the period the section 481(a) adjustment is to be taken into account, the balance of the taxpayer's accounts receivable as of the last day of each of two consecutive taxable years is less than 66⅔ percent of the taxpayer's accounts receivable balance at the beginning of the first year of the section 481(a) adjustment, the balance of the section 481(a) adjustment (relating to accounts receivable) not previously taken into account shall be included in income in the second taxable year. This paragraph (g)(3)(i) shall not apply to any hospital (within the meaning of paragraph (g)(3)(ii) of this section).

(ii) Cooperatives. Notwithstanding paragraph (g)(2)(i) of this section, if a taxpayer is a cooperative within the meaning of section 1381(a), the entire section 481(a) adjustment may, at the taxpayer's option, be taken into account in the year of change.

(iii) Cessation of trade or business. If a taxpayer ceases to engage in the trade or business to which the section 481(a) adjustment relates prior to the expiration of the adjustment period described in paragraph (g)(2) (i) or (ii) of this section, the taxpayer must take into account, in the year of such cessation, the balance of the adjustment not previously taken into account in computing taxable income. If the taxpayer is acquired in a transaction to which section 381 applies, and the acquiring corporation continues to engage in the trade or business to which the section 481(a) adjustment relates, the acquiring taxpayer shall continue to take into account the section 481(a) adjustment as if it were the distributor or transferor taxpayer.

(4) Additional rules relating to section 481(a) adjustment. In addition to the rules set forth in paragraph (g) (2) and (3) of this section, the following rules shall apply in taking the section 481(a) adjustment into account—

(i) Any net operating loss and tax credit carryforwards will be allowed to offset any positive section 481(a) adjustment,

(ii) Any net operating loss arising in the year of change or in any subsequent year that is attributable to a negative section 481(a) adjustment may be carried back to earlier taxable years in accordance with section 172, and

(iii) For purposes of determining estimated income tax payments under sections 6654 and 6655, the section 481(a) adjustment will be recognized in taxable income ratably throughout a taxable year.

(5) Outstanding section 481(a) adjustment from previous change in method of accounting. If a taxpayer changed its method of accounting to the cash method for a taxable year prior to the year the taxpayer was required by this section to change from the cash method (the section 488 year), any section 481(a) adjustment from such prior change in method of accounting that is outstanding as of the section 488 year shall be taken into account in accordance with the provisions of this paragraph (g)(5). A taxpayer shall account for any remaining portion of the prior section 481(a) adjustment outstanding as of the section 488 year by continuing to take such remaining portion into account under the provisions and conditions of the prior change in method of accounting, or, at the taxpayer's option, combining or netting the remaining portion of the prior section 481(a) adjustment with the section 481(a) adjustment required under this section, and taking into account under the provisions of this section the resulting net amount of the adjustment. Any taxpayer choosing to combine or net the section 481(a) adjustments as described in the preceding sentence shall indicate such choice on the Form 3115 required to be filed by such taxpayer under the provisions of paragraph (h) of this section.

(6) Examples. The following examples illustrate the provisions of paragraph (g) of this section.

Example (1). Y is required by this section to change from the cash method of accounting for its taxable year beginning January 1, 1987. Y changes to an overall accrual method. The adjustment required by section 481(a) to effect the change is $10,000. Y has been using the cash method for the 10-year period preceding the year of change. Y is required by paragraph (g)(2)(i) of this section to include the section 481(a) adjustment in taxable income ratably over four consecutive taxable years, beginning with 1987, i.e., $2,500 of the section 481(a) adjustment should be included in income for each of the four years.

Example (2). The facts are the same as in example (1), except that Y is required to change from the cash method and changes to an overall accrual method of accounting for its taxable year beginning January 1, 1989. The result is the same as in example (1), except that the four-year period for ratably taking the section 481(a) adjustment into account begins with the 1989 taxable year.

Example (3). Assume that X is required by this section to change from the cash method and that it changes to an overall accrual method for its taxable year beginning January 1, 1987. The adjustment required by section 481 (a) to effect the change is $10,000. X was formed on January 1, 1986, and began business operations during that year. Since X only used the cash method for one year, X is required by paragraph (g)(2)(i) of this section to include all ($10,000) of the section 481(a) adjustment in taxable income for the 1987 taxable year.

Example (4). The facts are the same as in example (1). In addition, Y previously changed from an accrual method of

accounting to the cash method for its taxable year beginning January 1, 1983. As a result of that prior change, Y was required to take into account a $5,000 negative section 481(a) adjustment ratably over a ten-year period, beginning with the 1983 taxable year.

As of the beginning of the 1987 taxable year $3,000 of that adjustment had not been taken into account. Y may continue to take the remaining negative $3,000 section 481(a) adjustment into account ratably over the remaining adjustment period for the prior change in method of accounting (i.e., six remaining years). Alternatively, Y may combine or net the negative $3,000 adjustment with the positive $10,000 section 481(a) adjustment required by this section, and include the resulting $7,000 amount in taxable income ratably over four consecutive taxable years, beginning with 1987. Y is not allowed to take the entire unamortized amount of the prior section 481(a) adjustment into account for its 1987 taxable year.

(h) Procedures for change in method of accounting—(1) Applicability. Paragraph (h) of this section applies to taxpayers who change from the cash method as required by this section. Paragraph (h) of this section does not apply to a change in accounting method required by any Code section (or regulations thereunder) other than this section.

(2) Automatic rule for changes to an overall accrual method. Taxpayers to whom paragraph (h) of this section applies who desire to change to an overall accrual method must make that change under the provisions of this paragraph (h)(2). The consent of the Commissioner to the change in method of accounting is granted to taxpayers who change to an overall accrual method under this paragraph (h)(2). A taxpayer changing to an accrual method under this paragraph (h)(2) shall complete and file a current Form 3115. The Form 3115 shall be filed no later than the due date (including extension) of the taxpayer's federal income tax return for the year of change and shall be attached to that return. In addition, the taxpayer must set forth on a statement accompanying the Form 3115 the period over which the section 481(a) adjustment will be taken into account and the basis for such conclusion. Moreover, the taxpayer shall type or legibly print the following statement at the top of page 1 on Form 3115: "Automatic Change to Accrual Method—Section 448."

(3) Changes to a method other than overall accrual method—(i) In general. Taxpayers to whom paragraph (h) of this section applies who desire to change to a special method of accounting must make that change under the provisions of this paragraph (h)(3). Such taxpayers include taxpayers who change to an accrual method of accounting and a special method of accounting such as a long-term contract method. Taxpayers who change their accounting method under this paragraph (h)(3) shall submit an application for change in accounting method under the applicable administrative procedures in effect at the time of change, including the applicable procedures regarding the time and place of filing the application for change in method. Moreover, taxpayers who change their accounting method under this paragraph (h)(3) shall type or legibly print the following statement on the top of page 1 of Form 3115: "Change to a Special Method of Accounting-Section 448." The filing of a Form 3115 by any taxpayer requesting a change of method of accounting under this paragraph (h)(3) for its taxable year beginning in 1987 shall not be considered late if such form is filed with the appropriate office of the Internal Revenue Service on or before the later of (A) the date that is the 180th day of the taxable year of change; or (B) September 14, 1987. If the Commissioner approves the taxpayer's application for change in method of accounting, then the timing of the adjustment required under section 481(a), if applicable, shall be determined under the provisions of paragraph (g)(2) of this section. If the Commissioner denies the taxpayer's application for change in accounting method, or the taxpayer's application is untimely, the taxpayer must change to an overall accrual method of accounting under the provisions of paragraph (h)(1) of this section for the taxable year of the taxpayer's request to change from the cash method.

(ii) Extension of filing deadline. Notwithstanding paragraph (h)(3)(i) of this section, if the events or circumstances which under section 448 disqualify a taxpayer from using the cash method occur after the time prescribed under applicable procedures for filing the Form 3115, the filing of such form shall not be considered late if such form is filed on or before 30 days after the close of the taxable year.

(i) Effective date—(1) In general. Except as provided in paragraph (i)(2) of this section, this section applies to any taxable year beginning after December 31, 1986.

(2) Election out of section 448—(i) In general. A taxpayer may elect not to have this section apply to any (A) transaction with a related party (within the meaning of section 267(b) of the Internal Revenue Code of 1954, as in effect on October 21, 1986), (B) loan, or (C) lease, if such transaction, loan, or lease was entered into on or before September 25, 1985. Any such election described in the preceding sentence may be made separately with respect to each transaction, loan, or lease. For rules relating to the making of such election,

see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986). Notwithstanding the provisions of this paragraph (i)(2), the gross receipts attributable to a transaction, loan, or lease described in this paragraph (i)(2) shall be taken into account for purposes of the $5,000,000 gross receipts test described in paragraph (f) of this section.

(ii) Special rules for loans. If the taxpayer makes an election under paragraph (i)(2)(i) of this section with respect to a loan entered into on or before September 25, 1985, the election shall apply only with respect to amounts that are attributable to the loan balance outstanding on September 25, 1985. The election shall not apply to any amounts advanced or lent after September 25, 1985, regardless of whether the loan agreement was entered into on or before such date. Moreover, any payments made on outstanding loan balances after September 25, 1985, shall be deemed to first extinguish loan balances outstanding on September 25, 1985, regardless of any contrary treatment of such loan payments by the borrower and lender.

[T.D. 8143, 52 FR 22766, June 16, 1987]

§ 1.448–2T Nonaccrual of certain amounts by service providers (temporary).

(a) In general. Except as otherwise provided, this section applies to any person using an accrual method of accounting with respect to amounts to be received from the performance of services by such person. This section applies to such persons regardless of whether such persons changed their method of accounting from the cash method under section 448. For example, this section applies to a taxpayer who used an overall accrual method of accounting in taxable years prior to 1987.

(b) Nonaccrual-experience method; treatment as method of accounting. Any person to whom this section applies is not required to accrue any portion of amounts to be received from the performance of services which, on the basis of experience, will not be collected. This nonaccrual of amounts to be received for the performance of services shall be treated as a method of accounting under the Code (the nonaccrual-experience method).

(c) Method not available if interest charged on amounts due—(1) In general. The nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid, or for which there is any penalty for failure to timely pay any amounts due. For this purpose, interest or penalties for late payment will be deemed to be charged by a taxpayer if such treatment is in accordance with the economic substance of a transaction, regardless of the characterization of the transaction by the parties, or the treatment of the transaction under state or local law. However, the offering of a discount for early payment of an amount due will not be regarded as the charging of interest or penalties for late payment under this section, if (i) the full amount due is otherwise accrued as gross income by the taxpayer at the time the services are provided, and (ii) the discount for early payment is treated as an adjustment to gross income in the year of payment, if payment is received within the time required for allowance of such discount.

(2) Example. The provisions of this paragraph (c) may be illustrated by the following example:

Example. X uses an accrual method of accounting for amounts to be received from the provision of services. For such amounts, X has two billing methods. Under one method, for amounts that are more than 90 days past due, X charges interest at a market rate until such amounts (together with interest) are paid. Under the other billing method, X charges no interest for amounts past due. X cannot use the nonaccrual-experience method of accounting with respect to any of the amounts billed under the method that charges interest on amounts that are more than 90 days past due. X may, however, use the nonaccrual-experience method with respect to the amounts billed under the method that does not charge interest for amounts past due.

(d) Method not available for certain receivables. The nonaccrual-experience method of accounting may be used only with respect to amounts earned by the taxpayer and otherwise recognized in income (an account receivable) through the performance of services by such taxpayer. For example, the nonaccrual-experience method may not be used with respect to amounts owed to the taxpayer by reason of the taxpayer's activities with respect to (1) lending money; (2) selling goods; or (3) acquiring receivables or other rights to receive payment from other persons (including persons related to the taxpayer) regardless of whether those other persons earned such amounts through the provision of services.

(e) Use of experience to estimate uncollectible amounts—(1) In general. In determining the portion of any amount due which, on the basis of experience, will not be collected, the formula prescribed by paragraph (e)(2) of this section shall be used by the taxpayer with respect to each separate trade or business of the taxpayer. No other method or formula may be used by a taxpayer in determining the uncollectible amounts under this section.

(2) Six-year moving average—(i) General rule. For any taxable year the uncollectible amount of a receivable is the amount of that receivable which bears the same ratio to the account receivable outstanding at the close of the taxable year as (A) the total bad debts (with respect to accounts receivable) sustained throughout the period consisting of the taxable year and the five preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the accounts receivable earned throughout the entire six (or fewer) taxable year period (i.e., the total amount of sales resulting in accounts receivable) throughout the period. Accounts receivable described in paragraphs (c) and (d) of this section are not taken into account in computing the ratio.

(ii) Period of less than six years. A period shorter than six years generally will be appropriate only if there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. A decline in the general economic conditions in the area, which substantially increases the risk of loss, is a relevant factor in determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the loans outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to loans outstanding at the close of the six taxable years. A substantial increase in a taxpayer's bad debt experience, is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall be made in accordance with the applicable procedures for requesting a letter ruling and shall include a statement of the reasons such experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) Special rule for new taxpayers. In the case of any current taxable year which is preceded by less than 5 taxable years, paragraph (e)(2)(i) of this section shall be applied by using the experience of the current year and the actual number of preceding taxable years. However, for this purpose, experience from preceding taxable years of a predecessor trade or business may be used in applying paragraph (e)(2)(i) of this section.

(3) Mechanics of nonaccrual-experience method. The nonaccrual-experience method shall be applied with respect to each account receivable of the taxpayer which is eligible for such method. With respect to a particular account receivable, the taxpayer will determine, in the manner prescribed in paragraph (e) of this section, the amount of such account receivable that is not expected to be collected. Such determination shall be made only once with respect to each account receivable, regardless of the term of such receivable. The estimated uncollectible amount shall not be recognized as gross income. Thus, the amount recognized as gross income shall be the amount that would otherwise be recognized as gross income with respect to the account receivable, less the amount which is not expected to be collected. Upon the collection of the account receivable, additional gross income shall be recognized with respect to the collection of any amount not initially expected to be collected. Similarly, no bad debt deduction under section 166 for a wholly or partially worthless account receivable shall be allowed for any amount not previously taken into income under the nonaccrual-experience method.

(4) Examples. The following examples illustrate the provisions of paragraph (e) of this section:

Example (1). X is a calendar year service provider that uses an accrual method of accounting with respect to the amounts (accounts receivable) to be received from the provision of services. X does not require the payment of interest or penalties with respect to past due accounts receivable. Assume that under this section, X adopts for taxable year 1987 the nonaccrual-experience method of accounting with respect to its accounts receivable. Further, assume that X's total accounts receivable and bad debt experience for the current and five preceding taxable years is as follows:

Years	Total accounts receivable	Bad debts adjusted for recoveries
1982	$ 30,000	$ 5,700
1983	40,000	7,200
1984	50,000	11,000
1985	60,000	10,200
1986	70,000	14,000
1987	80,000	16,800
	330,000	64,900

Thus, the ratio of the bad debts (adjusted for recoveries) for the current and five preceding taxable years to the total accounts receivable over the same period is 19.67% ($64,900/$330,000). Assume that $49,300 of the total $80,000 of accounts receivable earned throughout the taxable year 1987 are outstanding as of the close of such year. Assume further that the $49,300 of the accounts receivable outstanding as of the close of the tax year 1987 consist of 10 separate accounts receivable. The uncollectible amount of each receivable is

19.67%. The amount of these accounts receivable and the uncollectible amount of each is as follows:

	Accounts receivable	Applicable ratio	Uncollectible amount
1.	$ 5,200	.1967	$1,022.84
2.	7,300	.1967	1,435.91
3.	3,200	.1967	629.44
4.	4,300	.1967	845.81
5.	1,700	.1967	334.39
6.	4,000	.1967	786.80
7.	6,300	.1967	1,239.21
8.	8,000	.1967	1,573.60
9.	3,200	.1967	629.44
10.	6,100	.1967	1,199.87
		49,300	9,697.31

For taxable year 1987, X will not accrue as income $9,697.31 of its accounts receivable of $49,300 outstanding as of the close of the year.

Example (2). The facts are the same as in example (1). In 1988 the entire amount of account receivable number 8 becomes wholly worthless. Since in 1987 X did not accrue as income under the nonaccrual-experience method $1,573.60 of that account receivable, no deduction under section 166 is allowable with respect to that amount of the account receivable; a deduction of $6,426.40 under section 166 is allowable for 1988.

Example (3). The facts are the same as in example (1). In 1988 X collects, in full, account receivable number 5. Accordingly, in 1988 X must recognize additional gross income of $334.39, the amount of the account receivable that was initially considered uncollectible.

(5) **Special rule for estimated tax.** For purposes of section 6654 or 6655 only (relating to the addition to tax for underpayment of estimated tax), a taxpayer's income does not include eligible income attributable to the period before May 16, 1988. A taxpayer's eligible income is the excess (if any) of—

(i) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using accounts receivable earned throughout the period ending at the close of the six-year period (or other shorter period) described in paragraph (e)(2)(i) of this section, over

(ii) Income (including the amount of any adjustment required under section 481(a)) computed with a bad debt experience ratio using the year-end balances of accounts receivable over such six-year (or other shorter) period.

(f) [Reserved].

(g) Coordination of change in accounting method with section 481—(1) Taxpayers required to change their method of accounting under section 448. The provisions of this paragraph (g)(1) apply to taxpayers who under § 1.448-1T(h) change from the cash method as required by section 448 and who also change under paragraph (h) of this section to a method of accounting that includes the nonaccrual-experience method. With respect to such taxpayers, the section 481(a) adjustment resulting from the change in method of accounting to the nonaccrual-experience method shall be combined or netted with the section 481(a) adjustment applicable to the change in method of accounting required under section 448. The resulting amount shall then be taken into account in accordance with the provisions of § 1.448-1T(g) applicable to the change in method of accounting required by section 448.

(2) Taxpayers not required to change their method of accounting under section 448. The provisions of this paragraph (g)(2) apply to taxpayers who are not required by section 448 to change their method of accounting (e.g., taxpayers who were using an accrual method of accounting for taxable years preceding 1987) and who change to the nonaccrual-experience method under paragraph (h)(3) of this section. With respect to such taxpayers, the section 481(a) adjustment resulting from the change in method of accounting to the nonaccrual-experience method shall be taken into account ratably over four taxable years. The provisions of this paragraph (g)(2) shall apply to any taxpayer regardless of whether such taxpayer was required to change its method of accounting for bad debts under section 805 of the Tax Reform Act of 1986.

(h) Changes in method of accounting to nonaccrual-experience method—(1) Automatic changes to overall accrual method. The provisions of this paragraph (h)(1) apply to taxpayers who change from the cash method as required by section 448, and change to an overall accrual method of accounting under the automatic change provisions of § 1.448-1T(h)(2). Taxpayers to whom this paragraph (h)(1) applies may automatically change their method of accounting to the nonaccrual-experience method under this paragraph (h)(1), if they otherwise qualify under this section for the use of such method. Taxpayers changing to the nonaccrual-experience method under this paragraph (h)(1) shall comply with the provisions of § 1.448-1T(h)(2). Moreover, such taxpayers shall type or legibly print the following statement at the top of page 1 of Form 3115: "Automatic Change to Nonaccrual-Experience Method—Section 448." The consent of the Commissioner to the change in method of accounting is granted to taxpayers changing to the nonaccrual-experience method under this paragraph (h)(1).

(2) Changes to a method other than overall accrual method. The provisions of this paragraph (h)(2) apply to taxpayers who change from the cash method as required by section 448 and who also change to a permissible special method of accounting under § 1.448-1T(h)(3). Taxpayers to whom this paragraph (h)(2) applies may change their method of accounting to the nonaccrual-experience method under this paragraph (h)(2). Taxpayers changing to the nonaccrual-experience method under this paragraph (h)(2) shall comply with the provisions of § 1.448-1T(h)(3). Moreover, such taxpayers shall type or legibly print the following statement on the top of page 1 of Form 3115: "Change to Nonaccrual-Experience Method and Special Method of Accounting-Section 448." The consent of the Commissioner to the change in method of accounting is granted to taxpayers changing to the nonaccrual-experience method under this paragraph (h)(2).

(3) Taxpayers not required to change their method of accounting under section 448. The provisions of this paragraph (h)(3) apply to taxpayers who are not required by section 448 to change their method of accounting for the taxable year in which such taxpayers desire to adopt the nonaccrual-experience method (e.g., taxpayers who were using an accrual method of accounting for taxable years preceding 1987). Such taxpayers may automatically change their method of accounting to the nonaccrual-experience method under the provisions of this paragraph (h)(3), for their taxable year beginning in 1987, if they otherwise qualify under the provisions of this section for the use of such method. Taxpayers changing to the nonaccrual-experience method for their taxable year beginning in 1987 shall complete and file a current Form 3115. The Form 3115 shall be filed no later than the due date (including extension) of the taxpayer's federal income tax return for the year of change and shall be attached to that return. Moreover, the taxpayer shall type or legibly print the following statement at the top of page 1 of Form 3115: "Automatic Change to Nonaccrual-Experience Method—Taxpayer not Required to Change Method of Accounting Under Section 448." The consent of the Commissioner to the change in method of accounting is granted to taxpayers changing to the nonaccrual-experience method for their taxable year beginning in 1987 under this paragraph (h)(3). With respect to taxpayers described in this paragraph (h)(3) who desire to change to the nonaccrual-experience method for a taxable year beginning after December 31, 1987, such taxpayers shall submit an application for change in accounting method under the administrative procedures applicable to taxpayers at the time of change, including the applicable procedures regarding the time and place of filing the application for change in method. Taxpayers described in the preceding sentence include taxpayers who were required to change their method of accounting under section 448 for an earlier taxable year, but who did not change to the nonaccrual-experience method at that time.

(i) Effective date. This section applies to any taxable year beginning after December 31, 1986.

[T.D. 8143, 52 FR 22774, June 16, 1987; T.D. 8194, 53 FR 12513, April 15, 1988]

Taxable Year For Which Items Of Gross Income Included

§ 1.451–1 General rule for taxable year of inclusion.

(a) General rule. Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the

regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and paragraph (a) of § 1.706–1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

(b) Special rule in case of death. (1) A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and paragraph (a)(2) of § 1.443–1. In computing taxable income for such year, there shall be included only amounts properly includible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, amounts accrued only by reason of his death shall not be included in computing taxable income for such year. If the taxpayer uses no regular accounting method, only amounts actually or constructively received during such year shall be included. (For rules relating to the inclusion of partnership income in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.)

(2) If the decedent owned an installment obligation the income from which was taxable to him under section 453, no income is required to be reported in the return of the decedent by reason of the transmission at death of such obligation. See section 453(d)(3). For the treatment of installment obligations acquired by the decedent's estate or by any person by bequest, devise, or inheritance from the decedent, see section 691(a)(4) and the regulations thereunder.

(c) Special rule for employee tips. Tips reported by an employee to his employer in a written statement furnished to the employer pursuant to section 6053(a) shall be included in gross income of the employee for the taxable year in which the written statement is furnished the employer. For provisions relating to the reporting of tips by an employee to his employer, see section 6053 and § 31.6053–1 of this chapter (Employment Tax Regulations).

(d) Special rule for ratable inclusion of original issue discount. For ratable inclusion of original issue discount in respect of certain corporate obligations issued after May 27, 1969, see section 1232(a)(3).

(e) Special rule for inclusion of qualified tax refund effected by allocation. For rules relating to the inclusion in income of an amount paid by a taxpayer in respect of his liability for a qualified State individual income tax and allocated or reallocated in such a manner as to apply it toward the taxpayer's liability for the Federal income tax, see paragraph (f)(1) of § 301.6361–1 of this chapter (Regulations on Procedure and Administration).

[T.D. 6500, 25 FR 11709, Nov. 26, 1960, as amended by T.D. 7001, 34 FR 997, Jan. 23, 1969; T.D. 7154, 36 FR 24996, Dec. 28, 1971; T.D. 7577, 43 FR 59357, Dec. 20, 1978]

§ 1.451–2 Constructive receipt of income.

(a) General rule. Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. In the case of interest, dividends, or other earnings (whether or not credited) payable in respect of any deposit or account in a bank, building and loan association, savings and loan association, or similar institution, the following are not substantial limitations or restrictions on the taxpayer's control over the receipt of such earnings:

(1) A requirement that the deposit or account, and the earnings thereon, must be withdrawn in multiples of even amounts;

(2) The fact that the taxpayer would, by withdrawing the earnings during the taxable year, receive earnings that are not substantially less in comparison with the earnings for the corresponding period to which the taxpayer would be entitled had he left the account on deposit until a later date (for example, if an amount equal to three months' interest must be forfeited upon withdrawal or redemption before maturity of a one year or less certificate of deposit, time deposit, bonus plan, or other deposit arrangement then the earnings payable on premature withdrawal or redemption

would be substantially less when compared with the earnings available at maturity);

(3) A requirement that the earnings may be withdrawn only upon a withdrawal of all or part of the deposit or account. However, the mere fact that such institutions may pay earnings on withdrawals, total or partial, made during the last three business days of any calendar month ending a regular quarterly or semiannual earnings period at the applicable rate calculated to the end of such calendar month shall not constitute constructive receipt of income by any depositor or account holder in any such institution who has not made a withdrawal during such period;

(4) A requirement that a notice of intention to withdraw must be given in advance of the withdrawal. In any case when the rate of earnings payable in respect of such a deposit or account depends on the amount of notice of intention to withdraw that is given, earnings at the maximum rate are constructively received during the taxable year regardless of how long the deposit or account was held during the year or whether, in fact, any notice of intention to withdraw is given during the year. However, if in the taxable year of withdrawal the depositor or account holder receives a lower rate of earnings because he failed to give the required notice of intention to withdraw, he shall be allowed an ordinary loss in such taxable year in an amount equal to the difference between the amount of earnings previously included in gross income and the amount of earnings actually received. See section 165 and the regulations thereunder.

(b) Examples of constructive receipt. Amounts payable with respect to interest coupons which have matured and are payable but which have not been cashed are constructively received in the taxable year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder. However, if a dividend is declared payable on December 31 and the corporation followed its usual practice of paying the dividends by checks mailed so that the shareholders would not receive them until January of the following year, such dividends are not considered to have been constructively received in December. Generally, the amount of dividends or interest credited on savings bank deposits or to shareholders of organizations such as building and loan associations or cooperative banks is income to the depositors or shareholders for the taxable year when credited. However, if any portion of such dividends or interest is not subject to withdrawal at the time credited, such portion is not constructively received and does not constitute income to the depositor or shareholder until the taxable year in which the portion first may be withdrawn. Accordingly, if, under a bonus or forfeiture plan, a portion of the dividends or interest is accumulated and may not be withdrawn until the maturity of the plan, the crediting of such portion to the account of the shareholder or depositor does not constitute constructive receipt. In this case, such credited portion is income to the depositor or shareholder in the year in which the plan matures. However, in the case of certain deposits made after December 31, 1970, in banks, domestic building and loan associations, and similar financial institutions, the ratable inclusion rules of section 1232(a)(3) apply. See § 1.1232-3A. Accrued interest on unwithdrawn insurance policy dividends is gross income to the taxpayer for the first taxable year during which such interest may be withdrawn by him.

[T.D. 6500, 25 FR 11709, Nov. 26, 1960, as amended by T.D. 6723, 29 FR 5342, April 21, 1964; T.D. 7154, 36 FR 24997, Dec. 28, 1971; T.D. 7663, 44 FR 76782, Dec. 28, 1979]

§ 1.451–3 Long-term contracts.

(a) Introduction and Effective date—(1) In general. Income from a long-term contract (as defined in paragraph (b)(1) of this section) may be included in gross income in accordance with one of the two long-term contract methods, namely, the percentage of completion method (as described in paragraph (c) of this section) or the completed contract method (as described in paragraph (d) of this section), or any other method. Whichever method is chosen must, in the opinion of the Commissioner, clearly reflect income. See § 1.446-1(a)(2) and (c). In addition, it must be applied consistently to all long-term contracts within the same trade or business except that a taxpayer who has long-term contracts of substantial duration and long-term contracts of less than substantial duration in the same trade or business may report the income from all the contracts of substantial duration on the same long-term contract method and report the income from the contracts of less than substantial duration pursuant to another proper method of accounting. For example, if a manufacturer of heavy machinery has special-order contracts of a type that generally take 15 months to complete and also has contracts of a type that generally take 3 months to complete, the manufacturer may use a long-term contract

method for the 15-month contracts and a proper inventory method pursuant to section 471 and the regulations thereunder for the 3-month contracts. Similarly, if a construction contractor has construction contracts of a type that generally take 15 calendar months to complete and other construction contracts that take only 5 months to complete but that are long-term contracts because they are not completed in the taxable years in which they are entered into (pursuant to paragraph (b)(1)(i) of this section), such contractor may either use a long-term contract method for all the contracts of both types or use a long-term contract method for the 15-month contracts and another proper method of accounting for the 5-month contracts. If a taxpayer distinguishes between contracts of substantial duration and other long-term contracts of less than substantial duration, he must adhere to a consistently applied standard for determining substantial duration.

(2) **Reporting requirement.** When a taxpayer reports income under the percentage of completion method or the completed contract method, a statement to that effect shall be attached to his income tax return.

(3) **Allocation among activities required.** The percentage of completion method and the completed contract method apply only to the accounting for income and expenses attributable to long-term contracts. The term "expenses attributable to long term contracts" means all direct labor costs and direct material costs (within the meaning of paragraph (d)(5)(i) or (6)(i) of this section), and all indirect costs except those described in paragraph (d)(5)(iii) or, in the case of extended period long-term contracts, paragraph (d)(6)(iii). Other income and expense items, such as investment income, expenses not attributable to such contracts, and costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of such contracts, shall be accounted for under a proper method of accounting. See section 446(c) and § 1.446-1(c).

(4) **Severing and aggregating contracts.** In the case of income attributable to a long-term contract, whether or not a long-term contract method is used, for the purpose of clearly reflecting income it may be necessary in some instances for the Commissioner either to treat one agreement as several contracts or to treat several agreements as one contract. The rules of paragraph (e)(1) of this section shall apply to determine whether an agreement should be so severed or several agreements so aggregated.

(5) **Certain taxpayers not using a long-term contract method.** In the case of a taxpayer using a method of accounting that uses inventories (other than a long-term contract method) for any extended period long-term contract entered into after December 31, 1982, see paragraphs (d)(6)(v) and (g) of this section.

(6) **Use of inventory methods in connection with the long-term contract method.** Effective for taxable years beginning after December 31, 1982, the taxpayer may use an inventory method to determine the costs attributable to a long-term contract accounted for under a long-term contract method only in accordance with paragraph (d)(8) of this section.

(7) **Effective date.** Except as otherwise provided, this section is effective for taxable years ending after December 31, 1982. For taxable years ending before January 1, 1983, see CFR § 1.451-3, revised as of 4/1/85.

(b) **Definitions, and special rules relating to certain contracts—(1) Long-term contract—(i) In general.** Except as provided in paragraph (b)(1)(ii) of this section, the term "long-term contract" means a building, installation, construction or manufacturing contract which is not completed within the taxable year in which it is entered into.

(ii) **Manufacturing contracts.** Notwithstanding paragraph (b)(1)(i) of this section, a manufacturing contract is a "long-term contract" only if such contract involves the manufacture of (A) unique items of a type which is not normally carried in the finished goods inventory of the taxpayer, or (B) items which normally require more than 12 calendar months to complete (regardless of the duration of the actual contract). Thus, for example, a contract to manufacture a unit of industrial machinery specifically designed for the needs of a customer and not normally carried in the taxpayer's inventory or a contract to manufacture machinery which will require more than 12 calendar months to complete are long term contracts[.] However, a contract to manufacture 15,000 folding chairs which take 3 days each to manufacture is not a long-term contract even though it takes more than 12 calendar months to manufacture all 15,000 chairs and the contract is not completed within the taxable year it is entered into.

(2) **Completion—(i) Final completion and acceptance—** (A) General rule. Except as otherwise provided in this paragraph (b)(2), and in paragraph (d) (2), (3), and (4) of this section (relating to disputes), a long-term contract shall not be considered "completed" until final completion and

acceptance have occurred. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring Federal income tax.

(B) Completion determined on basis of all facts and circumstances. Final completion and acceptance of a contract for Federal income tax purposes is determined from an analysis of all the relevant facts and circumstances, including the manner in which the parties to the contract deal with each other and with the subject matter of the contract, the physical condition and state of readiness of the subject matter of the contract, and the nature of any work or costs remaining to be performed or incurred on the contract. In considering the manner in which the parties deal with the subject matter of the contract, any use of the primary subject matter of the contract by the purchaser (except for testing purposes that produce no gross revenue, cost savings, or other substantial benefits for the purchaser) will be considered.

(C) Examples. The principles of paragraph (b)(2)(i) of this section are illustrated by the following examples:

Example (1). In 1982, A, a calendar year contractor, contracts with B to construct a building. The initial completion date specified in the contract is October 1984. In November 1984, the building is completed in every respect necessary for the use for which the building is intended. Later in November 1984, B occupies the building and notifies A that certain minor deficiencies should be corrected. A agrees to correct the deficiencies. Under these circumstances, the contract is considered completed for Federal income tax purposes in A's taxable year ending December 31, 1984, without regard to when A corrects the deficiencies. The contract is considered completed because the parties have dealt with each other and with the subject matter of the contract in a manner that indicates that final completion and acceptance have occurred.

Example (2). Assume the same facts as in example 1, except that there are no deficiencies in the building that require correction or repair. In addition, assume that the contract between A and B provides that none of the retainage under the contract may be released to A until A obtains an architect's certificate that the building has been completed according to the specifications of the contract. A obtains this certificate in February, 1985. Under these circumstances, the contract is considered completed for Federal income tax purposes in A's taxable year ending December 31, 1984, without regard to when A obtains the required architect's certificate, and without regard to when the retainage is released to A, because the parties have dealt with each other and with the subject matter of the contract in a manner that indicates that final completion and acceptance have occurred.

Example (3). In 1982, X, a calendar year taxpayer who manufactures industrial machinery, contracts with F to build and install one large item of industrial machinery to be delivered in August 1983 and to be installed and tested by X in F's factory. The contract provides that the machinery will be accepted by F when the tests performed by X demonstrate that the machinery will perform within certain environmental standards required by a government agency, regardless of whether an operating permit has been obtained. Because of technical problems the machinery is not ready for delivery until December 1983. F accepts delivery of the machinery in December 1983 subject to installation and testing to determine if the assembled machinery meets the environmental standards. The machinery is installed and tested during December 1983 through February 1984, and F accepts the machinery in February 1984. An operating permit required to operate the machinery under the environmental standards is issued by the governmental agency in February, 1985. Under these circumstances final completion and acceptance of the machinery for Federal income tax purposes occurs in February, 1984.

Example (4). In 1983, D, a calendar year taxpayer, contracts with E to construct a shopping center and related parking areas. The shopping center is completed in October 1985. In December 1985, the shopping center and three-fourths of the parking area are opened to the general public. At that time, the entire parking area of the shopping center has been graded and three-fourths has been paved, but the final asphalt coating has not been laid due to general weather conditions. Under these circumstances, the contract to construct the shopping center and parking area is considered completed for Federal income tax purposes in December 1985, because the shopping center and a major portion of the parking area were ready to be used and were used at that time.

(ii) Contracts with more than one subject matter—(A) General rule. In the case of a long-term contract (which, after the application of the rules provided in paragraph (e) of this section, is treated as a single long-term contract for Federal income tax purposes) for one or more units (such as an aircraft or an item of industrial machinery) that represent the primary subject matter of the contract, and for other items (such as training manuals, or spare or replacement parts or components) that do not represent the primary subject matter of the contract, "final completion and acceptance" shall be determined without regard to the contractor's obligation to supply the other items that do not represent the primary subject matter of the contract. If at the end of the taxable year in which the long-term contract is completed there remain any other items that do not represent the primary subject matter of the contract and that have not been finally completed and accepted then the costs that have been incurred prior to the end of such year and that are properly allocable to such other items (determined pursuant to paragraph (d) (5) or (6) (as the case may be) of this section), and a portion of the gross contract price (if any) reasonably allocable to such other items shall be separated from the long-term contract, and such costs and such portion of the gross contract price shall be accounted for under a proper method of accounting. Such proper method of accounting includes a long-term contract method only if a separate contract for such other items would be a long-term contract (as defined in paragraph (b)(1) of this section).

(B) Example. The principles of paragraph (b)(2)(ii)(A) of this section may be illustrated by the following example:

Example. In 1982, X contracts with the Y Government to manufacture five aircraft and to manufacture 12 spare and replacement parts for the five aircraft and for certain other aircraft supplied to Y under prior contracts. Assume that under all the facts and circumstances it is determined that the portion of the contract relating to the 12 spare and replacement parts does not have to be severed from the portion of the contract relating to the five aircraft. Assume also that under all the facts and circumstances it is determined that the five aircraft represent the primary subject matter of the contract, and that the spare and replacement parts do not represent the primary subject matter of the contract. In 1984, X tenders the five aircraft and seven of the spare and replacement parts to Y. Y accepts the aircraft and the parts subject to X's delivery of the balance of the spare and replacement parts. For Federal income tax purposes the contract is deemed to have been completed in 1984. Accordingly, X must include in gross income in 1984 the entire contract price, less the portion of the gross contract price reasonably allocable (if any) to the parts not delivered in 1984. X must deduct from gross income in 1984 the entire costs properly allocable to the contract, less the entire costs incurred that are properly allocable to the parts not delivered in 1984. X will account for the income and costs allocable to the parts not delivered in 1984 under a proper method of accounting.

(iii) Contingent compensation. In the case of a long-term contract, "final completion and acceptance" shall be determined without regard to any term of the contract providing for additional compensation contingent upon the continued successful performance of the subject matter of the contract after the subject matter of the contract has been accepted by the purchaser (such as an incentive fee payable if a satellite remains in operation after it is placed in orbit). Such contingent compensation shall be included in gross income in the appropriate taxable year determined under the taxpayer's method of accounting other than a long-term contract method.

(iv) Certain supervision of installation. In the case of a long-term contract, "final completion and acceptance" shall be determined without regard to any obligation on the part of the contractor to assist or to supervise installation or assembly of the subject matter of the contract where such installation or assembly is to be performed by the purchaser and, under applicable contract law, the subject matter of the contract may be accepted by the purchaser prior to such installation or assembly. If the preceding sentence applies to a contract, "final completion and acceptance" shall be determined without regard to such obligation[.] In addition, the entire gross contract price less the portion of the gross contract price (if any) reasonably allocable to such obligation, shall be included in gross income in the taxable year in which the contract is completed[.] Further, all costs properly allocable to the contract and which have been incurred prior to the end of the taxable year in which such contract is completed shall be deducted in such year[.] Finally, all other costs properly allocable to such contract and the portion of the gross contract price reasonably allocable to the obligation to assist or to supervise installation shall be accounted for under a proper method of accounting other than a long-term contract method.

(v) Subcontractors. In the case of a subcontractor who completes work on a long-term contract prior to the completion of the entire contract, "final completion and acceptance" of the contract with respect to such subcontractor shall be deemed to have occurred when the subcontractor's work has been completed and has been accepted by the party with whom the subcontractor has contracted.

(vi) Disputes. Completion of a long-term contract is determined without regard to whether a dispute exists at the time the taxpayer tenders the subject matter of the contract to the party with whom the taxpayer has contracted. See paragraphs (d)(2), (3) and (4) of this section.

(3) Extended period long-term contract—(i) General Rule. This paragraph (b)(3) does not apply to contracts accounted for under the percentage of completion method. Except as provided in paragraph (b)(3)(ii) of this section, the term "extended period long-term contract" means any long-term contract that the taxpayer estimates (at the time such contract is entered into) will not be completed (as defined in paragraph (b)(2) of this section) within the 2-year period beginning on the first date (hereinafter, "the contract commencement date") that the taxpayer incurs any costs (other than costs such as bidding expenses, or expenses incurred in connection with negotiating the contract) allocable to such contract (under the cost allocation rules of paragraph (d)(6) of this section). The preceding sentence shall be applied without regard to when costs allocable to a contract are recorded under the cost accounting procedures used by the taxpayer. In general, the contract commencement date will be the first date that any of the following activities occur; the taxpayer incurs design or engineering costs allocable to the contract other than design or engineering costs incurred solely for purposes of bidding for the contract; materials or equipment are shipped to the jobsite; or workers whose labor cost is treated as direct labor are sent to the jobsite. If the first date when any costs allocable to a contract are incurred is not determinable, the contract commencement date of a contract shall be

the date such contract is entered into, unless the taxpayer establishes to the satisfaction of the district director that another date is a more appropriate contract commencement date. The contract commencement date shall not be earlier than the date the contract is entered into, unless the taxpayer delayed entering into the contract for a principal purpose of avoiding the rules of this section.

(ii) Certain construction contracts. The term "extended period long-term contract" does not include any construction contract entered into by a taxpayer—

(A) Who estimates (at the time such contract is entered into) that such contract will be completed within the 3-year period beginning on the contract commencement date of such contract, or

(B) Whose average annual gross receipts (determined under paragraph (b)(3)(iii) of this section) over the 3 taxable years preceding the taxable year the contract is entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence) do not exceed $25 million.

For purposes of this paragraph (b)(3)(ii), the term "construction contract" means any contract for the building, construction, or erection of, or the installation of any integral component to, improvements to real property. For purposes of the preceding sentence, construction includes reconstruction and rehabilitation. An improvement to real property includes buildings or other structures intended to be permanently affixed to real property, roadways, dams, or bridges, but does not include such items as vessels or offshore drilling platforms. An integral component to an improvement to real property includes property not produced at the site of the real property but intended to be permanently affixed to an improvement to real property, for example, elevators and central heating and cooling systems. In the case of a contract that provides for the manufacture and the installation of an integral component to an improvement to real property (such as the pollution control equipment for a power plant), only the part of the overall gross contract price and the costs properly allocable to the work of installing the finished component is a construction contract. For example, in the case of a contract both to manufacture and to install an elevator in an office building, only the portion of the gross contract price and only the costs properly allocable to installing the elevator is a construction contract. However, in determining whether the installation portion of a contract is expected to be completed within three years, the time expected to complete both the manufacture and the installation of the contract subject matter must be taken into account. Similarly, in determining whether the manufacturing portion of a contract is expected to be completed within two years, the time expected to complete both the manufacture and the installation of the contract subject matter must be taken into account. Alternatively, the taxpayer may consistently account for the manufacturing portion and the installation portion of all such agreements as separate contracts if there is an appropriate allocation of the gross contract price between the manufacturing portion and the installation portion of the agreement. The preceding sentence applies without regard to paragraph (e)(1) of this section.

(iii) Determination of gross receipts—(A) Aggregation and attribution of gross receipts. The following rules shall apply in determining the gross receipts of the taxpayer for purposes of paragraph (b)(3)(ii)(B) of this section, that is, for determining if the average annual gross receipts of the taxpayer over the 3 taxable years preceding the taxable year in which a construction contract is entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence) exceed $25 million. Under paragraph (b)(3)(iii)(B) of this section, the average annual gross receipts of all trades or businesses (regardless of the nature of such trades or businesses) under common control with the taxpayer who enters into the construction contract are combined. Under paragraph (b)(3)(iii)(C), a portion of the average annual gross receipts from building, installation or construction contracts (hereinafter "construction gross receipts") of trades or businesses not under common control with the taxpayer who enters into the contract, but which are related to the taxpayer through a chain of attribution (using indirect and constructive ownership), are attributed to the taxpayer who enters into the contract. Except as provided in paragraph (b)(3)(iii)(C)(4)(i), the rules of paragraph (b)(3)(iii)(B) and (C) are both applied. For purposes of paragraph (b)(3) of this section, "gross receipts" include the gross receipts realized from the active conduct of any trade or business, (e.g.,—sales revenue), and shall be the gross receipts of the taxable year in which such receipts are recognized properly under the tax accounting method of the taxpayer. For this purpose "gross receipts" shall not include amounts that, under Federal income tax law, are interest, dividends, rents, royalties, annuities or the amount realized from the sale or exchange of property used in the trade or business or held for the production of income. Gross receipts of a contract includes the gross contract price (whether the

contract is a general contract or a subcontract, and whether or not the contract is a long-term contract). If the taxpayer enters into a contract which provides that any direct materials (as described in paragraph (d)(5)(i) of this section) will be supplied by the party for whom the contract is being performed (and thus the cost of which is not represented in the gross contract price), gross receipts do not include the cost of such direct materials unless the contractual arrangement was entered into for a principal purpose of reducing the contractor's gross receipts.

(B) Aggregation of all gross receipts of trades or businesses under common control. If, at any time during the calendar year in which the taxpayer enters into a construction contract, such taxpayer and any other trades or businesses (whether or not incorporated) are under common control, then the average annual gross receipts of each such trade or business (for the 3 taxable years of such trade or business preceding the taxable year of such trade or business in which the construction contract is entered into or, if less, the number of preceding taxable years such trade or business has been in existence) shall be combined with the average annual gross receipts of the taxpayer for taxpayer's 3 taxable years preceding the taxable year of the taxpayer in which the construction contract is entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence). Gross receipts attributable to transactions between trades or businesses under common control shall be eliminated. For purposes of paragraph (b)(3) of this section, the term "trades or businesses under common control" means any group of trades or businesses that is either—

(1) A "parent-subsidiary group under common control" as defined in § 1.52-1(c),

(2) A "brother-sister group under common control" as defined in § 1.52-1(d), or

(3) A "combined group under common control" as defined in § 1.52-1(e).

(C) Attribution of construction gross receipts to or from individuals, proprietorships, corporations, partnerships, trusts and estates not under common control—(1) Attribution of construction gross receipts to the contractor from persons owning an interest in the contractor. For purposes of paragraph (b)(3) of this section, if a 5 percent or greater interest in the person who enters into a construction contract (hereinafter, "the contractor") is owned (at any time during the calendar year in which the construction contract is entered into), directly, or indirectly through the application of this paragraph (b)(3)(iii)(C), by or for any person, the average annual gross receipts of the contractor for the contractor's 3 taxable years preceding the taxable year of the contractor in which the contract was entered into (or, if less, the number of preceding taxable years the contractor has been in existence) shall include the average annual construction gross receipts of such person (for the 3 taxable years of such person preceding the taxable year of such person in which the contract was entered into or, if less, the number of preceding taxable years in which such person has been in existence) in proportion to the interest of such person in the contractor. If an interest is not owned for the entire calendar year, or if an interest varies during the calendar year, the amount of such interest for such year shall be the weighted average based on the number of days each interest is owned during such calendar year.

(2) Attribution of construction gross receipts to the contractor from persons in which the contractor owns an interest. For purposes of paragraph (b)(3) of this section, if (at any time during the calendar year in which the contractor enters into a construction contract) a 5 percent or greater interest in any person is owned, directly, or indirectly through the application of this paragraph (b)(3)(iii)(C), by or for the contractor, the average annual gross receipts of the contractor for the contractor's 3 taxable years preceding the taxable year of the contractor in which the contract was entered into (or, if less, the number of preceding taxable years the taxpayer has been in existence) shall include the average annual construction gross receipts of such person (for the 3 taxable years of such person preceding the taxable year of such person in which the contract was entered into or, if less, the number of preceding taxable years such person has been in existence) in proportion to the interest of the contractor in such person. If an interest is not owned for the entire calendar year, or if an interest varies during the calendar year, the amount of such interest for such year shall be the weighted average based on the number of days each interest is owned during such calendar year.

(3) Rules for determining ownership—(i) In general. In determining the ownership of an interest in any person for purposes of paragraph (b)(3)(iii)(C) of this section, the indirect and constructive ownership rules of this paragraph (b)(3)(iii)(C)(3) shall apply, subject to the operating rules contained in paragraph (b)(3)(iii)(C)(4). For purposes of paragraph (b)(3)(iii)(C), an "interest" means: in the case of a corporation, stock; in the case of a trust or estate, an actuarial interest;

in the case of a partnership, an interest in capital or profits; and in the case of a sole proprietorship, the proprietorship.

(ii) Members of a family. An individual shall be considered as owning any interest in any person owned, directly or indirectly, by or for—

(A) Such individual's spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance, whether final or interlocutory), and

(B) Such individual's children, grandchildren, parents and grandparents. A legally adopted child of an individual shall be treated as the child of such individual.

(iii) Attribution from partnerships, estates, trusts and corporations. (A) From Partnerships. An interest in any person owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having a 5 percent or greater interest in either the profits or capital of the partnership, in proportion to such partner's interest in profits or capital, whichever is greater.

(B) From estate and trusts. An interest in any person (hereinafter an "organization interest") owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of such estate or trust who has an actuarial interest of 5 percent or greater in such organization interest, to the extent of such actuarial interest, as determined under § 11.414(c)-4(b)(3).

An interest in any person owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such person.

(C) From corporations. An interest in any person owned, directly or indirectly, by or for a corporation shall be considered as owned by any shareholder who owns (directly, and indirectly through the application of paragraph (b)(3)(iii)(C) of this section) 5 percent or more in value of such corporation's stock, in proportion to the value of the stock owned by such shareholder to the total value of all the outstanding stock in such corporation.

(iv) Attribution to partnerships, estates, trusts and corporations—(A) To partnerships. An interest in any person owned, directly or indirectly, by or for a partner having a 5 percent or greater interest in partnership profits or capital shall be considered as owned by the partnership in proportion to the partner's interest in profits or capital, whichever is greater.

(B) To estates and trusts. An interest in any person owned, directly or indirectly, by or for a beneficiary having an actuarial interest of 5 percent or greater in the value of property of an estate or trust shall be considered as owned by such estate or trust in proportion to the beneficiary's actuarial interest in the assets of the estate or trust. For purposes of this paragraph (b)(3)(iii)(C)(3)(iv-)(B) the actuarial interest of a beneficiary shall be determined under the maximum exercise of discretion by the executor or trustee in favor of such beneficiary.

An interest in any person owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by such trust.

(C) To corporations. An interest in any person owned, directly or indirectly, by or for a shareholder who owns (directly and indirectly through the application of paragraph (b)(3)(iii)(C) of this section) 5 percent or more in value of the stock in a corporation shall be considered as owned by such corporation in proportion to the value of the stock owned by such shareholder to the total value of all the outstanding stock in such corporation.

(v) Options. If a person has an option to acquire any outstanding interest in any organization, such interest shall be considered as owned by such person. An option to acquire an option, and each one of a series of such options, shall be considered as an option to acquire such an interest.

(4) Operating rules—(i) Common control. Paragraph (b)(3)(iii)(C) of this section shall not apply between two persons both of whom, under paragraph (b)(3)(iii)(B), are members of the group of trades or businesses under common control that includes the contractor. However, in applying paragraph (b)(3)(iii)(C) between two persons where one or both of such persons are not members of the group of trades or businesses under common control that includes the contractor, paragraph (b)(3)(iii)(C) shall be applied without regard to paragraph (b)(3)(iii)(B).

(ii) Reattribution. Except as provided in paragraph (b)(3)(iii)(C)(4)(iii) (relating to no double family attribution) or (iv) (relating to no reattribution to certain co-owners), in applying paragraphs (b)(3)(iii)(C)(3)(ii), (iii), (iv), or (v), an interest constructively owned by a person shall, in applying paragraphs (b)(3)(iii)(C)(3), (ii), (iii), (iv) or

(v), be considered as actually owned by such person, and such interest may be reattributed to another person.

(iii) No double family attribution. An interest constructively owned by an individual by reason of paragraph (b)(3)(iii)(C)(3)(ii) shall not be considered as owned by such individual for purposes of again applying such paragraph to make another the constructive owner of such interest.

(iv) No reattribution to certain co-owners. An interest constructively owned by a person by reason of paragraph (b)(3)(iii)(C)(3)(iv) shall not be considered as owned by such person for purposes of applying paragraph (b)(3)(iii)(C)(3)(iii) in order to make another person the constructive owner of such interest.

(v) Option rule in lieu of family rule. If an interest may be considered as owned by an individual under paragraphs (b)(3)(iii)(C)(3) (ii) or (v), it shall be considered as owned by such individual under paragraph (b)(3)(iii)(C)(3)(v).

(vi) Limitation. In applying paragraph (b)(3)(iii)(C)(3) to determine the ownership of an interest by any person for any one purpose—

(A) A corporation shall not be considered to own its own stock by reason of paragraph (b)(3)(iii)(C)(3)(iv)(C), and

(B) If an interest owned by any person may be included in the computation more than one time, such interest shall be included only once, in the manner that will impute to the person concerned the largest total interest.

(D) Short taxable years. For any taxpayer required to determine its average annual gross receipts over the three taxable year period of such person preceding the taxable year in which a construction contract is entered into, if such period includes a taxable year of less than 12 full months, the taxpayer shall place the gross receipts of such taxable year on an annual basis by dividing the gross receipts of such taxable year by the number of full calendar months in such taxable year and multiplying the result by 12.

(iv) Classification of contracts—(A) Initial classification by taxpayer. The taxpayer shall determine whether a contract is an extended period long-term contract at the time such contract is entered into. In estimating the time required to perform any contract, the taxpayer shall anticipate and provide a reasonable allowance for delay, rework, change orders, technology or design problems, and other problems. If the taxpayer determines that a contract is an extended period long-term contract, the cost allocation rules of paragraph (d)(6) of this section shall apply, and such contract shall be treated as an extended period long-term contract even if such contract is actually completed within the 2-year period (3 years in the case of certain construction contracts) beginning on the contract commencement date of such contract. Except as provided in paragraph (b)(3)(iv)(B) of this section, a long-term contract that is not completed within the 2-year period (3 years in the case of certain construction contracts) beginning on the actual contract commencement date of such contract and which the taxpayer did not classify and account for as an extended period long-term contract will not be required to be reclassified (for any taxable year) and accounted for as an extended period long-term contract if, at the time the contract was entered into, the taxpayer reasonably could have expected the contract to be completed within that time. The taxpayer shall maintain contemporaneous written records setting forth the basis for classifying each contract, and such records shall be in sufficient detail to enable the district director readily to determine whether the taxpayer's estimate of the time required to complete a contract was made on a reasonable basis. A contract term specifying an expected completion or delivery date may be considered evidence that the parties expected completion or delivery to occur on or about the date specified, especially if there are actual bona fide penalties for not meeting the specified date. The taxpayer's estimate will not be considered unreasonable if a contract was not completed within the expected time primarily because of unforeseeable factors not within the control of the taxpayer. For purposes of the preceding sentence, "unforeseeable factors" are abnormal factors, such as prolonged third-party litigation, abnormal weather (considering the season and the jobsite), prolonged strikes, and prolonged delays in securing required permits or licenses, that could not reasonably be anticipated considering the nature of the contract and prior experience.

(B) Exception for unreasonable classification, amended returns. If under all the facts and circumstances it is determined that a contract which the taxpayer did not classify and account for as an extended period long-term contract reasonably should have been so classified and accounted for, the taxpayer shall reclassify and account for such contract as an extended period long-term contract for the current taxable year and all subsequent taxable years. In addition, the taxpayer should file an amended return for each prior taxable year

(assuming that the period for assessment has not run for such year) in which costs were incurred with respect to such contract, and such amended returns should reflect an allocation to the contract of costs incurred in such prior years using the cost allocation rules provided in paragraph (d)(6) of this section. If a contract is not an extended period long-term contract by reason of the $25 million gross receipts test of paragraph (b)(3)(ii)(B) of this section, such contract shall not be reclassified regardless of the taxpayer's gross receipts for any subsequent year and regardless of the time required to complete such contract.

(v) Special rule for contract commencement date in case of components or subassemblies produced by the taxpayer. If the cost of components or subassemblies produced by the taxpayer represents a significant amount of the total costs allocable to a contract, the contract commencement date of such contract shall be the first date the taxpayer incurs any costs allocable either to (1) such type or category of components or subassemblies, or (2) any other subject matter of the contract. The contract commencement date shall not be earlier than the date the contract is entered into, unless the taxpayer delayed entering into the contract for a principal purpose of avoiding the rules for this section. For example, assume an airplane manufacturer who also manufactures a type of engine that represents a significant amount of the total costs of the airplanes produced enters into one or more contracts to manufacture airplanes containing such type of engine. For purposes of determining the contract commencement date with respect to each contract, the first date the manufacturer incurs any cost allocable to any of the engines is the first date that the taxpayer incurs any cost allocable to such type of engine, even if the manufacturer has not yet produced enough engines to satisfy all contracts.

See § 1.451-3(d)(6)(iv) for the cost allocation rules required in the case of certain components or subassemblies.

(c) Percentage of completion method. **(1)** Under the percentage of completion method, the portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year must be included in gross income for such taxable year.

(2) The determination of the percentage of completion of a contract generally may be made on either of the following methods:

(i) By comparing, as of the end of the taxable year, the costs incurred with respect to the contract with the estimated total contract costs, or

(ii) By comparing, as of the end of the taxable year, the work performed on the contract with the estimated total work to be performed.

In determining the percentage of completion pursuant to subdivision (i) of this subparagraph with respect to a long-term contract, a taxpayer may use any method of cost comparisons (such as comparisons of total direct and indirect costs incurred to date to estimated total direct and indirect costs, of total direct costs incurred to date to estimated total direct costs, or of direct labor costs incurred to date to estimated total direct labor costs) so long as such method is used consistently with respect to such contract and such method clearly reflects income. In determining the percentage of completion pursuant to subdivision (ii) of this subparagraph, the criteria used to compare the work performed on a contract as of the end of the taxable year with the estimated total work to be performed must clearly reflect the earning of income with respect to the contract. Thus, for example, in the case of a roadbuilder, a standard of completion based solely upon miles of roadway completed in a case where the terrain is substantially different with respect to roadway completed during one taxable year as compared with roadway completed during another taxable year may not clearly reflect the earning of income with respect to the contract. If the method described in subdivision (i) of this subparagraph is used and the taxpayer revises the estimated total costs as of the end of a taxable year, certificates of architects or engineers or other appropriate documentation showing the basis for such revision must be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return. If the method described in subdivision (ii) of this subparagraph is used, certificates of architects or engineers or other appropriate documentation showing the percentage of completion of each contract during the taxable year must be available at the principal place of business of the taxpayer for inspection in connection with an examination of the income tax return.

(3) Under the percentage of completion method, all costs incurred during the taxable year with respect to a long-term contract (account being taken of the material and supplies on hand at the beginning and the end of the taxable year for use in the contract) must be deducted. "Costs incurred during the taxable year with respect to a

long-term contract" do not include costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of the long-term contract. See paragraph (a)(3) of this section.

(d) Completed contract method—(1) In general. Except as otherwise provided in paragraphs (d)(2), (3) or (4) (relating to disputes) of this section, under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which such contract is completed (as defined in paragraph (b)(2) of this section). All costs properly allocable to a long-term contract (determined pursuant to paragraph (d)(5) or (6) of this section) must be deducted from gross income for the taxable year in which the contract is completed. In addition, account must be taken of any material and supplies charged to the contract but remaining on hand at the time of completion.

(2) Contracts with disputes from buyer claims. (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract to the party with whom he is contracting, there exists an amount reasonably in dispute because such party wishes to have the original contract price reduced or to have additional work performed on the contract. Any item of income or deduction with respect to an amount reasonably in dispute shall be taken into account in the taxable year in which such dispute is resolved. In addition, any item of income or deduction which is properly allocable to such contract and which is not included in or deducted from gross income in a prior taxable year pursuant to subdivisions (ii), (iii), (iv), or (v) of this subparagraph and which is not taken into account under the preceding sentence shall be included in or deducted from gross income in the taxable year in which the final dispute is resolved.

(ii) If the amount reasonably in dispute affects so much of the contract price that it is not possible to determine whether a profit (an excess of the gross contract price over the costs properly allocable to such contract) or loss (an excess of the costs properly allocable to the long-term contract over the gross contract price) will ultimately be realized on such contract, then no item of income or deduction which is properly allocable to such contract shall be included in or deducted from gross income in the taxable year in which such contract is completed (without regard to such dispute).

(iii) In all other cases, the entire amount of the gross contract price reduced (but not below zero) by an amount equal to the amount reasonably in dispute shall be included in gross income in the taxable year in which such contract is completed (without regard to the dispute).

(iv) If the taxpayer is assured of a profit on such contract regardless of the outcome of the dispute, then all costs which are properly allocable to such contract and which have been incurred prior to the end of the taxable year in which such contract is completed (without regard to the dispute) shall be deducted in such year.

(v) If the taxpayer is assured of a loss on such contract regardless of the outcome of the dispute, then there shall be deducted in the taxable year in which such contract is completed (without regard to the dispute) the total amount of costs properly allocable to such contract which are incurred prior to the end of such year reduced by the amount by which the gross contract price was reduced pursuant to subdivision (iii) of this subparagraph. All other costs which are properly allocable to such contract shall be deducted in the taxable year in which incurred.

(vi) For purposes of this paragraph, where there is additional work to be performed with respect to a contract in dispute, the term "taxable year in which the dispute is resolved" means the taxable year in which such work is completed rather than the taxable year in which the outcome of the dispute is determined by agreement, decision, or otherwise.

(vii) The application of this subparagraph may be illustrated by the following examples:

Example (1). X, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a building for Y pursuant to a long-term contract. According to the terms of the contract, the gross contract price is $2,000,000. X finishes construction of the building in 1972 at a cost of $1,900,000. Y examines the building and is dissatisfied with the construction. He demands either alterations or a reduction in the gross contract. The amount reasonably in dispute is $500,000. This dispute affects so much of the contract price that X is unable to determine whether a profit or a loss will ultimately be realized on such contract. Accordingly, pursuant to this subparagraph, X does not include any portion of the gross contract price in gross income and does not deduct any costs which are properly allocable to the contract until the taxable year in which the dispute is resolved.

Example (2). A, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a bridge for B pursuant to a long-term contract. The terms of the contract provide for a $10,000,000 gross contract price. A finishes construction of the bridge in 1972 at a cost of $9,500,000. When B examines the bridge, he insists that either certain girders be repainted or that the contract price be reduced. The amount reasonably in dispute is $100,000. Since under the

terms of the contract, A would be assured of a profit of at least $400,000 ($10,000,000–[$9,500,000 + $100,000]) even if the dispute were resolved unfavorable to A, $9,900,000 ($10,000,000–$100,000 in dispute) of the gross contract price must be included in A's gross income in 1972 and $9,500,000 of costs must be deducted from A's gross income in 1972 pursuant to this subparagraph. In 1973 A and B resolve the dispute, A repaints certain girders at a cost to A of $60,000, and A and B agree that the contract price is not to be reduced. In 1973 A must include $100,000 ($10,000,000–$9,000,000) in gross income and must deduct $60,000 from gross income.

Example (3). M, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a plant for N pursuant to a long-term contract. Under the terms of the contract M is entitled to receive $1,000,000 upon completion of the plant. M finishes construction of the plant in 1973 at a cost of $1,200,000. N examines the plant and determines that an elevator operates unsatisfactorily and insists that M either replace the elevator or that the contract price be reduced. The amount reasonably in dispute is $100,000. Under the terms of the contract M would be assured of a loss of at least $200,000 ($1,200,000–$1,000,000) even if the dispute were resolved in favor of M. Pursuant to this subparagraph M must include $900,000 ($1,000,000–$100,000) in gross income for 1973 and must deduct $1,100,000 ($1,200,000–$100,000) from gross income in 1973. In 1974 the dispute is resolved, and M replaces certain components of the elevator at a cost of $50,000. M must include $100,000 ($1,000,000–$900,000) in gross income for 1974, and must deduct $150,000 ($100,000 of previously undeducted costs plus $50,000 of additional costs) from gross income in 1974.

Example (4). Assume the same facts as in Example (3) except that N is insisting that the contract price be reduced because an elevator has insufficient capacity and that in 1974 the dispute is resolved by a reduction in the gross contract price of $40,000 (from $1,000,000 to $960,000). By the end of 1973, M is assured of a loss of at least $200,000 ($1,200,000–$1,000,000) under the terms of the contract even if the dispute were resolved in favor of M. Pursuant to this subparagraph, M must include in gross income for 1973 $900,000 ($1,000,000–$100,000) and must deduct from gross income in such year $1,100,000 ($1,200,000–$100,000). In 1974, when the dispute is resolved, M must include $60,000 ($960,000–$900,000) in gross income and must deduct $100,000 ($1,200,000–$1,100,000) from gross income.

Example (5). Assume the same facts as in Example (3) except that N is also insisting that the contract price be reduced by an additional amount because an underground storage facility has insufficient capacity. M determines that the total amount reasonably in dispute is $160,000, $100,000 attributable to the elevator plus $60,000 attributable to the underground storage facility. Under the terms of the contract, M would be assured of a loss of at least $200,000 ($1,200,000–$1,000,000) even if both disputes were resolved in favor of M. Pursuant to this subparagraph, M must include $840,000 ($1,000,000–$160,000) in gross income for 1973 and must deduct $1,040,000 ($1,200,000–$160,000) from gross income in 1973. In 1974 the dispute relating to the elevator is resolved, and M replaces certain components of the elevator at a cost of $50,000. M must include $100,000 (the amount of the gross contract price not included in gross income in 1973 by reason of the elevator dispute) in gross income for 1974 and must deduct $150,000 ($100,000 of previously undeducted costs plus $50,000 of additional costs) from gross income in 1974. In 1975, the dispute relating to the underground storage facility is resolved by a reduction in the gross contract price of $20,000 (from $1,000,000 to $980,000). In 1975 M must include $40,000 ($60,000–$20,000) in gross income and must deduct $60,000 (his previously undeducted costs) from gross income.

(3) Contracts with disputes from taxpayer claims. (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract to the party with whom he is contracting, a dispute exists because the taxpayer is requesting that the amount to be paid to him under such contract be increased.

(ii) Except as provided in subparagraph (2) of this paragraph, in all cases described in subdivision (i) of this subparagraph, the entire amount of the gross contract price shall be included in gross income in the taxable year the contract is completed (without regard to the dispute), and all costs which are properly allocable to such contract and which have been incurred prior to the end of the taxable year in which such contract is completed (without regard to the dispute) shall be deducted in such year.

(iii) Any item of income which is properly allocable to such contract and which is not included in gross income in a prior taxable year pursuant to subdivision (ii) of this subparagraph shall be included in gross income in the taxable year in which any such dispute (or part thereof) is resolved. Any item of deduction which is properly allocable to such contract and which is incurred in a taxable year subsequent to the year such contract is completed (without regard to the dispute) shall be deducted from gross income in the taxable year in which such item of deduction is incurred.

(iv) For purposes of this paragraph, the term "gross contract price" means the original stated price of the contract with any modifications to which the parties have agreed as of the end of the taxable year. Thus, for example, such term includes any amount which the taxpayer is claiming by virtue of changes in the specifications of the contract which the other parties to the contract have agreed is proper, but it does not include any amount which the contractor is claiming which is disputed by the other parties to the contract. However, no amount is excluded from the term, "gross contract price" solely because a party refuses to pay such amount when due. Thus, for example, if the parties to a contract agree that the gross contract price is $100,000, but a party refuses to pay $60,000 of such amount when due, such refusal does not prevent the gross contract price from being $100,000.

(v) The application of this subparagraph may be illustrated by the following examples:

Example (1). S, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a building for T pursuant to a long-term contract. Under the terms of the contract, S is entitled to receive $100,000 upon completion of the building. S finishes construction of the building in 1974 at a cost of $105,000. T examines the building in 1974 and agrees that it meets his specifications; however, as of the end of 1974, S and T are unable to agree as to the merits of S's claim for an additional $10,000 for certain items which S alleges are changes in contract specifications and T alleges are within the scope of the contract's original specifications. Under these circumstances, S must include in income in 1974 the gross contract price of $100,000 and must deduct from gross income in such year the $105,000 of costs. In 1975 the dispute is resolved by a payment to S of $2,000 with respect to his claim. S must include this $2,000 in gross income in 1975.

Example (2). Assume the same facts as in Example (1) except that S's claim for an additional $10,000 relates to two items which S alleges are changes in contract specifications, namely $7,000 for changes in the heating system and $3,000 for changes in the electrical system. In 1975 the dispute with respect to the electrical system is resolved by a payment to S of $750, and in 1976 the dispute with respect to the heating system is resolved by a payment to S of $1,250 and by S's performance of additional work at a cost of $250. S must include the $750 in gross income for 1975 and the $1,250 in gross income for 1976, and S must deduct the $250 from gross income in 1976.

(4) **Contracts with disputes from both buyer and taxpayer claims.** (i) This subparagraph applies in any case where, on or after a taxpayer tenders the subject matter of a long-term contract, a dispute exists involving both claims by the taxpayer for an increase in the contract price and claims by the other party to the contract either for a reduction in the contract price or for the performance of additional work under the contract. In any case described in the preceding sentence, principles similar to the principles of subparagraphs (2) and (3) of this paragraph shall be applied.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). W, a calendar year taxpayer utilizing the completed contract method of accounting, constructs a factory for Z pursuant to a long-term contract. Under the terms of the contract, Z agrees to pay W a total of $100,000 for construction of the factory. W finishes construction of the factory in December 1974 at a cost of $110,000. When Z examines the factory in December 1974, Z is dissatisfied with the location and workmanship of certain heating ducts. As of the end of 1974, W contends that the heating ducts as constructed are in accordance with contract specifications. The amount reasonably in dispute with respect to the heating ducts is $6,000. As of this time, W is claiming $14,000 in addition to the original contract price for certain changes in contract specifications which W alleges have increased his costs. Z denies that such changes have increased W's costs. In 1975 the disputes between W and Z are resolved by performance of additional work by W at a cost of $1,000 and by an agreement that the contract price would be revised downward to $96,000. Under these circumstances, W must include in his gross income for 1974, $94,000 (the gross contract price less the amount reasonably in dispute because of Z's claim, or $100,000–$6,000). In 1974, W must also deduct $104,000 (his costs incurred of $110,000 less $6,000, an amount equal to the amount in dispute). In 1975, W must include in gross income an additional $2,000 ($96,000–$94,000) and must deduct $7,000 (the $1,000 of costs W incurs in such year plus the $6,000 of previously undeducted costs).

Example (2). R, a calendar year taxpayer utilizing the completed contract method of accounting, agrees to construct an office building for X for a total contract price of $10,000,000. R begins construction in 1973 and tenders the building to X in November 1975. As of November 1975, R has incurred $15,000,000 of costs which are allocable to the contract. When X examines the building, X is dissatisfied with certain aspects of the construction and demands that a substantial amount of additional work be done. The amount reasonably in dispute with respect to X's demand is $4,000,000. R is claiming an additional $2,000,000 for certain changes in contract specifications which have allegedly increased his costs. As of the end of 1975, neither dispute has been resolved. In 1976, the dispute relating to X's claim is resolved by R's performance of additional work at a cost of $3,500,000 and X's agreement to pay R an additional $400,000. In 1977, the dispute relating to R's claim is resolved by X's agreement to increase the contract price by $1,800,000. Under these circumstances R must include in his gross income for 1975 $6,000,000 ($10,000,000–$4,000,000) and must deduct from gross income $11,000,000 ($15,000,000–$4,000,000). In 1976, when the dispute relating to X's claim is resolved, R must include in gross income $4,400,000 (the $4,000,000 of the gross contract price which was excluded from gross income in 1975 by reason of X's claim plus the $400,000 by which the contract price was increased) and must deduct $7,500,000 (the previously undeducted costs of $4,000,000 plus the costs of the work performed to resolve the dispute of $3,500,000). In 1977, when the dispute relating to R's claim is resolved, R must include in gross income the $1,800,000 by which the contract price was increased in settlement of R's claim.

(5) **General rule for allocation of costs to long-term contracts.** The following rules shall apply in determining what costs are properly allocable to a long-term contract (other than an extended period long-term contract to which the rules of paragraph (d)(6) of this section apply) in the case of a taxpayer using the completed contract method of accounting for tax purposes:

(i) **Direct costs.** Direct material costs and direct labor costs must be treated as costs properly allocable to a long-term contract. "Direct material costs" include the costs of those materials which become an integral part of the subject matter of the long-term contract and those materials which are consumed in the ordinary course of building, constructing, installing, or manufacturing the subject matter of a long-term contract. See § 1.471-3(b) for the elements of direct material costs. "Direct labor costs" include the cost of labor which can be identified or associated with a particular long-term contract. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and payments to a sup-

plemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

(ii) Indirect costs allocated to long-term contracts. The term "indirect costs" includes all costs (other than direct material costs and direct labor costs) which are incident to and necessary for the performance of particular long-term contracts. Indirect costs which must be allocated to long-term contracts include:

(A) Repair expenses of equipment or facilities used in the performance of particular long-term contracts,

(B) Maintenance of equipment or facilities used in the performance of particular long-term contracts,

(C) Utilities, such as heat, light, and power, relating to equipment or facilities used in the performance of particular long-term contracts,

(D) Rent of equipment or facilities used in the performance of particular long-term contracts,

(E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential payroll taxes and contributions to a supplemental unemployment benefit plan incurred in the performance of particular long-term contracts,

(F) Indirect materials and supplies used in the performance of particular long-term contracts,

(G) Tools and equipment not capitalized used in the performance of particular long-term contracts,

(H) Costs of quality control and inspection incurred in the performance of particular long-term contracts,

(I) Taxes otherwise allowable as a deduction under section 164 (other than State and local, and foreign income taxes) to the extent such taxes are attributable to labor, materials, supplies, equipment or facilities used in the performance of particular long-term contracts,

(J) Depreciation, amortization and cost recovery allowances reported for the taxable year for financial purposes on equipment and facilities used in the performance of particular long-term contracts (but not in excess of the depreciation, amortization or cost recovery allowance allowable for the taxable year under Chapter I of the Code with respect to any item of equipment or facility),

(K) Cost depletion incurred in the performance of particular long-term contracts,

(L) Administrative costs incurred in the performance of particular long-term contracts (but not including any costs of selling or any return on capital),

(M) Compensation paid to officers attributable to services performed on particular long-term contracts (other than incidental or occasional services), and

(N) Cost of insurance incurred in the performance of particular long-term contracts, such as insurance on machinery and equipment used in the construction of the subject matter of a long-term contract.

(iii) Costs not allocated to long-term contracts. Costs which are not required to be included in costs attributable to a long-term contract include:

(A) Marketing and selling expenses, including bidding expenses,

(B) Advertising expenses,

(C) Other distribution expenses,

(D) Interest,

(E) General and administrative expenses attributable to the performance of services which benefit the long-term contractor's activities as a whole (such as payroll expenses, legal and accounting expenses, etc.),

(F) Research and experimental expenses (described in section 174 and the regulations thereunder),

(G) Losses under section 165 and the regulations thereunder,

(H) Percentage of depletion in excess of cost depletion,

(I) Depreciation, amortization and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is not enroute to or not located at a job-site), and depreciation, amortization and cost recovery allowances under Chapter I of the Code in excess of depreciation, amortization and cost recovery allowances reported by the taxpayer in the taxpayer's financial reports,

(J) Income taxes attributable to income received from long-term contracts,

(K) Contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions under chapter 1 of the Code. "Other employee benefit expenses" include (but are not limited to): worker's compensation; amounts deductible or for whose payment reduction in earnings and profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.,

(L) Cost attributable to strikes, rework labor, scrap and spoilage, and

(M) Compensation paid to officers attributable to the performance of services which benefit the long-term contractor's activities as a whole.

(6) **Allocation of costs to extended period long-term contracts.** Except as provided in paragraph (g) of this section, this paragraph (d)(6) applies to taxable years beginning after December 31, 1982. The following rules shall apply in determining what costs are properly allocable to an extended period long-term contract (as defined in paragraph (b)(3) of this section) in the case of a taxpayer using the completed contract method of accounting for long-term contracts for tax purposes. These rules may also apply to certain extended period long-term contracts accounted for under a method of accounting that uses inventories (other than a long-term contract method). See paragraph (d)(6)(v) of this section.

(i) **Direct costs.** Direct material costs and direct labor costs must be treated as costs properly allocable to an extended period long-term contract. "Direct material costs" include the costs of those materials which become an integral part of the subject matter of the extended period long-term contract and those materials which are consumed in the ordinary course of building, constructing, installing or manufacturing the subject matter of an extended period long-term contract. See § 1.471-3(b) for the elements of direct material costs. "Direct labor costs" include the cost of labor which can be identified or associated with a particular extended period long-term contract. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor.

(ii) **Indirect costs allocated to extended period long-term contracts.** The term "indirect costs" include all costs other than direct material costs and direct labor costs. In determining what indirect costs are properly allocable to an extended period long-term contract, all such costs that directly benefit the performance of extended period long-term contracts, or are incurred by reason of the performance of extended period long-term contracts must be allocated to extended period long-term contracts unless otherwise provided in paragraph (d)(6)(iii) of this section. Certain types of costs may directly benefit, or be incurred by reason of the performance of extended period long-term contracts of the taxpayer even though the same type of costs also benefits other activities of the taxpayer. Accordingly, such costs require a reasonable allocation between the portion of such costs that are attributable to extended period long-term contracts and the portion attributable to the other activities of the taxpayer. Indirect costs that must be allocated to extended period long-term contracts include:

(A) Repair expenses of equipment or facilities used in the performance of particular extended period long-term contracts,

(B) Maintenance of equipment or facilities used in the performance of particular extended period long-term contracts,

(C) Utilities, such as heat, light, and power, relating to equipment or facilities used in the performance of particular extended period long-term contracts,

(D) Rent of equipment or facilities used in the performance of particular extended period long-term contracts,

(E) Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan incurred in the performance of particular extended period long-term contracts,

(F) Indirect materials and supplies used in the performance of particular extended period long-term contracts,

(G) Tools and equipment not capitalized used in the performance of particular extended period long-term contracts,

(H) Costs of quality control and inspection incurred in the performance of particular extended period long-term contracts,

(I) Taxes otherwise allowable as a deduction under section 164 (other than State and local[,] and foreign income taxes) to the extent such taxes are attributable to labor, materials, supplies, equipment or facilities used in the performance of particular extended period long-term contracts,

(J) Depreciation, amortization and cost recovery allowances on equipment and facilities (to the extent allowable as deductions under Chapter I of the Code) used in the performance of particular extended period long-term contracts,

(K) Depletion (whether or not in excess of cost) incurred in the performance of particular extended period long-term contracts,

(L) Administrative costs (whether or not performed on a job-site) directly attributable to the performance of particular extended period long-term contracts (but not including any cost of selling, or any return on capital),

(M) Direct and indirect costs incurred by any administrative, service, or support function or department to the extent such costs are allocable to particular extended period long-term contracts pursuant to paragraph (d)(9) of this section,

(N) Compensation paid to officers attributable to services performed on particular extended period long-term contracts (but not including any cost of selling),

(O) Costs of insurance incurred in the performance of particular extended period long-term contracts, such as insurance on machinery and equipment used in the construction of the subject matter of an extended period long-term contract,

(P) Contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan or other plan deferring the receipt of compensation whether or not the plan qualifies under section 401(a) (except for amounts described in paragraph (d)(6)(iii)(I) of this section), and other employees benefit expenses paid or accrued on behalf of labor, to the extent such contributions or expenses are otherwise allowable as deductions under chapter 1 of the Code. "Other employee benefit expenses" include (but are not limited to): worker's compensation; amounts deductible or for whose payment reduction in earnings of profits is allowed under section 404A and the regulations thereunder; payments pursuant to a wage contribution plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation which has the effect of a stock bonus, pension, profit-sharing, or annuity plan, or other plan deferring the receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc.,

(Q) Research and experimental expenses (described in section 174 and the regulations thereunder) directly attributable to particular extended period long-term contracts in existence at the time such expenses are incurred, or incurred under an agreement to perform research or experimentation,

(R) Rework labor, scrap and spoilage to the extent incurred in the performance of particular extended period long-term contracts, and

(S) Bidding expenses incurred in the solicitation of particular extended period long-term contracts ultimately awarded to the taxpayer. For purposes of this section, the term "bidding expenses" does not include any research and experimental expenses described in section 174 and the regulations thereunder. The taxpayer shall defer all bidding expenses paid or incurred in the solicitation of a particular extended period long-term contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs assigned to the contract. If the contract is not awarded to the taxpayer, bidding costs become deductible in the taxable year the contract is awarded, or the taxable year the taxpayer is notified in writing that no contract will be awarded and that the contract (or similar or related contract) will not be re-bid, or in the taxable year that the taxpayer abandons its bid or

proposal, whichever occurs first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of bridges and the taxpayer was awarded a contract to build only one of the two bridges), the taxpayer shall deduct the portion of the bidding expenses related to the portion of the bid not awarded to the taxpayer; in the case of a bid or proposal for a multi-unit contract, however, all the bidding expenses shall be allocated to a contract awarded to the taxpayer to produce any or such units (for example, where the taxpayer submitted one bid to produce three similar turbines and the taxpayer was awarded a contract to produce only two of the three turbines).

(iii) Costs not allocated to extended period long-term contracts. Costs which are not required to be included in costs attributable to an extended period long-term contract include:

(A) Marketing, selling and advertising expenses,

(B) Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer (see paragraph (d)(6)(ii)(S) of this section),

(C) Interest,

(D) General and administrative expenses (but not including any cost described in paragraph (d)(6)(ii)(L) or (M) of this section) and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of any extended period long-term contracts,

(E) Research and experimental expenses (described in section 174 and the regulations thereunder) neither directly attributable to particular extended period long-term contracts in existence at the time such expenses are incurred nor incurred under any agreement to perform research or experimentation,

(F) Losses under section 165 and the regulations thereunder,

(G) Depreciation, amortization and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle (for this purpose, an asset is not considered to be temporarily idle on non-working days, and an asset used in construction is considered to be idle when it is not en route to or not located at a job-site),

(H) Income taxes attributable to income received from extended period long-term contracts,

(I) Contributions paid to or under a pension or annuity plan allowable as a deduction under section 404 (and section 404A if applicable) to the extent such contributions represent past service costs, and

(J) Costs attributable to strikes.

(iv) Special rule for component parts or subassemblies produced by the taxpayer. In the case of any type of component or subassembly produced by the taxpayer, the taxpayer shall use the cost allocation rules prescribed in paragraph (d)(6) and (8) of this section to determine the unit cost of the components or subassemblies that reasonably can be expected to be incorporated into the subject matter of extended period long-term contracts of the taxpayer. The taxpayer may use other proper cost allocation rules (see § 1.471-11) to determine the unit cost of the components or subassemblies other than those described in the preceding sentence. For each taxable year, the taxpayer's estimate of the number of components or subassemblies that can be expected to be incorporated into the subject matter of extended period long-term contracts shall be considered reasonable if the estimate is based upon facts known at the beginning of the taxable year.

(v) Taxpayers not using a long-term contract method. Taxpayers who use a method of accounting that uses inventories (other than a long-term contract method) must use the cost allocation rules provided in paragraph (d)(6) of this section (rather than the cost allocation rules provided in § 1.471-11) for any extended period long-term contract unless the taxpayer reasonably expects that

(A) 40% of the gross income from such contract will be recognized no later than the taxable year after the taxable year in which the contract is entered into;

(B) 70% of the gross income from such contract will be recognized no later than the second taxable year after the taxable year in which the contract is entered into; and

(C) 100% of the gross income from such contract will be recognized no later than the third taxable year after the taxable year in which the contract is entered into.

In determining whether the taxpayer meets the "reasonably expected" test of this paragraph

(d)(6)(v), rules consistent with the rules of paragraph (b)(3)(iv) of this section will apply.

(7) Guarantees, warranties, maintenance costs, etc. "Costs which are properly allocable to a long-term contract" do not include costs incurred with respect to any guarantee, warranty, maintenance, or other service agreement relating to the subject matter of the long-term contract. See paragraph (a)(3) of this section.

(8) Separate accounts; annual cost allocation; use of inventory methods in connection with the completed contract method—(i) General rule. This paragraph (d)(8) is effective for taxable years beginning after December 31, 1982. For taxable years beginning before January 1, 1983, see 26 CFR 1.451-3(d)(6) (revised as of April 1, 1985). The taxpayer shall maintain separate accounts for each long-term contract, and both the direct costs (as described in paragraph (d)(5)(i) or (d)(6)(i) of this section) and the indirect costs (as described in paragraph (d)(5)(ii) or (d)(6)(ii) of this section) incurred during the taxable year attributable to long-term contracts shall be allocated to particular long-term contracts for the taxable year such costs are incurred. Any change in the taxpayer's method of accounting for costs attributable to long-term contracts required by this paragraph (d)(8) is a change in method of accounting to which section 446(e) and the regulations and procedures thereunder apply.

(ii) Direct labor. Direct labor costs incurred during the taxable year shall be allocated to particular long-term contracts using a specific identification (or "tracing") method. However, if direct labor costs attributable to more than one long-term contract are intermingled so that it is impractical to specifically identify (or "trace") such costs to a particular long-term contract, such costs shall be allocated to particular long-term contracts using any reasonable method, provided that the method employed reasonably allocates direct labor costs among long-term contracts completed during the taxable year and long-term contracts that have not been completed as of the end of the taxable year. For the purpose of allocating elements of direct labor cost other than basic compensation to particular long-term contracts, all such cost elements may be grouped together and then allocated to particular long-term contracts in proportion to the charge for basic compensation.

(iii) Direct materials—(A) General rule. The cost of direct materials that are dedicated to a long-term contract in a taxable year shall be allocated to that long-term contract for that year. The cost that is allocated to the particular contract for the year of dedication shall be determined using the taxpayer's method of accounting for inventories (e.g., specific identification, FIFO, LIFO, etc.) of the material whose cost is being allocated. The costing rule in the preceding sentence applies both when materials are purchased specifically for a contract and when materials previously held by the taxpayer are dedicated to the contract. Examples of dedication of materials to a long-term contract include the following: (1) Delivery of materials to a job site (if only one contract is being performed at that site); (2) association of materials with a specific contract (for example, by purchase order, entry on books and records, shipping instructions, etc.); and, if not previously assigned, the physical incorporation of the material into the subject matter of the contract or the consumption of the material in the production of the subject matter of the contract.

(B) Alternative rule for taxable years beginning after December 31, 1982 and before January 1, 1986. For taxable years beginning after December 31, 1982, and before January 1, 1986, taxpayers may, in lieu of applying the general rule of paragraph (d)(8)(iii)(A) of this section, allocate direct costs incurred during the taxable year to particular long-term contracts using the specific identification (or "tracing") method, and if direct costs attributable to more than one long-term contract are intermingled so that such costs cannot be identified (or "traced") specifically to a particular long-term contract, such costs shall be allocated to particular long-term contracts using any reasonable method, provided that the method employed reasonably allocates direct costs among long-term contracts completed during the taxable year and long-term contracts that have not been completed as of the end of the taxable year. However, taxpayers utilizing the rule of this paragraph (d)(8)(iii)(B) may not use any LIFO or lower of cost or market method of identifying or allocating direct costs to any long-term contract.

(iv) Indirect costs. The indirect costs-required to be allocated to a long-term contract under paragraph (d)(5)(ii) or (d)(6)(ii) of this section shall be allocated to particular contracts for the year such costs are incurred using either—

(A) A specific identification (or "tracing") method, or

(B) A method using burden rates, such as ratios based on direct costs, hours, or other items, or similar formulas, so long as the method employed for such allocation reasonably allocates indirect costs among long-term contracts completed during

the taxable year and long-term contracts that have not been completed as of the end of the taxable year. Indirect costs may ordinarily be allocated to long-term contracts on the basis of direct labor and material costs, direct labor hours, or any other basis which results in a reasonable allocation of such indirect costs.

(9) Allocation of administrative, service, or support costs to extended period long-term contracts—(i) Introduction. (A) If a function or department of the taxpayer incurs costs that directly benefit or are incurred by reason of the extended period long-term contract activities of the taxpayer, the costs of such function or department are allocable to such extended period long-term contracts. See paragraph (d)(6)(ii)(M) of this section. However, if a function or department incurs costs that do not directly benefit and are not incurred by reason of the taxpayer's extended period long-term contracts, but rather, for example, benefit only the overall management or policy guidance functions of the taxpayer, the costs incurred by such function or department are not allocable to any extended period long-term contract. In some cases, the costs incurred by a function or department may directly benefit or be incurred by reason of the taxpayer's extended period long-term contract activities as well as the taxpayer's overall management or policy guidance function. In such cases, the taxpayer shall reasonably allocate the costs of such function or department between the taxpayer's extended period long-term contract activities and the taxpayer's overall management or policy guidance functions. Paragraph (d)(9) of this section provides guidance in making these allocations.

(B) If the methods of allocation used by the taxpayer, or the taxpayer's selection of specific types of costs to be allocated differs from the allocation methods or the specific types of costs to be allocated described in this paragraph (d)(9), the taxpayer's allocation methods and selection of specific types of costs to be allocated shall generally not be changed if, with respect to the taxpayer's extended period long-term contracts taken as a whole—

(1) The total amount of costs incurred during the taxable year of a type described in this paragraph (d)(9) that the taxpayer allocated to such contracts does not differ significantly from the total amount of costs that would be allocated to such contracts under this paragraph (d)(9); and

(2) The taxpayer's selection of cost allocation methods and specific types of costs to be allocated are applied consistently and do not result in any disproportionate allocation of costs to contracts expected to be completed in the near future.

(ii) General rule. The total amount of administrative, service, or support costs that directly benefit or are incurred by reason of only a particular extended period long-term contract shall be directly assigned to such contract. The direct and indirect cost (hereinafter "service costs") of administrative, service or support functions or departments (hereinafter "service departments") that directly benefit or are incurred by reason of more than one activity shall be allocated to particular extended period long-term contracts on the basis of a factor or relationship that reasonably relates the incurring of the service cost to the benefits received by the extended period long-term contract. In general, the direct costs of a service department include costs that can be identified specifically with the services provided by the department, and the indirect costs of a service department include costs not identified specifically with the services provided by the function or department, but incurred by reason of the direct costs of the function or department. Such direct and indirect costs include, but are not limited to, compensation (including compensation described in paragraph (d)(6)(ii)(E) and (P) of this section) of employees directly engaged in performing the services provided by the department, travel, materials and supplies consumed by the department, supervisory and clerical compensation, occupancy costs (rents or an allocable share of depreciation and property taxes), depreciation or rent of office machines, utilities, telephone, and other department overhead. The types of activities that are administrative, service or support functions or departments are not predetermined, but depend upon the facts and circumstances of each contractor's activities and business organization. In a decentralized business organization, all costs incurred at higher levels, for example, at a parent corporation or organization, or at the headquarters of a subsidiary corporation or division, are not necessarily general and administrative expenses (as described in paragraph (d)(5)(iii)(D) of this section) with respect to an extended period long-term contract.

(iii) Rules for allocation of service costs. The taxpayer shall allocate the total direct and indirect costs of a service department to extended period long-term contracts by applying consistently any reasonable method of cost allocation authorized by cost accounting principles. Reasonable methods include:

(A) The direct reallocation method, whereby the total costs (direct and indirect) of all service de-

partments are allocated only to production departments, and then from the production departments to particular extended period long-term contracts and to other production activities that are not extended period long-term contracts. The service costs allocable to such other production activities shall be accounted for under a proper method of accounting. This direct reallocation method ignores benefits provided by one service department for other service departments, and also excludes such other service departments from the base used to make the allocation;

(B) The step-allocation method, whereby a sequence of allocations is made beginning with the allocation to other service departments and to production departments of the total costs (direct and indirect) of the service department that provides benefits to the greatest number of other service departments, and ending with the allocation of the total costs (including the costs allocated to it from the other service departments) of the service department that provides benefits to the least number of other service departments. Under this allocation method, the cost of service departments allocated properly to functions or departments that are not service departments or production departments (for example, payroll costs allocated to a financial planning function or department) are not reallocated to any other service department or production department. The taxpayer shall then allocate the costs of the production departments (including the reallocated service department costs) to extended period long-term contracts and to other production activities that are not extended period long-term contracts. The service costs allocable to such other production activities shall be accounted for under a proper method of accounting, or

(C) Other methods of cost allocation authorized by cost accounting principles. However, a reasonable method does not include allocating service department costs to other service departments without taking such allocation into account in allocating the costs of such other service departments.

(iv) Relationship of service costs to benefits received. Factors or relationships that relate the incurring of service costs to the benefits received by an extended period long-term contract include measures based upon the total output of the service department (for example, the approximate number of service hours or the approximate number or the dollar volume of transactions provided to an extended period long-term contract as a fraction of the total number of service hours or the total number or the total dollar volume of transactions provided by the department), or measures based upon the relative size of the extended period long-term contract to the size of the taxpayer's other production activities (for example, the number of direct labor employees or direct labor hours or direct labor costs (as described in paragraph (d)(6)(i) of this section) incurred on an extended period long-term contract as a fraction of the total number of direct labor employees, direct labor hours, or direct labor costs incurred by the taxpayer in all production activities). In general, allocation methods prescribed in regulations of the Cost Accounting Standards Board, 4 CFR Chapter III, Subchapter G, as well as other allocation methods consistent with the principles or paragraph (d)(g) of this section are acceptable allocation methods, provided that the taxpayer applies such methods consistently.

(v) Additional requirements.

(A) If, pursuant to section 482 and the regulations thereunder, the district director makes an allocation of income or deductions between members of a group of controlled entities to reflect the performance of services or the provision of equipment or facilities at other than an arm's length charge, any taxpayer that has extended period long-term contracts and is affected by such allocation is required to take such allocation into account in making the taxpayer's allocation to extended period long-term contracts of the cost of administrative, service or support functions or departments.

(B) If the taxpayer establishes to the satisfaction of the district director that all of a particular type of administrative, service or support function is performed only at the jobsite (that is, at the offices of a production plant or at a construction site), then all the direct and indirect costs of such function incurred at the jobsite shall be directly allocated to each particular extended period long-term contract and any other activities performed at that jobsite, and no further allocation of that type of cost shall be required.

(C) For each taxable year that the taxpayer allocates costs service to an extended period long-term contract, the taxpayer shall maintain the records used to make such allocation so that the allocations may be readily examined and verified by the district director. The taxpayer shall also maintain records describing the types of costs that the taxpayer has deducted currently under paragraph (d)(6)(iii)(D) (general and administrative expenses), so that the amount, nature and allocation

of such costs may be verified readily by the district director. A change in the method or base used in allocating such service costs (such as changing from an allocation base using direct labor cost to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are required or not required to be allocated to extended period long-term contracts is a change in method of accounting to which section 446(e) and the regulations and procedures thereunder apply. See § 1.446–1(e).

(vi) Illustration of types of activities with respect to which costs ordinarily are required to be allocated. Costs incurred by the following types of functions or departments ordinarily are required to be allocated to extended period long-term contracts:

(A) The administration and coordination of manufacturing or construction projects (wherever performed in the business organization of the taxpayer);

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records of employees whose labor cost is allocable to extended period long-term contracts;

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery and return of materials and equipment to or from factories or jobsites, and expediting and follow-up;

(D) Materials handling and warehousing operations;

(E) Accounting and data services operations related to contract activities, including cost accounting, accounts payable, disbursements, billing, accounts receivable and payroll;

(F) Data processing;

(G) Security services; and

(H) Legal departments that provide legal services to contracts.

(vii) Illustration of types of activities with respect to which costs ordinarily are not required to be allocated. Costs incurred by the following types of functions or departments ordinarily are not required to be allocated to extended period long-term contracts:

(A) Functions or departments responsible for overall management of the taxpayer, or for setting overall policy for all of the taxpayer's activities or trades or businesses (such as, the board of directors (including their immediate staff), and the chief executive, financial, accounting and legal officers (including their immediate staffs) of the taxpayer, provided that no substantial part of the costs of such departments or functions directly benefit extended period long-term contracts);

(B) General business planning;

(C) Financial accounting (including the accounting services required to prepare consolidated reports, but not including any accounting for particular contracts);

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management);

(E) General economic analysis and forecasting;

(F) Internal audit;

(G) Shareholder, public and industrial relations;

(H) Tax department; and

(I) Other departments or functions that are not responsible for day-to-day operations but are instead responsible for setting policy and establishing procedures to be used by all of the taxpayer's activities or trades or businesses.

(viii) Policy and overall management services. Examples of such functions or departments that are responsible for setting policy and establishing procedures applicable to all of the taxpayer's activities or trades or businesses (see paragraph (d)(9)(vii)(I) of this section) are:

(A) Purchasing policy (such as maintaining lists of approved suppliers, developing purchasing manuals and policy directives of general application, developing general quality standards for purchased materials and components, general auditing and review of purchasing activities to assure compliance with the taxpayer's purchasing policy and compliance with government purchasing requirements, and management of small business participation),

(B) Personnel policy (such as establishing and managing personnel policy in general, developing general wage, salary and benefit policies, developing employee training programs unrelated to particular contracts, negotiations with labor unions and relations with retired workers),

(C) Quality control policy,

(D) Safety engineering policy,

(E) Insurance or risk management policy (but not including bid or performance bonds or insurance related to particular contracts), and

(F) Environmental management policy. However, the cost of establishing any system or procedure that will only benefit a particular extended period long-term contract shall be directly allocated to such contract.

(ix) Costs not described. The costs of any administrative, service or support function or department of the taxpayer not described in paragraph (d)(9)(iv) or (vii) of this section are required to be allocated to extended period long-term contracts to the extent that the nature of the benefits provided by such function or department is more like the type of benefits described in paragraph (d)(9)(vi) than the type of benefits described in paragraph (d)(9)(vii).

(x) Illustrations of the allocations required by this paragraph (d)(9). The following illustrate the types of considerations that are to be taken into account in making the allocations required by paragraph (d)(9) of this section. The taxpayer need not use the same method to allocate a particular type of administrative, service or support cost as the method described in these illustrations provided that the method used by the taxpayer is reasonable. See paragraph (d)(9)(iii) of this section. The allocation methods illustrated may be used to allocate other types of service costs not illustrated.

(A) Security services. The cost of security or protection services benefits all areas covered by the service and should be allocated to each physical area that receives the service in proportion either to the size of the physical area, number of employees in the area, or in proportion to the relative fair market value of assets located in the area, or in any other reasonable basis applied consistently. That part of the total cost allocable to a factory or jobsite where the only work being performed is an extended period long-term contract shall be directly allocated to that contract. The treatment of the cost of security services allocable to other service departments depends upon the method of allocation adopted by the taxpayer under paragraph (d)(9)(iii) of this section.

(B) Legal services. The cost of a legal department includes rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephone, library, and other overhead and the compensation of the attorneys and other employees assigned to the department. For this purpose compensation includes compensation described in paragraphs (d)(6)(ii)(E) and (P) of this section. These costs only benefit activities of the taxpayer requiring legal services. These costs are generally allocable directly to an extended period long-term contract on the basis of the approximate number of hours of legal services (including research) performed in connection with the contract, including bidding, negotiating, drafting, or reviewing the contract (including subcontracts and supply contracts), obtaining necessary licenses and permits, and in resolving contract disputes, termination claims or disputes arising from the performance of the contract. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any contract, approximations are appropriate, detailed time records need not be kept, and insubstantial amounts of services provided to a contract by senior legal staff as administrators or as reviewers may be ignored. The taxpayer shall also allocate directly to a contract the cost of any outside legal services provided to the contract. Instead of an allocation based upon total hours of legal services provided to an activity, the taxpayer may choose to allocate the costs of a legal department to an extended period long-term contract and to other production activities on the basis of total direct costs (as described in paragraph (d)(6)(i) of this section) incurred on an extended period long-term contract as a fraction of the total direct costs incurred on all production activities. Legal costs may also be allocable to long-term contracts of the taxpayer that are not extended period long-term contracts under paragraph (d)(5)(ii) of this section. Legal activities relating to general corporate functions, financing, securities law compliance, antitrust law compliance, tax compliance, industrial relations, compliance with laws and regulations not related to particular contracts, after the fact review of contracts to insure compliance with company policies, patents and licensing unrelated to particular contracts, and similar general legal functions are not required to be allocated to long-term contracts.

(C) Centralized payroll department. The cost of a payroll department includes rent (or an allocation of building depreciation and occupancy costs), office machines, supplies, telephones and other overhead and compensation of employees assigned to the department. The department cost may also include the cost of data processing and file maintenance, or these costs may be incurred by a separate data processing or records department and allocated to the payroll department. Payroll service costs benefit any production department or other service department incurring labor costs.

The cost of a payroll department is generally allocated on the basis of the gross amount of payroll processed.

(D) Centralized data processing. The cost of a data processing department includes rent or depreciation of data processing machines, supplies, rent (or an allocation of building depreciation and occupancy costs), power, telephone and other overhead, and the compensation of employees assigned to the department. These costs benefit all production departments and all other service departments that require data processing services. Data processing costs are generally allocated based upon the number of data processing hours supplied. Other reasonable bases, such as an allocation based upon total direct costs, may also be used. The costs of data processing systems developed for particular long-term contract shall be directly allocated to such contract.

(E) Engineering and design services. The cost of an engineering or design department includes rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephones, library, and other overhead, and compensation of employees assigned to the department. Unless the engineering and design services are properly accounted for separately, the cost of engineering or design service departments generally is directly allocable to a long-term contract (whether or not the contract is an extended period long-term contract) on the basis of the approximate number of hours of work performed on the contract as a fraction of the total hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates. Engineering and design services may also be treated as direct costs of the contract, provided that the taxpayer also treats all engineering and design overhead as a direct or indirect cost of the contract.

(F) Safety engineering. The cost of a safety engineering department includes the compensation paid to employees assigned to the department, rent (or an allocation of building depreciation and occupancy costs), travel, office machines, supplies, telephones, library, and other overhead. These costs benefit all the production activities of the taxpayer and should be allocated to an extended period long-term contract on the basis of the approximate number of safety inspections made on the contract as a fraction of total inspections, or on the basis of the number of employees assigned to the contract as a fraction of total production employees or on the basis of total labor hours worked on the contract as a fraction of total production hours, whichever is most reasonable. The cost of a safety engineering department responsible only for setting safety policy and establishing safety procedures to be used in all of the taxpayer's production activities or trades or businesses is not required to be allocated to extended period long-term contracts and other production activities. However, in determining the total costs of a safety engineering department to be allocated, costs attributable to providing a safety program only for a particular long-term contract shall be directly assigned to the contract.

(e) Severing and aggregating contracts—(1) In general. (i) (A) For the purpose of clearly reflecting income (e.g., to prevent the unreasonable deferral of recognition of income or the premature recognition of loss), it may be necessary in some instances for the Commissioner either to treat one agreement as several contracts or to treat several agreements as one contract.

(B) However, in the case of long-term contracts since the factors described in this paragraph are different from the factors for determining whether certain elements of an agreement are eligible for long-term contract treatment, the factors described in this paragraph do not apply in determining which elements of an agreement that are ineligible for long-term contract treatment must be separated from those elements that are eligible for long-term contract treatment.

(C) In general only the Commissioner (and not the taxpayer) may take action under this paragraph. Thus, for example, if the taxpayer enters into one agreement, the taxpayer may not treat that agreement as several contracts for purposes of this section unless and until that agreement is changed into several agreements. See examples 3 and 5 for instances when one agreement is changed into several agreements.

(ii) Whether an agreement should be so severed or several agreements so aggregated will depend on all the facts and circumstances. Such facts and circumstances may include whether there is separate delivery or separate acceptance of units representing a portion of the subject matter of the contract, whether such units are independently priced, whether there is no business purpose for one agreement rather than several agreements or several agreements rather than one agreement, and such other factors as customary commercial practice, the dealings between parties to the contract, the nature of the subject matter of the contract, the total number of units to be constructed, manufactured, or installed under the contract, and the

contemplated time between the completion of each unit.

(iii) Generally, one agreement will not be treated as several contracts unless such agreement contemplates separate delivery or separate acceptance of portions of the subject matter of the contract. However, separate delivery or separate acceptance of portions of the subject matter of a contract does not necessarily require severing of an agreement (see example (4) of paragraph (e)(2) of this section).

(iv) One agreement may be severed, or several agreements may be aggregated, based upon the pricing formula of such agreements. For example, in the case of a multi-unit agreement for several similar items, if the price to be paid for similar units is determined under different terms or formulas (for example, if some units are priced under a cost-plus incentive fee arrangement, and later units are to be priced under a fixed-price arrangement), then the difference in the pricing terms or formulas may indicate that the agreement should be treated as several contracts.

(v) An agreement generally will be treated as several contracts where there is no business purpose for entering into one agreement rather than several agreements.

A factor which may evidence that no such business purpose exists is that the agreement covers two or more subject matters, none of which readily can be determined to be the primary subject matter of the contract (within the meaning of paragraph (b)(2)(ii) of this section); such factor must be considered along with other factors indicating the presence or absence of business purpose.

(vi) Several agreements generally will not be aggregated unless there is no business purpose for entering into several agreements rather than one agreement.

(vii) An example of a factor which is evidence that two agreements entered into between the same parties should be aggregated is that (without regard to the order in which the agreements were entered into or performed, and without regard to whether one of the agreements could actually be performed without the prior or contemporaneous performance of the other agreement) a reasonable business-person would not have entered into one of the agreements for the terms agreed upon but for entering into the other agreement in such other agreement for the terms agreed upon (or for more favorable terms). See example (2) of paragraph (e)(2) of this section. An example of a factor which is not evidence that two agreements entered into between the same parties should be aggregated is that one of the agreements would not have been entered into containing the terms agreed upon but for the expectation that the parties would enter into the other agreement.

(viii) If the number of items to be supplied is increased (as by the exercise of an option or the issuance of a "change order"), the supplying of such additional items generally results in the agreement being changed into several agreements. See paragraph § 1.451-3(e)(1)(i).

(ix) See paragraph (b)(2)(ii) of this section for special rules relating to the time for completion of certain contracts having more than one subject matter.

(2) **Examples.** The application of paragraph (e) of this section may be illustrated by the following examples.

Example (1). X, a calendar year taxpayer engaged in the construction business and using a long-term contract method, enters into one agreement in 1972 with A, a real estate developer, to build three houses of different designs in three different suburbs of a large city. The houses are to be completed, accepted, and put into service in 1973, 1974, and 1975, respectively. The portion of the total contract price attributable to each house can reasonably be determined. In these circumstances it may be necessary for the Commissioner to sever and treat the agreement as separate contracts to build each house for purposes of applying X's long-term contract method.

Example (2). Y, a calendar year shipbuilder using a long-term contract method, enters into two agreements at about the same time during 1982 with M. These agreements are the product of a single negotiation. Under each agreement the taxpayer is to construct for M a submarine of the same class. Although the specifications for each submarine are similar, it is anticipated that, since the taxpayer has never constructed this class of submarine before, the costs incurred in constructing the first submarine (to be delivered in 1983) will be substantially greater than the costs incurred in constructing the second submarine (to be delivered in 1984.) If the agreements are treated as separate contracts, it is estimated that the first contract could result in little or no gain, while the second contract would result in substantial profits. A reasonable business person would not have entered into the agreement to construct the first submarine for the price specified without entering into the agreement to construct the second submarine. In these circumstances, it may be necessary for the Commissioner to aggregate the two agreements for purposes of applying Y's long-term contract method.

Example (3). Assume the same facts as in example (2) with the addition of the following facts: In 1983, M issues a "change order" providing for a third submarine of the same class to be constructed by Y and delivered to M in 1985. The portion of the total contract price attributable to the "change order" providing for the third submarine can reasonably be determined. A reasonable business person would have entered into the agreements to construct the first two submarines for the price specified without regard to whether M would issue the "change order" for the third submarine. In these circumstances the "change order" providing for the third submarine

must be treated as a separate contract for purposes of applying Y's long-term contract method.

Example (4). Z, a calendar year taxpayer engaged in the construction business and using a long-term contract method, enters into an agreement in 1983 to build a ten story office building for the Y Bank. In 1984, the structure is completed and the first three floors of the building are completed and accepted, and Y occupies these floors and uses them for the conduct of its banking business. Construction, however, continues on the remaining seven floors, which are completed and accepted in 1985. In these circumstances, it is clear that even though separate acceptance of portions of the subject matter of the agreement has occurred, the subject matter of the agreement was essentially a single unit, namely a building, and that there was a business purpose for entering into one contract rather than several contracts. Consequently, the agreement ordinarily will not be severed into separate contracts for purposes of applying Z's long-term contract method.

Example (5). The facts are the same as in example (4), except that due to a change in business conditions, Y will not require (either for its own use or for rental) the remaining seven floors for at least two years and, pursuant to a separate agreement entered into in 1984 between the parties, substantially all work on completing the remaining seven floors is stopped. In these circumstances, due to the change in business conditions and the actions of the parties, the original agreement (as modified by the second agreement) is changed into two agreements, each of which is treated as a separate contract for purposes of this section, one contract (entered into in 1983) for the construction of a ten story building with the first three floors completed for occupancy, and a separate contract (or contracts) to finish work on the remaining seven floors on an "as requested" basis.

Example (6). T, a calendar year taxpayer engaged in the business of manufacturing aircraft and related equipment, enters into an agreement in 1982 with the B government to manufacture 10 military aircraft for delivery in 1984. It is anticipated at the time the agreement is entered into that B may enter into an agreement with T for the production and sale of as many as 300 of these aircraft over the next 20 years. In negotiating the price for the agreement, B and T take into account the expected total cost of manufacturing the 10 aircraft, the risks and the opportunities associated with the agreement and all other factors that the parties consider relevant, in such a manner that T would have entered into the agreement with the terms agreed upon whether or not T would actually enter into one or more additional production agreements. However, it is unlikely that T would have entered into the agreements but for the expectation that T and B would enter into additional production agreements. In 1984, the 10 aircraft are completed by T and accepted by B. In 1984, T also enters into an agreement with B to manufacture 20 aircraft of the same type for delivery in 1986. In negotiating the price for these 20 aircraft, B and T take into account the fact that the expected unit costs for this production of 20 will be different than the unit costs of the 10 aircraft completed in 1984, but also that the expected unit costs of this production of 20 will be substantially higher than the costs of future production. Because the price awarded for each of the two agreements takes into account the expected total costs and the risks expected for each agreement standing alone, the terms agreed upon for any one of the agreements are independent of the terms agreed upon for the other agreements. Under the facts of this example, the two agreements may not be aggregated into one contract for purposes of applying T's long-term contract method.

Example (7). R, a calendar year taxpayer engaged in the manufacture of industrial machinery, enters into one agreement in 1982 with Z to manufacture five specialized machines and to manufacture spare and replacement parts for the machines. The machines are to be delivered in 1982 and 1983, and the spare and replacement parts are to be delivered in 1983 through 1985. The portion of the total contract price attributable to the five machines and to the spare and replacement parts reasonably can be determined. The portion of the total contract price reasonably attributable to the spare and replacement parts is more than an insignificant amount of the total contract price. Assume that, under all the facts and circumstance, it is determined that the portion of the agreement attributable to the five machines need not be severed as between the machines. In these circumstances, because the agreement contemplates separate delivery of the machines and the parts, because more than an insignificant amount of the total contract price is allocable to the spare and replacement parts, and because spare or replacement parts are items different than an entire machine, it may be necessary for the Commissioner to sever the agreement, treating the agreement to manufacture the five machines as a separate contract and the agreement to manufacture the spare and replacement parts as another separate contract (or as several separate contracts depending on the facts and circumstances) for purposes of applying R's long-term contract method.

(3) Cross reference. See § 1.6001-1 (a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

(f) Changing to or from a long-term method of accounting. A taxpayer may change to or from the percentage of completion method or the completed contract method only with the consent of the Commissioner. See section 446(e) and § 1.446–1(e).

(g) Effective date and transition to 1983 cost allocation rules; special rules—(1) In general. In the case of a taxpayer using the completed contract method or a method of accounting that uses inventories (other than a long-term contract method), the cost allocation rules prescribed in paragraph (d)(6) of this section (hereinafter "the 1983 cost allocation method") shall apply (with the phase-in described in paragraph (g)(2) of this section) to costs incurred by the taxpayer in taxable years beginning after December 31, 1982, but only with respect to extended period long-term contracts (as defined in paragraph (b)(3) of this section) entered into after December 31, 1982. No costs incurred with respect to any contract entered into before January 1, 1983 are required to be accounted for under the 1983 cost allocation method. Such costs shall be accounted for under the cost allocation method prescribed in paragraph (d)(5) of this section. Because the transition to the 1983 cost allocation method is to be applied on a "cut-off" basis, sections 446(e) and 481 do not apply to the transition to the 1983 cost allocation method.

(2) Phase-in. For costs required to be allocated to an extended period long-term contract under the 1983 cost allocation method that are not required to be allocated to the contract under the cost allocation method prescribed in paragraph (d)(5) of this section (or in paragraph (c) of § 1.471-11 in the case of a taxpayer accounting for extended period long-term contracts under a method of accounting that uses inventories (other than a long-term contract method)), in lieu of allocating the full amount of such costs to the extended period long-term contract, the taxpayer shall allocate to the contract only the applicable percentage of such costs incurred in taxable years beginning after December 31, 1982 and before January 1, 1986, with respect to extending period long-term contracts entered into after December 31, 1982. The applicable percentage shall be determined as follows:

For taxable years beginning in calendar year—	The applicable percentage is—
1983	33⅓
1984	66⅔
1985 or thereafter	100

In the case of a taxpayer whose taxable year does not begin on January 1, costs incurred with respect to extended period long-term contracts entered into after December 31, 1982, shall be accounted for under the cost allocation method prescribed in paragraph (d)(5) of this section (or paragraph (c) of § 1.471-11 in the case of a taxpayer using an inventory method) in the case of costs incurred in taxable years beginning before January 1, 1983, and under the 1983 cost allocation method (with the application of paragraph (g) of this section) in the case of taxable years beginning after December 31, 1982.

(3) Special rule for completion of certain contracts in taxable years ending before January 1, 1983. Any contract that would (but for this paragraph (g)(3)) be considered to be completed in a taxable year ending before January 1, 1983, solely by reason of the application of paragraphs (b)(2)(i)(B), (ii), (iii), or (iv) of this section, shall be considered to be completed on the first day of the taxpayer's first taxable year ending after December 31, 1982. The application of this paragraph (g)(3) shall not be considered to be a change in method of accounting to which section 481 applies.

(4) Special rule for severing and aggregating certain contracts in taxable years ending before January 1, 1983. Any contract of a taxpayer that would (but for this paragraph (g)(4)) be considered completed in a taxable year ending before January 1, 1983—

(i) Solely by reason of the application of those provisions of paragraph (e)(1) of this section expressly made applicable to taxable years ending after December 31, 1982 (hereinafter, the "severing/aggregating modifications") or,

(ii) Solely by reason of the application of both the severing/aggregating modifications and the application of paragraphs (b)(2)(i)(B), (ii), (iii) or (iv) of this section (hereinafter, the "completion modifications"), shall be treated as having been completed on the first day after December 31, 1982, on which any contract that was severed from such contract (by reason of the severing/aggregating modifications) is completed (determined with application of the completion modifications). The application of this paragraph (g)(4) shall not be considered to be a change in method of accounting to which section 481 applies.

(5) Special rule for estimated tax payments. For purposes of the addition to the tax for underpayment of estimated tax under section 6654 (relating to individuals) and section 6655 (relating to corporations), the gross income realized in the taxpayer's first taxable year ending after December 31, 1982, attributable to long-term contracts deemed to be completed in such taxable years solely by the application of paragraphs (b)(2)(i)(B), (ii), (iii), or (iv), (g)(3) or (g)(4) of this section or those portions of paragraph (e)(1) of this section made applicable to taxable years ending after December 31, 1982, shall be considered to be taxable income for such taxable year, but only with respect to installments of estimated tax required to be paid on or after April 13, 1983.

(6) Taxpayer changing from a method more inclusive of indirect costs. Except as provided in paragraphs (g)(1) and (2) of this section, if a taxpayer wishes to change to a method of accounting for indirect costs prescribed under this section (or under § 1.471-11(c) in the case of a taxpayer using an inventory method of accounting for long-term contracts) from a method of accounting for indirect costs that is more inclusive of indirect costs, the taxpayer must secure the consent of the Commissioner prior to making the change in accordance with the regulations and procedures established under section 446(e).

[T.D. 6500, 25 FR 11710, Nov. 26, 1960, as amended by T.D. 7397, 41 FR 2637, Jan. 19, 1976; T.D. 8067, 51 FR 378, Jan. 6, 1986; 51 FR 6520, Feb. 25, 1986; 51 FR 6914, Feb. 27, 1986; T.D. 8067, 51 FR 16021, April 30, 1986]

§ 1.451–4 Accounting for redemption of trading stamps and coupons.

(a) In general—(1) Subtraction from receipts. If an accrual method taxpayer issues trading stamps or premium coupons with sales, or an accrual method taxpayer is engaged in the business of selling trading stamps or premium coupons, and such stamps or coupons are redeemable by such taxpayer in merchandise, cash, or other property, the taxpayer should, in computing the income from such sales, subtract from gross receipts with respect to sales of such stamps or coupons (or from gross receipts with respect to sales with which trading stamps or coupons are issued) an amount equal to—

(i) The cost to the taxpayer of merchandise, cash, and other property used for redemptions in the taxable year,

(ii) Plus the net addition to the provision for future redemptions during the taxable year (or less the net subtraction from the provision for future redemptions during the taxable year).

(2) Trading stamp companies. For purposes of this section, a taxpayer will be considered as being in the business of selling trading stamps or premium coupons if—

(i) The trading stamps or premium coupons sold by him are issued by purchasers to promote the sale of their merchandise or services,

(ii) The principal activity of the trade or business is the sale of such stamps or coupons,

(iii) Such stamps or coupons are redeemable by the taxpayer for a period of at least 1 year from the date of sale, and

(iv) Based on his overall experience, it is estimated that not more than two-thirds of the stamps or coupons sold which it is estimated, pursuant to paragraph (c) of this section, will be ultimately redeemed, will be redeemed within 6 months of the date of sale.

(b) Computation of the net addition to or subtraction from the provision for future redemptions—(1) Determination of the provision for future redemptions. (i) The provision for future redemptions as of the end of a taxable year is computed by multiplying "estimated future redemptions" (as defined in subdivision (ii) of this subparagraph) by the estimated average cost of redeeming each trading stamp or coupon (computed in accordance with subdivision (iii) of this subparagraph).

(ii) For purposes of this section, the term "estimated future redemptions" as of the end of a taxable year means the number of trading stamps or coupons outstanding as of the end of such year that it is reasonably estimated will ultimately be presented for redemption. Such estimate shall be determined in accordance with the rules contained in paragraph (c) of this section.

(iii) For purposes of this section, the estimated average cost of redeeming each trading stamp or coupon shall be computed by including only the costs to the taxpayer of acquiring the merchandise, cash, or other property needed to redeem such stamps or coupons. The term "the costs to the taxpayer of acquiring the merchandise, cash, or other property needed to redeem such stamps or coupons" includes only the price charged by the seller (less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer provided a consistent course is followed) plus transportation or other necessary charges in acquiring possession of the goods. Items such as the costs of advertising, catalogs, operating redemption centers, transporting merchandise or other property from a central warehouse to a branch warehouse (or from a warehouse to a redemption center), and storing the merchandise or other property used to redeem stamps or coupons should not be included in costs of redeeming stamps or premium coupons, but rather should be accounted for in accordance with the provisions of sections 162 and 263.

(2) Changes in provision for future redemptions. For purposes of this section, a "net addition to" or "net subtraction from" the provision for future redemptions for a taxable year is computed as follows:

(i) Carry over the provision for future redemptions (if any) as of the end of the preceding taxable year,

(ii) Compute the provision for future redemptions as of the end of the taxable year in accordance with subparagraph (1) of this paragraph, and

(iii) If the amount referred to in subdivision (ii) of this subparagraph exceeds the amount referred to in subdivision (i) of this subparagraph, such excess is the net addition to the provision for future redemptions for the taxable year. On the other hand, if the amount referred to in such subdivision (i) exceeds the amount referred to in such subdivision (ii), such excess is the net subtraction from the provision for future redemptions for the taxable year.

(3) Example. The provisions of this paragraph and paragraph (a)(1) of this section may be illustrated by the following example:

Example. (a) X Company, a calendar year accrual method taxpayer, is engaged in the business of selling trading stamps to merchants. In 1971, its first year of operation, X sells 10 million stamps at $5 per 1,000; it redeems 3 million stamps for merchandise and cash of an average value of $3 per 1,000 stamps. At the end of 1971 it is estimated (pursuant to paragraph (c) of this section) that a total of 9 million stamps of the 10 million stamps issued in 1971 will eventually be presented for redemption. At this time it is estimated that the average cost of redeeming stamps (as described in subparagraph (1)(iii) of this paragraph) would continue to be $3 per 1,000 stamps. Under these circumstances, X computes its gross income from sales of trading stamps as follows:

Gross receipts from sales (10 million stamps at $5 per 1,000)		$50,000
Less:		
Cost of actual redemptions (3 million stamps at $3 per 1,000)	$9,000	
Provision for future redemptions on December 31, 1971 (9 million stamps–3 million stamps × $3 per 1,000)	18,000	
		27,000
1971 gross income from sales of stamps		23,000

(b) In 1972, X also sells 10 million stamps at $5 per 1,000 stamps. During 1972 X redeems 7 million stamps at an average cost of $3.01 per 1,000 stamps. At the end of 1972 it is determined that the estimated future redemptions (within the meaning of subparagraph (1)(ii) of this paragraph) is 8 million. It is further determined that the estimated average cost of redeeming stamps would continue to be $3.01 per 1,000 stamps. X thus computes its gross income from sales of trading stamps for 1972 as follows:

Gross receipts from sales (10 million stamps at $5 per 1,000)		$50,000
Less:		
Cost of actual redemptions (7 million stamps at $3.01 per 1,000)	$21,070	
Plus:		
Provision for future redemptions on Dec. 31, 1972 (8 million stamps at $3.01 per 1,000)	24,080	
Minus provision for future redemptions on Dec. 31, 1971	18,000	
Addition to provision for future redemptions	6,080	
Total cost of redemptions		27,150
1972 Gross income from sales of stamps		22,850

(c) Estimated future redemptions—(1) In general. A taxpayer may use any method of determining the estimated future redemptions as of the end of a year so long as—

(i) Such method results in a reasonably accurate estimate of the stamps or coupons outstanding at the end of such year that will ultimately be presented for redemption,

(ii) Such method is used consistently, and

(iii) Such taxpayer complies with the requirements of this paragraph and paragraphs (d) and (e) of this section.

(2) Utilization of prior redemption experience. Normally, the estimated future redemptions of a taxpayer shall be determined on the basis of such taxpayer's prior redemption experience. However, if the taxpayer does not have sufficient redemption experience to make a reasonable determination of his "estimated future redemptions," or if because of a change in his mode of operation or other relevant factors the determination cannot reasonably be made completely on the basis of the taxpayer's own experience, the experiences of similarly situated taxpayers may be used to establish an experience factor.

(3) One method of determining estimated future redemptions. One permissible method of determining the estimated future redemptions as of the end of the current taxable year is as follows:

(i) Estimate for each preceding taxable year and the current taxable year the number of trading stamps or coupons issued for each such year which will ultimately be presented for redemption.

(ii) Determine the sum of the estimates under subdivision (i) of this subparagraph for each taxable year prior to and including the current taxable year.

(iii) The difference between the sum determined under subdivision (ii) of this subparagraph and the total number of trading stamps or coupons which have already been presented for redemption is the estimated future redemptions as of the end of the current taxable year.

(4) Determination of an "estimated redemption percentage." For purposes of applying subparagraph (3)(i) of this paragraph, one permissible method of estimating the number of trading stamps or coupons issued for a taxable year that will ultimately be presented for redemption is to multiply such number of stamps issued for such year by an "estimated redemption percentage." For purposes of this section the term "estimated redemption percentage" for a taxable year means a fraction, the numerator of which is the number of trading stamps or coupons issued during a taxable year that it is reasonably estimated will ultimately be redeemed, and the denominator of which is the number of trading stamps or coupons issued during such year. Consequently, the product of such percentage and the number of stamps issued for

such year equals the number of trading stamps or coupons issued for such year that it is estimated will ultimately be redeemed.

(5) Five-year rule. (i) One permissible method of determining the "estimated redemption percentage" for a taxable year is to—

(a) Determine the percentage which the total number of stamps or coupons redeemed in the taxable year and the 4 preceding taxable years is of the total number of stamps or coupons issued or sold in such 5 years; and

(b) Multiply such percentage by an appropriate growth factor as determined pursuant to guidelines published by the Commissioner.

(ii) If a taxpayer uses the method described in subdivision (i) of this subparagraph for a taxable year, it will normally be presumed that such taxpayer's "estimated redemption percentage" is reasonably accurate.

(6) Other methods of determining estimated future redemptions. (i) If a taxpayer uses a method of determining his "estimated future redemptions" (other than a method which applies the 5-year rule as described in subparagraph (5)(i) of this paragraph) such as a probability sampling technique, the appropriateness of the method (including the appropriateness of the sampling technique, if any) and the accuracy and reliability of the results obtained must, if requested, be demonstrated to the satisfaction of the district director.

(ii) No inference shall be drawn from subdivision (i) of this subparagraph that the use of any method to which such subdivision applies is less acceptable than the method described in subparagraph (5)(i) of this paragraph. Therefore, certain probability sampling techniques used in determining estimated future redemptions may result in reasonably accurate and reliable estimates. Such a sampling technique will be considered appropriate if the sample is—

(a) Taken in accordance with sound statistical sampling principles,

(b) In accordance with such principles, sufficiently broad to produce a reasonably accurate result, and

(c) Taken with sufficient frequency as to produce a reasonably accurate result.

In addition, if the sampling technique is appropriate, the results obtained therefrom in determining estimated future redemptions will be considered accurate and reliable if the evaluation of such results is consistent with sound statistical principles. Ordinarily, samplings and recomputations of the estimated future redemptions will be required annually. However, the facts and circumstances in a particular case may justify such a recomputation being taken less frequently than annually. In addition, the Commissioner may prescribe procedures indicating that samples made to update the results of a sample of stamps redeemed in a prior year need not be the same size as the sample of such prior year.

(d) Consistency with financial reporting—(1) Estimated future redemptions. For taxable years beginning after August 22, 1972, the estimated future redemptions must be no greater than the estimate that the taxpayer uses for purposes of all reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.

(2) Average cost of redeeming stamps. For taxable years beginning after August 22, 1972, the estimated average cost of redeeming each stamp or coupon must be no greater than the average cost of redeeming each stamp or coupon (computed in accordance with paragraph (b)(1)(iii) of this section) that the taxpayer uses for purposes of all reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes.

(e) Information to be furnished with return—(1) In general. For taxable years beginning after August 22, 1972, a taxpayer described in paragraph (a) of this section who uses a method of determining the "estimated future redemptions" other than that described in paragraph (c)(5)(i) of this section shall file a statement with his return showing such information as is necessary to establish the correctness of the amount subtracted from gross receipts in the taxable year.

(2) Taxpayers using the 5-year rule. If a taxpayer uses the method of determining estimated future redemptions described in paragraph (c)(5)(i) of this section, he shall file a statement with his return showing, with respect to the taxable year and the 4 preceding taxable years—

(i) The total number of stamps or coupons issued or sold during each year, and

(ii) The total number of stamps or coupons redeemed in each such year.

(3) Trading stamp companies. In addition to the information required by subparagraph (1) or (2) of this paragraph, a taxpayer engaged in the trade or business of selling trading stamps or

premium coupons shall include with the statement described in subparagraph (1) or (2) of this paragraph such information as may be necessary to satisfy the requirements of paragraph (a)(2)(iv) of this section.

[T.D. 6500, 25 FR 11710, Nov. 26, 1960, as amended by T.D. 7201, 37 FR 16911, Aug. 23, 1972, 37 FR 18617, Sept. 14, 1972]

§ 1.451–5 Advance payments for goods and long-term contracts.

(a) Advance payment defined. (1) For purposes of this section, the term "advance payment" means any amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales or a long-term contract method of accounting (described in § 1.451–3), pursuant to, and to be applied against, an agreement:

(i) For the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(ii) For the building, installing, constructing or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.

(2) For purposes of subparagraph (1) of this paragraph:

(i) The term "agreement" includes (a) a gift certificate that can be redeemed for goods, and (b) an agreement which obligates a taxpayer to perform activities described in subparagraph (1)(i) or (ii) of this paragraph and which also contains an obligation to perform services that are to be performed as an integral part of such activities; and

(ii) Amounts due and payable are considered "received".

(3) If a taxpayer (described in subparagraph (1) of this paragraph) receives an amount pursuant to, and to be applied against, an agreement that not only obligates the taxpayer to perform the activities described in subparagraph (1)(i) and (ii) of this paragraph, but also obligates the taxpayer to perform services that are not to be performed as an integral part of such activities, such amount will be treated as an "advance payment" (as defined in subparagraph (1) of this paragraph) only to the extent such amount is properly allocable to the obligation to perform the activities described in subparagraph (1)(i) and (ii) of this paragraph. The portion of the amount not so allocable will not be considered an "advance payment" to which this section applies. If, however, the amount not so allocable is less than 5 percent of the total contract price, such amount will be treated as so allocable except that such treatment cannot result in delaying the time at which the taxpayer would otherwise accrue the amounts attributable to the activities described in subparagraph (1)(i) and (ii) of this paragraph.

(b) Taxable year of inclusion—(1) In general. Advance payments must be included in income either—

(i) In the taxable year of receipt; or

(ii) Except as provided in paragraph (c) of this section.

(a) In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or

(b) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

(2) Examples. This paragraph may be illustrated by the following examples:

Example (1). S, a retailer who uses for tax purposes and for purposes of the reports referred to in subparagraph (1)(ii)(a) of this paragraph, an accrual method of accounting under which it accounts for its sales of goods when the goods are shipped, receives advance payments for such goods. Such advance payments must be included in gross receipts for tax purposes either in the taxable year the payments are received or in the taxable year such goods are shipped (except as provided in paragraph (c) of this section).

Example (2). T, a manufacturer of household furniture, is a calendar year taxpayer who uses an accrual method of accounting pursuant to which income is accrued when furniture is shipped for purposes of its financial reports (referred to in subparagraph (1)(ii)(a) of this paragraph) and an accrual method of accounting pursuant to which the income is accrued when furniture is delivered and accepted for tax purposes. See § 1.446-1(c)(1)(ii). In 1974, T receives an advance payment of $8,000 from X with respect to an order of furniture to be manufactured for X for a total price of $20,000. The furniture is shipped to X in December 1974, but it is not delivered to and accepted by X until January 1975. As a result of this contract, T must include the entire advance payment in its gross income for tax purposes in 1974 pursuant to subparagraph (1)(ii)(b) of this paragraph. T must include the remaining $12,000 of the

gross contract price in its gross income in 1975 for tax purposes.

(3) **Long-term contracts.** In the case of a taxpayer accounting for advance payments for tax purposes pursuant to a long-term contract method of accounting under § 1.451-3, or of a taxpayer accounting for advance payments with respect to a long-term contract pursuant to an accrual method of accounting referred to in the succeeding sentence, advance payments shall be included in income in the taxable year in which properly included in gross receipts pursuant to such method of accounting (without regard to the financial reporting requirement contained in subparagraph (1)(ii) (a) or (b) of this paragraph). An accrual method of accounting to which the preceding sentence applies shall consist of any method of accounting under which the income is accrued when, and costs are accumulated until, the subject matter of the contract (or, if the subject matter of the contract consists of more than one item, an item) is shipped, delivered, or accepted.

(4) **Installment method.** The financial reporting requirement of subparagraph (1)(ii) (a) or (b) of this paragraph shall not be construed to prevent the use of the installment method under section 453. See § 1.446-1(c)(1)(ii).

(c) **Exception for inventoriable goods.** (1)(i) If a taxpayer receives an advance payment in a taxable year with respect to an agreement for the sale of goods properly includible in his inventory, or with respect to an agreement (such as a gift certificate) which can be satisfied with goods or a type of goods that cannot be identified in such taxable year, and on the last day of such taxable year the taxpayer—

(a) Is accounting for advance payments pursuant to a method described in paragraph (b)(1)(ii) of this section for tax purposes,

(b) Has received "substantial advance payments" (as defined in subparagraph (3) of this paragraph) with respect to such agreement, and

(c) Has on hand (or available to him in such year through his normal source of supply) goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such year,

then all advance payments received with respect to such agreement by the last day of the second taxable year following the year in which such substantial advance payments are received, and not previously included in income in accordance with the taxpayer's accrual method of accounting, must be included in income in such second taxable year.

(ii) If advance payments are required to be included in income in a taxable year solely by reason of subdivision (i) of this subparagraph, the taxpayer must take into account in such taxable year the costs and expenditures included in inventory at the end of such year with respect to such goods (or substantially similar goods) on hand or, if no such goods are on hand by the last day of such second taxable year, the estimated cost of goods necessary to satisfy the agreement.

(iii) Subdivision (ii) of this subparagraph does not apply if the goods or type of goods with respect to which the advance payment is received are not identifiable in the year the advance payments are required to be included in income by reason of subdivision (i) of this subparagraph (for example, where an amount is received for a gift certificate).

(2) If subparagraph (1)(i) of this paragraph is applicable to advance payments received with respect to an agreement, any advance payments received with respect to such agreement subsequent to such second taxable year must be included in gross income in the taxable year of receipt. To the extent estimated costs of goods are taken into account in a taxable year pursuant to subparagraph (1)(ii) of this paragraph, such costs may not again be taken into account in another year. In addition, any variances between the costs or estimated costs taken into account pursuant to subparagraph (1)(ii) of this paragraph and the costs actually incurred in fulfilling the taxpayer's obligations under the agreement must be taken into account as an adjustment to the cost of goods sold in the year the taxpayer completes his obligations under such agreement.

(3) For purposes of subparagraph (1) of this paragraph, a taxpayer will be considered to have received "substantial advance payments" with respect to an agreement by the last day of a taxable year if the advance payments received with respect to such agreement during such taxable year plus the advance payments received prior to such taxable year pursuant to such agreement, equal or exceed the total costs and expenditures reasonably estimated as includible in inventory with respect to such agreement. Advance payments received in a taxable year with respect to an agreement (such as a gift certificate) under which the goods or type of goods to be sold are not identifiable in such year shall be treated as "substantial advance payments" when received.

(4) The application of this paragraph is illustrated by the following example:

Example. In 1971, X, a calendar year accrual method taxpayer, enters into a contract for the sale of goods (properly includible in X's inventory) with a total contract price of $100. X estimates that his total inventoriable costs and expenditures for the goods will be $50. X receives the following advance payments with respect to the contract:

1971	$35
1972	20
1973	15
1974	10
1975	10
1976	10

The goods are delivered pursuant to the customer's request in 1977. X's closing inventory for 1972 of the type of goods involved in the contract is sufficient to satisfy the contract. Since advance payments received by the end of 1972 exceed the inventoriable costs X estimates that he will incur, such payments constitute "substantial advance payments". Accordingly, all payments received by the end of 1974, the end of the second taxable year following the taxable year during which "substantial advance payments" are received, are includible in gross income for 1974. Therefore, for taxable year 1974 X must include $80 in his gross income. X must include in his cost of goods sold for 1974 the cost of such goods (or similar goods) on hand or, if no such goods are on hand, the estimated inventoriable costs necessary to satisfy the contract. Since no further deferral is allowable for such contract, X must include in his gross income for the remaining years of the contract, the advance payment received each year. Any variance between estimated costs and the costs actually incurred in fulfilling the contract is to be taken into account in 1977, when the goods are delivered. See paragraph (c)(2) of this section.

(d) Information schedule. If a taxpayer accounts for advance payments pursuant to paragraph (b)(1)(ii) of this section, he must attach to his income tax return for each taxable year to which such provision applies an annual information schedule reflecting the total amount of advance payments received in the taxable year, the total amount of advance payments received in prior taxable years which has not been included in gross income before the current taxable year, and the total amount of such payments received in prior taxable years which has been included in gross income for the current taxable year.

(e) Adoption of method. (1) For taxable years ending on or after December 31, 1969, and before January 1, 1971, a taxpayer (even if he has already filed an income tax return for a taxable year ending within such period) may secure the consent of the Commissioner to change his method of accounting for such year to a method prescribed in paragraph (b)(1)(ii) of this section in the manner prescribed in section 446 and the regulations thereunder, if an application to secure such consent is filed on Form 3115 within 180 days after March 23, 1971.

(2) A taxpayer who is already reporting his income in accordance with a method prescribed in paragraph (b)(1)(ii)(a) of this section need not secure the consent of the Commissioner to continue to utilize this method. However, such a taxpayer, for all taxable years ending after March 23, 1971, must comply with the requirements of paragraphs (b)(1)(ii)(a) (including the financial reporting requirement) and (d) (relating to an annual information schedule) of this section.

(f) Cessation of taxpayer's liability. If a taxpayer has adopted a method prescribed in paragraph (b)(1)(ii) of this section, and if in a taxable year the taxpayer dies, ceases to exist in a transaction other than one to which section 381(a) applies, or his liability under the agreement otherwise ends, then so much of the advance payment as was not includible in his gross income in preceding taxable years shall be included in his gross income for such taxable year.

(g) Special rule for certain transactions concerning natural resources. A transaction which is treated as creating a mortgage loan pursuant to section 636 and the regulations thereunder rather than as a sale shall not be considered a "sale or other disposition" within the meaning of paragraph (a)(1) of this section. Consequently, any payment received pursuant to such a transaction, which payment would otherwise qualify as an "advance payment", will not be treated as an "advance payment" for purposes of this section.

[T.D. 7103, 36 FR 5495, 5977, Mar. 24, 1971, as amended by T.D. 7397, 41 FR 2641, Jan. 19, 1976; T.D. 8067, 51 FR 393, Jan. 6, 1986]

§ 1.451–6 Election to include crop insurance proceeds in gross income in the taxable year following the taxable year of destruction or damage.

(a) In general. (1) For taxable years ending after December 30, 1969, a taxpayer reporting gross income on the cash receipts and disbursements method of accounting may elect to include insurance proceeds received as a result of the destruction of, or damage to, crops in gross income for the taxable year following the taxable year of such destruction or damage, if the taxpayer establishes that, under his normal business practice, the income from such crops would have been included in gross income for any taxable year following the taxable year of such destruction or damage. However, if the taxpayer receives such insurance proceeds in the taxable year following the taxable year of such destruction or damage, then he shall include such proceeds in gross income for the taxable year of receipt without having to make an election under section 451(d) and

this section. For the purposes of this section, payments received under the Agricultural Act of 1949 as amended, as the result of (i) destruction or damage to crops caused by drought, flood, or any other natural disaster, or (ii) the inability to plant crops because of such a natural disaster, shall be treated as insurance proceeds received as a result of destruction or damage to crops. The preceding sentence shall apply to payments which are received by the taxpayer after December 31, 1973.

(2) In the case of a taxpayer who receives insurance proceeds as a result of the destruction of, or damage to, two or more specific crops, if such proceeds may, under section 451(d) and this section, be included in gross income for the taxable year following the taxable year of such destruction or damage, and if such taxpayer makes an election under section 451(d) and this section with respect to any portion of such proceeds, then such election will be deemed to cover all of such proceeds which are attributable to crops representing a single trade or business under section 446(d). A separate election must be made with respect to insurance proceeds attributable to each crop which represents a separate trade or business under section 446(d).

(b)(1) **Time and manner of making election.** The election to include in gross income insurance proceeds received as a result of destruction of, or damage to, the taxpayer's crops in the taxable year following the taxable year of such destruction or damage shall be made by means of a statement attached to the taxpayer's return (or an amended return) for the taxable year of destruction or damage. The statement shall include the name and address of the taxpayer (or his duly authorized representative), and shall set forth the following information:

(i) A declaration that the taxpayer is making an election under section 451(d) and this section;

(ii) Identification of the specific crop or crops destroyed or damaged;

(iii) A declaration that under the taxpayer's normal business practice the income derived from the crops which were destroyed or damaged would have been included in this gross income for a taxable year following the taxable year of such destruction or damage;

(iv) The cause of destruction or damage of crops and the date or dates on which such destruction or damage occurred;

(v) The total amount of payments received from insurance carriers, itemized with respect to each specific crop and with respect to the date each payment was received;

(vi) The name(s) of the insurance carrier or carriers from whom payments were received.

(2) **Scope of election.** Once made, an election under section 451(d) is binding for the taxable year for which made unless the district director consents to a revocation of such election. Requests for consent to revoke an election under section 451(d) shall be made by means of a letter to the district director for the district in which the taxpayer is required to file his return, setting forth the taxpayer's name, address, and identification number, the year for which it is desired to revoke the election, and the reasons therefor.

[T.D. 7097, 36 FR 5215, March 18, 1971, as amended by T.D. 7526, 42 FR 64624, Dec. 27, 1977]

§ 1.451–7 Election relating to livestock sold on account of drought.

(a) **In general.** Section 451(e) provides that for taxable years beginning after December 31, 1975, a taxpayer whose principal trade or business is farming (within the meaning of § 6420(c)(3)) and who reports taxable income on the cash receipts and disbursements method of accounting may elect to defer for one year a certain portion of income. The income which may be deferred is the amount of gain realized during the taxable year from the sale or exchange of that number of livestock sold or exchanged solely on account of a drought which caused an area to be designated as eligible for assistance by the Federal Government (regardless of whether the designation is made by the President or by an agency or department of the Federal Government). That number is equal to the excess of the number of livestock sold or exchanged over the number which would have been sold or exchanged had the taxpayer followed its usual business practices in the absence of such drought. For example, if in the past it has been a taxpayer's practice to sell or exchange annually 400 head of beef cattle but due to qualifying drought conditions 550 head were sold in a given taxable year, only income from the sale of 150 head may qualify for deferral under this section. The election is not available with respect to livestock described in section 1231(b)(3) (relating to cattle, horses (and other livestock) held by the taxpayer for 24 months (12 months) and used for draft, breeding, dairy, or sporting purposes).

(b) **Usual business.** The determination of the number of animals which a taxpayer would have sold if it had followed its usual business practice in

the absence of drought will be made in light of all facts and circumstances. In the case of taxpayers who have not established a usual business practice, reliance will be placed upon the usual business practice of similarly situated taxpayers in the same general region as the taxpayer.

(c) Special rules—(1) Connection with drought area. To qualify under section 451(e) and this section, the livestock need not be raised, and the sale or exchange need not take place, in a drought area. However, the sale or exchange of the livestock must occur solely on account of drought conditions, the existence of which affected the water, grazing, or other requirements of the livestock so as to necessitate their sale or exchange.

(2) Sale prior to designation of area as eligible for Federal assistance. The provisions of this section will apply regardless of whether all or a portion of the excess number of animals were sold or exchanged before an area becomes eligible for Federal assistance, so long as the drought which caused such dispositions also caused the area to be designated as eligible for Federal assistance.

(d) Classifications of livestock with respect to which the election may be made. The election to have the provisions of section 451(e) apply must be made separately for each broad generic classification of animals (e.g., hogs, sheep, cattle) for which the taxpayer wishes the provisions to apply. Separate elections shall not be made solely by reason of the animals' age, sex, or breed.

(e) Computation—(1) Determination of amount deferred. The amount of income which may be deferred for a classification of livestock pursuant to this section shall be determined in the following manner. The total amount of income realized from the sale or exchange of all livestock in the classification during the taxable year shall be divided by the total number of all such livestock sold. The resulting quotient shall then be multiplied by the excess number of such livestock sold on account of drought.

(2) Example. The provisions of this paragraph may be illustrated by the following example:

Example. A, a calendar year taxpayer, normally sells 100 head of beef cattle a year. As the result of drought conditions existing during 1976, A sells 135 head during that year. A realizes $35,100 of income from the sale of the 135 head. On August 9, 1976, as a result of the drought, the affected area was declared a disaster area thereby eligible for Federal assistance. The amount of income which A may defer until 1977, presuming the other provisions of this section are met, is determined as follows:

$35,100 (total income from sales of beef cattle)/135 (total number of beef cattle sold)×35 (excess number of beef cattle sold, i.e., 135–100)=$9,100 (amount which A may defer until 1977)

(f) Successive elections. If a taxpayer makes an election under section 451(e) for successive years, the amount deferred from one year to the next year shall not be deemed to have been received from the sale or exchange of livestock during the later year. In addition, in determining the taxpayer's normal business practice for the later year, earlier years for which an election under section 451(e) was made shall not be considered.

(g) Time and manner of making election. The election provided for in this section must be made by the later of (1) the due date for filing the income tax return (determined with regard to any extensions of time granted the taxpayer for filing such return) for the taxable year in which the early sale of livestock occurs, or (2) (the 90th day after the date these regulations are published as a Treasury decision in the FEDERAL REGISTER). The election must be made separately for each taxable year to which it is to apply. It must be made by attaching a statement to the return or an amended return for such taxable year. The statement shall include the name and address of the taxpayer and shall set forth the following information for each classification of livestock for which the election is made:

(1) A declaration that the taxpayer is making an election under section 451(e);

(2) Evidence of the existence of the drought conditions which forced the early sale or exchange of the livestock and the date, if known, on which an area was designated as eligible for assistance by the Federal Government as a result of the drought conditions.

(3) A statement explaining the relationship of the drought area to the taxpayer's early sale or exchange of the livestock;

(4) The total number of animals sold in each of the three preceding years;

(5) The number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice in the absence of drought;

(6) The total number of animals sold, and the number sold on account of drought, during the taxable year; and

(7) A computation, pursuant to paragraph (e) of this section, of the amount of income to be deferred for each such classification.

(h) **Revocation of election.** Once an election under this section is made for a taxable year, it may be revoked only with the approval of the Commissioner.

(i) **Cross reference.** For provisions relating to the involuntary conversion of livestock sold on account of drought see section 1033(e) and the regulations thereunder.

[T.D. 7526, 42 FR 64624, Dec. 27, 1977]

§ 1.453–1 Installment method of reporting income.

(a) **In general.** (1) Section 453 permits dealers in personal property, that is, persons who regularly sell or otherwise dispose of personal property on the installment plan, to elect to return the income from the sale or other disposition thereof on the installment method. To the extent provided in paragraph (d) of § 1.453–2, sales under a revolving credit type plan will be treated as sales on the installment plan and the income from the sales so treated may be returned on the installment method. A dealer who makes sales of personal property under both a revolving credit plan and a traditional installment plan may elect to report only sales under the traditional installment plan on the installment method; or he may elect to report only sales under the revolving credit plan on the installment method; or he may elect to report both sales under the revolving credit plan and the traditional installment plan on the installment method. A traditional installment plan usually has the following characteristics:

(i) The execution of a separate installment contract for each sale of personal property, and

(ii) The retention by the dealer of some type of security interest in such property.

(2) The installment method may also be applied with certain limitations (see paragraph (c) of this section) to the sale or other disposition of real property and the casual sale or other casual disposition of certain personal property.

(b) **Income to be reported.** (1) Persons permitted to use the installment method of accounting prescribed in section 453 may return as income from installment sales in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when the property is paid for bears to the total contract price. In the case of dealers in personal property, for this purpose, gross profit means sales less cost of goods sold. See § 1.453–2 for rules applicable to the computation of income of dealers in personal property reporting on the installment method. In the case of sales of real estate and casual sales of personal property, gross profit means the selling price less the adjusted basis as defined in section 1011 and the regulations thereunder. Gross profit, in the case of a sale of real estate by a person other than a dealer and a casual sale of personal property, is reduced by commissions and other selling expenses for purposes of determining the proportion of installment payments returnable as income. For rules applicable in determining "selling price" and the use of certain other terms, see also paragraph (c) of § 1.453–4.

(2) For purposes of section 453, any total unstated interest (as defined in section 483(b)) under a contract for the sale or exchange of property, payments on account of which are subject to the application of section 483, shall not be included as a part of the selling price or the total contract price. For rules relating to payments received prior to January 1, 1964, see paragraph (a)(2) of § 1.483–2.

(3) For purposes of section 453, any amount of original issue discount in respect of certain corporate obligations issued after May 27, 1969, as computed pursuant to paragraph (b)(2)(iii) of § 1.1232–3 (relating to obligations issued in exchange for property) shall not be included as part of the selling price or the total contract price.

(c) **Limitations on the use of the installment method.** (1) Income from the sale or other disposition of real property or from casual sales or other casual dispositions of personal property may be reported on the installment method for taxable years beginning after December 31, 1953, only if, in the taxable year of the sale or other disposition, (i) there are no payments or (ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

(2) The income from a casual sale or other casual disposition of personal property may be reported on the installment method only if (i) the property is not of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, and (ii) its sale price exceeds $1,000.

(3) See § 1.453–3 for the treatment of purchaser evidences of indebtedness that are payable on demand or readily tradable.

(4) Income shall be computed and reported separately for each casual sale or other casual disposi-

tion of personal property as installment payments are received in the year of sale and subsequent years.

(d) Treatment of gain or loss on default by the purchaser of personal property sold on the installment plan. If for any reason the purchaser defaults in any of his installment payments, and the vendor (whether he is a dealer in personal property or a person who has made a casual sale or other casual disposition of personalty), returning income on the installment method, repossesses the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the repossession occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the repossession or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of repossession of the property repossessed and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the repossession. (See also § 1.453–6.) The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the repossession of the property shall be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453(d)(2) and paragraph (b)(2) of § 1.453–9. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the repossession unless it is clearly shown that after the property was repossessed the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the repossession. (See also section 166 and the regulations thereunder.) If the property repossessed is bid in by the vendor at a lawful public auction or judicial sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary. The fair market value of the property repossessed shall be reflected in the appropriate permanent records of the vendor at the time of such repossession.

(e) **Other accounting methods.** If the vendor chooses as a matter of consistent practice to return the income from installment sales on an accrual method or on the cash receipts and disbursements method, such a course is permissible.

(f) **Records.** In adopting the installment method of accounting the seller must maintain such records as are necessary to clearly reflect income in accordance with this section, section 446 and § 1.446–1.

[T.D. 6500, 25 FR 11714, Nov. 26, 1960, as amended by T.D. 6682, 28 FR 11173, Oct. 18, 1963; T.D. 6873, 31 FR 941, Jan. 25, 1966; T.D. 7154, 36 FR 24997, Dec. 28, 1971; T.D. 7197, 37 FR 13531, July 11, 1972]

§ 1.453–2 Special rules applicable to dealers in personal property.

(a) **In general.** A person who regularly sells personal property on the installment plan may adopt (but is not required to do so) one of the following four ways of protecting his interest in case of default by the purchaser:

(1) By an agreement that title is to remain in the vendor until the purchaser has completely performed his part of the transaction;

(2) By a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the selling price;

(3) By a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the vendor; or

(4) By conveyance to a trustee pending performance of the contract and subject to its provisions.

(b) **Definition of sale on the installment plan.** The term "sale on the installment plan" means—

(1) A sale of personal property by the taxpayer under any plan for the sale or other disposition of personal property, which plan, by its terms and conditions, contemplates that each sale under the plan will be paid for in two or more payments, or

(2) A sale of personal property by the taxpayer under any plan for the sale or other disposition of personal property—

(i) Which plan, by its terms and conditions, contemplates that such sale will be paid for in two or more payments, and

(ii) Which sale is in fact paid for in two or more payments.

Normally, a sale under a traditional installment plan (as described in paragraph (a)(1) of § 1.453–1), meets the requirements of subparagraph (1) of this paragraph. See paragraph (d) of this section for the application of the requirements of subparagraph (2) of this paragraph to sales under revolving credit plans.

(c) Installment income of dealers in personal property—(1) In general. The income from sales on the installment plan of a dealer, that is, a person regularly engaged in the sale of personal property on the installment plan, may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which the gross profit realized or to be realized on the total sales on the installment plan made during each year bears to the total contract price of all such sales made during that respective year. However, if the dealer demonstrates to the satisfaction of the district director that income from sales on the installment plan is clearly reflected, the income from such sales may be ascertained by treating as income that proportion of the total payments received in the taxable year from sales on the installment plan (such payments being allocated to the year against the sales of which they apply) which either (i) the gross profit realized or to be realized on the total credit sales made during each year bears to the total contract price of all credit sales during that respective year, or (ii) the gross profit realized or to be realized on all sales made during each year bears to the total contract price of all sales made during that respective year. See, however, paragraph (d)(6)(vi) of this section for rules permitting, under certain circumstances, all sales under a revolving credit plan to be considered as having been made in the taxable year. A dealer who desires to compute income by the installment method shall maintain accounting records in such a manner as to enable an accurate computation to be made by such method in accordance with the provisions of this section, section 446, and § 1.446–1.

(2) Gross profit and total contract price. For purposes of subparagraph (1) of this paragraph, in computing the gross profit realized or to be realized on the total sales on the installment plan, there shall be included in the total selling price and, thus, in the total contract price of all such sales,

(i) The amount of carrying charges or interest which is determined at the time of each sale and is added to the established cash selling price of such property and is treated as part of the selling price for customer billing purposes, and

(ii) In the case of sales made in taxable years beginning on or after January 1, 1960, the amount of carrying charges or interest determined with respect to such sales which are added contemporaneously with the sale on the books of account of the seller but are treated as periodic service charges for customer billing purposes.

Any change in the amount of the carrying charges or interest in a year subsequent to the sale will not affect the computation of the gross profit for the year of sale but will be taken into account at the time the carrying charges or interest are adjusted. However, this subparagraph does not apply to sales of personal property under a revolving credit plan described in paragraph (d)(1) of this section, nor to sales described in section 453(b)(1) and paragraph (c) of § 1.453–1. The application of this subparagraph to carrying charges or interest described in subdivision (ii) of this subparagraph may be illustrated by the following example:

Example. X Corporation makes sales on the traditional installment plan. The customer's order specifies that the total price consists of a cash price plus a "time price differential" of 1½ percent per month on the outstanding balance in his account and he is billed in this manner. On its books and for purposes of reporting to stockholders, X Corporation consistently makes the following entries each month when it records its sales. A debit entry is made to accounts receivable (for the total price) and balancing credit entries are made to sales (for the established selling price) and to a reserve account for collection expense (for the amount of the time price differential). In computing the gross profit realized or to be realized on the total sales on the installment plan, the total selling price and, thus, the total contract price for purposes of this paragraph would, with respect to sales made in taxable years beginning on or after January 1, 1960, include the time price differential.

(3) Carrying charges not included in total contract price. In the case of sales by dealers in personal property made during taxable years beginning after December 31, 1963, the income from which is returned on the installment method, if the carrying charges or interest with respect to such sales is not included in the total contract price, payments received with respect to such sales shall be treated as applying first against such carrying charges or interest. For application of this rule to revolving credit sales, see paragraph (d)(6)(v) of this section.

(d) Revolving credit plans. (1) To the extent provided in this paragraph, sales under a revolving credit plan will be treated as sales on the installment plan. The term "revolving credit plan" includes cycle budget accounts, flexible budget accounts, continuous budget accounts, and other

similar plans or arrangements for the sale of personal property under which the customer agrees to pay each billing-month (as defined in subparagraph (6)(iii) of this paragraph) a part of the outstanding balance of his account. Sales under a revolving credit plan do not constitute sales on the installment plan merely by reason of the fact that the total debt at the end of a billing-month is paid in installments. The terms and conditions of a revolving credit plan do not contemplate that each sale under the plan will be paid for in two or more payments and thus do not meet the requirements of paragraph (b)(1) of this section. In addition, since under a revolving credit plan payments are not generally applied to liquidate any particular sale, and since the terms and conditions of such plan contemplate that account balances may be paid in full or in installments, it is generally impossible to determine that a particular sale under a revolving credit plan is to be or is in fact paid for in installments so as to meet the requirements of paragraph (b)(2) of this section. However, subparagraphs (2) and (3) of this paragraph provide rules under which a certain percentage of charges under a revolving credit plan will be treated as sales on the installment plan. For purposes of arriving at this percentage, these rules, in general, treat as sales on the installment plan those sales under a revolving credit plan (1) which are of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments and (2) which are charged to accounts on which subsequent payments indicate that such sales are being paid for in two or more installments.

(2)(i) The percentage of charges under a revolving credit plan which will be treated as sales on the installment plan shall be computed by making an actual segregation of charges in a probability sample of the revolving credit accounts and by applying the rules contained in subparagraph (3) of this paragraph to determine what percentage of charges in the sample is to be treated as sales on the installment plan. (See subparagraph (5) of this paragraph for rules to be used if some of the sales under a revolving credit plan are nonpersonal property sales (as defined in subparagraph (6)(iv) of this paragraph).) Such segregation shall be made of charges which make up the balances in the sample accounts as of the end of each customer's last billing-month ending within the taxable year. (See subparagraph (6)(v) of this paragraph for rules to be used in determining which charges make up the balance of an account.) However, in making such segregation, any account to which a sale is charged during the taxable year on which no payment is credited after the billing-month within which the sale is made (hereinafter called the "billing-month of sale") and on or before the end of the first billing-month ending in the taxpayer's next taxable year shall be disregarded and not taken into account in the determination of what percentage of charges in the sample is to be treated as sales on the installment plan. In order to obtain a probability sample, the accounts shall be selected in accordance with generally accepted probability sampling techniques. The appropriateness of the sampling technique and the accuracy and reliability of the results obtained must, if requested, be demonstrated to the satisfaction of the district director. If the district director is not satisfied that the taxpayer's sample is appropriate or that the results obtained are accurate and reliable, the taxpayer shall recompute his sample percentage or make appropriate adjustments to his original computations in a manner satisfactory to the district director. The taxpayer shall maintain records in sufficient detail to show the method of computing and applying the sample.

(ii) For taxable years ending before January 31, 1964, a taxpayer who has reported for income tax purposes all or a portion of sales under a revolving credit plan as sales on the installment method may apply the percentage obtained for the first taxable year ending on or after such date in determining the percentage of charges under a revolving credit plan for such prior taxable year (or years) which will be treated as sales on the installment plan. However, in computing the percentage to be applied in determining the percentage of charges under a revolving credit plan which will be treated as sales on the installment plan for such prior taxable year (or years), the rule stated in paragraph (c)(3) of this section shall not apply. See subparagraph (6)(v) of this paragraph for rules relating to the application of payments to finance charges for such prior taxable years.

(3) For the purpose of determining the percentage described in subparagraph (2) of this paragraph, a charge under a revolving credit plan will be treated as a sale on the installment plan only if such charge is a sale (as defined in subparagraph (6)(i) of this paragraph) and meets the requirements contained in subdivisions (i) and (ii) of this subparagraph.

(i) The sale must be of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments. If the aggregate of sales charged during a billing-month to an account under a revolving credit plan exceeds the required monthly payment, then all sales

during such billing-month shall be considered to be of the type which the terms and conditions of such plan contemplate will be paid for in two or more installments. The required monthly payment shall be the amount of the payment which the terms and conditions of the revolving credit contract require the customer to make with respect to a billing-month. If the amount of such payment is not fixed at the date the contract is entered into, but is dependent upon the balance of the account, then such amount shall be the amount that the customer is required to pay (but not including any past-due payments) as shown on the statement either (a) for the last billing-month ending within the taxpayer's taxable year or (b) for the billing-month of sale, whichever method the taxpayer adopts for all his accounts. A taxpayer shall not change such method of determining the required monthly payment based upon the balance of the account without obtaining the consent of the district director. In any case where the required monthly payment is not set in accordance with a consistent method used during the entire taxable year, the district director may determine the required monthly payment in accordance with the method used during the major portion of such taxable year if he determines that the use of such method is necessary in order to reflect properly the income from sales under a revolving credit plan. The requirements stated in this subdivision may be illustrated by the following examples:

Example (1). Under the terms of a revolving credit plan the required monthly payment to be made by customer A is $20. During the billing-month ending in December, sales aggregating $80 are charged to customer A's account, and during the next billing-month, ending in January, sales aggregating $19.95 and finance charges of $.60 are charged to A's account. Since the aggregate of sales charged to customer A's account during the billing-month ending in December ($80) exceeds the required monthly payment ($20), the terms and conditions of the plan contemplate that the sales charged during such billing-month are of the type which will be paid for in two or more installments. Since the aggregate of sales charged to customer A's account during the billing-month ending in January ($19.95) does not exceed the required monthly payment, the sales making up the aggregate of sales in such billing-month are not of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments.

Example (2). The terms of a revolving credit plan require a payment of 20 percent of the balance of the customer's account as of the end of the billing-month for which the statement is rendered. A customer makes purchases aggregating $25 in his next to the last billing-month ending within the taxpayer's taxable year, and the balance at the end of that month is $150. At the end of the customer's last billing-month ending within the taxpayer's taxable year, the balance of the account has decreased to $110. If the taxpayer determines the required monthly payment by reference to the payment required on the statement for the last billing-month ending within the taxable year and applies such method consistently to all accounts, then the sales making up the $25 aggregate of sales are of the type which the terms and conditions of the plan contemplate will be paid for in two or more installments. Although such aggregate was less than the $30 payment (20%×$150) required on the statement rendered for the billing-month of sale, it was more than the $22 (20%×$110) that the customer was required to pay on the statement rendered for his last billing-month ending within the taxable year, and thus meets the requirements of this subdivision. If, however, the taxpayer determines the required monthly payment by reference to the payment required on the statement for the billing-month of sale, then the sales making up the aggregate of sales during such billing-month do not meet the requirements of this subdivision because such aggregate was less than the $30 payment required on the statement rendered for such month.

(ii) The sale must be charged to an account on which the first payment after the billing-month of sale indicates that the sale is being paid in installments. The first payment after the billing-month of sale indicates that the sale is being paid in installments if, and only if, such payment is an amount which is less than the balance of the account as of the close of the billing-month of sale. For purposes of this subdivision, such balance shall be reduced by any return or allowance credited to the account after the close of the billing-month of sale and before the close of the billing-month within which the first payment after the billing-month of sale is credited to the account, unless the taxpayer demonstrates that the return or allowance was attributable to a charge made in a month subsequent to the billing-month of sale. The requirements stated in this subdivision may be illustrated by the following examples, in which it is assumed that the taxpayer's annual accounting period ends on January 31.

Example (1). Customer A's revolving credit account shows the following sales and payments:

Month ending	Aggregate sales in month	Payments	Balance
December 20	$150	0	$150
January 20	75	$30	195
February 20	0	195	0

All sales made in the billing-month ending December 20 meet the requirements of this subdivision because the first payment on the account after such billing-month ($30) was less than the balance of the account as of the close of such billing-month ($150); and none of the sales made in the billing-month ending January 20 meets the requirements of this subdivision because the balance of the account as of the end of such billing-month was liquidated in one payment. By application of the rules of subparagraph (6)(v) of this paragraph, the balance in the account as of the last billing-month ending in the taxable year ($195) consists of $120 of the $150 of sales made in the billing-month ending December 20 and all of the $75 of sales made in the billing-month ending January 20. Therefore, $120 of the account balance meets the requirements of this subdivision and $75 does not.

Example (2). Customer B's revolving credit account shows the following sales and payments:

Month ending	Aggregate sales in month	Payments	Balance
December 20	$50	0	$50
January 20	100	0	150
February 20	0	$50	100

None of the sales made in the billing-month ending December 20 meets the requirements of this subdivision because the first payment credited to the account after such billing-month ($50) is not less than the balance of the account as of the close of such month ($50). All of the sales made in the billing-month ending January 20 meet the requirements of this subdivision because the first payment after such billing-month ($50) is less than the balance of the account as of the close of such month ($150).

Example (3). Customer C's revolving credit account shows the following purchases and credits:

Month ending	Item	Charges	Credits	Balance
Jan. 20	Coat	$55		
	Dress	40		
	Shirt	5		
				$100
Feb. 20	Return			
	Payments			$5
	....		95	0

None of the sales made in the billing-month ending December 20 meets the requirements of this subdivision because the first payment credited to the account after such billing-month ($95) was equal to the balance of the account as of the end of such billing-month, $95. For this purpose, the balance of $100 is reduced by the $5 return which was credited to the account after the close of the billing-month of sale and before the close of the billing-month within which the first payment after the billing-month of sale is credited.

(4) The provisions of subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples in which it is assumed that the taxpayer is a dealer in personal property whose annual accounting period ends on January 31.

Example (1). Customer A's revolving credit ledger account shows the following:

Month ending	Aggregate sales in month [1]	Returns and allowances	Payments	Finance charges	Balance
Jan. 20	$15.00	0	0	0	$15.00
Feb. 20	0	0	0	$0.15	15.15

[1] Including sales of personal property and nonpersonal property sales.

For purposes of the segregation provided for in subparagraph (2)(1) of this paragraph, customer A's account will be disregarded and not taken into account in the determination of what percentage of charges in the sample is to be treated as sales on the installment plan because no payment was credited to that account after the billing-month of sale and on or before February 20.

Example (2). This example is applicable with respect to sales made during taxable years beginning before January 1, 1964. Under the terms of the taxpayer's revolving credit plan, payments are required in accordance with the following schedule:

Unpaid balance	*Required monthly payment*
0–$99.99	$20
$100–$199.99	40
$200–$299.99	60

Customer B's revolving credit ledger account for the period beginning on September 21, 1963, and ending February 20, 1964, shows the following:

Month ending—	Aggregate sales in month [1]	Returns and allowances	Payments	Finance charges	Balance
Oct. 20	$55.00	0	0	0	$55.00
Nov. 20	45.00	0	$20.00	$0.35	80.35
Dec. 20	20.00	0	20.00	.60	80.95
Jan. 20	26.00	$5.00	20.00	.61	82.56
Feb. 20	0	10.00	72.56	0	0

[1] Including sales of personal property and nonpersonal property sales.

The three $20 payments and the $5 return or allowance made in the billing-months ending in the taxable year are applied, under the rules in subparagraph (6)(v), to liquidate the earliest outstanding charges, first to the $55 aggregate of sales in the billing-month ending October 20 and next to $10 of the aggregate of sales made in the billing-month ending November 20. Thus, the balance of the account as of the close of the billing-month ending January 20, $82.56, is made up as follows:

Remainder of sales in billing-month ending Nov. 20 ($45 – $10)	$35.00
Finance charge for billing-month ending Nov. 20	.35
Sales for billing-month ending Dec. 20	20.00
Finance charge for billing-month ending Dec. 20	0.60
Sales for billing-month ending Jan. 20	26.00
Finance charge for billing-month ending Jan. 20	.61
Total	82.56

The sales of $35 remaining from the aggregate of sales for the billing-month ending November 20 meet the requirements of subparagraph (3)(i) of this paragraph because the aggregate of sales charged during such billing-month ($45) exceeds the required monthly payment ($20), and such sales meet the requirements of subparagraph (3)(ii) of this paragraph because the first payment after the billing-month of sale ($20) is an amount less than the balance of the account as of the close of such month ($80.35). Therefore, $35 of sales will be treated as sales on the installment plan. The $20 aggregate of sales charged during the billing-month ending December 20 does not

meet the requirements of subparagraph (3)(1) of this paragraph because it is in an amount which does not exceed the required monthly payment ($20). (The finance charge of $0.60 added in the billing-month does not enter into the determination of the aggregate of sales for the month because the term "sales" (as defined in subparagraph (6)(i) of this paragraph) does not include finance charges). The $26 aggregate of sales for the billing-month ending January 20 does not meet the requirements of subparagraph (3)(ii) of this paragraph because the first payment after such billing-month ($72.56) was equal to the balance of the account as of the close of such billing-month ($72.56). For this purpose, the balance of $82.56 is reduced by the $10 return or allowance which was credited after the billing-month of sale and before February 20. Thus, of the $82.56 balance of B's account as of the close of the last billing-month ending within corporation X's taxable year, $35 will be treated as sales on the installment plan for purposes of determining the percentage provided for in subparagraph (2) of this paragraph.

Example (3). This example is applicable with respect to sales made during taxable years beginning after December 31, 1963. Assume the facts in example (2), except that Customer B's revolving credit ledger account is for the period beginning on September 21, 1964 and ending February 20, 1965. Since payments received are first used to liquidate any outstanding finance charges under the rule in subparagraph (6)(v), the $20 payment in December liquidated the $0.35 finance charge accrued at the end of the November billing-month and the $20 payment in January liquidated the $0.60 finance charge accrued at the end of the December billing-month. The balance of the three $20 payments ($59.05) and the $5 return or allowance are applied (under the rules in subparagraph (6)(v)) to liquidate the earliest outstanding sales, first to the $55 aggregate of sales in the billing-month ending October 20 and next to $9.05 of the aggregate of sales made in the billing-month ending November 20. Thus, the balance of the account as of the close of the billing-month ending January 20, $82.56, is made up as follows:

Remainder of sales in billing-month ending Nov. 20 ($45 – $9.05)	$35.95
Sales for billing-month ending Dec. 20	20.00
Sales for billing-month ending Jan. 20	26.00
Finance charge for billing-month ending Jan. 20	.61
Total	82.56

The sales of $35.95 remaining from the aggregate of sales for the billing-month ending November 20 meet the requirements of subparagraph (3)(i) of this paragraph because the aggregate of sales charged during such billing-month ($45) exceeds the required monthly payment ($20), and such sales meet the requirements of subparagraph (3)(ii) of this paragraph because the first payment after the billing-month of sale ($20) is an amount less than the balance of the account as of the close of such month ($80.35). Therefore, $35.95 of sales will be treated as sales on the installment plan. The $20 aggregate of sales charged during the billing-month ending December 20 does not meet the requirements of subparagraph (3)(i) of this paragraph because it is in an amount which does not exceed the required monthly payment ($20). The $26 aggregate of sales for the billing-month ending January 20 does not meet the requirements of subparagraph (3)(ii) of this paragraph because the first payment after such billing-month ($72.56) was equal to the balance of the account as of the close of such billing-month ($72.56). For this purpose, the balance of $82.56 is reduced by the $10 return or allowance which was credited after the billing-month of sale and before February 20. Thus, of the $82.56 balance of B's account as of the close of the last billing-month ending within corporation X's taxable year $35.95 will be treated as sales on the installment plan for purposes of determining the percentage provided for in subparagraph (2) of this paragraph.

(5) Sales under a revolving credit plan which are nonpersonal property sales (as defined in subparagraph (6)(iv) of this paragraph) do not constitute sales on the installment plan. Therefore, the charges under a revolving credit plan must be reduced by the nonpersonal property sales, if any, under such plan, before application of the sample percentage as provided for in subparagraph (2)(i) of this paragraph. The taxpayer may treat as the nonpersonal property sales under the plan for the taxable year an amount which bears the same ratio to the total sales under the revolving credit plan made in the taxable year as the total nonpersonal property sales made in such year bears to the total sales made in such year.

(6) For purposes of this paragraph—

(i) The term "sales" includes sales of services, such as a charge for watch repair, as well as sales of property, but does not include finance or service charges.

(ii) The term "charges" includes sales of services and property as well as finance or service charges.

(iii) A billing-month is that period of time for which a periodic statement of charges and credits is rendered to a customer.

(iv) The term "nonpersonal property sales" means all sales which are not sales of personal property made by the taxpayer. Thus, sales of a department leased by the taxpayer to another are nonpersonal property sales. Likewise, charges for services rendered by the taxpayer are nonpersonal property sales unless such services are incidental to and rendered contemporaneously with the sale of personal property, in which case such charges shall be considered as constituting part of the selling price of such property.

(v) Except as otherwise provided in this subdivision, each payment received from a customer under a revolving credit plan before the close of the last billing-month ending in the taxable year shall be applied to liquidate the earliest outstanding charges under such plan, notwithstanding any rule of law or contract provision to the contrary. For purposes of determining which charges remain in the balance of an account at the end of the last billing-month ending in the taxable year, the taxpayer may apply returns and allowances which are credited before the close of the last billing-month ending in the taxable year either (a) to liquidate or reduce the charge for the specific item so returned

or for which an allowance is permitted, or (b) to liquidate or reduce the earliest outstanding charges. The method so selected for applying returns and allowances shall be followed on a consistent basis from year to year unless the district director consents to a change. Additionally, finance or service charges which are computed on the basis of the balance of the account at the end of the previous billing-month (usually reduced by payments during the current billing-month) are accrued at the end of the current billing-month and are therefore considered, for purposes of determining the earliest outstanding charges, as charged to the account after any sales made during the current billing-month. However, for purposes of determining which charges remain in the balance of an account at the end of the last billing-month ending in a taxable year which began after December 31, 1963, payments received during such year shall be applied first against any finance or service charges which were outstanding at the time such payment was received. The preceding sentence shall not apply with respect to a computation made for purposes of applying the rule described in subparagraph (2)(ii) of this paragraph.

(vi) The taxpayer shall allocate those sales under a revolving credit plan which are treated as sales on the installment plan to the proper year of sale in order to apply the appropriate gross profit percentage as provided for in paragraph (c) of this section. This allocation shall be made on the basis of the percentages of charges treated as sales on the installment plan which are attributable to each taxable year as determined in the sample of accounts described in subparagraph (2) of this paragraph. However, if the taxpayer demonstrates to the satisfaction of the district director that income from sales on the installment plan is clearly reflected, all sales may be considered as being made in the taxable year for purposes of applying the gross profit percentage.

(7) The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X is a dealer in personal property and has elected to report on the installment method those sales under its revolving credit plan which may be treated as sales on the installment plan. Corporation X's taxable year ends on January 31, and the total balance of all its revolving credit accounts as of January 31, 1964, is $2,000,000. The total sales made in the taxable year are $10,000,000 of which $500,000 are nonpersonal property sales. The gross profit percentage realized or to be realized on all sales made in the taxable year is 40 percent. The amount of the gross profit contained in the year-end balance of $2,000,000 which may be deferred to succeeding years is computed as follows:

(i) In order to reduce the charges appearing in the year-end balance of revolving credit accounts receivable by the nonpersonal property sales contained therein, corporation X determines the amount of such nonpersonal property sales under the method permitted in subparagraph (5) of this paragraph. Corporation X first determines the ratio which total nonpersonal property sales made during the year ($500,000) bears to total sales made during the year ($10,000,000), and then applies the percentage (5 percent) thus obtained to the year-end balance of revolving credit accounts receivable ($2,000,000). The nonpersonal property sales thus determined ($100,000) is subtracted from such year-end balance to obtain the charges under the revolving credit plan appearing in the year-end balance ($1,900,000) to which the sample percentage is to be applied.

(ii) In accordance with generally accepted sampling techniques, the taxpayer selects a probability sample of all revolving credit accounts having balances for billing-months ending in January 1964. The technique employed results in a random selection of accounts with total balances of $100,000.

(iii) Analysis of these sample accounts discloses that of the $100,000 of balances, $10,000 of balances are in accounts on which no payment was credited after a billing-month of sale and on or before the end of the first billing-month ending in the taxable year beginning February 1, 1964. These balances are, therefore, disregarded and not taken into account in the determination of what percentage of sales in the sample is to be treated as sales on the installment plan. Of the remaining $90,000 of balances, the taxpayer determines, by analyzing the ledger cards in the sample, that $63,000 of balances are composed of sales which meet the requirements of subparagraph (3)(i) and (ii) of this paragraph and are thus treated as sales on the installment plan. The remaining $27,000 of balances either did not meet the requirements of subparagraph (3)(i) or (ii) of this paragraph or were not sales (as defined in subparagraph (6)(i) of this paragraph). The percentage of charges in the sample treated as sales on the installment plan is, therefore, 70 percent ($63,000÷$90,000).

(iv) The charges in the year-end balance which are to be treated as sales on the installment plan, $1,330,000, are computed by multiplying the charges determined in subdivision (i) of this subparagraph ($1,900,000) by the percentage obtained in subdivision (iii) of this subparagraph (70 percent).

(v) The deferred gross profit attributable to sales under the revolving credit plan for the taxable year, $532,000, is determined by multiplying the amount determined in subdivision (iv) of this subparagraph, $1,330,000, by the gross profit percentage, 40 percent. (Corporation X will be able to demonstrate to the satisfaction of the district director that (a) since the gross profit percentage for all sales does not vary materially from the gross profit percentage for all sales made under the revolving credit plan, (b) since only an insubstantial amount of sales included in year-end account balances was made prior to the taxable year, and (c) since the prior year's gross profit percentage does not vary materially from the gross profit percentage for the taxable year, income from sales on the installment plan will be clearly reflected by applying the current year's gross profit percentage for all sales under the revolving credit plan treated as sales on the installment plan.)

(e) Treatment of payments on sales made in years prior to change to installment method. No payments received in the taxable year shall be excluded in computing the amount of income to be returned on the ground that they were received on a sale the total profit from which was returned as income during a taxable year or years prior to the change by the taxpayer to the installment method of returning income. In this regard see section

453(c) and § 1.453–7 for the method of determining the sales on which the payments shall not be excluded and the computation of the adjustments for amounts previously included in income in the case of a change from the accrual method to the installment method. Deductible items are not to be allocated to the years in which the profits from the sales of a particular year are to be returned as income, but must be deducted for the taxable year in which the items are "paid or incurred" or "paid or accrued." See section 461 and the regulations thereunder, and section 7701(a)(25).

[T.D. 6500, 25 FR 11714, Nov. 26, 1960, as amended by T.D. 6682, 28 FR 11173, Oct. 18, 1963; T.D. 6804, 30 FR 2841, March 5, 1965]

§ 1.453–3 Purchaser evidences of indebtedness payable on demand or readily tradable.

(a) In general. A bond or other evidence of indebtedness (hereinafter in this section referred to as an obligation) issued by any person and payable on demand shall not be treated as an evidence of indebtedness of the purchaser in applying section 453(b) to a sale or other disposition of real property or to a casual sale or other casual disposition of personal property. In addition, an obligation issued by a corporation or a government or political subdivision thereof—

(1) With interest coupons attached (whether or not the obligation is readily tradable in an established securities market),

(2) In registered form (other than an obligation issued in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(3) In any other form designed to render such obligation readily tradable in an established securities market shall not be treated as an evidence of indebtedness of the purchaser in applying section 453(b) to a sale or other disposition of real property or to a casual sale or other casual disposition of personal property. For purposes of this section, an obligation is to be considered in registered form if it is registered as to principal, interest, or both and if its transfer must be effected by the surrender of the old instrument and either the reissuance by the corporation of the old instrument to the new holder or the issuance by the corporation of a new instrument to the new holder.

(b) Treatment as payment. If under section 453(b)(3) an obligation is not treated as an evidence of indebtedness of the purchaser, then—

(1) For purposes of determining whether the payments received in the taxable year of the sale or disposition exceed 30 percent of the selling price, and

(2) For purposes of returning income on the installment method during the taxable year of the sale or disposition or in a subsequent taxable year,

the receipt by the seller of such obligation shall be treated as a payment. The rules stated in this paragraph may be illustrated by the following examples:

Example (1). On July 1, 1970, A, an individual on the cash method of accounting reporting on a calendar year basis, transferred all of his stock in corporation X (traded on an established securities market and having a fair market value of $1 million) to corporation Y in exchange for 250 of corporation Y's registered bonds (which are traded in an over-the-counter bond market) each with a principal amount and fair market value of $1,000 (with interest payable at the rate of 8 percent per year), and Y's unsecured promissory note, with a principal amount of $750,000. At the time of such exchange A's basis in the corporation X stock is $900,000. The promissory note is payable at the rate of $75,000 annually, due on July 1, of each year following 1970, until the principal balance is paid. The note provides for the payment of interest at the rate of 10 percent per year also payable on July 1 of each year. Under the rule stated in subparagraph (1) of this paragraph, the 250 registered bonds of corporation Y are treated as a payment for purposes of the 30 percent test described in section 453(b)(2)(A)(ii). The payment on account of the bonds equals 25 percent of the selling price determined as follows:

$250,000 payment (i.e., 250 of corporation Y's registered bonds each with a principal amount and fair market value of $1,000)./$1 million selling price (i.e., $250,000 of corporation Y's registered bonds plus promissory note of $750,000).=25 percent.

Since the payments received in the taxable year of the sale do not exceed 30 percent of the selling price and the sales price exceeds $1,000, A may report the income received on the sale of his corporation X stock on the installment method. A elects to report the income on the installment method. The gross profit to be realized when the corporation X stock is fully paid for is 10 percent of the total contract price, computed as follows: $100,000 gross profit (i.e., $1 million contract price less $900,000 basis in corporation X stock) over $1 million contract price. However, since subparagraph (2) of this paragraph also treats the 250 corporation Y registered bonds as a payment for purposes of reporting income, A must include $25,000 (i.e., 10 percent times $250,000) in his gross income for calendar year 1970, the taxable year of sale.

Example (2). Assume the same facts as in example (1). Assume further that on July 1, 1971, corporation Y makes its first installment payment to A under the terms of the unsecured promissory note with 75 more of its $1,000 registered bonds. A must include $7,500 (i.e., 10 percent gross profit percentage times $75,000) in his gross income for calendar year 1971. In addition, A includes the interest payment made by corporation Y on July 1, in his gross income for 1971.

(c) Payable on demand. Under section 453(b)(3), an obligation shall be treated as payable on demand only if the obligation is treated as payable on demand under applicable state or local law.

(d) Designed to be readily tradable in an established securities market—(1) In general. Obligations issued by a corporation or government or political subdivision thereof will be deemed to be in a form designed to render such obligations readily tradable in an established securities market if—

(i) Steps necessary to create a market for them are taken at the time of issuance (or later, if taken pursuant to an expressed or implied agreement or understanding which existed at the time of issuance),

(ii) If they are treated as readily tradable in an established securities market under subparagraph (2) of this paragraph, or

(iii) If they are convertible obligations to which paragraph (e) of this section applies.

(2) Readily tradable in an established securities market. An obligation will be treated as readily tradable in an established securities market if—

(i) The obligation is part of an issue or series of issues which are readily tradable in an established securities market, or

(ii) The corporation issuing the obligation has other obligations of a comparable character which are described in subdivision (i) of this subparagraph.

For purposes of subdivision (ii) of this subparagraph, the determination as to whether there exist obligations of a comparable character depends upon the particular facts and circumstances. Factors to be considered in making such determination include, but are not limited to, substantial similarity with respect to the presence and nature of security for the obligation, the number of obligations issued (or to be issued), the number of holders of such obligation, the principal amount of the obligation, and other relevant factors.

(3) Readily tradable. For purposes of subparagraph (2)(i) of this paragraph, an obligation shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such obligation or is part of an issue a portion of which is in fact traded in an established securities market.

(4) Established securities market. For purposes of this paragraph, the term established securities market includes (i) a national securities exchange which is registered under section 6 of the Securities and Exchange Act of 1934 (15 U.S.C. 78f), (ii) an exchange which is exempted from registration under section 5 of the Securities Exchange Act of 1935 (15 U.S.C. 78e) because of its limited volume of transactions, and (iii) any over-the-counter market. For purposes of this subparagraph, an over-the-counter market is reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of obligations by identified brokers or dealers, other than a quotation sheet prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer.

(5) Examples. The rules stated in this paragraph may be illustrated by the following examples:

Example (1). On June 1, 1971, 25 individuals owning equal interests in a tract of land with a fair market value of $1 million sell the land to corporation Y. The $1 million sales price is represented by 25 bonds issued by corporation Y each having a face value of $40,000. The bonds are not in registered form and do not have interest coupons attached, and, in addition, are payable in 120 equal installments each due on the first business day of each month. In addition, the bonds are negotiable and may be assigned by the holder to any other person. However, the bonds are not quoted by any brokers or dealers who deal in corporate bonds, and, furthermore, there are no comparable obligations of corporation Y (determined with reference to the characteristics set forth in subparagraph (2) of this paragraph) which are so quoted. Therefore, the bonds are not treated as readily tradable in an established securities market. In addition, under the particular facts and circumstances stated, the bonds will not be considered to be in a form designed to render them readily tradable in an established securities market. Since the bonds are not in registered form, do not have coupons attached, are not in a form designed to render them readily tradable in an established securities market, the receipt of such bonds by the holder is not treated as a payment for purposes of section 453(b), notwithstanding that they are freely assignable.

Example (2). On April 1, 1972, corporation M purchases in a casual sale of personal property a fleet of trucks from corporation N in exchange for corporation M's negotiable notes, not in registered form and without coupons attached. The corporation M notes are comparable to earlier notes issued by corporation M, which notes are quoted in the Eastern Bond section of the National daily quotation sheet, which is an interdealer quotation system. Both issues of notes are unsecured, held by more than 100 holders, have a maturity date of more than 5 years, and were issued for a comparable principal amount. On the basis of these similar characteristics it appears that the latest notes will also be readily tradable. Since an interdealer system reflects an over-the-counter market, the earlier notes are treated as readily tradable in an established securities market. Since the later notes are obligations comparable to the earlier ones, which are treated as readily tradable in an established securities market, the later notes are also treated as readily tradable in an established securities market (whether or not such notes are actually traded).

(e) Special rule for convertible securities—(1) General rule. For purposes of paragraph (d)(1) of this section, if an obligation contains a right whereby the holder of such obligation may convert

it directly or indirectly into another obligation which would be treated as a payment under paragraph (b) of this section or may convert it directly or indirectly into stock which would be treated as readily tradable or designed to be readily tradable in an established securities market under paragraph (d) of this section, the convertible obligation shall be considered to be in a form designed to render such obligation readily tradable in an established securities market unless such obligation is convertible only at a substantial discount. In determining whether the stock or obligation, into which an obligation is convertible, is readily tradable or designed to be readily tradable in an established securities market, the rules stated in paragraph (d) of this section shall apply, and for purposes of such paragraph (d) if such obligation is convertible into stock then the term "stock" shall be substituted for the term "obligation" wherever it appears in such paragraph (d).

(2) **Substantial discount rule.** Whether an obligation is convertible at a substantial discount depends upon the particular facts and circumstances. A substantial discount shall be considered to exist if at the time the convertible obligation is issued, the fair market value of the stock or obligation into which the obligation is convertible is less than 80 percent of the fair market value of the obligation (determined by taking into account all relevant factors, including proper discount to reflect the fact that the convertible obligation is not readily tradable in an established securities market and any additional consideration required to be paid by the taxpayer). Also, if a privilege to convert an obligation into stock or an obligation which is readily tradable in an established securities market may not be exercised within a period of 1 year from the date the obligation is issued, a substantial discount shall be considered to exist.

(f) **Effective date.** The provisions of this section shall apply to sales or other dispositions occurring after May 27, 1969, which are not made pursuant to a binding written contract entered into on or before such date. No inference shall be drawn from this section as to any question of law concerning the application of section 453 to sales or other dispositions occurring on or before May 27, 1969.

[T.D. 6500, 25 FR 11715, Nov. 26, 1960, as amended by T.D. 7197, 37 FR 13532, July 11, 1972]

§ 1.453–4 Sale of real property involving deferred periodic payments.

(a) **In general.** Sales of real property involving deferred payments include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) **Classes of sales.** Such sales, under either paragraph (a)(1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of real property which may be accounted for on the installment method, that is, sales of real property in which (i) there are no payments during the taxable year of the sale or (ii) the payments in such taxable year (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price, or

(2) Deferred-payment sales of real property in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

(c) **Determination of "selling price".** In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the "selling price"; and for the purpose of determining the payments and the total contract price as those terms are used in section 453, and §§ 1.453–1 through 1.453–7, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property. The term "payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments, the total contract price, or the selling price.

[T.D. 6500, 25 FR 11715, Nov. 26, 1960]

§ 1.453–5 Sale of real property treated on installment method.

(a) **In general.** In any transaction described in paragraph (b)(1) of § 1.453–4, that is, sales of real property in which there are no payments during the year of sale or the payments in that year do not exceed 30 percent of the selling price, the

vendor may return as income from each such transaction in any taxable year that proportion of the installment payments actually received in that year which the gross profit (as described in paragraph (b) of § 1.453–1) realized or to be realized when the property is paid for bears to the total contract price. In any case, the sale of each lot or parcel of a subdivided tract must be treated as a separate transaction and gain or loss computed accordingly. (See paragraph (a) of § 1.61–6.)

(b) Defaults and repossessions—(1) Effective date. This paragraph shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and §§ 1.1038–1 through 1.1038–3.

(2) Gain or loss on reacquisition of property. If the purchaser of real property on the installment plan defaults in any of his payments, and the vendor returning income on the installment method reacquires the property sold, whether title thereto had been retained by the vendor or transferred to the purchaser, gain or loss for the year in which the reacquisition occurs is to be computed upon any installment obligations of the purchaser which are satisfied or discharged upon the reacquisition or are applied by the vendor to the purchase or bid price of the property. Such gain or loss is to be measured by the difference between the fair market value at the date of reacquisition of the property reacquired (including the fair market value of any fixed improvements placed on the property by the purchaser) and the basis in the hands of the vendor of the obligations of the purchaser which are so satisfied, discharged, or applied, with proper adjustment for any other amounts realized or costs incurred in connection with the reacquisition.

(3) Fair market value of reacquired property. If the property reacquired is bid in by the vendor at a foreclosure sale, the fair market value of the property shall be presumed to be the purchase or bid price thereof in the absence of clear and convincing proof to the contrary.

(4) Basis of obligations. The basis in the hands of the vendor of the obligations of the purchaser satisfied, discharged, or applied upon the reacquisition of the property will be the excess of the face value of such obligations over an amount equal to the income which would be returnable were the obligations paid in full. For definition of the basis of an installment obligation, see section 453(d)(2) and paragraph (b)(2) of § 1.453–9.

(5) Bad debt deduction. No deduction for a bad debt shall in any case be taken on account of any portion of the obligations of the purchaser which are treated by the vendor as not having been satisfied, discharged, or applied upon the reacquisition of the property, unless it is clearly shown that after the property was reacquired the purchaser remained liable for such portion; and in no event shall the amount of the deduction exceed the basis in the hands of the vendor of the portion of the obligations with respect to which the purchaser remained liable after the reacquisition. See section 166 and the regulations thereunder.

(6) Basis of reacquired property. If the property reacquired is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of any fixed improvements placed on the property by the purchaser.

[T.D. 6500, 25 FR 11716, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5923, April 13, 1967]

§ 1.453–6 Deferred payment sale of real property not on installment method.

(a) Value of obligations. (1) In transactions included in paragraph (b)(2) of § 1.453–4, that is, sales of real property involving deferred payments in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. Such obligations, however, are not considered in determining whether the payments during the year of sale exceed 30 percent of the selling price.

(2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. Only in rare and extraordinary cases does property have no fair market value.

(b) Repossession of property where title is retained by vendor—(1) Gain or loss on repossession. If the vendor in sales referred to in para-

graph (a) of this section has retained title to the property and the purchaser defaults in any of his payments, and the vendor repossesses the property, the difference between—

(i) The entire amount of the payments actually received on the contract and retained by the vendor plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, and

(ii) The sum of the profits previously returned as income in connection therewith and an amount representing what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser had the sale not been made, will constitute gain or loss, as the case may be, to the vendor for the year in which the property is repossessed.

(2) Basis of repossessed property. The basis of the property described in subparagraph (1) of this paragraph in the hands of the vendor will be the original basis at the time of the sale plus the fair market value at the time of repossession of fixed improvements placed on the property by the purchaser, except that, with respect to repossessions occurring after September 18, 1958, the basis of the property shall be reduced by what would have been a proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property during the period the property was in the hands of the purchaser if the sale had not been made.

(c) Reacquisition of property where title is transferred to purchaser—(1) Gain or loss on reacquisition. If the vendor in sales described in paragraph (a) of this section has previously transferred title to the purchaser, and the purchaser defaults in any of his payments, and the vendor accepts a voluntary reconveyance of the property, in partial or full satisfaction of the unpaid portion of the purchase price, the receipt of the property so reacquired, to the extent of its fair market value at that time, including the fair market value of fixed improvements placed on the property by the purchaser, shall be considered as the receipt of payment on the obligations satisfied. If the fair market value of the property is greater than the basis of the obligations of the purchaser so satisfied (generally, such basis being the fair market value of such obligations previously recognized in computing income), the excess constitutes ordinary income. If the value of such property is less than the basis of such obligations, the difference may be deducted as a bad debt if uncollectible, except that, if the obligations satisfied are securities (as defined in section 165(g)(2)(C)), any gain or loss resulting from the transaction is a capital gain or loss subject to the provisions of sections 1201 through 1241.

(2) Basis of reacquired property. If the reacquired property described in subparagraph (1) of this paragraph is subsequently sold, the basis for determining gain or loss is the fair market value of the property at the date of reacquisition, including the fair market value of the fixed improvements placed on the property by the purchaser. See section 166 and the regulations thereunder with respect to property reacquired by the vendor in a foreclosure proceeding.

(d) Effective date. Paragraphs (b) and (c) of this section shall apply only with respect to taxable years beginning before September 3, 1964, in respect of which an election has not been properly made to have the provisions of section 1038 apply. For rules applicable to taxable years beginning after September 2, 1964, and for taxable years beginning after December 31, 1957, to which such an election applies, see section 1038, and §§ 1.1038–1 through 1.1038–3.

[T.D. 6500, 25 FR 11716, Nov. 26, 1960, as amended by T.D. 6916, 32 FR 5923, April 13, 1967]

§ 1.453–7 Change from accrual to installment method by dealers.

(a) In general. A taxpayer who is a dealer in personal property and who is entitled to the benefits of section 453(a) may elect to report his taxable income on the installment method of accounting without securing consent of the Commissioner. In the event a dealer elects to change from the accrual method of accounting to the installment method for either sales under a revolving credit plan or sales on the traditional installment plan, or both types of sales (see paragraph (a)(1) of § 1.453–1), any installment payments actually received in the year of change or in subsequent taxable years on account of sales (or other dispositions of property) of a type or types for which the installment method is elected and which were made in any taxable year before the year of change shall not be excluded from taxable income. For the purpose of determining which payments on account of sales made under a revolving credit type plan shall not be excluded, the dealer shall make a determination of charges under a revolving credit plan made in any taxable year before the year of the change which under the provisions of paragraph (d) of § 1.453–2 are treated as sales on

the installment plan. However, for this purpose, in lieu of the percentage determined under paragraph (d)(2) of § 1.453–2 for any such year, the percentage so determined for the year of change may be used. Profits attributable to sales on the installment plan, even though included in taxable income in their entirety in a year of sale before the year in which the change to the installment method is made, are also includible in taxable income as payments are received in the year of change and in subsequent taxable years. But the tax imposed for the year of change or any subsequent taxable years (such years being referred to as "adjustment years") beginning after December 31, 1953, shall be reduced by an adjustment proportionate to the tax attributable to the gross profit which is, by reason of the change to the installment method, included in gross income a second time, determined by the method of computation described in section 453(c) and paragraph (b) of this section.

(b) Adjustment to tax. (1) The adjustment to tax under section 453(c)(2) is determined as follows:

(i) Determine separately the portion of the tax for each taxable year before the year of change which is attributable to the gross profit from installment sales which was included in gross income in that year and which is also includible in gross income for any adjustment year;

(ii) Determine separately the portion of the tax for each adjustment year which is attributable to the gross profit described in subdivision (i) of this subparagraph;

(iii) Select for each adjustment year the lesser of the amounts determined under subdivisions (i) and (ii) of this subparagraph;

(iv) The tax imposed in any adjustment year shall be reduced by the amount as determined in subdivision (iii) of this subparagraph or the sum of all such amounts if more than one prior taxable year is involved;

(v) The portion of the tax for any taxable year attributable to the gross profit described in subdivision (i) of this subparagraph shall be that proportion of the tax determined for such year without regard to the adjustments under this paragraph, which the gross profit included in gross income in the prior year and includible in gross income for the adjustment year bears to the gross income of that year.

(2) The tax determined in any of the steps provided in subparagraph (1) of this paragraph shall be the tax imposed by chapter 1, subtitle A of the Internal Revenue Code of 1954 other than the tax imposed by section 56 (relating to the minimum tax for tax preferences); or chapter 1, not including subchapter D, relating to excess profits, nor subchapter E, relating to tax on self-employment income, of the Internal Revenue Code of 1939.

(3) The computation of the adjustment provided in section 453(c)(2) may be illustrated by the following example, the principles of which are equally applicable to sales under a revolving credit plan which are reported on the installment method:

ADJUSTMENTS IN TAX ON CHANGE TO INSTALLMENT METHOD

	Taxable years (prior to change)		Adjustment years (after change)	
	Year 1	Year 2	Year 3	Year 4
Gross profit from installment sales (receivable in periodic payments over 5 years)	$100,000	....	$20,000([1])	$12,000([4])
		$50,000	10,000([2])	8,000([5])
			80,000([3])	40,000([6])
				90,000([7])
Other income	80,000	200,000	90,000	90,000
Gross income	180,000	250,000	200,000	240,000
Deductions	60,000	50,000	50,000	60,000
Taxable income	120,000	200,000	150,000	180,000
Tax rate assumed (percentage of tax, other than tax imposed by sec. 56)	30	50	40	40
Tax would be	$36,000	$100,000	$60,000	$72,000

	Lesser tax portions

COMPUTATION OF ADJUSTMENT IN YEAR 3

Year 1 Items

In year 3 (portion of tax)	20,000/200,000 × 60,000 = $6,000	
In year 1 (portion of tax)	20,000/180,000 × 36,000 = $4,000	$4,000

Year 2 Items

In year 3 (portion of tax)	10,000/200,000 × 60,000 = $3,000	3,000
In year 2 (portion of tax)	10,000/250,000 × 100,000 = $4,000	
Adjustment to tax of year 3		7,000

COMPUTATION OF ADJUSTMENT IN YEAR 4

Year 1 Items

In year 4 (portion of tax)	12,000/240,000 × 72,000 = $3,600	
In year 1 (portion of tax)	12,000/180,000 × 36,000 = $2,400	$2,400

Year 2 Items

In year 4 (portion of tax)	8,000/240,000 × 72,000 = $2,400	2,400
In year 2 (portion of tax)	8,000/250,000 × 100,000 = $3,200	
Adjustment to tax of year 4		4,800

[1] From year 1 sales.
[2] From year 2 sales.
[3] From year 3 sales.
[4] From year 1 sales.
[5] From year 2 sales.
[6] From year 3 sales.
[7] From year 4 sales.

(c) Special rules for partnerships. In the case of a change from an accrual method of accounting to the installment method of accounting by a partnership which is a dealer in personal property, payments attributable to installment sales under such accrual method shall be included in the gross income of the partnership in their entirety as payments are received in the year of change and in subsequent taxable years, even though included in gross income of the partnership for a year before the year in which the change to the installment method is made. Each partner's distributive share of the profits attributable to installment sales included in partnership taxable income for the year of sale and for each "adjustment year" shall be taken into account separately in accordance with section 702(a)(8) and paragraph (a)(8) of § 1.702–1. The income tax of each partner for adjustment years shall be computed with the adjustment provided by section 453(c)(2) for amounts previously taxed. However, it is not necessary for a partner to have been a member of the partnership for the year of sale and each subsequent taxable year, including adjustment years, in order to apply the adjustment to tax provided by section 453(c)(2).

[T.D. 6500, 25 FR 11716, Nov. 26, 1960, as amended by T.D. 6682, 28 FR 11176, Oct. 18, 1963; T.D. 7575, 43 FR 40494, Sept. 12, 1978]

§ 1.453–8 Requirements for adoption of or change to installment method.

(a) Dealers in personal property—(1) Time for election. An election to adopt or change to the installment method for a type or types of sales must be made on an income tax return for the taxable year of the election, filed on or before the time specified (including extensions thereof) for filing such return. For a taxable year ending before October 31, 1963, the reporting of sales under a revolving credit plan on the installment method on a return for such year constitutes an election to report that type of sale on the installment method, even though no specification was made of the type or types of sales for which the election was made.

(2) Adoption of installment method. A taxpayer who adopts the installment method for the first taxable year in which he makes sales on the installment plan of any kind must indicate in his income tax return for that taxable year that the installment method of accounting is being adopted and specify the type or types of sales included within such election. If a taxpayer in the year of the initial election made only one type of sale on the installment plan, but during a subsequent taxable year makes another type of sale on the installment plan and adopts the installment method for such other type of sale, he must indicate in his income tax return for such subsequent year that he is electing to adopt the installment method of accounting for that type of sale.

(3) Change to installment method. A taxpayer who changes to the installment method for a particular type or types of sales on the installment plan in accordance with § 1.453–7 must, for each type of sale on the installment plan for which the installment method is to be used, attach a separate statement to his income tax return for the taxable year with respect to which such change is made. Each statement must show—

(i) The method of accounting used in computing taxable income before the change;

(ii) The type of sale on the installment plan for which the installment is being elected;

(iii) The span of taxable years over which it will be necessary to compute adjustments; and

(iv) A schedule similar to the schedule shown in the example in paragraph (b)(3) of § 1.453–7, showing the computation of the required adjustments under section 453(c)(2).

Similar statements must be attached to and filed with income tax returns for subsequent taxable years in which adjustments are required because of the inclusion of installment payments in gross income a second time.

(b) Sales of real property and casual sales of personal property. (1) A taxpayer who sells or otherwise disposes of real property, or who makes a casual sale or other casual disposition of personal property, and who elects to report the income therefrom on the installment method must set forth in his income tax return (or in a statement attached thereto) for the year of the sale or other disposition the computation of the gross profit on the sale or other disposition under the installment method. In any taxable year in which the taxpayer receives payments attributable to such sale or other disposition, he must also show in his income tax return the computation of the amount of income which is being reported in that year on such sale or other disposition.

(2) The information required by subparagraph (1) of this paragraph must be submitted for each separate sale or other disposition but, in the case of multiple sales or other dispositions, separate computations may be shown in a single statement.

(c) Installment method and other accounting methods. Notwithstanding the fact that, in general, a dealer in personal property may change to the installment method of accounting without permission, a dealer may not change from the installment method of accounting for sales on the installment plan to an accrual method of accounting or to any other method of accounting without the permission of the Commissioner, except as provided in paragraph (d) of this section.

(d) Revocation of election to report income on the installment basis—(1) In general. Under section 453(c)(4) taxpayers who are dealers in personal property and who have elected installment basis income reporting subject to the provisions of section 453(c)(1) (relating to change from accrual to installment basis) may revoke their previously made election.

(2) Years to which applicable. Under this paragraph a taxpayer may revoke an election to report income on the installment basis for any year of change (the first year for which income was computed using the installment basis) ending on or after December 30, 1969, and for any year of change which ended before such date if the 3-year statutory period under section 6501 (relating to limitation on assessment or collection), including

extensions, for such years has not expired on December 30, 1969.

(3) **Time and manner of revoking election.** The revocation by a taxpayer may be made by filing an amended return on an appropriate form or forms, such as Form 1040X for an individual taxpayer, for the year of change (the first year for which income was computed using the installment basis) and for each subsequent year for which a return was filed using the installment basis. The taxpayer should indicate on such amended returns that he is revoking an election to report income on the installment basis. Such revocation must be made within 3 years from the last date prescribed for the filing of the return for the year of change including any extension of time granted the taxpayer. In reporting income on the amended returns described in this paragraph, the taxpayer shall use the accrual method of accounting.

(4) **Period for assessment of deficiency and for refund or credit.** (i) The statutory period for the assessment of any deficiency for any taxable year ending before the filing of a notice of revocation under this paragraph, which is attributable to the revocation of the election to use the installment basis, shall not expire before the expiration of 2 years from the date of the filing of such notice, and such deficiency may be assessed before the expiration of such 2-year period notwithstanding the provisions of any law or rule of law which would otherwise prevent such assessment.

(ii) If refund or credit of any overpayment, resulting from a revocation of an election to use the installment basis, for any taxable year ending before the date of the filing of the notice of revocation is prevented on the date of such filing, or within 1 year from such date, by the operation of any law or rule of law (other than section 7121 (relating to closing agreements) or section 7122 (relating to compromises)), refund or credit of such overpayment may nevertheless be made or allowed if a claim for such credit or refund is filed within 1 year from the date the notice of revocation is filed. No interest shall be allowed on the refund or credit of such overpayment for any period prior to the date of the filing of the notice of revocation.

(5) **Elections after revocation.** If a taxpayer, pursuant to the provisions of section 453(c)(4) and this paragraph, revokes an election to report income on the installment basis, a subsequent election to report income on the installment basis under section 453(c)(1) may not be made, except with the consent of the Commissioner, with respect to any taxable year beginning before the fifth taxable year following the year of change with respect to which the revocation was made. A taxpayer who wishes to make a subsequent election to report income under section 453(a) with respect to any taxable year before the fifth taxable year following the year of change for the revoked election must file an application to do so on Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224.

[T.D. 6500, 25 FR 11717, Nov. 26, 1960, as amended by T.D. 6682, 28 FR 11176, Oct. 18, 1963; T.D. 7104, 36 FR 5603, March 25, 1971]

§ 1.453–9 Gain or loss on disposition of installment obligations.

(a) **In general.** Subject to the exceptions contained in section 453(d)(4) and paragraph (c) of this section, the entire amount of gain or loss resulting from any disposition or satisfaction of installment obligations, computed in accordance with section 453(d), is recognized in the taxable year of such disposition or satisfaction and shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received by the taxpayer.

(b) **Computation of gain or loss.** (1) The amount of gain or loss resulting under paragraph (a) of this section is the difference between the basis of the obligation and (i) the amount realized, in the case of satisfaction at other than face value or in the case of a sale or exchange, or (ii) the fair market value of the obligation at the time of disposition, if such disposition is other than by sale or exchange.

(2) The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). In 1960 the M Corporation sold a piece of unimproved real estate to B for $20,000. The company acquired the property in 1948 at a cost of $10,000. During 1960 the company received $5,000 cash and vendee's notes for the remainder of the selling price, or $15,000, payable in subsequent years. In 1962, before the vendee made any further payments, the company sold the notes for $13,000 in cash. The corporation makes its returns on the calendar year basis. The income to be reported for 1962 is $5,500, computed as follows:

Proceeds of sale of notes		$13,000
Selling price of property	$20,000	
Cost of property	10,000	

Total profit	10,000	
Total contract price	20,000	
Percent of profit, or proportion of each payment returnable as income, $10,000 divided by $20,000, 50 percent.		
Face value of notes	15,000	
Amount of income returnable were the notes satisfied in full, 50 percent of $15,000	7,500	
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full	7,500	
Taxable income to be reported for 1962		5,500

Example (2). Suppose in example (1) the M Corporation, instead of selling the notes, distributed them in 1962 to its shareholders as a dividend, and at the time of such distribution, the fair market value of the notes was $14,000. The income to be reported for 1962 is $6,500, computed as follows:

Fair market value of notes	$14,000
Basis of obligation—excess of face value of notes over amount of income returnable were the notes satisfied in full (computed as in example (1))	7,500
Taxable income to be reported for 1962	6,500

(c) **Disposition from which no gain or loss is recognized.** (1)(i) Under section 453(d)(4)(A), no gain or loss shall be recognized to a distributing corporation with respect to the distribution made after November 13, 1966, of installment obligations if (a) the distribution is made pursuant to a plan for the complete liquidation of a subsidiary under section 332, and (b) the basis of such obligations in the hands of the distributee is determined under section 334(b)(1).

(ii) Under section 453(d)(4)(B), no gain or loss shall be recognized to a distributing corporation with respect to the distribution of installment obligations if the distribution is made, pursuant to a plan for the complete liquidation of a corporation which meets the requirements of section 337, under conditions whereby no gain or loss would have been recognized to the corporation had such installment obligations been sold or exchanged on the day of the distribution. The preceding sentence shall not apply to the extent that under section 453(d)(1) gain to the distributing corporation would be considered as gain to which section 341(f)(2), 617(d)(1), 1245(a)(1), 1250(a)(1), 1251(c)(1), or 1252(a)(1) applies, computed under the principles of the regulations under such provisions. See paragraph (d) of § 1.1245-6, paragraph (c)(6) of § 1.1250-1, paragraph (e)(6) of § 1.1251-1, and paragraph (d)(3) of § 1.1252-1.

(2) Where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under section 453(d) in the case of a disposition of an installment obligation. Such exceptions include: Certain transfers to corporations under sections 351 and 361; contributions of property to a partnership by a partner under section 721; and distributions by a partnership to a partner under section 731 (except as provided by section 736 and section 751).

(3) Any amount received by a person in payment or settlement of an installment obligation acquired in a transaction described in subparagraphs (1) or (2) of this paragraph (other than an amount received by a stockholder with respect to an installment obligation distributed to him pursuant to section 337) shall be considered to have the character it would have had in the hands of the person from whom such installment obligation was acquired.

(d) **Carryover of installment method.** For the treatment of income derived from installment obligations received in transactions to which section 381(a) is applicable, see section 381(c)(8) and the regulations thereunder.

(e) **Installment obligations transmitted at death.** Where installment obligations are transmitted at death, see section 691(a)(4) and the regulations thereunder for the treatment of amounts considered income in respect of a decedent.

(f) **Losses.** See subchapter P (section 1201 and following), chapter 1 of the Code, as to the limitation on capital losses sustained by corporations and the limitation as to both capital gains and capital losses of individuals.

(g) **Disposition of installment obligations to life insurance companies.** (1) Notwithstanding the provisions of section 453(d)(4) and paragraph (c) of this section or any provision of subtitle A relating to the nonrecognition of gain, the entire amount of any gain realized on the disposition of an installment obligation by any person, other than a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801-3), to a life insurance company or to a partnership of which a life insurance company is a partner shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. If a corporation which is a life insurance company for the taxable year was a corporation which was not a life insurance company for the preceding taxable year, such corporation shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance

company, on the last day of the preceding taxable year, all installment obligations which it held on such last day. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section. Similarly, a partnership of which a life insurance company becomes a partner shall be treated, for purposes of section 453(d)(1) and this paragraph, as having transferred to a life insurance company, on the last day of the preceding taxable year of such partnership, all installment obligations which it holds at the time such life insurance company becomes a partner. The gain, if any, realized by reason of the installment obligations being so transferred shall be recognized and treated in accordance with section 453(d)(1) and paragraphs (a) and (b) of this section.

(2) The provisions of section 453(d)(5) and subparagraph (1) of this paragraph shall not apply to losses sustained in connection with the disposition of installment obligations to a life insurance company.

(3) For the effective date of the provisions of section 453(d)(5) and this paragraph, see paragraph (f) of § 1.453-10.

(4) Application of the provisions of this paragraph may be illustrated by the following examples:

Example (1). A, an individual, in a transaction to which section 351 applies, transfers in 1961 certain assets, including installment obligations, to a new corporation, X, which qualifies as a life insurance company (as defined in section 801(a)) for the year 1961. A makes his return on the calendar year basis. Section 453(d)(5) provides that the nonrecognition provisions of section 351 will not apply to the installment obligations transferred by A to X Corporation. Therefore, the entire amount of any gain realized by A on the transfer of the installment obligations shall be recognized in 1961, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (2). The M Corporation did not qualify as a life insurance company (as defined in section 801(a)) for the taxable year 1958. On December 31, 1958, it held $60,000 of installment obligations. The M Corporation qualified as a life insurance company for the taxable year 1959. Accordingly, the M Corporation is treated as having transferred to a life insurance company, on December 31, 1958, the $60,000 of installment obligations it held on such date. The gain, if any, realized by M by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (3). During its taxable year 1958, none of the partners of the N partnership qualified as a life insurance company (as defined in section 801(a)). The N partnership held $30,000 of installment obligations on December 31, 1958. On July 30, 1959, the O Corporation, a life insurance company (as defined in section 801(a)), became a partner in the partnership. The N partnership held $50,000 of installment obligations on July 30, 1959. Pursuant to section 453(d)(5), the N partnership is treated as having transferred to a life insurance company, on December 31, 1958, the $50,000 of installment obligations it held on July 30, 1959. The gain, if any, realized by the N partnership by reason of such installment obligations being so transferred shall be recognized in the taxable year 1958, with the amount of any such gain computed in accordance with the provisions of section 453(d)(1) and paragraph (b) of this section.

Example (4). In 1960, the P Corporation, in a reorganization qualifying under section 368(a), transferred certain assets (including installment obligations) to the R Corporation, a life insurance company as defined in section 801(a). P realized a loss upon the transfer of the installment obligations, which was not recognized under section 361. Pursuant to subparagraph (2) of paragraph (c) of this section, no loss with respect to the transfer of these obligations will be recognized to P under section 453(d)(1).

[T.D. 6500, 25 FR 11718, Nov. 26, 1960, as amended by T.D. 6590, 27 FR 1319, Feb. 13, 1962; T.D. 6832, 30 FR 8574, July 7, 1965; T.D. 7084, 36 FR 267, Jan. 8, 1971; T.D. 7418, 41 FR 18812, May 7, 1976]

§ 1.453-10 Effective date.

(a) Except as provided in this section, the provisions of section 453 and §§ 1.453-1 through 1.453-9 shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(b) The provisions of paragraphs (a)(2) and (3), (b), and (c) of § 1.453-8 shall apply to taxable years ending after December 17, 1958.

(c) Under the provisions of sections 453(b) and 7851(a)(1)(C), section 453(b)(1) and the regulations with respect thereto shall also apply—

(1) To a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was returnable (by reason of section 44(b) of the Internal Revenue Code of 1939) on the basis and in the manner prescribed in section 44(a) of such code.

(2) To a sale or other disposition during a taxable year beginning after December 31, 1953, and ending before August 17, 1954, though such taxable year is subject to the provisions of the Internal Revenue Code of 1939.

(d) Under the provisions of sections 453(c)(1)(B) and 7851(a)(1)(C) section 453(c) and the regulations with respect thereto shall also apply to taxable years beginning after December 31, 1953, and ending before August 17, 1954, though such taxable years are subject to the provisions of the Internal Revenue Code of 1939.

(e) The provisions of paragraph (b)(3) of § 1.453–6 shall apply to repossessions occurring after December 18, 1958.

(f) The provisions of section 453(d)(5) and paragraph (g) of § 1.453–9 shall apply to taxable years ending after December 31, 1957, but only as to transfers or other dispositions of installment obligations occurring after such date.

[T.D. 6500, 25 FR 11718, Nov. 26, 1960, as amended by T.D. 6590, 27 FR 1320, Feb. 13, 1962; T.D. 6682, 28 FR 11177, Oct. 18, 1963]

§ 1.453C–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 453C of the Internal Revenue Code.

(2) Rental of property incidental to holding such property for investment.

(c) Property used in trade or business of farming.

§ 1.453C-8T Sales of timeshares and residential lots (temporary).

(a) In general.

(1) Scope of election.

(2) Determination of timeshare ownership.

(3) Related persons.

(4) Residential lot.

(b) Interest must be paid on deferred tax.

(1) In general.

(2) Determination of tax liability attributable to receipt of payments on an obligation.

(3) Period for which interest is determined.

(i) In general.

(ii) Midpoint method.

(4) Computation of interest.

(5) Time when interest payment due.

(6) Deduction for interest allowable.

(c) Example.

§ 1.453C-9T Effective dates and transitional rules (temporary).

(a) Effective dates.

(1) In general.

(2) Certain dispositions deemed made on first day of effective taxable year.

(3) Example.

(b) Certain transitional rules.

(1) In general.

(2) Dealer sales of real property.

(3) Dealer sales of personal property.

(4) Application of § 1.453C-5T (b) and (c).

(5) Examples.

(6) Effect of death, termination or cessation of trade or business.

(i) In general.

(ii) Section 381 transactions.

(7) S corporation election and terminations.

(8) Tax returns to be identified.

(9) Estimated tax payments.

[T.D. 8224, 53 FR 34719, Sept. 8, 1988]

§ 1.453C–1T Overview of limitation on installment method of reporting (temporary).

Section 453C limits the use of the installment method under sections 453 and 453A (as in effect prior to their amendment by section 10202 of the Revenue Act of 1987) with respect to a taxpayer's applicable installment obligations. Under section 453C, a taxpayer with applicable installment obligations must compute the amount of the taxpayer's applicable installment indebtedness and then allocate on a pro rata basis such indebtedness to each applicable installment obligation arising in the taxable year and outstanding as of the close of the taxable year. The allocated amount is deemed to be a payment made on that obligation and is accounted for under the ordinary rules applicable to the installment method. Thus, the taxpayer must apply the gross profit ratio applicable to the installment sale to determine gain and recovery of basis with respect to the deemed payment.

[T.D. 8224, 53 FR 34720, Sept. 8, 1988]

§ 1.453C–2T Applicable installment obligations (temporary).

(a) Definitions—(1) In general. The term "applicable installment obligation" (AIO) means any obligation that arises from the disposition under the installment method—

(i) After February 28, 1986 and before January 1, 1988, of—

(A) Personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan, or

(B) Real property held by the taxpayer for sale to customers in the ordinary course of business, and

(ii) After August 16, 1986, in taxable years beginning before January 1, 1988, of—

(A) Real property used in the taxpayer's trade or business if the sales price of such property exceeds $150,000, or

(B) Real property held for the production of rental income if the sales price of such property exceeds $150,000.

For purposes of paragraph (a)(1)(ii) of this section, in determining whether the sales price exceeds $150,000, all sales or exchanges that are part of the same transaction are treated as one sale or exchange. See section 1274A(d). For rules relating to the determination of whether property is

held for the production of rental income, see § 1.453C-7T.

(2) Obligations must be held by certain persons. The term "AIO" includes any obligation described in paragraph (a)(1) of this section only if such obligation is held by—

(i) The taxpayer that disposed of the property for which the obligation was received,

(ii) Any person that is a member of the same affiliated group (within the meaning of section 1504(a), but without regard to section 1504(b)) as the taxpayer that disposed of the property for which the obligation was received, or

(iii) Any person whose basis in such obligation is determined (in whole or in part) by reference to another person's basis in such obligation. But only if that obligation was an AIO when held by such other person.

(3) Special rule for related party transactions. The term "AIO" includes any installment obligation arising from the disposition of property if—

(i) The taxpayer received such property from a related person, and

(ii) An AIO would have arisen from an installment sale of such property by such related person.

For purposes of this paragraph (a)(3), a person is related to the taxpayer if such person has a relationship to the taxpayer as specified in section 267(b) or 707(b), substituting 10 percent for 50 percent each place it appears.

(4) Exceptions. The term "AIO" does not include any obligation arising from any disposition of—

(i) Personal use property,

(ii) Property used or produced by the taxpayer in the trade or business of farming,

(iii) Personal property under a revolving credit plan, or

(iv) Personal property if such obligation meets the requirements of section 811(c)(2) of the Tax Reform Act of 1986.

For rules relating to the determination of whether property is personal use property, or property used or produced by a taxpayer in the trade or business of farming, see § 1.453C-7T.

(b) Look-through of disposition of interest in an entity—(1) In general. Except as provided in this paragraph (b), an obligation arising from an installment disposition of stock, a partnership interest, or a similar interest in any entity shall, for purposes of paragraph (a) of this section, be treated as arising from the disposition of such interest and not from a disposition of the underlying assets.

(2) Rule in case of tax avoidance. An obligation arising from an installment disposition of stock, a partnership interest, or a similar interest in any entity shall be deemed an AIO if, based on all the facts and circumstances, a principal purpose for disposing of the interest in the entity (rather than disposing of the entity's assets) was the avoidance of the application of section 453C and the regulations thereunder.

(c) Certain AIOs treated as one. For purposes of paragraph (a)(*l*) of this section, a dealer in personal property that, under section 453A (as in effect prior to its amendment by section 10202 of the Revenue Act of 1987), returns its income from AIOs under the installment method (without regard to section 453C) on an aggregate basis, may treat the obligations from which income is returned on such basis as one obligation. For purposes of the preceding sentence, income is returned on an aggregate basis if, with respect to all or part of its sales, a taxpayer computes a single gross profit ratio, and reports income and recovery of basis from such sales on the aggregate amount of payments received from such sales.

[T.D. 8224, 53 FR 34720, Sept. 8, 1988]

§ 1.453C–3T Allocable installment indebtedness (temporary).

(a) Definition—(1) In general. The term "allocable installment indebtedness" (AII), for any taxable year, means the excess of—

(i) The installment percentage of the taxpayer's average quarterly indebtedness for such taxable year, over

(ii) The aggregate amount treated as AII with respect to AIOs that are outstanding as of the close of the taxable year, but that arose in a prior taxable year.

(2) Installment percentage. For purposes of paragraph (a)(1) of this section, the term "installment percentage" means the percentage (not in excess of 100 percent) determined by dividing—

(i) The outstanding face amount of all AIOs of the taxpayer outstanding as of the close of the taxable year, by

(ii) The sum of—

(A) The aggregate adjusted basis of all assets other than installment obligations (including AIOs) held as of the close of the taxable year, and

(B) The outstanding face amount of installment obligations (including AIOs) outstanding as of such time.

(3) Outstanding face amount. The outstanding face amount of an obligation is the total of all remaining payments due under the obligation excluding interest (stated or unstated) or original issue discount. The outstanding face amount includes the fair market value of any contingent payment. Payments deemed received under § 1.453C-5T (a) or (d) do not affect the outstanding face amount of an obligation. However, payments deemed received under § 1.453C-5T(e) reduce the outstanding face amount of an obligation.

(b) Reduction of AII for receipt of tax paid amounts. For purposes of applying paragraph (a)(1)(ii) of this section, for any taxable year (and any subsequent taxable year) in which an actual payment is treated as a tax paid amount under § 1.453C-5T(b), the AII with respect to AIOs that are outstanding as of the close of the taxable year of actual payment, but that arose in a preceding taxable year shall be reduced (but not below zero) by the amount of such payment which pursuant to § 1.453C-5T(b) is not taken into account for purposes of sections 453 and 453A (as in effect prior to their amendment by section 10202 of the Revenue Act of 1987).

(c) Additional rules for computing AII—(1) Computing average quarterly indebtedness. For purposes of paragraph (a)(1)(i) of this section, the average quarterly indebtedness of a taxpayer is determined by adding the taxpayer's outstanding indebtedness (as defined in § 1.453C-4T) at the end of each 3-month period ending with or within the taxable year, and dividing the result by the number of 3-month periods ending with or within the taxable year. These 3-month periods are determined by reference to the 3-month period that ends on the last day of the taxable year. If such reference period does not end on the last day of a calendar month, it is deemed to end on the last day of such month, but only for the purpose of determining on what date such period begins and the immediately preceding 3-month period ends. Any remaining period of less than three months is treated as a 3-month period. Thus, for example, a taxable year beginning January 1, and ending on July 15 consists of the following three 3-month periods: May 1-July 15, February 1-April 30, and January 1-January 31. A taxable year consisting of less than 3 months is treated as one 3-month period ending on the last day of the taxable year.

(2) Annual indebtedness used for casual sales. In applying paragraph (a)(1)(i) of this section—

(i) If a taxpayer has no AIOs of the type described in paragraph (a)(1)(i) of § 1.453C-2T outstanding at any time during the taxable year, such taxpayer must substitute the taxpayer's outstanding indebtedness (as defined in § 1.453C-4T) as of the close of the taxable year for the taxpayer's average quarterly indebtedness.

(ii) If a taxpayer has AIOs of the type described in paragraph (a)(1)(i) of § 1.453C-2T outstanding during the taxable year, but no such obligations outstanding as of the close of the taxable year, such taxpayer may substitute the taxpayer's indebtedness as of the close of the taxable year for the taxpayer's average quarterly indebtedness.

(3) Rule in case of tax avoidance. For purposes of calculating average quarterly indebtedness under paragraph (c)(1) of this section or annual indebtedness under paragraph (c)(2) of this section, repayment of amounts with a principal purpose of avoiding or reducing the determination of such indebtedness shall be ignored. For example, decreases in indebtedness occurring toward the close of a 3-month period (or year, if applicable) that have the effect of reducing AII will be examined closely.

(4) Determination of adjusted bases of assets. For purposes of paragraph (a)(2) of this section, in determining the aggregate adjusted bases of assets (other than installment obligations) held as of the close of the taxable year, a taxpayer may elect to use the deduction for depreciation which is used in computing earnings and profits under section 312(k) (without regard to whether the taxpayer is required to compute earnings and profits). For rules relating to this election, see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(5) Personal use property. For purposes of paragraph (a) of this section, personal use property and installment obligations arising from the sale of such property shall not be taken into account in determining the aggregate adjusted bases of assets and the aggregate face amount of installment obligations. For special rules relating to the determination of whether property is personal use property, see § 1.453C-7T.

(d) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). (i) A is a dealer in personal property and reports income on a fiscal year basis. For taxable year one, A receives one AIO. As of the close of taxable year one, the outstanding face amount of the one AIO is $384,000. The AIO calls for monthly payments of $4,000 for an eight-year period beginning in taxable year two. The AIO provides for adequate stated interest under sections 483 and 1274.

(ii) The adjusted bases of assets (other than installment obligations) held by A as of the close of taxable year one is $235,000. A has no installment obligations other than the AIO. A's average quarterly indebtedness is $280,000.

(iii) A's installment percentage is .62036, determined as follows:

$$\frac{\$384{,}000}{\$235{,}000 + \$384{,}000} = .62036$$

Thus, for taxable year one A's AII is $173,701 (.62036×$280,000).

Example (2). (i) The facts are the same as in example (1). In taxable year two, A receives the 12 monthly payments due on the AIO arising in taxable year one for a total of $48,000. Thus, as of the close of taxable year two the outstanding face amount of the obligation arising in taxable year one is $336,000. In taxable year two, A receives an additional AIO with a face amount of $324,000. The AIO calls for monthly payments of $3,000 for a nine-year period beginning in taxable year three. The AIO provides for adequate stated interest under sections 483 and 1274. The adjusted bases of assets (other than installment obligations) held by A as of the close of taxable year two is $316,000. A's average quarterly indebtedness is $307,000 for taxable year two.

(ii) The actual payments of $48,000 that A received on the AIO arising in taxable year one do not exceed the $173,701 of AII previously allocated to the AIO. Thus, under § 1.453C-5T(b) such actual payments are not taken into account for purposes of sections 453 and 453A (as in effect prior to their amendment by the 1987 Act).

(iii) As of the close of taxable year two, the outstanding face amount of all AIOs outstanding as of such time (i.e., both the taxable year one and two obligations) is $660,000. A's installment percentage for taxable year two is .67623, determined as follows:

$$\frac{\$660{,}000}{\$316{,}000 + \$660{,}000} = .67623$$

A's AII for taxable year two is $81,902, determined as follows:

(.67623×307,000)-(173,701-48,000)=$81,902 (First, A must multiply its installment percentage (.67623) by its average quarterly indebtedness ($307,000). From this result, A must subtract the AII with respect to the AIO arising in taxable year one but still outstanding as of the close of taxable year two ($173,701). However, the AII attributable to the year one AIO must, under paragraph (b) of this section, first be reduced by the actual payments of $48,000 received on the taxable year one obligation not taken into account under § 1.453C-5T(b) for purposes of pre-1987 Act sections 453 and 453A).

[T.D. 8224, 53 FR 34720, Sept. 8, 1988]

§ 1.453C–4T Indebtedness (temporary).

(a) **Definition.** For purposes of section 453C and the regulations thereunder, the term "indebtedness" includes only amounts treated as liabilities for federal income tax purposes as of the date such amounts are so treated under the taxpayer's method of accounting. The determination of whether an amount is indebtedness for purposes of this paragraph (a) is made without regard to whether the amount is recourse or nonrecourse and without regard to whether the amount is secured or unsecured (except as provided in paragraph (b)(3) of this section). Thus, the term "indebtedness" includes but is not limited to—

(1) Loans, promissory notes, mortgages, bonds, debt instruments and other obligations issued for cash or property;

(2) Liabilities of an accrual basis taxpayer with respect to which the "all events test" has been met and "economic performance" has occurred within the meaning of section 461(h). Examples of such liabilities include compensation, product liability, interest, utilities, accounts payable, taxes (other than federal income taxes), etc.;

(3) Retainers, deposits and other prepayments received by the taxpayer for goods or services unless such amounts have been included in taxable income;

(4) Reserves with respect to which a federal income tax deduction is allowable (e.g., insurance company reserves and reserves for bad debts to the extent allowed under the Internal Revenue Code); and

(5) Customer deposits of a financial institution.

(b) **Certain amounts not treated as indebtedness**—

(1) **In general.** For purposes of section 453C and the regulations thereunder, the term "indebtedness" does not include amounts, such as certain reserves and contingent liabilities, not yet treated as liabilities for federal income tax purposes (including liabilities with respect to which the "all events test" has not been met and "economic performance" has not occurred within the meaning of section 461(h)). Thus, for example, the term "indebtedness" does not include—

(i) Federal income tax liability (including current federal income tax expense and deferred federal income tax expense); and

(ii) Wrapped indebtedness (as defined in § 15a.453-1(b)(3)(ii)) if such indebtedness is treated in accordance with the provisions of § 15a.453-1(b)(3)(ii).

(2) **Related party debts.** See § 1.453C-6T(e) for circumstances in which indebtedness between two

or more persons treated as one taxpayer is not taken into account for purposes of section 453C and the regulations thereunder.

(3) **Certain secured indebtedness.** For purposes of section 453C and the regulations thereunder, the term "indebtedness" does not include indebtedness—

(i) Secured by personal use property (within the meaning of § 1.453C-7T(a)); or

(ii) Secured by an obligation described in paragraph (a)(1)(ii) of § 1.453C-2T, but only if such obligation is pledged as security for the indebtedness after December 17, 1987.

[T.D. 8224, 53 FR 34721, Sept. 8, 1988]

§ 1.453C–5T Mechanics of limitation on installment method (temporary).

(a) **AII deemed to be payment on AIOs.** For purposes of sections 453 and 453A (as in effect prior to their amendment by section 10202 of the Revenue Act of 1987), the AII of a taxpayer for a taxable year is allocated to AIOs that arise in such taxable year, and that are outstanding as of the close of such taxable year. A taxpayer must allocate to each such AIO an amount of AII that bears the same ratio to total AII as the remaining contract price (see paragraph (c) of this section) of the AIO bears to the aggregate remaining contract price of all such AIOs. Subject to the limitation described in paragraph (c) of this section, the AII allocated to an AIO is deemed a payment received on the AIO immediately before the close of the taxable year.

(b) **Treatment of subsequent actual payment.** If any amount of AII (including excess AII as defined in paragraph (d) of this section) is deemed to be a payment on an AIO, a subsequent actual payment received on that AIO shall be treated as a tax paid amount and shall not be taken into account for purposes of sections 453 and 453A (as in effect prior to their amendment by section 10202 of the Revenue Act of 1987) to the extent of the amount of AII (and excess AII) deemed to be a payment on the AIO.

(c) **Remaining contract price limitation on paragraph (a) of this section.** Notwithstanding paragraph (a) of this section, the amount of AII deemed to be a payment on an AIO for any taxable year shall not exceed the remaining contract price with respect to the AIO. For purposes of this section, the remaining contract price with respect to an AIO means the excess (if any) of—

(1) The total contract price of the disposition from which the AIO arose, over

(2) The deemed and actual payments (other than payments treated as tax paid amounts under paragraph (b) of this section) received on the AIO.

(d) **Excess AII.** If, for any taxable year, the AII for the taxable year exceeds the amount to be allocated under paragraphs (a) and (c) of this section to AIOs arising in and outstanding as of the close of the taxable year, the excess AII shall, under the rules of this section, be allocated to outstanding AIOs that arose in the first immediately preceding taxable year, etc.

(e) **Deemed payments under section 453A(d).** Section 453A(d) (as added to the Code by section 10202(c) of the Revenue Act of 1987) provides that the proceeds of indebtedness secured by the pledge (after December 17, 1987) of an obligation described in § 1.453C-2T(a)(1)(ii) are treated as a payment received on such an obligation. Such proceeds are also treated as a deemed payment for purposes of section 453C and the regulations thereunder. Thus, deemed payments under section 453A(d) reduce the remaining contract price (see paragraph (c) of this section) of a pledged AIO. In addition, such deemed payments reduce the outstanding face amount (see § 1.453C-3T(a)(3)) of a pledged obligation.

(f) **Examples.** The provisions of this section may be further illustrated by the following examples:

Example (1). Assume taxpayer A has five AIOs arising in the taxable year. The total remaining contract price of the obligations as of the close of the taxable year is $2,100,000. The remaining contract price of each obligation as of such time is $420,000, $380,000, $440,000, $400,000 and $460,000, respectively. The ratio of the remaining contract price of each obligation to the sum of the remaining contract prices of all obligations is as follows:

Remaining contract price of each AIO	Sum of remaining contract prices of all AIOs	Ratio of each AIO to all AIOs
1. $420,000	$2,100,000	.20000
2. $380,000	2,100,000	.18095
3. $440,000	2,100,000	.20952
4. $400,000	2,100,000	.19048
5. $460,000	2,100,000	.21905

Assume that A has $460,000 of AII. Under the method of allocation described in paragraph (a) of this section, the amount of such AII allocated to, and deemed to be a payment on, each obligation is as follows:

Ratio of each AIO to all AIOs	AII	Deemed payment
1. .20000	$460,000	$ 92,000
2. .18095	460,000	83,237
3. .20952	460,000	96,379
4. .19048	460,000	87,621

Ratio of each AIO to all AIOs	AII	Deemed payment
5. .21905	460,000	100,763

Example (2). (i) In taxable year one, taxpayer B has two AIOs that arose during the taxable year. These AIOs have remaining contract prices as of the close of the taxable year of $25,000 (obligation one) and $16,000 (obligation two). In addition, in that year, B has AII of $3,820. Under the method of allocation described in paragraph (a) of this section, $2,329 (($25,000/$41,000)×$3,820) is allocated to obligation one, and $1,491 (($16,000/$41,000)×$3,820) is allocated to obligation two. The allocated amounts are deemed to be payments received on such obligations. Each deemed payment is accounted for under the general rules of the installment method. Thus, the gross profit ratio applicable to the sales must be applied to the deemed payments to determine the amount of gain reportable under the installment method, and the amount of basis recovery.

(ii) During the second taxable year, B did not receive any additional AIOs. However, in that year, B received a $5,000 payment on obligation one and a $1,000 payment on obligation two. These actual payments are treated as the receipt of tax paid amounts not taken into account for purposes of sections 453 and 453A to the extent of the amounts of AII deemed in year one to be a payment on the obligations. Since $2,329 was deemed to be a payment in year one on obligation one, only the remaining amount of the actual payment on obligation one, $2,671, is subject to the general rules of installment method reporting. The entire $1,000 payment on obligation two is treated as the receipt of tax paid amounts ($1,491 was deemed to be a payment in year one on obligation two). Thus, under paragraph (a) of this section, the remaining contract price of obligation one is $20,000 ($25,000-$2,329-$2,671), and the remaining contract price of obligation two is $14,509 ($16,000-$1,491).

(iii) For the second taxable year, B has AII of $4,081. Since no AIOs arose in the second taxable year, the entire amount of the AII is excess AII, and must be allocated to the AIOs that arose in the immediately preceding taxable year and are outstanding as of the close of the current taxable year. Under the method of allocation described in paragraph (a) of this section, $2,365 (($20,000/$34,509)×$4,081) of the excess AII is allocated to obligation one, and $1,716 (($14,509/$34,509)×$4,081) is allocated to obligation two. These amounts are deemed to be payments received on the obligations in the second taxable year.

Example (3). In taxable year one, taxpayer C receives two AIOs with remaining contract prices at the close of the year of $10,000 (obligation one) and $12,000 (obligation two). C has no AII in year one. No payments are received on these obligations in taxable year two. In taxable year two, however, C sells property for a total contract price of $9,000. For the sale, C receives a cash down payment of $1,800 and an AIO (obligation three) with a face amount of $7,200 due in a balloon payment five years from the date of the sale. For taxable year two, C has $7,857 of AII to be allocated. However, the maximum amount allocable to obligation three (the only AIO arising in taxable year two) is $7,200, the excess of the total contract price ($9,000) over the amount of the actual payment ($1,800) received before the close of the taxable year. The remaining amount of AII, $657, is excess AII. The excess AII is allocated to the two obligations that arose in taxable year one and are still outstanding as of the close of taxable year two. Under the method of allocation described in paragraph (a) of this section, $298.64 (($10,000/$22,000)×$657) of the $657 excess AII is allocated to, and treated as a payment on, obligation one, and $358.36 (($12,000/$22,000×$657) of the excess AII is allocated to, and treated as a payment on obligation two.

[T.D. 8224, 53 FR 34722, Sept. 8, 1988]

§ 1.453C–6T Aggregation rules (temporary).

(a) In general. This section prescribes rules relating to the circumstances in which related taxpayers will be treated as one taxpayer for purposes of section 453C and the regulations thereunder.

(b) Controlled groups and businesses under common control. For purposes of section 453C and the regulations thereunder, all persons treated as a single employer under section 52 shall be treated as one taxpayer. Thus, for example, corporations that are members of the same controlled group (within the meaning of section 52(a)) shall be treated as one taxpayer. Similarly, trades or businesses under common control shall be treated as one taxpayer. In applying section 453C and the regulations thereunder to a group of persons treated as one taxpayer under this paragraph (b), AII is determined using the aggregate of the assets and liabilities of all the members of the group. The total AII so determined then is allocated (under § 1.453C-5T) to all AIOs held by members of the group. For purposes of this paragraph (b), the term "trades or businesses under common control" means a group of trades or businesses (including partnerships, sole proprietorships, etc.) that is—

(1) A "parent-subsidiary group under common control" as defined in § 1.52-1(c),

(2) A "brother-sister group under common control" as defined in § 1.52-1(d), or

(3) A "combined group under common control" as defined in § 1.52-1(e).

(c) Passthrough entities—(1) Application at entity level. Except as otherwise provided in paragraphs (b) and (d) of this section, section 453C and the regulations thereunder apply to a passthrough entity without regard to the adjusted bases of assets or the liabilities of the entity's members. For purposes of this section, the term "passthrough entity" includes, but is not limited to, partnerships, S corporations, and trusts.

(2) AIOs held by owners of certain passthrough entities—(i) Partnerships. For purposes of applying section 453C and the regulations thereunder to the AIOs separately held by a partner of a partnership subject to this paragraph (c), such partner shall take into account the adjusted basis of its partnership interest (as opposed to its share of the adjusted bases of underlying assets) and its share

of partnership liabilities (as determined under section 752).

(ii) S corporations. For purposes of applying section 453C and the regulations thereunder to AIOs separately held by a shareholder of an S corporation subject to this paragraph (c), such shareholder shall take into account the adjusted basis of the shareholder's stock in such corporation and the shareholder's adjusted basis in any liability of the corporation that is treated under section 1366(d) as indebtedness of the corporation to the shareholder. In addition, such shareholder must take into account any indebtedness of the shareholder, the proceeds of which are loaned to the corporation.

(d) Rule in case of tax avoidance—(1) In general. If, based on the facts and circumstances, a transaction between an entity (including any corporation, partnership, or other entity) and its owners is structured for a principal purpose of avoiding the application of section 453C, such entity and its owners shall be treated as one taxpayer for purposes of section 453C and the regulations thereunder (if not otherwise treated as one taxpayer under paragraph (b) of this section). In applying section 453C and the regulations thereunder to an entity and its owners under this paragraph (d), the entity and its owners shall determine the total AII using the aggregate of all the assets and all the liabilities of the entity and its owners. The total AII so determined then is allocated (under § 1.453C-5T) to the AIOs held by the entity and its owners.

(2) Example. Individual taxpayer A owns an unencumbered parcel of real property from which A derives rental income. The adjusted basis of this property is $400,000. A is primarily liable on unsecured indebtedness of $500,000. In anticipation of a sale of the rental property A organizes Y, an S corporation, and transfers the rental property to Y. A principal purpose of the transaction is to avoid the application of section 453C and the regulations thereunder. Corporation Y sells the property for an installment note with an outstanding face amount of $600,000 on December 31, 1987. Absent the application of the rule in paragraph (d)(1) of this section, no AII would be allocated to the installment obligation since Y has no outstanding indebtedness. However, the rule in paragraph (d)(1) of this section requires that A and Y be treated as one taxpayer. Thus, the indebtedness of A is allocated to the installment obligation and treated as a payment received by Y on December 31, 1987.

(e) Disregard of amounts attributable to certain related party transactions—(1) Liabilities. Except as provided in paragraph (e)(3) of this section, a liability that arises as a result of any transaction (including the issuance of stock or a partnership interest) between any persons treated as one taxpayer under paragraph (b) or (d) of this section shall not be considered an asset of the lender or indebtedness of the borrower for purposes of section 453C and the regulations thereunder.

(2) Assets. An ownership interest in any entity shall not be treated as an asset of the owner of such interest if the entity and its owners are treated as one taxpayer under paragraph (b) or (d) of this section.

(3) AIOs. Notwithstanding paragraph (e)(1) of this section, an AIO arising from a transaction described in that paragraph shall be treated as an AIO of the persons treated as one taxpayer. In addition, the persons treated as one taxpayer are treated as having a liability represented by the AIO. In computing the indebtedness of such persons, however, the face amount of a liability represented by such an AIO may be reduced by the amount of the basis reduction required by paragraph (e)(4) of this section.

(4) Basis reduction. For purposes of section 453C and the regulations thereunder, the adjusted basis of property transferred from one member of a group treated as one taxpayer to another member of such group shall be reduced by the portion of the gain that has not been recognized or otherwise has been deferred as of the end of the taxable year (but before the application of this section for such taxable year), either under § 1.1502-13 or because the gain on the transfer was eligible to be reported under the installment method.

(5) Example. The following example illustrates the provisions of this paragraph (e):

Example. (i) Corporations Y and Z are accrual basis, calendar year C corporations all of the outstanding stock of which is owned by A, an individual. At the end of 1987, Y has a note receivable from Z, and Z has a note payable to Y. This note relates to funds Z borrowed from Y. In addition, Z has an AIO with a face amount of $1,000,000 outstanding at the end of 1987 representing the purchase price of property sold by Z to Y. Z had a $600,000 basis in the property.

(ii) Pursuant to paragraph (b) of this section, Y and Z are treated as one taxpayer for purposes of applying section 453C. Paragraph (e)(1) of this section provides that the loan between Y and Z is disregarded both as indebtedness (i.e., the note payable) and as an asset (i.e., the note receivable) of the Y-Z group. Pursuant to paragraph (e)(3) of this section, however, the $1,000,000 AIO held by Z is not disregarded as an AIO of the Y-Z group for purposes of section 453C. In addition the $1,000,000 liability represented by the AIO is treated as indebtedness of the Y-Z group. The property Y purchased from Z is

treated as an asset of the Y-Z group, but pursuant to paragraph (e)(4) of this section the basis of such property for purposes of section 453C must be reduced by the $400,000 gain deferred by Z in the installment sale. The Y-Z group may also reduce the $1,000,000 indebtedness by the same $400,000 pursuant to paragraph (e)(3) of this section.

(f) Special rule in applying paragraphs (b) and (d) of this section. If two or more persons treated as one taxpayer under paragraphs (b) or (d) of this section have different taxable years, whenever a taxable year of such a person that holds an AIO ends, the taxable years of all other persons treated as one taxpayer are deemed to end for purposes of applying paragraph (b) and (d) of this section. The AII computed and allocated under this special rule shall be treated as a payment received on the last day of the actual taxable year of each such person.

(g) Example. The following example illustrates the provisions of this section:

Example. (i) X, a widely held C corporation, is the common parent of wholly owned subsidiaries S1 and S2. X is a calendar year taxpayer, and S1 and S2 are fiscal year taxpayers with taxable years ending November 30. Under paragraph (b) of this section, X, S1 and S2 are treated as one taxpayer.

(ii) On November 30, 1987, S1 has outstanding no AIOs, but S2 has outstanding one AIO (obligation one) and X has outstanding one AIO (obligation two). These obligations arose from dealer sales occurring on July 1, 1987, and have outstanding face amounts (as of November 30, 1987) of $100,000 and $150,000, respectively. The remaining contract prices of the obligations as of November 30, 1987, are also $100,000 and $150,000. The adjusted bases of X's assets (other than obligation two and the stock in S1 and S2) on November 30, 1987, is $38,000. The adjusted bases of S1's assets and S2's assets (other than obligation one) are $46,000 and $57,000, respectively. Thus, the aggregate adjusted bases of the group's assets (other than installment obligations) is $141,000. The liabilities of the group are as follows:

	2/28/87	5/31/87	8/31/87	11/30/87
X	$20,000	$22,000	$19,000	$24,000
S1	37,000	31,000	23,000	35,000
S2	10,000	8,000	11,000	18,000
Total	67,000	61,000	53,000	77,000

Thus, the aggregate average quarterly indebtedness for the group is $64,500. The group's installment percentage is .63939 ($250,000/($250,000+$141,000)). Thus, the aggregate AII for the group is $41,241 ($64,500×.63939). Both obligation one and obligation two arose during the taxable year ending November 30, 1987. Therefore, the aggregate AII must be allocated to obligations one and two using the method described in § 1.453C-5T(a): $16,496 (($100,000/$250,000)×$41,241) to obligation one and $24,745 (($150,000/$250,000)×$41,241) to obligation two. These amounts are treated as payments received on the obligations on November 30, 1987. S2 must report the income resulting from the deemed payment on obligation one on its income tax return for the taxable year ending November 30, 1987. X, however, must report the income resulting from the deemed payment on obligation two on its income tax return for the taxable year ending December 31, 1987.

(iii) On December 31, 1987, obligations one and two remain outstanding and no other AIOs are held by X, S1, or S2. The adjusted bases of X's assets (other than obligation two and the stock in S1 and S2) on December 31, 1987 is $39,000. The adjusted bases of S1's assets and S2's assets (other than obligation one) are $45,000 and $58,000 respectively. Thus, the aggregate adjusted basis of the group's assets (other than installment obligations) is $142,000. The liabilities of the group are as follows:

	3/31/87	6/30/87	9/30/87	12/31/87
X	$21,000	$21,000	$18,000	$25,000
S1	38,000	32,000	24,000	36,000
S2	10,000	8,000	11,000	18,000
Total	69,000	61,000	53,000	79,000

Thus, the aggregate average quarterly indebtedness for the group is $65,500. The group's installment percentage is .63776 ($250,000/($250,000+$142,000)). Thus, the aggregate AII for the group is $532 (($65,500×.63776)-$41,241 (the AII previously allocated to obligations one and two)). Since no obligations arose during December 1987, the $532 of AII must be allocated, under § 1.453C-5T(a), to obligations one and two: $213 to obligation one and $319 to obligation two. These amounts are treated as a payment received on the obligations on December 31, 1987. Thus, X reports on its 1987 tax return income attributable to $25,064 of deemed payments.

[T.D. 8224, 53 FR 34724, Sept. 8, 1988]

§ 1.453C–7T Special rules (temporary).

(a) Personal use property—(1) Definition. For purposes of section 453C and the regulations thereunder, the term "personal use property" means any property held by an individual substantially all the use of which is by an individual and not in connection with a trade or business or any activity described in section 212. The term does not include cash or cash equivalents.

(2) Indebtedness secured by personal use property. For purposes of paragraph (c) (1) and (2) of § 1.453C-3T (relating to the determination of annual and average quarterly indebtedness), any indebtedness secured by personal use property (as defined in paragraph (a) of this section), or by installment obligations arising from the disposition of such property, shall not be taken into account. For purposes of this section, indebtedness is "secured by personal use property" only if at least 90 percent of the value of the property securing the indebtedness is personal use property. However, if the amount of the indebtedness secured by personal use property exceeds the fair market value of such property, the excess is not considered to be secured by personal use property.

(b) Real property held for rental income—(1) In general. For purposes of section 453C and the regulations thereunder, except as otherwise provid-

ed in this paragraph (b), real property is held for the production of rental income if—

(i) The property is used by customers or held for use by customers; and

(ii) The gross income attributable to the property represents (or, in the case of property held for use by customers, the expected gross income attributable to the property would represent) amounts paid or to be paid principally for the use of such property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

(2) Rental of property incidental to holding such property for investment. For purposes of this paragraph (b), real property is not held for the production of rental income if—

(i) The principal purpose for holding the property is to realize gain from the appreciation of the property (without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development); and

(ii) The annual gross rental income from the property (based on the 12 months preceding the disposition of such property) is less than two percent of the lesser of—

(A) The unadjusted basis of such property; or

(B) The selling price of such property (as defined in § 15a.453-1(b)(2)(ii)).

For purposes of this paragraph (b)(2), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis.

(c) Property used in trade or business of farming. For purposes of section 453C and the regulations thereunder, property is used in the trade or business of farming if such property is used by the taxpayer in the trade or business of farming as that term is defined in section 2032A(e) (4) or (5). For this purpose, the term "taxpayer" includes a "farm-related taxpayer," as defined in section 464 (f)(3)(B). The term "AIO," within the meaning of § 1.453C-2T (a), does not include any obligation arising from the disposition of property used or produced by a taxpayer (or a farm-related taxpayer) in the trade or business of farming.

[T.D. 8224, 53 FR 34734, Sept. 8, 1988]

§ 1.453C–8T Sales of timeshares and residential lots (temporary).

(a) In general—(1) Scope of election. If a taxpayer elects, section 453C and the regulations thereunder (except for this section) shall not apply to any AIO—

(i) Which arises from a sale in the ordinary course of the taxpayer's trade or business to an individual of—

(A) Any—

(1) Timeshare right to use or timeshare ownership interest in residential real property for not more than 6 weeks, or

(2) The right to use specified campgrounds for recreational purposes, or

(B) Any residential lot but only if the taxpayer (or any related person) is not to make any improvements with respect to such lot, and

(ii) Which is not guaranteed or insured by any person other than an individual. (Thus, for example, any Federal or private insurance relating to the payment of an obligation disqualifies such obligation from the election described in this paragraph (a)).

For rules relating to the making of the election to have section 453C not apply, see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986). Notwithstanding paragraph (a)(2) of those regulations, a taxpayer may make this election at any time on or before December 7, 1988. In the case of AIOs held by a partnership, S corporation, or trust, the election must be made by such entity and not by its owners.

(2) Determination of timeshare ownership. For purposes of paragraph (a)(1)(i)(A)(1) of this section, a timeshare right to use, or a timeshare interest in property held by an individual's spouse, children, grandchildren, or parents is considered held by such individual.

(3) Related persons. For purposes of paragraph (a)(1)(i)(B) of this section, a person is related to the taxpayer if such person has a relationship to the taxpayer as specified in section 267(b) or 707(b) determined by substituting 10 percent for 50 percent each place it appears.

(4) Residential lot. For purposes of paragraph (a)(1)(i)(B) of this section, a residential lot is a parcel of unimproved land upon which the purchaser intends to construct (or intends to contract to have another person construct) a dwelling unit

for use as a residence by the purchaser. The terms "dwelling unit" and "use as a residence" as used herein are defined by section 280A. A parcel of land shall not be considered improved merely because it has been provided with common infrastructure items such as roads and sewers.

(b) Interest must be paid on deferred tax—(1) In general. If a taxpayer makes the election to have section 453C and the regulations thereunder (excluding this paragraph (b)) not apply to any obligation described in paragraph (a) of this section, the taxpayer (or the taxpayer's owners, in the case of a partnership, S corporation, or trust) shall pay interest on the portion of any tax for any taxable year (determined without regard to any deduction allowable for such interest) that is attributable to the receipt of payments on the obligation in such year (other than payments received in the taxable year of sale).

(2) Determination of tax liability attributable to receipt of payments on an obligation. For purposes of paragraph (b)(1) of this section, the tax liability attributable to a payment received on any obligation for which the election under paragraph (a) of this section has been made shall be determined by allocating to such payment its applicable share of the excess of—

(i) The taxpayer's tax liability (including alternative minimum tax) for such year determined with regard to payments received on all obligations for which the election under paragraph (a) of this section applies, over

(ii) The taxpayer's tax liability (including alternative minimum tax) for such year determined without regard to payments received on all obligations for which the election under paragraph (a) of this section applies.

For this purpose, the applicable share of the excess that is allocated to a payment is an amount that bears the same ratio to the total excess as the gain attributable to the payment bears to the total gain attributable to all such payments received in the taxable year. The tax liability is determined without regard to any deduction for interest determined under paragraph (b) of this section. In the case of obligations held by a partnership, S corporation, or trust, the determination described in this paragraph (b)(2) shall be made at the owner level.

(3) Period for which interest is determined—(i) In general. Interest on any tax liability attributable to an obligation to which the election described in paragraph (a) of this section applies shall be determined for the period from the date of the sale to the date the payment on the obligation is received.

(ii) Midpoint method. For purposes of paragraph (b)(3)(i) of this section, a taxpayer may, at the taxpayer's option, treat all payments received during the taxable year on all obligations to which the election described in paragraph (a) of this section applies as if they were received on the day halfway between the beginning and end of the taxable year (midpoint method). A taxpayer adopts the midpoint method by using it to compute the interest owed under this paragraph (b). The midpoint method is a method of accounting that must be used consistently from one taxable year to the next and cannot be revoked without the consent of the Commissioner. In addition, for its first taxable year ending after December 31, 1986, a taxpayer may adopt the midpoint method by using it on an amended return filed on or before December 7, 1988.

(4) Computation of interest. The interest for the period described in paragraph (b)(3) of this section shall be determined by using the applicable Federal rate under section 1274(d) (determined without regard to section 1274(d) (2) or (3)) in effect as of the date of the sale, compounded semiannually, or as prescribed by the Commissioner in revenue rulings under section 1274, an equivalent rate based on compounding periods other than a semiannual period (e.g., annual, quarterly, or monthly compounding periods).

(5) Time when interest payment due. Any interest determined under paragraph (b) of this section shall be treated as an addition to tax for the taxable year during which the payment on the obligation is received, and the last date for payment of such tax shall be the due date (determined without regard to extensions) of the return for such taxable year.

(6) Deduction for interest allowable. The interest determined under paragraph (b) of this section shall be taken into account in computing the amount of any deduction allowable to the taxpayer for interest paid or accrued for the taxable year in which the payment on the obligation is received (subject to any applicable limitation on the deductibility of interest on an underpayment of tax). The timing of such deduction shall be determined under the taxpayer's method of accounting.

(c) Example. The provisions of this section may be illustrated by the following example:

Example. (i) A, an accrual basis corporation, is a calendar year dealer in undeveloped residential lots. In taxable year 1987, A receives two AIOs for which the election described in paragraph (a) of this section is effective. The face amount of each obligation is $180,000. Each obligation provides for

monthly principal payments of $1,000 for a period of 15 years and for adequate stated interest under sections 483 and 1274. The dates of the two sales are June 1, 1987, and July 1, 1987. The first monthly payment on the June 1, 1987 obligation is due on July 1, 1987, and on the first of every month thereafter until satisfied. The first monthly payment on the July 1, 1987 obligation is due on September 1, 1987, and on the first day of every month thereafter until satisfied.

(ii) Under paragraph (b)(1) of this section, no interest is required to be paid on the payments received in the year of sale. The first payments on which interest is required to be paid occur on January 1, 1988. With respect to the June 1, 1987 obligation, the first payment is received 7 whole monthly compounding periods from the date of the sale. With respect to the July 1, 1987 obligation, the first payment is received 6 whole monthly compounding periods from the date of the sale.

(iii) The gross profit ratio applicable to the June 1, 1987 sale is 0.6600. The gross profit ratio applicable to the July 1, 1987 sale is 0.4500. A has taxable income unrelated to these installment sales of $21,000 determined without regard to any deduction allowable for the interest determined under paragraph (b) of this section. With respect to the June 1, 1987 sale, A receives a partial payment of principal of $1,000 on January 1, 1988. Based on the gross profit ratio, $660 of the payment is gain and $340 is recovery of basis. With respect to the July 1, 1987 sale, A receives a partial payment of principal of on January 1, 1988. Based on the gross profit ratio, $450 of the payment is gain and $550 is recovery of basis. A's gain on the other eleven 1988 payments on the June 1, 1987 obligation is $7,260. A's gain on the other eleven payments on the July 1 obligation is $4,950. Thus, A recognizes total gain of $13,320 on the two obligations in 1988.

(iv) A determines that it has no alternative minimum tax liability when it calculates income with regard to payments received on all obligations for which the election has been made. Thus, A's tax liability determined with regard to such payments is $5,148 (0.15×$34,320). A also determines that it has no alternative minimum tax liability when it calculates income without regard to payments received on all obligations for which the election has been made. Thus, A's tax liability determined without regard to such payments is $3,150 (0.15×$21,000). The excess of A's tax liability with regard to such payments over its tax liability without regard to such payments is $1,998. Of this $1,998 excess, $99 ($1,998×$660/$13,320) is allocated to and treated as the tax liability attributable to the January 1, 1988 payment on the June 1, 1987 obligation and $67 ($1,998×$450/$13,320) is allocated to and treated as the tax liability attributable to the January 1, 1988 payment on the July 1, 1987 obligation.

(v) The long-term applicable Federal rate in effect on the date of the June 1, 1987 sale is 8.34 percent, compounded monthly. The long-term applicable Federal rate in effect on the date of the July 1, 1987 sale is 8.57 percent, compounded monthly. The amount of interest due with respect to the January 1, 1988 payment on the June 1, 1987 obligation is $4.92. The amount of interest due with respect to the January 1, 1988 payment on the July 1, 1987 obligation is $2.92. These amounts of interest are taken into account as interest on an underpayment of tax in computing the amount of any deduction allowable for interest for taxable year 1988, and are treated as an addition to tax due on the due date of A's return for taxable year 1988. A must similarly determine the interest due on the gain with respect to each monthly payment received on the two obligations in taxable year 1988. However, if A adopts the midpoint method described in paragraph (b)(3)(ii) of this section, A may treat all of the payments received during 1988 on each of the obligations as received on July 1, 1988.

[T.D. 8224, 53 FR 34725, Sept. 8, 1988]

§ 1.453C–9T Effective dates and transitional rules.

(a) Effective dates—(1) In general. Except as otherwise provided, section 453C and the regulations thereunder apply to taxable years ending after December 31, 1986, with respect to dispositions of property occurring after February 28, 1986, and before January 1, 1988.

(2) Certain dispositions deemed made on first day of effective taxable year. In the case of a taxpayer's first taxable year ending after December 31, 1986, for purposes of section 453C and the regulations thereunder only, any disposition made after February 28, 1986 (or August 16, 1986, in the case of a disposition of real property of the type described in § 1.453C-2T(a)(1)(ii)), and before the beginning of such taxable year, is deemed made on the first day of such taxable year.

(3) Example. The following example illustrates the provisions of paragraph (a) of this section:

Example. X is a fiscal year dealer in personal property with a taxable year ending on June 30. After February 28, 1986, but before July 1, 1986 (i.e., during X's 1986 taxable year), X receives AIOs. After June 30, 1986 (i.e., during X's 1987 taxable year), X receives more AIOs. Since the AIOs received after June 30, 1986, are received in X's first taxable year ending after December 31, 1986, section 453C applies to these obligations under paragraph (a)(1) of this section. Under paragraph (a)(2) of this section, for purposes of section 453C and the regulations thereunder, the AIOs arising after February 28, 1986, and on or before June 30, 1986, are deemed to arise on July 1, 1986, the first day of X's first taxable year beginning after February 28, 1986 and ending after December 31, 1986, and section 453C applies to the obligations.

(b) Certain transitional rules—(1) In general—(i) Applicability. This paragraph (b) applies to AIOs that—

(A) Arise from the sale of property in the ordinary course of the trade or business of the taxpayer; and

(B) Are outstanding as of the close of the first or second taxable year of the taxpayer ending after December 31, 1986.

(ii) Deemed 1987 and 1988 payments. (A) The term "deemed 1987 payment" means, with respect to any AIO to which paragraph (b) of this section applies, the amount of AII for the first taxable year of the taxpayer ending after December 31, 1986, that is treated under § 1.453C-5T(a) as a payment on such obligation.

(B) The term "deemed 1988 payment" means, with respect to any AIO to which paragraph (b) of this section applies, the amount of AII for the

second taxable year of the taxpayer ending after December 31, 1986, that is treated under § 1.453C-5T (a) and (d) as a payment received on such obligation.

(iii) Income attributable to deemed 1987 and 1988 payments. The income of a taxpayer that is attributable to a deemed 1987 payment or a deemed 1988 payment on an AIO to which paragraph (b) of this section applies is the amount that bears the same relationship to such deemed payment as the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

(2) Dealer sales of real property—(i) Applicability. This paragraph (b)(2) applies to installment obligations described in paragraph (b) of this section that arise out of a sale of real property.

(ii) Treatment of deemed 1987 payments. A taxpayer's income attributable to deemed 1987 payments on AIOs to which paragraph (b)(2) of this section applies shall be taken into account ratably over the three taxable years beginning with the first taxable year of the taxpayer ending after December 31, 1986.

(iii) Treatment of deemed 1988 payments. A taxpayer's income attributable to deemed 1988 payments on AIOs to which paragraph (b)(2) of this section applies shall be taken into account ratably over the two taxable years beginning with the second taxable year of the taxpayer ending after December 31, 1986.

(3) Dealer sales of personal property—(i) Applicability. This paragraph (b)(3) applies to installment obligations described in paragraph (b) of this section that arise out of a sale of personal property.

(ii) Treatment of deemed 1987 and 1988 payments. Solely for purposes of determining the time for payment of tax and any interest payable with respect to such tax—

(A) Any increase in tax imposed on a taxpayer that is attributable to deemed 1987 payments on AIOs to which paragraph (b)(3) of this section applies shall be treated as imposed ratably over the three taxable years beginning with the first taxable year of the taxpayer that ends after December 31, 1986; and

(B) Any increase in tax imposed on a taxpayer that is attributable to deemed 1988 payments on AIOs to which paragraph (b)(3) of this section applies shall be treated as imposed ratably over the two taxable years beginning with the second taxable year of the taxpayer that ends after December 31, 1986.

(iii) Increase in tax attributable to deemed 1987 and 1988 payments. (A) The increase in tax imposed on a taxpayer that is attributable to deemed 1987 payments on AIOs to which this paragraph (b)(3) applies is the excess (if any) of—

(1) The tax that would be imposed on the taxpayer for the first taxable year ending after December 31, 1986, determined by taking into account income attributable to deemed 1987 payments on AIOs to which this paragraph (b)(3) applies, over

(2) The tax that would be imposed on the taxpayer for such taxable year, determined without regard to income attributable to deemed 1987 payments on AIOs to which paragraph (b)(3) of this section applies.

(B) The increase in tax imposed on a taxpayer that is attributable to deemed 1988 payments on AIOs to which paragraph (b)(3) of this section applies is the excess (if any) of—

(1) The tax that would be imposed on the taxpayer for the second taxable year ending after December 31, 1986, determined by taking into account income attributable to deemed 1988 payments on installment obligations to which paragraph (b)(3) of this section applies, over

(2) The tax that would be imposed on the taxpayer for such taxable year, determined without regard to income attributable to deemed 1988 payments on AIOs to which paragraph (b)(3) of this section applies.

(iv) Tax imposed. For purposes of paragraph (b)(3) of this section, the tax imposed is the greater of zero or the amount of tax imposed by chapter 1 of the Internal Revenue Code of 1986 (including the alternative minimum tax) determined without reducing such amount by—

(A) The credit under section 31 for tax withheld;

(B) The credit under section 33 for tax withheld at source on nonresident aliens and foreign corporations; and

(C) Payments of tax or estimated tax by the taxpayer.

(4) Application of §§ 1.453C-5T (b) and (c). The taxable year in which an amount is treated as received for purposes of § 1.453C-5T(b) (relating to the treatment of subsequent payments as the

receipt of tax paid amounts) and § 1.453C-5T(c) (relating to the limitation on amounts treated as received) shall be determined without regard to paragraphs (b) (2) and (3) of this section. Thus, an amount is treated as received in a taxable year for such purposes even if under paragraph (b) (2) or (3) of this section, the income or tax attributable to such amount is taken into account or treated as imposed over the two-year or three-year period beginning with such taxable year.

(5) **Examples.** The following examples illustrate the application of paragraph (b) of this section:

Example (1). (i) Corporation X is a fiscal year dealer in real property with a taxable year ending on June 30. At the close of its taxable year ending June 30, 1987, X holds 10 AIOs, all of which arose during that taxable year. These AIOs provide for adequate stated interest under sections 483 and 1274, and each has a year-end balance of $210,000.

(ii) Assume that the adjusted bases of assets (other than AIOs) held by X as of the close of the taxable year is $2,000,000. Thus, the installment percentage for the taxable year is .51220 ($2,100,000 (the outstanding face amount as of the close of the taxable year of all AIOs) /$4,100,000 (the sum of such amount and the adjusted bases of other assets held by X as of the close of the taxable year)). Assume further that X's average quarterly indebtedness for the taxable year is $460,976. Accordingly, the amount of AII for the taxable year is $236,112 (.51220×$460,976). Under § 1.453C-5T(a), a ratable portion of this amount is treated as a payment received on each AIO for X's taxable year ending June 30, 1987. Thus, X has a deemed 1987 payment of $23,611 on each of the 10 AIOs.

(iii) Assume that the gross profit ratio with respect to each of the 10 sales for which an AIO was received is 45.833%. Thus, $10,822 ($23,611×.45833) of each deemed 1987 payment is income. (The remaining portion of each deemed payment ($12,-789) is recovery of basis.) Accordingly, the total income attributable to the deemed 1987 payments is $108,220. Assume X has no other items of income or loss for the taxable year.

(iv) Under paragraph (b)(2)(ii) of this section, the $108,220 is taken into account ratably over the three taxable years beginning with taxable year 1987. Thus, $36,073 is taken into account in each such taxable year.

(v) During its taxable year ending June 30, 1988, X receives actual payments of $20,000 on each of the AIOs. All of each $20,000 payment is treated as the receipt of a tax paid amount under § 1.453C-5T(b) even though only one third of the income attributable to the 1987 AII has been taken into account.

Example (2). The facts are the same as in example (1), except that X receives the 10 AIOs in its 1988 taxable year. Under paragraph (b)(2)(iii) of this section, the $108,220 of income attributable to the deemed 1988 payments of $236,112 is taken into account ratably over the two taxable years beginning with taxable year 1988. Thus, $54,110 is taken into account in each such taxable year.

Example (3). (i) Corporation X is a calendar year dealer in personal property. On March 1, 1987, X receives an AIO with a face amount of $1,000,000 arising from the sale of property in the ordinary course of its business. The obligation provides for adequate stated interest under sections 483 and 1274. The gross profit ratio on the obligation is 66%. The total gain from such disposition is thus $660,000. X receives no payments on the obligation during 1987. On December 31, 1987, X has no other AIOs outstanding. X has no other items of income or deduction for the taxable year and no credits. X has AII of $650,000 for 1987. Thus, X has a deemed 1987 payment of $650,000 on the AIO and total income attributable to the deemed 1987 payment of $429,000 ($650,000 ×.66).

(ii) The increase in tax attributable to the deemed 1987 payment is $29,346, the excess of $161,346 over $132,000. The tax imposed with regard to income attributable to the deemed 1987 payment is $161,346, determined as follows:

Regular tax computation:

Taxable income.....$429,000

Regular tax.....$161,346

Alternative minimum tax computation:

Alternative minimum taxable
income.....$660,000

Tentative minimum tax.....$132,000

Because X's regular tax liability exceeds its tentative minimum tax, $161,346 is the tax imposed. The tax imposed without regard to income attributable to the deemed 1987 payment is $132,000, determined as follows:

Regular tax computation:

Taxable income.....$0

Regular tax.....$0

Alternative minimum tax computation:

Alternative minimum taxable
income.....$660,000

Tentative minimum tax.....$132,000

Because X's regular tax is $0 and X's tentative minimum tax exceeds its regular tax by $132,000, $132,000 is the tax imposed.

(iii) The increase of $29,346 attributable to the deemed 1987 payment will be imposed ratably over the three taxable years beginning with X's 1987 taxable year. Thus, X will pay taxes of $141,782 ($161,346-$29,346+$9,782) in 1987 and have an additional tax liability of $9,782 in 1988 and in 1989. X may not include the additional $9,782 in the amount of its regular tax in 1988 or 1989 for purposes of determining whether it is liable for alternative minimum tax. X is liable for an additional $9,782 of tax in each of those years whether it is liable for alternative minimum or regular tax in those years.

Example (4). (i) The facts are the same as in example (3), except that in 1988 X has a $30,000 net operating loss ("NOL") for purposes of the regular tax and a $10,000 NOL for purposes of the alternative minimum tax. Both of these NOLs are carried back under section 172(b) to 1987. Since the NOL carryback to 1987 is taken into account in computing X's taxable income for 1987, X's increase in tax attributable to the deemed 1987 payment must be computed.

(ii) The increase in tax attributable to the deemed 1987 payment is $19,362, the excess of $149,362 over $130,000. The tax imposed with regard to income attributable to the deemed 1987 payment is $149,362, determined as follows:

Regular tax computation:

Taxable income before NOL carryback	$429,000
NOL carryback	(30,000)
Taxable income	$399,000
Regular tax	$149,362

Alternative minimum tax computation:

Alternative minimum taxable income before NOL carryback	$660,000
NOL carryback	(10,000)
Alternative minimum taxable income	$650,000
Tentative minimum tax	$130,000

Because X's regular tax liability exceeds its tentative minimum tax, $149,362 is the tax imposed. The tax imposed without regard to income attributable to the deemed 1987 payment is $130,000, determined as follows:

Regular tax computation:

Taxable income..... $0

Regular tax..... $0

Alternative minimum tax computation:

Alternative minimum taxable income before NOL carryback	$660,000
NOL carryback	(10,000)
Alternative minimum taxable income	$650,000
Tentative minimum tax	$130,000

Since X's regular tax is $0 and X's tentative minimum tax exceeds its regular tax by $130,000, that amount is the tax imposed.

(iii) The increase of $19,362 attributable to the deemed 1987 payment will be imposed ratably over the three taxable years beginning with 1987. X will thus pay taxes of $136,454 ($149,362-$19,362+$6,454) in 1987 and have an additional tax liability of $6,454 in each of 1987 and 1988.

(6) Effect of death, termination or cessation of trade or business—(i) In general. If a taxpayer holding an AIO to which this section applies dies, terminates, or ceases to engage in the trade or business to which the obligation relates and paragraph (b)(6)(ii) of this section does not apply, the income or tax attributable to deemed 1987 or 1988 payments not taken into account under this section in any prior taxable year shall be taken into account in the taxable year of such death, termination, or cessation.

(ii) Section 381 transactions. If a corporation acquires AIOs to which this section applies in a transaction to which section 381 applies and continues to engage in the trade or business to which the obligations relate, the income or tax attributable to deemed 1987 or 1988 payments on such obligations shall be taken into account—

(A) By treating the acquiring corporation as if it were the distributor or transferor corporation for taxable years of the acquiring corporation ending after the last day of the last taxable year of the distributor or transferor corporation; and

(B) By taking into account for purposes of paragraphs (b) (2) and (3) of this section the taxable years of the distributor or transferor corporation beginning after December 31, 1986, and the taxable years of the acquiring corporation ending after the last day of the last taxable year of the distributor or transferor corporation.

(7) S corporation election and terminations. (i) In general. For purposes of paragraph (b)(6)(i) of this section, neither the election by an existing corporation taxable under subchapter C to be taxable under subchapter S nor the termination of an S election shall be treated as the termination of the taxpayer or the cessation by the taxpayer of engaging in the trade or business.

(ii) Change to S corporation status. If the tax attributable to deemed 1987 or 1988 payments on AIOs held by a corporation is treated under paragraph (b)(3) of this section as imposed ratably over a two-year or three-year period and the corporation is not an S corporation in the first year of such period, the S corporation shall pay the portion of the tax treated as imposed for taxable years in which the corporation is an S corporation. In any case in which the tax attributable to deemed 1987 or 1988 payments is payable by an S corporation, the tax treated as imposed for a taxable year shall be due as of the due date (without regard to extensions) of the return of the S corporation for such taxable year, and shall be reported on such return.

(iii) Termination of S corporation election. If the tax attributable to deemed 1987 or 1988 payments on AIOs held by a corporation is treated under paragraph (b)(3) of this section as imposed ratably over a two-year or three-year period and the corporation is an S corporation in the first year of such period, the owners shall pay the entire amount of such tax even if a portion of the tax is treated as imposed for a taxable year in which the corporation is no longer an S corporation.

(8) Tax returns to be identified. A dealer in personal property reporting a ratable portion of the tax attributable to deemed 1987 or 1988 payments on a return must type or legibly print on page 1 of the return (or such other place on the return as may be required by any instruction to the return) the following: "Section 453C tax computation."

(9) Estimated tax payments—(i) In general. For purposes of sections 6654(d)(1)(B) and 6655(d)(1)(B) (relating to the determination of the required payment for estimated tax purposes), the tax shown on the return for the taxable year (or, if no return is filed, the tax for such taxable year) shall—

(A) Exclude any portion of the tax attributable to deemed 1987 or 1988 payments that pursuant to

paragraph (b)(3)(ii) of this section is treated as imposed in a taxable year other than the current taxable year;

(B) Include any portion of the tax attributable to deemed 1987 or 1988 payments that pursuant to paragraph (b)(3)(ii) of this section is treated as imposed in the current taxable year.

(ii) Manner in which income is taken into account. For purposes of sections 6654(d)(2) and 6655(e), a taxpayer (whether a dealer in real or personal property) shall—

(A) Treat the 1987 portion of the income attributable to deemed 1987 payments on installment obligations to which paragraph (b) of this section applies (see paragraph (b)(9)(iii)(A) of this section) as income for the last month of the taxpayer's first taxable year ending after December 31, 1986; then

(B) Treat a ratable portion of one half of the remaining income attributable to deemed 1987 payments on installment obligations to which paragraph (b) of this section applies as income for each month of the taxpayer's second taxable year ending after December 31, 1986; then

(C) Treat a ratable portion of the remaining income attributable to deemed 1987 payments on installment obligations to which paragraph (b) of this section applies as income for each month of the third taxable year ending after December 31, 1986;

(D) Treat the 1988 portion of the income attributable to deemed 1988 payments on installment obligations to which paragraph (b) of this section applies (see paragraph (b)(9)(iii)(B) of this section) as income for the last month of the second taxable year ending after December 31, 1986; then

(E) Treat a ratable portion of the remaining income attributable to deemed 1988 payments on installment obligations to which paragraph (b) of this section applies as income for each month of the third taxable year ending after December 31, 1986.

(iii) 1987 and 1988 portions. (A) The 1987 portion of the income attributable to deemed 1987 payments on installment obligations to which paragraph (b) of this section applies is the amount of such income that would be taken into account for the first taxable year ending after December 31, 1986, determined as if all such obligations were obligations to which paragraph (b)(2) of this section applies.

(B) The 1988 portion of the income attributable to deemed 1988 payments on installment obligations to which paragraph (b) of this section applies is the amount of such income that would be taken into account for the second taxable year ending after December 31, 1986, determined as if all such obligations were obligations to which paragraph (b)(2) of this section applies.

(iv) Example. The following example illustrates the application of paragraph (b)(9) of this section:

Example. The facts are the same as in example (1) of paragraph (b)(5) of this section. For purposes of determining annualized income installments of estimated tax, X shall treat the 1987 portion of the income attributable to deemed 1987 payments on installment obligations to which this section applies as income for the last month of X's taxable year ending in 1987. For this purpose, the 1987 portion of the income attributable to such payments is the amount of such income that is taken into account for X's taxable year ending in 1987 under paragraph (b)(2) of this section. Thus, X must treat $36,073 as income for the last month of X's taxable year ending in 1987. In addition, X must treat a ratable portion of the remaining income attributable to the deemed 1987 payments ($72,146) as income for each month of the two succeeding taxable years (which also end June 30). Thus, $3,006 ($72,-146/24) is treated as income for each such month. Since the 1987 portion of the income attributable to deemed payments is determined by treating all installment obligations to which this section applies as if they were obligations to which paragraph (b)(2) of this section applies, the result would be the same even if X were a dealer in personal property.

[T.D. 8224, 53 FR 34726, Sept. 8, 1988]

§ 1.453C–10T Questions and answers relating to section 811(c)(2) of the Tax Reform Act of 1986 (temporary).

The following questions and answers relate to section 811(c)(2) of the Tax Reform Act of 1986:

Q-1. Are installment obligations that satisfy the requirements of section 811(c)(2) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2085) (the 1986 Act) subject to either: (a) section 453C of the Code as enacted by section 811(a) of the 1986 Act (the proportionate disallowance rule); or (b) the repeal of the installment method for dealers under section 10202 of the Revenue Act of 1987 (Pub. L. 100-203, 101 Stat. 1330) (the 1987 Act)?

A-1. Installment obligations that satisfy the requirements of section 811(c)(2) are exempt from the proportionate disallowance rule of section 453C, which applies to certain obligations arising from dispositions of property after February 28, 1986, and before January 1, 1988. Installment obligations that satisfy the requirements of section 811(c)(2) are also exempt from the repeal of the installment method for dealers under section 10202 of the 1987 Act (section 453(b)(2)(A)), effective for obligations arising from dispositions of

property after December 31, 1987. Thus, income from such obligations may be taken into account under the installment method of accounting allowed under the Code as in effect prior to the 1986 Act if the method is otherwise available to the taxpayer.

Q-2. What are the requirements of section 811(c)(2)?

A-2. Section 811(c)(2) applies only to obligations that satisfy the following requirements: One, the installment obligations must arise from the disposition of tangible personal property by a manufacturer or any affiliate thereof (collectively, the manufacturer) to a dealer (i.e., the sale of the property must be intended for resale or leasing by the dealer). Two, the obligation must include eligible terms, as defined below. (Obligations that satisfy these two requirements are hereinafter referred to as "eligible obligations"). Three, the obligation must arise from a disposition made in a taxable year for which the taxpayer is eligible for section 811(c)(2) treatment. In order to initially become eligible for section 811(c)(2) treatment, the aggregate outstanding face amount of the eligible obligations must be at least 50% of the total sales giving rise to eligible obligations (the 50% test) both for the taxpayer's first taxable year beginning after October 22, 1986, and for the preceding taxable year. See A-7 of this section for rules relating to the satisfaction of the 50% test for subsequent taxable years.

Q-3. What do the eligible terms require?

A-3. Eligible terms require that the dealer (and only the dealer) must be obligated to make payments on the principal of the obligation. Moreover, the dealer must not be obligated to make these payments until the dealer resells (or rents) the property. In addition, the manufacturer must have the right to repurchase the property at a fixed or ascertainable price, with such right to repurchase exercisable by the manufacturer beginning on any day within the first 9 months after the date of sale.

Q-4. If an installment obligation includes the eligible terms when issued and an eligible term is later eliminated, does section 811(c)(2) continue to apply? If not, on what date does section 811(c)(2) cease to apply to the obligation?

A-4. Section 811(c)(2) applies to an installment obligation only if the obligation includes the eligible terms at the time the obligation is issued and at all times thereafter. If an eligible term is eliminated, the general rules applicable to installment sales by dealers apply to the installment obligation as if the obligation arose from a disposition occurring on the first day of the month in which an eligible term is eliminated. Therefore, any gain on the obligation that remains to be recognized is included in income for the taxable year during which an eligible term is eliminated. (See section 10202(e)(2)(B)(ii) of the Revenue Act of 1987 for a special rule with respect to an obligation from which an eligible term is eliminated before January 1, 1988). The following examples illustrate the provisions of this A-4:

Example 1. Manufacturer A sells tangible personal property to Dealer B on January 1, 1987. B makes a 25% down payment and gives A an installment obligation for the remaining 75% of the purchase price. The obligation requires B to pay the remaining 75% of the purchase price when B resells the property. The obligation also grants A the right to repurchase the property at a fixed price beginning on or after July 1, 1987. Because of changed business conditions, A and B modify the installment obligation on June 5, 1987, to grant A the right to repurchase the property beginning on or after November 1, 1987. On June 1, 1987, section 811(c)(2) ceases to apply to the obligation because on June 5, 1987 A does not have the right to repurchase the property at a fixed or ascertainable price beginning on any day within the first 9 months after the date of the sale. On June 1, 1987, the obligation is subject to the proportionate disallowance rule of section 453C as amended by section 10202 of the 1987 Act as if the obligation arose from a disposition occurring on June 1, 1987.

Example 2. (i) Manufacturer A, a calendar year taxpayer, sells tangible personal property to Dealer B on January 1, 1988. For each item, B makes a 20% down payment and gives A an installment obligation for the remaining 80% of the purchase price. The obligation requires B to pay 50% of the remaining balance on the date B sells the property. The remaining 50% of the balance is due 60 days after the resale date. The obligation further grants A the right to repurchase the property at a fixed price beginning September 15, 1988.

(ii) Pursuant to a separate agreement between A and B existing on January 1, 1988, a customer who ultimately purchases the property from B may assume B's installment obligation to A. To effect the assumption, A must consider the retail customer credit worthy, and the retail customer must execute a promissory note to A for the unpaid principal. When A accepts the retail customer's promissory note in place of B's installment obligation, A releases B from liability on B's installment obligation except to the extent of the retail customer's failure to pay on its note. The financing agreement also provides that the maturity date and interest rate of the retail customer's promissory note may differ from that of the dealer's installment obligation.

(iii) B sells one piece of property to customer C on March 20, 1988. On that date, C assumes B's installment obligation to A. On March 1, 1988, section 811(c)(2) ceases to apply to A's installment obligation from B because on March 20, 1988, an eligible term was eliminated (i.e., a person other than the dealer became obligated to make payments on the principal of the obligation). Section 811(c)(2) ceases to apply whether or not the substitution of C for B as the obligor on the installment obligation constitutes a disposition of that obligation. Because of this substitution, the installment obligation must be accounted for under the general rules applicable to an obligation arising from a disposition occurring on March 1, 1988. Therefore, as required by section 453(b)(2)(A), the installment obligation cannot be accounted for under the installment method of

accounting for A's 1988 taxable year. See, however, A-5(a) of this section for rules relating to the treatment of the obligation as an eligible obligation during January and February for purposes of the 50% test.

Q-5. How is the 50% test calculated?

A-5. (a) To determine whether a taxpayer satisfies the 50% test for a taxable year, the taxpayer calculates a fraction (the testing fraction), the numerator of which is the average balance of outstanding eligible obligations, calculated on a monthly basis and including eligible obligations arising from sales in prior years, and the denominator of which is the sales for that year giving rise to eligible obligations. The testing fraction must be at least 50% to satisfy the requirements of section 811(c)(2). An obligation that ceases to be an eligible obligation because an eligible term is eliminated nonetheless remains, for purposes of calculating the 50% test, an eligible obligation for the period preceding the month in which the eligible term is eliminated. A sale giving rise to an obligation that ceases to be an eligible obligation because an eligible term is eliminated continues to be included in the denominator of the testing fraction.

(b) To determine the numerator of the testing fraction, the taxpayer first determines the monthly balance of eligible obligations (monthly eligible balance). The monthly eligible balance consists of the face amount of eligible obligations (including eligible obligations arising from sales in previous taxable years) outstanding at the end of the month. Payments of principal on an eligible obligation reduce the amount included in the monthly eligible balance. The sum of the monthly eligible balances is divided by the number of months in the taxable year (counting fractions of a month as whole months in the case of a short taxable year) to determine the numerator of the testing fraction. (In determining the number of months in a taxable year for purposes of this calculation, a month is counted even though no eligible obligations were outstanding at the end of that month.) The denominator of the testing fraction is a number equal to the total amount of all sales arising during the taxable year giving rise to eligible obligations. If a sale giving rise to an eligible obligation includes a down payment, the amount of the sale includes the amount of the down payment. The denominator includes only sales occurring in the taxable year of the determination. Sales occurring in a previous year are not included in the denominator, even though eligible obligations arising from those sales remain outstanding.

(c) The following example illustrates the provisions of this A-5:

Example. On January 1, 1987, Manufacturer A, a calendar year taxpayer, has five outstanding eligible obligations (1986 obligations). On January 1, 1987, the outstanding face amount of each 1986 obligation is $80,000. On January 15, 1987, A sells to Dealer B 15 pieces of tangible personal property for $75,000 each. For each sale, B makes a down payment of $25,000 and gives A an installment obligation with eligible terms for the remaining $50,000. Each obligation provides for adequate stated interest under sections 483 and 1274. On April 15, 1987, A sells to Dealer C 10 pieces of tangible personal property, each for $65,000 with no down payment. For each sale, C issues an installment obligation with the eligible terms for $65,000. Each obligation provides for adequate stated interest under sections 483 and 1274. During 1987, A makes no other dispositions of property giving rise to eligible obligations. During 1987 A receives no payments from B or C on their obligations. With respect to 1986 obligations, A receives $80,000 plus interest on each of the following dates: April 15, 1987; May 15, 1987; June 15, 1987; July 15, 1987 and August 15, 1987. A calculates the 50% test as follows:

Month	Monthly eligible balance	
January	$ 400,000	(5 × $80,000)
	750,000	(15 × $50,000)
	1,150,000	
February	1,150,000	
March	1,150,000	
April	1,150,000	
	(80,000)	
	650,000	(10 × $65,000)
	1,720,000	
May	1,720,000	
	(80,000)	
	1,640,000	
June	1,640,000	
	(80,000)	
	1,560,000	
July	1,560,000	
	(80,000)	
	1,480,000	
August	1,480,000	
	(80,000)	
	1,400,000	
September	1,400,000	
October	1,400,000	
November	1,400,000	
December	1,400,000	
Total	16,850,000	

The average balance of eligible obligations is $1,404,167 ($16,850,000/12). Total sales giving rise to eligible obligations equal $1,775,000 ((15 × $75,000) + (10 × $65,000)). The testing fraction is 79% ($1,404,167/$1,775,000). Because 79% is greater than 50%, A satisfies the 50% test for 1987. In order to become eligible for section 811(c)(2) treatment, A must also satisfy the 50% test for 1986. See A–6 of this section.

Q-6. For what taxable year must a taxpayer first satisfy the requirements of section 811(c)(2)?

A-6. (a) A taxpayer must meet the requirements of section 811(c)(2) for its first taxable year beginning after October 22, 1986. One of these requirements is that a taxpayer must satisfy the 50% test both for its first taxable year beginning after Octo-

ber 22, 1986, and for the preceding taxable year (i.e., its first taxable year ending on or after October 22, 1986). For example, section 811(c)(2) applies to a calendar year taxpayer only if the taxpayer satisfies the 50% test for both 1986 and 1987. If the taxpayer fails to satisfy the 50% test for either 1986 or 1987, section 811(c)(2) can never apply to any obligation arising from sales by the taxpayer.

(b) Section 811(c)(2)(C) treats obligations issued before October 22, 1986, as containing the eligible terms if the obligations were modified to contain the eligible terms within sixty days after October 22, 1986. Sales giving rise to modified obligations are taken into account in calculating the denominator, and the modified obligations themselves are taken into account in calculating the numerator, of the testing fraction as if the obligations were modified on the date of their original issuance. See A-5 of this section.

Q-7. Must a taxpayer always satisfy the 50% test for both the taxable year and the preceding taxable year?

A-7. (a) If a taxpayer satisfies the 50% test for both its first taxable year beginning after October 22, 1986, and its preceding taxable year (i.e., its first taxable year ending on or after October 22, 1986), such a taxpayer will not cease to be eligible for section 811(c)(2) treatment until the second consecutive taxable year for which it fails to satisfy the 50% test. A taxpayer that ceases to be eligible for section 811(c)(2) treatment because it fails the 50% test for two consecutive years can again become eligible for section 811(c)(2) treatment by subsequently satisfying the 50% test for two consecutive taxable years. The obligations of a taxpayer that arise from dispositions made in a taxable year for which the taxpayer is not eligible for section 811(c)(2) treatment, however, can never become eligible for section 811(c)(2) treatment. Likewise, eligible obligations arising from dispositions made in a taxable year for which the taxpayer is eligible for section 811(c)(2) treatment do not cease to be subject to section 811(c)(2) treatment if the taxpayer subsequently fails the 50% test for two consecutive taxable years.

(b) The following examples illustrate the provisions of this A-7:

Example (1). A calendar year taxpayer fails the 50% test in 1986, but satisfies the test in 1987 and 1988. Section 811(c)(2) does not apply for 1987 or for any year thereafter. See A-6 of this section.

Example (2). A calendar year taxpayer satisfies the 50% test in 1986 and 1987, fails the 50% test in 1988, and satisfies the 50% test in 1989. Section 811(c)(2) applies to the taxpayer's eligible obligations arising from dispositions made in 1987, 1988, and 1989.

Example (3). A calendar year taxpayer satisfies the 50% test in 1986 and 1987, but fails the 50% test in both 1988 and 1989. Section 811(c)(2) applies to the taxpayer's eligible obligations arising from dispositions made in 1987 and 1988 but does not apply to obligations arising from dispositions made in 1989 and 1990. If the taxpayer satisfies the 50% test for 1990 and 1991, section 811(c)(2) applies to eligible obligations arising from dispositions made in 1991.

[T.D. 8213, 53 FR 26244, July 12, 1988; T.D. 8224, 53 FR 34719, Sept. 8, 1988]

§ 1.454–1 Obligations issued at discount.

(a) Certain non-interest-bearing obligations issued at discount—(1) Election to include increase in income currently. If a taxpayer owns—

(i) A non-interest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals (other than an obligation issued by a corporation after May 27, 1969, as to which ratable inclusion of original issue discount is required under section 1232(a)(3)), or

(ii) An obligation of the United States, other than a current income obligation, in which he retains his investment in a matured series E U.S. savings bond, or

(iii) A nontransferable obligation (whether or not a current income obligation) of the United States for which a series E U.S. savings bond was exchanged (whether or not at final maturity) in an exchange upon which gain is not recognized because of section 1037(a) (or so much of section 1031(b) as relates to section 1037),

and if the increase, if any, in redemption price of such obligation described in subdivision (i), (ii), or (iii) of this subparagraph during the taxable year (as described in subparagraph (2) of this paragraph) does not constitute income for such year under the method of accounting used in computing his taxable income, then the taxpayer may, at his election, treat the increase as constituting income for the year in which such increase occurs. If the election is not made and section 1037 (or so much of section 1031 as relates to section 1037) does not apply, the taxpayer shall treat the increase as constituting income for the year in which the obligation is redeemed or disposed of, or finally matures, whichever is earlier. Any such election must be made in the taxpayer's return and may be made for any taxable year. If an election is made with respect to any such obligation described in subdivision (i), (ii), or (iii) of this subparagraph, it shall apply also to all other obligations of the type described in such subdivisions owned by the taxpayer at the beginning of the first

taxable year to which the election applies, and to those thereafter acquired by him, and shall be binding for the taxable year for which the return is filed and for all subsequent taxable years, unless the Commissioner permits the taxpayer to change to a different method of reporting income from such obligations. See section 446(e) and paragraph (e) of § 1.446–1, relating to requirement respecting a change of accounting method. Although the election once made is binding upon the taxpayer, it does not apply to a transferee of the taxpayer.

(2) Amount of increase in case of non-interest-bearing obligations. In any case in which an election is made under section 454, the amount which accrues in any taxable year to which the election applies is measured by the actual increase in the redemption price occurring in that year. This amount does not accrue ratably between the dates on which the redemption price changes. For example, if two dates on which the redemption price increases (February 1 and August 1) fall within a taxable year and if the redemption price increases in the amount of 50 cents on each such date, the amount accruing in that year would be $1 ($0.50 on February 1 and $0.50 on August 1). If the taxpayer owns a non-interest-bearing obligation of the character described in subdivision (i), (ii), or (iii) of subparagraph (1) of this paragraph acquired prior to the first taxable year to which his election applies, he must also include in gross income for such first taxable year (i) the increase in the redemption price of such obligation occurring between the date of acquisition of the obligation and the first day of such first taxable year and (ii), in a case where a series E bond was exchanged for such obligation, the increase in the redemption price of such series E bond occurring between the date of acquisition of such series E bond and the date of the exchange.

(3) Amount of increase in case of current income obligations. If an election is made under section 454 and the taxpayer owns, at the beginning of the first taxable year to which the election applies, a current income obligation of the character described in subparagraph (1)(iii) of this paragraph acquired prior to such taxable year, he must also include in gross income for such first taxable year the increase in the redemption price of the series E bond which was surrendered to the United States in exchange for such current income obligation; the amount of the increase is that occurring between the date of acquisition of the series E bond and the date of the exchange.

(4) Illustrations. The application of this paragraph may be illustrated by the following examples:

Example (1). Throughout the calendar year 1954, a taxpayer who uses the cash receipts and disbursements method of accounting holds series E U.S. savings bonds having a maturity value of $5,000 and a redemption value at the beginning of the year 1954 of $4,050 and at the end of the year 1954 of $4,150. He purchased the bonds on January 1, 1949, for $3,750, and holds no other obligation of the type described in this section. If the taxpayer exercises the election in his return for the calendar year 1954, he is required to include $400 in taxable income with respect to such bonds. Of this amount, $300 represents the increase in the redemption price before 1954 and $100 represents the increase in the redemption price in 1954. The increases in redemption value occurring in subsequent taxable years are includible in gross income for such taxable years.

Example (2). In 1958 B, a taxpayer who uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year, purchased for $7,500 a series E United States savings bond with a face value of $10,000. In 1965, when the stated redemption value of the series E bond is $9,760, B surrenders it to the United States in exchange solely for a $10,000 series H U.S. current income savings bond in an exchange qualifying under section 1037(a), after paying $240 additional consideration. On the exchange of the series E bond for the series H bond in 1965, B realizes a gain of $2,260 ($9,760 less $7,500), none of which is recognized for that year by reason of section 1037(a). B retains the series H bond and redeems it at maturity in 1975 for $10,000, but in 1966 he exercises the election under section 454(a) in his return for that year with respect to five series E bonds he purchased in 1960. B is required to include in gross income for 1966 the increase in redemption price occurring before 1966 and in 1966 with respect to the series E bonds purchased in 1960; he is also required to include in gross income for 1966 the $2,260 increase in redemption price of the series E bond which was exchanged in 1965 for the series H bond.

(b) Short-term obligations issued on a discount basis. In the case of obligations of the United States or any of its possessions, or of a State, or Territory, or any political subdivision thereof, or of the District of Columbia, issued on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation originally sold does not accrue until the date on which such obligation is redeemed, sold, or otherwise disposed of. This rule applies regardless of the method of accounting used by the taxpayer. For examples illustrating rules for computation of income from sale or other disposition of certain obligations of the type described in this paragraph, see section 1221 and the regulations thereunder.

(c) Matured U.S. savings bonds—(1) Inclusion of increase in income upon redemption or final maturity. If a taxpayer (other than a corporation) holds—

(i) A matured series E U.S. savings bond,

(ii) An obligation of the United States, other than a current income obligation, in which he retains his investment in a matured series E U.S. savings bond, or

(iii) A nontransferable obligation (whether or not a current income obligation) of the United States for which a series E U.S. savings bond was exchanged (whether or not at final maturity) in an exchange upon which gain is not recognized because of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)),

the increase in redemption price of the series E bond in excess of the amount paid for such series E bond shall be included in the gross income of such taxpayer for the taxable year in which the obligation described in subdivision (i), (ii), or (iii) of this subparagraph is redeemed or disposed of, or finally matures, whichever is earlier, but only to the extent such increase has not previously been includible in the gross income of such taxpayer or any other taxpayer. If such obligation is partially redeemed before final maturity, or partially disposed of by being partially reissued to another owner, such increase in redemption price shall be included in the gross income of such taxpayer for such taxable year on a basis proportional to the total denomination of obligations redeemed or disposed of. The provisions of section 454(c) and of this subparagraph shall not apply in the case of any taxable year for which the taxpayer's taxable income is computed under an accrual method of accounting or for a taxable year for which an election made by the taxpayer under section 454(a) and paragraph (a) of this section applies. For rules respecting the character of the gain realized upon the disposition or redemption of an obligation described in subdivision (iii) of this subparagraph, see paragraph (b) of § 1.1037–1.

(2) Illustrations. The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and the calendar year as his taxable year:

Example (1). On June 1, 1941, A purchased for $375 a series E U.S. savings bond which was redeemable at maturity (10 years from issue date) for $500. At maturity of the bond, A exercised the option of retaining the matured series E bond for the 10-year extended maturity period. On June 2, 1961, A redeemed the series E bond, at which time the stated redemption value was $674.60. A never elected under section 454(a) to include the annual increase in redemption price in gross income currently. Under section 454(c), A is required to include $299.60 ($674.60 less $375) in gross income for 1961 by reason of his redemption of the bond.

Example (2). The facts are the same as in example (2) in paragraph (a)(4) of this section. On redemption of the series H bond received in the exchange qualifying under section 1037(a), B realizes a gain of $2,260, determined as provided in example (5) in paragraph (b)(4) of § 1.1037–1. None of this amount is includible in B's gross income for 1975, such amount having already been includible in his gross income for 1966 because of his election under section 454(a).

Example (3). C, who had elected under section 454(a) to include the annual increase in the redemption price of his non-interest-bearing obligations in gross income currently, owned a $1,000 series E U.S. savings bond, which was purchased on October 1, 1949, for $750, C died on February 1, 1955, when the redemption value of the bond was $820. The bond was immediately reissued to D, his only heir, who has not made an election under section 454(a). On January 15, 1960, when the redemption value of the bond is $1,000, D surrenders it to the United States in exchange solely for a $1,000 series H U.S. savings bond in an exchange qualifying under the provisions of section 1037(a). For 1960 D properly does not return any income from the exchange of bonds, although he returns the interest payments on the series H bond for the taxable years in which they are received. On September 1, 1964, prior to maturity of the series H bond, D redeems it for $1,000. For 1964, D must include $180 in gross income under section 454(c) from the redemption of the series H bond, that is, the amount of the increase in the redemption price of the series E bond ($1,000 less $820) occurring between February 1, 1955, and January 15, 1960, the period during which he owned the series E bond.

[T.D. 6500, 25 FR 11719, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15820, Nov. 17, 1967; T.D. 7154, 36 FR 24997, Dec. 28, 1971]

§ 1.455–1 Treatment of prepaid subscription income.

Effective with respect to taxable years beginning after December 31, 1957, section 455 permits certain taxpayers to elect with respect to a trade or business in connection with which prepaid subscription income is received, to include such income in gross income for the taxable years during which a liability exists to furnish or deliver a newspaper, magazine, or other periodical. If a taxpayer does not elect to treat prepaid subscription income under the provisions of section 455, such income is includible in gross income for the taxable year in which received by the taxpayer, unless under the method or practice of accounting used in computing taxable income such amount is to be properly accounted for as of a different period.

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–2 Scope of election under section 455.

(a) If a taxpayer makes an election under section 455 and § 1.455–6 with respect to a trade or business, all prepaid subscription income from such trade or business shall be included in gross income for the taxable years during which the liability exists to furnish or deliver a newspaper,

magazine, or other periodical. Such election shall be applicable to all prepaid subscription income received in connection with the trade or business for which the election is made; except that the taxpayer may further elect to include in gross income for the taxable year of receipt (as described in section 455(d)(3) and paragraph (c) of § 1.455–5) the entire amount of any prepaid subscription income if the liability from which it arose is to end within 12 months after the date of receipt, hereinafter sometimes referred to as "within 12 months" election.

(b) If the taxpayer is engaged in more than one trade or business in which a liability is incurred to furnish or deliver a newspaper, magazine, or other periodical, a separate election 455 with respect to each such trade or business. In addition, a taxpayer may make a separate "within 12 months" election for each separate trade or business for which it has made an election under section 455.

(c) An election made under section 455 shall be binding for the first taxable year for which the election is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Commissioner to the revocation of such election. Thus, in any case where the taxpayer has elected a method prescribed by section 455 for the inclusion of prepaid subscription income in gross income, such method of reporting income may not be changed without the prior approval of the Commissioner. In order to secure the Commissioner's consent to the revocation of such election, an application must be filed with the Commissioner in accordance with section 446(e) and the regulations thereunder. For purposes of subtitle A of the Code, the computation of taxable income under an election made under section 455 shall be treated as a method of accounting. For adjustments required by changes in method of accounting, see section 481 and the regulations thereunder.

(d) An election made under section 455 shall not apply to any prepaid subscription income received before the first taxable year to which the election applies. For example, Corporation M, which computes its taxable income under an accrual method of accounting and files its income tax returns on the calendar year basis, publishes a monthly magazine and customarily sells subscriptions on a 3-year basis. In 1958 it received $135,000 of 3-year prepaid subscription income for subscriptions beginning during 1958, and in 1959 it received $142,000 of prepaid subscription income for subscriptions beginning after December 31, 1958. In February 1959 it elected, with the consent of the Commissioner, to report its prepaid subscription income under the provisions of section 455 for the year 1959 and subsequent taxable years. The $135,000 received in 1958 from prepaid subscriptions must be included in gross income in full in that year, and no part of such 1958 income shall be allocated to the years 1959, 1960, and 1961 during which M was under a liability to deliver its magazine. The $142,000 received in 1959 from prepaid subscriptions shall be allocated to the years 1959, 1960, 1961, and 1962.

(e) No election may be made under section 455 with respect to a trade or business if, in computing taxable income, the cash receipts and disbursements method of accounting is used with respect to such trade or business. However, if the taxpayer is on a "combination" method of accounting under section 446(c)(4) and the regulations thereunder, it may elect the benefits of section 455 if it uses an accrual method of accounting for subscription income.

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–3 Method of allocation.

(a) Prepaid subscription income to which section 455 applies shall be included in gross income for the taxable years during which the liability to which the income relates is discharged or is deemed to be discharged on the basis of the taxpayer's experience.

(b) For purposes of determining the period or periods over which the liability of the taxpayer extends, and for purposes of allocating prepaid subscription income to such periods, the taxpayer may aggregate similar transactions during the taxable year in any reasonable manner, provided the method of aggregation and allocation is consistently followed.

[T.D. 6591, 27 FR 1798, Feb. 27, 1962]

§ 1.455–4 Cessation of taxpayer's liability.

(a) If a taxpayer has elected to apply the provisions of section 455 to a trade or business in connection with which prepaid subscription income is received, and if its liability to furnish or deliver a newspaper, magazine, or other periodical ends for any reason, then so much of the prepaid subscription income attributable to such liability as was not includible in its gross income under section 455 for preceding taxable years shall be included in its gross income for the taxable year in which such liability ends. A taxpayer's liability may end, for example, because of the cancellation

of a subscription. See section 381(c)(4) and the regulations thereunder for the treatment of prepaid subscription income in a transaction to which section 381(a) applies.

(b) If a taxpayer who has elected to apply the provisions of section 455 to a trade or business dies or ceases to exist, then so much of the prepaid subscription income attributable to such trade or business which was not includible in its gross income under section 455 for preceding taxable years shall be included in its gross income for the taxable year in which such death or cessation of existence occurs. See section 381(c)(4) and the regulations thereunder for the treatment of prepaid subscription income in a transaction to which section 381(a) applies.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.455–5 Definitions and other rules.

(a) Prepaid subscription income. **(1)** The term "prepaid subscription income" means any amount includible in gross income which is received in connection with, and is directly attributable to, a liability of the taxpayer which extends beyond the close of the taxable year in which such amount is received and which is income from a newspaper, magazine, or other periodical. For example where Corporation X, a publisher of newspapers, magazines, and other periodicals makes sales on a subscription basis and the purchaser pays the subscription price in advance, prepaid subscription income would include the amounts actually received by X in connection with its liability to furnish or deliver the newspaper, magazine, or other periodical.

(2) For purposes of section 455, prepaid subscription income does not include amounts received by a taxpayer in connection with sales of subscriptions on a prepaid basis where such taxpayer does not have the liability to furnish or deliver a newspaper, magazine, or other periodical. The provisions of this subparagraph may be illustrated by the following example. Corporation D has a contract with each of several large publishers which grants it the right to sell subscriptions to their periodicals. Corporation D collects the subscription price from the subscribers, retains a portion thereof as its commission and remits the balance to the publishers. The amount retained by Corporation D represents commissions on the sale of subscriptions, and is not prepaid subscription income for purposes of section 455 since the commissions represent compensation for services rendered and are not directly attributable to a liability of Corporation D to furnish or deliver a newspaper, magazine, or other periodical.

(b) Liability. The term "liability" means a liability of the taxpayer to furnish or deliver a newspaper, magazine, or other periodical.

(c) Receipt of prepaid subscription income. For purposes of section 455, prepaid subscription income shall be treated as received during the taxable year for which it is includible in gross income under section 451, relating to general rule for taxable year of inclusion, without regard to section 455.

(d) Treatment of prepaid subscription income under an established accounting method. Notwithstanding the provisions of section 455 and § 1.455–1, any taxpayer who, for taxable years beginning before January 1, 1958, has reported prepaid subscription income for income tax purposes under an established and consistent method or practice of deferring such income may continue to report such income in accordance with such method or practice for all subsequent taxable years to which section 455 applies without making an election under section 455.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.455–6 Time and manner of making election.

(a) Election without consent. **(1)** A taxpayer may, without consent, elect to treat prepaid subscription income of a trade or business under section 455 for the first taxable year—

(i) Which begins after December 31, 1957, and

(ii) In which there is received prepaid subscription income from the trade or business for which the election is made. Such an election shall be made not later than the time prescribed by law for filing the income tax return for such year (including extensions thereof), and shall be made by means of a statement attached to such return.

(2) The statement shall indicate that the taxpayer is electing to apply the provisions of section 455 to his trade or business, and shall contain the following information:

(i) The name and a description of the taxpayer's trade or business to which the election is to apply;

(ii) The method of accounting used in such trade or business;

(iii) The total amount of prepaid subscription income from such trade or business for the taxable year;

(iv) The period or periods over which the liability of the taxpayer to furnish or deliver a newspaper, magazine, or other periodical extends;

(v) The amount of prepaid subscription income applicable to each such period; and

(vi) A description of the method used in allocating the prepaid subscription income to each such period.

In any case in which prepaid subscription income is received from more than one trade or business, the statement shall set forth the required information with respect to each trade or business subject to the election.

(3) See paragraph (c) of this section for additional information required to be submitted with the statement if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid subscription income attributable to a liability which is to end within 12 months after the date of receipt.

(b) **Election with consent.** A taxpayer may, with the consent of the Commissioner, elect at any time to apply the provisions of section 455 to any trade or business in which it receives prepaid subscription income. The request for such consent shall be in writing, signed by the taxpayer or its authorized representative, and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R:C, Washington, D.C. 20224. The request must be filed on or before the later of the following dates: (1) 90 days after the beginning of the first taxable year to which the election is to apply or (2) May 28, 1962, and must contain the information described in paragraph (a)(2) of this section. See paragraph (c) of this section for additional information required to be submitted with the request if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid subscription income attributable to a liability which is to end within 12 months after the date of receipt.

(c) **"Within 12 months" election.** (1) A taxpayer who elects to apply the provisions of section 455 to any trade or business may also elect to include in gross income for the taxable year of receipt (as described in section 455(d)(3) and paragraph (c) of § 1.455–5) the entire amount of any prepaid subscription income from such trade or business if the liability from which it arose is to end within 12 months after the date of receipt. Any such election is binding for the first taxable year for which it is effective and for all subsequent taxable years, unless the taxpayer secures permission from the Commissioner to treat such income differently. Application to revoke or change a "within 12 months" election shall be made in accordance with the provisions of section 446(e) and the regulations thereunder.

(2) The "within 12 months" election shall be made by including in the statement required by paragraph (a) of this section or the request described in paragraph (b) of this section, whichever is applicable, a declaration that the taxpayer elects to include such income in gross income in the taxable year of receipt, and the amount of such income. If the taxpayer is engaged in more than one trade or business for which the election under section 455 is made, it must include, in such statement or request, a declaration for each trade or business for which it makes the "within 12 months" election. See also paragraph (e) of § 1.455–2.

(3) If the taxpayer does not make the "within 12 months" election for its trade or business at the time prescribed for making the election to include prepaid subscription income in gross income for the taxable years during which its liability to furnish or deliver a newspaper, magazine, or other periodical exists for such trade or business, but later wishes to make such election, it must apply for permission from the Commissioner. Such application shall be made in accordance with the provisions of section 446(e) and the regulations thereunder.

[T.D. 6591, 27 FR 1799, Feb. 27, 1962]

§ 1.456–1 Treatment of prepaid dues income.

Effective for taxable years beginning after December 31, 1960, a taxpayer which is a membership organization (as described in paragraph (c) of § 1.456–5) and which receives prepaid dues income as described in paragraph (a) of § 1.456–5 in connection with its trade or business of rendering services or making available membership privileges may elect under section 456 to include such income in gross income ratably over the taxable years during which its liability (as described in paragraph (b) of § 1.456–5) to render such services or extend such privileges exists, if such liability does not extend over a period of time in excess of 36 months. If the taxpayer does not elect to treat prepaid dues income under section 456, or if such income may not be reported under section 456, as for example, where the income relates to a liability to render services or make available membership privileges which extends beyond 36 months, then such income is includible in gross income for the

taxable year in which it is received (as described in paragraph (d) of § 1.456–5).

[T.D. 6937, 32 FR 16394, Nov. 30, 1967]

§ 1.456–2 Scope of election under section 456.

(a) An election made under section 456 and § 1.456–6, shall be applicable to all prepaid dues income received in connection with the trade or business for which the election is made. However, the taxpayer may further elect to include in gross income for the taxable year of receipt the entire amount of any prepaid dues income attributable to a liability extending beyond the close of the taxable year but ending within 12 months after the date of receipt, hereinafter referred to as the "within 12 months" election.

(b) If the taxpayer is engaged in more than one trade or business in connection with which prepaid dues income is received, a separate election may be made under section 456 with respect to each such trade or business. In addition, a taxpayer may make a separate "within 12 months" election for each separate trade or business for which it has made an election under section 456.

(c) A section 456 election and a "within 12 months" election shall be binding for the first taxable year for which the election is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Commissioner to the revocation of either election. In order to secure the Commissioner's consent to the revocation of the section 456 election or the "within 12 months" election, an application must be filed with the Commissioner in accordance with section 446(e) and the regulations thereunder. However, an application for consent to revoke the section 456 election or the "within 12 months" election in the case of all taxable years which end before November 30, 1967 must be filed on or before February 28, 1968. For purposes of Subtitle A of the Code, the computation of taxable income under an election made under section 456 or under the "within 12 months" election shall be treated as a method of accounting. For adjustments required by changes in method of accounting, see section 481 and the regulations thereunder.

(d) Except as provided in section 456(d) and § 1.456–7, an election made under section 456 shall not apply to any prepaid dues income received before the first taxable year to which the election applies. For example, Corporation X, a membership organization which files its income tax returns on a calendar year basis, customarily sells 3-year memberships, payable in advance. In 1961 it received $160,000 of prepaid dues income for 3-year memberships beginning during 1961, and in 1962 it received $185,000 of prepaid dues income for 3-year memberships beginning on January 1, 1962. In March 1962 it elected, with the consent of the Commissioner, to report its prepaid dues income under the provisions of section 456 for the year 1962 and subsequent taxable years. The $160,000 received in 1961 from prepaid dues must be included in gross income in full in that year, and except as provided in section 456(d) and § 1.456–7, no part of such income shall be allocated to the taxable years 1962, 1963, and 1964 during which X was under a liability to make available its membership privileges. The $185,000 received in 1962 from prepaid dues income shall be allocated to the years 1962, 1963, and 1964.

(e) No election may be made under section 456 with respect to a trade or business if, in computing taxable income, the cash receipts and disbursements method (or a hybrid thereof) of accounting is used with respect to such trade or business, unless the combination of the section 456 election and the taxpayer's hybrid method of accounting does not result in a material distortion of income.

[T.D. 6937, 32 FR 16394, Nov. 30, 1967; 32 FR 17479, Dec. 6, 1967]

§ 1.456–3 Method of allocation.

(a) Prepaid dues income for which an election has been made under section 456 shall be included in gross income over the period of time during which the liability to render services or make available membership privileges exists. The liability to render the services or make available the membership privileges shall be deemed to exist ratably over the period of time such services are required to be rendered, or such membership privileges are required to be made available. Thus, the prepaid dues income shall be included in gross income ratably over the period of the membership contract. For example, Corporation X, a membership organization, which files its income tax returns on a calendar year basis, elects, for its taxable year beginning January 1, 1961, to report its prepaid dues income in accordance with the provisions of section 456. On March 31, 1961, it sells a 2-year membership for $48 payable in advance, the membership to extend from May 1, 1961, to April 30, 1963. X shall include in its gross income for the taxable year 1961 $\frac{8}{24}$ of the $48, or $16, and for the taxable year 1962 $\frac{12}{24}$ of the $48, or $24, and for the taxable year 1963 $\frac{4}{24}$ of the $48, or $8.

(b) For purposes of determining the period or periods over which the liability of the taxpayer exists, and for purposes of allocating prepaid dues income to such periods, the taxpayer may aggregate similar transactions during the taxable year in any reasonable manner, provided the method of aggregation and allocation is consistently followed.
[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–4 Cessation of liability or existence.

(a) If a taxpayer has elected to apply the provisions of section 456 to a trade or business in connection with which prepaid dues income is received, and if the taxpayer's liability to render services or make available membership privileges ends for any reason, as for example, because of the cancellation of a membership then so much of the prepaid dues income attributable to such liability as was not includible in the taxpayer's gross income under section 456 for preceding taxable years shall be included in gross income for the taxable year in which such liability ends. This paragraph shall not apply to amounts includible in gross income under § 1.456–7.

(b) If a taxpayer which has elected to apply the provisions of section 456 ceases to exist, then the prepaid dues income which was not includible in gross income under section 456 for preceding taxable years shall be included in the taxpayer's gross income for the taxable year in which such cessation of existence occurs. This paragraph shall not apply to amounts includible in gross income under § 1.456–7.

(c) If a taxpayer is a party to a transaction to which section 381(a) applies and the taxpayer's method of accounting with respect to prepaid dues income is used by the acquiring corporation under the provisions of section 381(c)(4), then neither the liability nor the existence of the taxpayer shall be deemed to have ended or ceased. In such cases see section 381(c)(4) and the regulations thereunder for the treatment of the portion of prepaid dues income which was not included in gross income under section 456 for preceding taxable years.
[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–5 Definitions and other rules.

(a) **Prepaid dues income.** (1) The term "prepaid dues income" means any amount for membership dues includible in gross income which is received by a membership organization in connection with, and is directly attributable to, a liability of the taxpayer to render services or make available membership privileges over a period of time which extends beyond the close of the taxable year in which such amount is received.

(2) For purposes of section 456, prepaid dues income does not include amounts received by a taxpayer in connection with sales of memberships on a prepaid basis where the taxpayer does not have the liability to furnish the services or make available the membership privileges. For example, where a taxpayer has a contract with several membership organizations to sell memberships in such organizations and retains a portion of the amounts received from the sale of such memberships and remits the balance to the membership organizations, the amounts retained by such taxpayer represent commissions and do not constitute prepaid dues income for purposes of section 456.

(b) **Liability.** The term "liability" means a liability of the taxpayer to render services or make available membership privileges over a period of time which does not exceed 36 months. Thus, if during the taxable year a taxpayer sells memberships for more than 36 months and also memberships for 36 months or less, section 456 does not apply to the income from the sale of memberships for more than 36 months. For the purpose of determining the duration of a liability, a bona fide renewal of a membership shall not be considered to be a part of the existing membership.

(c) **Membership organization.** (1) The term "membership organization" means a corporation, association, federation, or other similar organization meeting the following requirements:

(i) It is organized without capital stock of any kind.

(ii) Its charter, bylaws, or other written agreement or contract expressly prohibits the distribution of any part of the net earnings directly or indirectly, in money, property, or services, to any member, and

(iii) No part of the net earnings of which is in fact distributed to any member either directly or indirectly, in money, property, or services.

(2) For purposes of this paragraph an increase in services or reduction in dues to all members shall generally not be considered distributions of net earnings.

(3) If a corporation, association, federation, or other similar organization subsequent to the time it elects to report its prepaid dues income in accordance with the provisions of section 456, (i)

issues any kind of capital stock either to any member or nonmember, (ii) amends its charter, bylaws, or other written agreement or contract to permit distributions of its net earnings to any member or, (iii) in fact, distributes any part of its net earnings either in money, property, or services to any member, then immediately after such event the organization shall not be considered a membership organization within the meaning of section 456(e)(3).

(d) Receipt of prepaid dues income. For purposes of section 456, prepaid dues income shall be treated as received during the taxable year for which it is includible in gross income under section 451, relating to the general rule for taxable year of inclusion, without regard to section 456.
[T.D. 6937, 32 FR 16395, Nov. 30, 1967]

§ 1.456–6 Time and manner of making election.

(a) Election without consent. A taxpayer may make an election under section 456 without the consent of the Commissioner for the first taxable year beginning after December 31, 1960, in which it receives prepaid dues income in the trade or business for which such election is made. The election must be made not later than the time prescribed by law for filing the income tax return for such year (including extensions thereof). The election must be made by means of a statement attached to such return. In addition, there should be attached a copy of a typical membership contract used by the organization and a copy of its charter, bylaws, or other written agreement or contract of organization or association. The statement shall indicate that the taxpayer is electing to apply the provisions of section 456 to the trade or business, and shall contain the following information:

(1) The taxpayer's name and a description of the trade or business to which the election is to apply.

(2) The method of accounting used for prepaid dues income in the trade or business during the first taxable year for which the election is to be effective and during each of 3 preceding taxable years, and if there was a change in the method of accounting for prepaid dues income during such 3-year period, a detailed explanation of such change including the adjustments necessary to prevent duplications or omissions of income.

(3) Whether any type of deferral method for prepaid dues income has been used during any of the 3 taxable years preceding the first taxable year for which the election is effective. Where any type of such deferral method has been used during this period, an explanation of the method and a schedule showing the amounts received in each such year and the amounts deferred to each succeeding year.

(4) A schedule with appropriate explanations showing:

(i) The total amount of prepaid dues income received in the trade or business in the first taxable year for which the election is effective and the amount of such income to be included in each taxable year in accordance with the election,

(ii) The total amount, if any, of prepayments of dues received in the first taxable year for which the election is effective which are directly attributable to a liability of the taxpayer to render services or make available membership privileges over a period of time in excess of 36 months, and

(iii) The total amount, if any, of prepaid dues income received in the trade or business in—

(a) The taxable year preceding the first taxable year for which the election is effective if all memberships sold by the taxpayer are for periods of 1 year or less,

(b) Each of the 2 taxable years preceding the first taxable year for which the election is effective if any memberships are sold for periods in excess of 1 year but none are sold for periods in excess of 2 years, or

(c) Each of the 3 taxable years preceding the first taxable year for which the election is effective if any memberships are sold for periods in excess of 2 years.

In each case there shall be set forth the amount of such income which would have been includible in each taxable year had the election been effective for the years for which the information is required.

In any case in which prepaid dues income is received from more than one trade or business, the statement shall set forth separately the required information with respect to each trade or business for which the election is made. See paragraph (c) of this section for additional information required to be submitted with the statement if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid dues income attributable to a liability which is to end within 12 months after the date of receipt.

(b) Election with consent. A taxpayer may elect with the consent of the Commissioner, to apply the provisions of section 456 to any trade or business in which it receives prepaid dues income. The request for such consent shall be in writing, signed by the taxpayer or its authorized representative, and shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224. The request must be filed on or before the later of the following dates: (1) 90 days after the beginning of the first taxable year to which the election is to apply, or (2) February 28, 1968 and should contain the information described in paragraph (a) of this section. See paragraph (c) of this section for additional information required to be submitted with the request if the taxpayer also elects to include in gross income for the taxable year of receipt the entire amount of prepaid dues income attributable to a liability which is to end within 12 months after the date of receipt.

(c) "Within 12 months" election. **(1)** The "within 12 months" election shall be made by including in the statement required by paragraph (a) of this section or the request described in paragraph (b) of this section, whichever is applicable, a declaration that the taxpayer elects to include such income in gross income in the taxable year of receipt, and the amount of such income for each taxable year to which the election is to apply which has ended prior to the time such statement or request is filed. If the taxpayer is engaged in more than one trade or business for which the election under section 456 is made, it must include, in such statement or request, a declaration for each trade or business for which it wishes to make the "within 12 months" election.

(2) If the taxpayer does not make the "within 12 months" election for a trade or business at the time it makes the election under paragraph (a) or (b) of this section, but later wishes to make such election, it must apply for permission from the Commissioner. Such application shall be made in accordance with the provisions of section 446(e).

[T.D. 6937, 32 FR 16395, Nov. 30, 1967; 32 FR 17479, Dec. 6, 1967]

§ 1.456–7 Transitional rule.

(a) Under section 456(d)(1), a taxpayer making an election under section 456 shall include in its gross income for the first taxable year to which the election applies and for each of the 2 succeeding taxable years not only that portion of prepaid dues income which is includible in gross income for each such taxable year under section 456(a), but also an additional amount equal to that portion of the total prepaid dues income received in each of the 3 taxable years preceding the first taxable year to which the election applies which would have been includible in gross income for such first taxable year and such 2 succeeding taxable years had the election under section 456 been effective during such 3 preceding taxable years. In computing such additional amounts—

(1) In the case of taxpayers who did not include in gross income for the taxable year preceding the first taxable year for which the election is effective, that portion of the prepaid dues income received in such year attributable to a liability which is to end within 12 months after the date of receipt, no effect shall be given to a "within 12 months" election made under paragraph (c) of § 1.456–6, and

(2) There shall be taken into account only prepaid dues income arising from a trade or business with respect to which an election is made under section 456 and § 1.456–6.

Section 481 and the regulations thereunder shall have no application to the additional amounts includible in gross income under section 456(d) and this section, but section 481 and the regulations thereunder shall apply to prevent other amounts from being duplicated or omitted.

(b) A taxpayer who makes an election with respect to prepaid dues income, and who includes in gross income for any taxable year to which the election applies an additional amount computed under section 456(d)(1) and paragraph (a) of this section, shall be permitted under section 456(d)(2) to deduct for such taxable year and for each of the 4 succeeding taxable years an amount equal to one-fifth of such additional amount, but only to the extent that such additional amount was also included in the taxpayer's gross income for any of the 3 taxable years preceding the first taxable year to which such election applies. The taxpayer shall maintain books and records in sufficient detail to enable the district director to determine upon audit that the additional amounts were included in the taxpayer's gross income for any of the 3 taxable years preceding such first taxable year. If, however, the taxpayer ceases to exist, as described in paragraph (b) of § 1.456–4, and there is included in gross income, under such paragraph, of the year of cessation the entire portion of prepaid dues income not previously includible in gross income under section 456 for preceding taxable years (other than for amounts received prior to the first year for which an election was made), all the amounts not previously deducted under this paragraph shall

be permitted as a deduction in the year of cessation of existence.

(c) The provisions of this section may be illustrated by the following example:

Example. (1) Assume that X Corporation, a membership organization qualified to make the election under section 456, elects to report its prepaid dues income in accordance with the provisions of section 456 for its taxable year ending December 31, 1961. Assume further that X Corporation receives in the middle of each taxable year $3,000 of prepaid dues income in connection with a liability to render services over a 3-year period beginning with the date of receipt. Under section 456(a), X Corporation will report income received in 1961 and subsequent years as follows:

Year of receipt	Total receipts	1961	1962	1963	1964	1965	1966	1967	1968
1961	$3,000	$500	$1,000	$1,000	$500	.....	.....	.....	.....
1962	3,000	.....	500	1,000	1,000	$500	.....	.....	.....
1963	3,000	.....	.....	500	1,000	1,000	$500	.....	.....
1964	3,000	.....	.....	.....	500	1,000	1,000	$500	.....
1965	3,000	.....	.....	.....	.....	500	1,000	1,000	$500
1966	3,000	.....	.....	.....	.....	.....	500	1,000	1,000
1967	3,000	.....	.....	.....	.....	.....	.....	500	1,000
1968	3,000	.....	.....	.....	.....	.....	.....	.....	500
Total reportable under section 456(a)		500	1,500	2,500	3,000	3,000	3,000	3,000	3,000

(2) Under section 456(d)(1), X Corporation must include in its gross income for the first taxable year to which the election applies and for each of the 2 succeeding taxable years, the amounts which would have been included in those years had the election been effective 3 years earlier. If the election had been effective in 1958, the following amounts received in 1958, 1959, and 1960 would have been reported in 1961 and subsequent years:

Year of receipt	Amount received	Years of including additional amounts		
		1961	1962	1963
1958	$3,000	$500	......	......
1959	3,000	1,000	$500	......
1960	3,000	1,000	1,000	$500
Total additional amounts to be included under section 456(d)(1)	2,500	1,500	500	

(3) Having included the additional amounts as required by section 456(d)(1), and assuming such amounts were actually included in gross income in the 3 taxable years preceding the first taxable year for which the election is effective, X Corporation is entitled to deduct under section 456(d)(2) in the year of inclusion and in each of the succeeding 4 years an amount equal to one-fifth of the amounts included, as follows:

Year of inclusion	Amount	Years of deduction						
		1961	1962	1963	1964	1965	1966	1967
1961	$2,500	$500	$500	$500	$500	$500	....	....
1962	1,500	....	300	300	300	300	$300	....
1963	500	....	....	100	100	100	100	$10
Total amount deductible under section 456(d)(2)	500	800	900	900	900	400	100	

(4) The net result of the inclusions under section 456(d)(1) and the deductions under section 456(d)(2) may be summarized as follows:

	1961	1962	1963	1964	1965	1966	1967	1968
Amount includible under section 456(a)	$500	$1,500	$2,500	$3,000	$3,000	$3,000	$3,000	$3,000
Amount includible under section 456(d)(1)	2,500	1,500	500	......	......	......	......	......
Total	3,000	3,000	3,000	3,000	3,000	3,000	3,000	3,000
Amount deductible under section 456(d)(2)	500	800	900	900	900	400	100	......
Net amount reportable under section 456	2,500	2,200	2,100	2,100	2,100	2,600	2,900	3,000

[T.D. 6937, 32 FR 16396, Nov. 30, 1967]

§ 1.457–1 Compensation deferred under eligible State deferred compensation plans.

(a) Year of inclusion in gross income—(1) In general. For taxable years beginning after December 31, 1978, section 457(a) provides that amounts deferred (within the meaning of § 1.457–1(d)(3)) under an eligible State deferred compensation plan that satisfies the requirements of § 1.457–2 (an "eligible plan") are includible in gross income only for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan.

(2) Maximum deferral; in general. Under section 457(c)(1), the exclusion from gross income described in this paragraph (a) does not apply to compensation deferred under one or more eligible plans to the extent that the compensation so deferred during a participant's taxable year exceeds the greater of—

(i) $7,500, or,

(ii) As applicable, the sum of the plan ceilings determined under § 1.457–2(f), to the extent such sum does not exceed $15,000.

(3) Maximum deferral; exclusions under section 403(b) taken into account. Under section 457(c)(2), for a participant's taxable year for which an amount is contributed to an annuity contract described in section 403(b) (including a custodial account described in section 403(b)(7)) on behalf of the participant, subparagraph (2) of this paragraph (a) is applied by substituting—

(i) For $7,500, an amount equal to $7,500, less the amount excludable from the participant's gross income under section 403(b) for the taxable year,

(ii) For the sum of the plan ceilings determined under § 1.457–2(f), an amount equal to the sum of the plan ceilings determined under § 1.457–2(f), less the amount excludable from the participant's gross income under section 403(b) for the taxable year, if such amount is not taken into account under such § 1.457–2(f), and

(iii) For $15,000, an amount equal to $15,000, less the amount excludable from the participant's gross income under section 403(b) for the taxable year.

(b) Amounts made available to participant or beneficiary—(1) In general. For purposes of section 457(a) and this section, amounts deferred under an eligible plan will not be considered made available to the participant or beneficiary if under the plan the participant or beneficiary may irrevocably elect, prior to the time any such amounts become payable, to defer payment of some or all of such amounts to a fixed or determinable future time. In addition, amounts deferred (including amounts previously deferred) under an eligible plan will not be considered made available to the participant solely because the participant is permitted to choose among various investment modes under the plan for the investment of such amounts whether before or after payments have commenced under the plan.

(2) Examples. Further examples of when amounts deferred will or will not be considered as being made available to the participant or beneficiary are provided below:

Example (1). (i) C, an individual, is a participant in an eligible State deferred compensation plan that provides the following:

(A) The total of the amounts deferred under the plan is payable to the participant in 120 substantially equal monthly installments commencing on the date 30 days after the participant attains normal retirement age under the plan (age 65), unless the participant elects, within the 90 day period ending on the date the participant attains normal retirement age, to receive a single sum payment of the deferred amounts. The single sum payment is payable to a participant on the date the first of the monthly payment would otherwise be payable to the participant.

(B) If a participant separates from the service of the State before attaining normal retirement age, the total of the amounts deferred under the plan is payable to the participant in a single sum payment on the date 90 days after the date of the separation, unless, before the date 30 days after the separation, the participant elects not to receive the single sum payment. The election is irrevocable. If the participant makes the election, the total of the amounts deferred under the plan is payable to the participant as described in (A), either in monthly installments or, at the election of the participant, in a single sum payment.

(ii) On June 6, 1982, C, a calendar year taxpayer aged 59, separates from the service of the State. On June 18, 1982, C elects not to receive the single sum payment payable on account of the separation. Because of C's election, no amount deferred under the plan is considered made available in 1982 by reason of C's right to receive the single sum payment.

(iii) On February 6, 1988, C attains age 65. C did not, within the 90 day period elect the single sum payment that is payable in lieu of the monthly installments. Amounts deferred under the plan are includible in C's gross income as they are paid to C in the monthly installments. No amount is considered made available by reason of C's right to elect the single sum payment.

Example (2). Assume the same facts as in example (1), except that the plan provides that notwithstanding that monthly installments have commenced under the plan, as described in (i)(A), the participant may, without restriction, elect to receive all or any portion of the amount remaining payable to the participant. The total of the amounts deferred under the plan is considered made available in 1988.

Example (3). Assume the same facts as in example (1), except that the plan provides that once monthly installment payments have commenced under the plan, as described in

(i)(A), the participant may accelerate the payment of the amount remaining payable to the participant upon the occurrence of an unforeseeable emergency as described in § 1.457–2(h)(4) in an amount not exceeding that described in § 1.457–2(h)(5). No amount is considered made available to C on account of C's right to accelerate payments upon the occurrence of an unforeseeable emergency.

Example (4). Under an eligible plan of which individual D is a participant, normal retirement age is age 65 at which time payments must begin. Payments may begin earlier upon a separation from the service. Under the plan, a participant who separates from the service before age 65 or the participant's beneficiary (if the separation is due to the participant's death) may elect to defer the distribution of the amounts deferred until the year in which the participant attains or would have attained age 65. This election may be made only prior to the time any payments commence and once made may not be revoked. If such an election is made, the participant, former participant, or beneficiary need not elect the method of payment, or if one is elected may change the method elected, until the date 30 days preceding the date upon which payments are to commence. No amount is considered made available by reason of D's right to defer the distribution of the amounts deferred until age 65, nor on account of D's right to delay the election of the method of payout. Similarly, if D dies at age 60, no amount is considered made available to D's beneficiary by reason of the beneficiary's right to defer the distribution of the amounts deferred until the year in which D would have attained age 65, nor on account of the beneficiary's right to delay the election of the method of payout.

Example (5). Under an eligible plan of which individual E is a participant, the maximum that may be deferred in any taxable year is 33⅓% of includible compensation, not to exceed $7,500. The plan does not provide for a catch-up deferral under section 457(b)(3). In one taxable year, E elects to have amounts deferred in excess of the limitation provided for under the plan. The amounts deferred in excess of the limitation will be considered to have been made available to E in the taxable year in which deferred.

Example (6). Assume the same facts as in example (5), except that E's employer also contributes amounts for the purchase of an annuity contract under section 403(b). In one taxable year, E has amounts contributed for the annuity within the limitations of section 403(b)(2), and also has amounts deferred under the eligible plan for the same year. The aggregate of the amounts contributed for the annuity contract and the amounts deferred under the plan exceed the deferral limitations under the plan. The excess deferrals will be considered made available to E in the year in which the amounts were deferred.

Example (7). Under an eligible plan of which F is a participant, amounts deferred have been invested in a money market investment fund. The plan then transfers the amounts deferred to a life insurance company for the purchase of life insurance contracts as an investment medium. However, the entity sponsoring the plan (1) retains all of the incidents of ownership of the contracts, (2) is the sole beneficiary under the contracts, and (3) is under no obligation to transfer the contracts or to pass through the proceeds of the contracts to any participant or a beneficiary of any participant. The movement of the amounts deferred to the life insurance company (whether or not made at the request of any plan participant) will not be considered to make the amounts available to the plan's participants. The cost of current life insurance protection under the life insurance contracts will not be considered made available to the plan's participants.

(c) Life insurance proceeds and death benefits paid under eligible plan. No amount received or made available under an eligible plan is excludable from gross income under section 101(a) (relating to life insurance contracts) or section 101(b) (relating to employees' death benefits).

(d) Definitions. For purposes of §§ 1.457–1 through 1.457–4:

(1) Participant. "Participant" means an individual who is eligible under § 1.457–2(d) to defer compensation under the plan.

(2) Beneficiary. "Beneficiary" means a beneficiary of a participant, a participant's estate, or any other person whose interest in the plan is derived from the participant.

(3) Amounts deferred. "Amount(s) deferred" under an eligible plan means compensation deferred under the plan, plus income attributable to compensation so deferred. Income attributable to compensation deferred under an eligible plan includes gain from the disposition of property. The term "amounts deferred" includes amounts deferred in taxable years beginning before January 1, 1979, if such amounts were deferred under a plan described in § 1.457–2(b), and such amounts were made a part of an eligible plan.

[T.D. 7836, 47 FR 42337, Sept. 27, 1982]

§ 1.457–2 Eligible State deferred compensation plan defined.

(a) In general. For purposes of §§ 1.457–1 through 1.457–4, an "eligible State deferred compensation plan" (sometimes referred to as "eligible plan") is a plan satisfying the requirements of paragraphs (c) through (k) of this section.

(b) Plan. For purposes of this section and § 1.457–3, the term "plan" includes any agreement or arrangement between a State (within the meaning of paragraph (c) of this section) and a participant or participants, under which the payment of compensation is deferred, but only if such agreement or arrangement is not described in § 1.457–3(b).

(c) State. The plan must be established and maintained by a State. For this purpose, the term "State" includes:

(1) The 50 states of the United States and the District of Columbia;

(2) A political subdivision of a State;

(3) Any agency or instrumentality of a State or political subdivision of a State;

(4) An organization that is exempt from tax under section 501(a) and engaged primarily in providing electrical service on a mutual or cooperative basis; and

(5) An organization that is described in section 501(c)(4) or (6) and exempt from tax under section 501(a) and at least 80% of the members of which are organizations described in subparagraph (4). Where it appears in this § 1.457–2, the term "State" means the entity described in this paragraph (c) that sponsors the plan.

(d) **Participants.** The plan must provide that only individuals who perform services for the State, either as an employee of the State or as an independent contractor, may defer compensation under the plan.

(e) **Maximum deferrals—(1) In general.** The plan must provide that the amount of compensation that may be deferred under the plan for a taxable year of a participant shall not exceed an amount specified in the plan (the "plan ceiling"). Except as described in paragraph (f) of this section, a plan ceiling shall not exceed the lesser of:

(i) $7,500, or

(ii) 33⅓% of the participant's includible compensation for the taxable year, reduced by any amount excludable from the participant's gross income for the taxable year under section 403(b) on account of contributions made by the State.

(2) **Includible compensation.** For purposes of this section, a participant's includible compensation for a taxable year includes only compensation from the State that is attributable to services performed for the State and that is includible in the participant's gross income for the taxable year. Accordingly, a participant's includible compensation for a taxable year does not include an amount payable by the State that is excludable from the employee's gross income under section 457(a) and § 1.457–1 or under section 403(b) (relating to annuity contracts purchased by section 501(c)(3) organizations or public schools), section 105(d) (relating to wage continuation plans) or section 911 (relating to citizens or residents of the United States living abroad). A participant's includible compensation for a taxable year is determined without regard to any community property laws.

(3) **Compensation taken into account at its present value.** For purposes of subparagraph (1) of this paragraph, compensation deferred under a plan shall be taken into account at its value in the plan year in which deferred. However, if the compensation deferred is subject to a substantial risk of forfeiture (as defined in section 457(e)(3)), such compensation shall be taken into account at its value in the plan year in which such compensation is no longer subject to a substantial risk of forfeiture.

(f) **Limited catch-up—(1) In general.** The plan may provide that, for 1 or more of the participant's last 3 taxable years ending before the participant attains normal retirement age, the plan ceiling is an amount not in excess of the lesser of:

(i) $15,000, reduced by any amount excludable from the participant's gross income for the taxable year under section 403(b) on account of contributions made by the State, or

(ii) The amount determined under subparagraph (2) of this paragraph.

(2) **Underutilized limitations.** The amount determined under this subparagraph (2) is the sum of:

(i) The plan ceiling established under paragraph (e)(1) of this section for the taxable year, plus

(ii) The plan ceiling established under paragraph (e)(1) of this section for any prior taxable year or years, less the amount of compensation deferred under the plan for such prior taxable year or years.

A prior taxable year shall be taken into account under subdivision (ii) of this subparagraph (2) only if (A) it begins after December 31, 1978, (B) the participant was eligible to participate in the plan during all or any portion of the taxable year, and (C) compensation deferred (if any) under the plan during the taxable year was subject to a plan ceiling established under paragraph (e)(1) of this section. A participant will be considered eligible to participate in the plan for a taxable year if the participant is described in paragraph (d) of this section for any part of that taxable year. A prior taxable year includes a taxable year in which the participant was eligible to participate in an eligible plan sponsored by a different entity, provided that the entities sponsoring the plans are located within the same State as that term is used in § 1.457–2(c)(1).

(3) **Restriction on limited catch-up.** The plan shall not provide that a participant may elect to have the limited catch-up provision of this paragraph (f) apply more than once, whether or not the limited catch-up is utilized in less than all of the three taxable years ending before the participant attains normal retirement age, and whether or not the participant or former participant rejoins

the plan or participates in another eligible plan after retirement. For example, if the participant elects to utilize the limited catch-up only for the one taxable year ending before normal retirement age, and, after retirement at that age, the participant renders services for the State as an independent contractor or otherwise, the plan may not provide that the participant may utilize the limited catch-up for any of the taxable years subsequent to retirement.

(4) Normal retirement age. For purposes of this paragraph (f), normal retirement age may be specified in the plan. If no normal retirement age is specified in the plan, then the normal retirement age is the later of the latest normal retirement age specified in the basic pension plan of the State, or age 65. A plan may define normal retirement age as any range of ages ending no later than age 70½ and beginning no earlier than the earliest age at which the participant has the right to retire under the State's basic pension plan without consent of the State and to receive immediate retirement benefits without actuarial or similar reduction because of retirement before some later specified age in the State's basic pension plan. The plan may further provide that in the case of a participant who continues to work beyond the ages specified in the preceding two sentences, the normal retirement age shall be that date or age designated by the participant, but such date or age shall not be later than the mandatory retirement age provided by the State, or the date or age at which the participant separates from the service with the State.

(g) Agreement for deferral. The plan must provide that, in general, compensation is to be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the first day of the month. However, a plan may provide that, with respect to a new employee, compensation is to be deferred for the calendar month during which the participant first becomes an employee, if an agreement providing for such deferral is entered into on or before the first day on which the participant becomes an employee.

(h) Payments under the plan—(1) In general. The plan may not provide that amounts payable under the plan will be paid or made available to a participant or beneficiary before the participant separates from service with the State, or, if the plan provides for payment in the case of an unforeseeable emergency, before the participant incurs an unforeseeable emergency.

(2) Separation from service; general rule. An employee is separated from service with the State if there is a separation from the service within the meaning of section 402(e)(4)(A)(iii), relating to lump sum distributions, and on account of the participant's death or retirement.

(3) Separation from service; independent contractor—(i) In general. An independent contractor is considered separated from service with the State upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the State, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration will not constitute a good faith and complete termination of the contractual relationship if the State anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a State is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the State nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a State is considered to intend to again contract for the services provided under an expired contract, if the State's doing so is conditioned only upon the State's incurring a need for the services, or the availability of funds or both.

(ii) Special rule. Notwithstanding subdivision (i), if, with respect to amounts payable to a participant who is an independent contractor, a plan provides that—

(A) No amount shall be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the State (or, in the case of more than one contract, all such contracts expire), and

(B) No amount payable to the participant on that date shall be paid to the participant if, after the expiration of the contract (or contracts) and before that date, the participant performs services for the State as an independent contractor or an employee,

the plan is considered to satisfy the requirement described in subparagraph (1) that no amounts payable under the plan will be paid or made available to the participant before the participant separates from service with the State.

(4) Unforeseeable emergency. For purposes of this paragraph (h), an unforeseeable emergency is,

and if the plan provides for payment in the case of an unforeseeable emergency must be defined in the plan as, severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent (as defined in section 152(a)) of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The circumstances that will constitute an unforeseeable emergency will depend upon the facts of each case, but, in any case, payment may not be made to the extent that such hardship is or may be relieved—

(i) Through reimbursement or compensation by insurance or otherwise,

(ii) By liquidation of the participant's assets, to the extent the liquidation of such assets would not itself cause severe financial hardship, or

(iii) By cessation of deferrals under the plan.

Examples of what are not considered to be unforeseeable emergencies include the need to send a participant's child to college or the desire to purchase a home.

(5) Emergency withdrawals. Withdrawals of amounts because of an unforeseeable emergency must only be permitted to the extent reasonably needed to satisfy the emergency need.

(i) Distributions of deferrals—(1) Commencement of distributions. A plan is not an eligible plan unless under the plan the payment of amounts deferred will commence not later than the later of—

(i) 60 days after the close of the plan year in which the participant or former participant attains (or would have attained) normal retirement age (within the meaning of § 1.457–2(f)(4)), or

(ii) 60 days after the close of the plan year in which the participant separates from service (within the meaning of §§ 1.457–2(h)(2) and (3)) with the State.

A plan is not other than an eligible plan merely because, prior to October 27, 1982, the distribution of amounts deferred under the plan may commence no later than the close of the participant's taxable year in which the participant attains age 70½.

(2) Limitations on distributions. Distributions must be made primarily for the benefit of participants (or former participants). Thus, the schedule selected by the participant for payments of benefits under the plan must be such that benefits payable to a beneficiary are not more than incidental. For example, if provision is made for payment of a portion of the amounts deferred to a beneficiary, the amounts payable to the participant or former participant (as determined by use of the expected return multiples in § 1.72–9, or, in the case of payments under a contract issued by an insurance company, by use of the mortality tables of such company), must exceed one-half of the maximum that could have been payable to the participant if no provision were made for payment to a beneficiary.

(3) Distributions to beneficiaries. A plan is not an eligible plan unless the plan provides that, if the participant dies before the entire amount deferred is paid to the participant, the entire amount deferred (or the remaining part of such deferrals if payment thereof has commenced) must be paid to a beneficiary over—

(i) The life of the beneficiary (or any shorter period), if the beneficiary is the participant's surviving spouse, or

(ii) A period not in excess of 15 years, if the beneficiary is not the participant's surviving spouse.

(j) Administration of plan. A plan is not an eligible plan unless all amounts deferred under the plan, all property and rights to property (including rights as a beneficiary of a contract providing life insurance protection) purchased with the amounts, and all income attributable to the amounts, property, or rights to property, remain (until paid or made available to the participant or beneficiary under the plan) solely the property and rights of the State (without being restricted to the benefits under the plan) subject to the claims of the general creditors of the State only. However, nothing in this paragraph (j) prohibits a plan's permitting participants to direct, from among different modes under the plan, the investment of the above amounts (see § 1.457–1(b)).

(k) Plan-to-plan transfers. The plan may provide for the transfer of amounts deferred by a former participant to another eligible plan of which the former participant has become a participant if the following conditions are met—

(1) The entities sponsoring the plans are located within the same State (as that term is used in § 1.457–2(c)(1)),

(2) The plan receiving such amounts provides for the acceptance of the amounts, and

(3) The plan provides that if the participant separates from service in order to accept employment with another such entity, payout will not commence upon separation from service, regardless of any other provision of the plan, and amounts previously deferred will automatically be transferred.

(*l*) **Effect on plan when not administered in accordance with paragraphs (c) through (k).** A plan that is administered in a manner which is inconsistent with one or more of the requirements of paragraphs (c) through (k) of this section ceases to be an eligible plan on the first day of the first plan year beginning more than 180 days after the date of written notification by the Internal Revenue Service that the requirements are not satisfied, unless the inconsistency is corrected before the first day of that plan year.

(m) **Examples.** The provisions of this section may be illustrated by the following examples:

Example 1. A, born on June 1, 1917, is a participant in an eligible State deferred compensation plan providing a normal retirement age of 65. The plan provides limitations on deferrals up to the maximum permitted under § 1.457–2(e) and (f).

For 1979, A, who will be 62, is scheduled to receive a salary of $20,000 from the State. A desires to defer the maximum amount possible in 1979. The maximum amount that A may defer under the plan is the lesser of $7,500, or 33⅓% of A's includible compensation (generally the equivalent of 25 percent of gross compensation). Accordingly, the maximum that A may defer for 1979 is $5,000 [$5,000=$20,000×.25]. Although A's taxable year 1979 is one of A's last 3 taxable years before the year in which A attains normal retirement age under the plan, A is not able to utilize the catch-up provisions of § 1.457–2(f) in 1979 because only taxable years beginning after December 31, 1978, may be taken into account under those provisions.

Example 2. Assume the same facts as in example 1. In A's taxable year 1980, A receives a salary of $20,000, and elects to defer only $1,000 under the plan. In A's taxable year 1981, A again receives a salary of $20,000 and elects to defer the maximum amount permissible under the plan's catch-up provisions prescribed under § 1.457–2(f). The applicable limit on deferrals under the catch-up provision is the lesser of $15,000 or the sum of the normal plan ceiling for 1981, plus any under-utilized deferrals for any taxable year before 1981. Thus, the maximum amount that A may defer in 1981 is $9,000, the normal plan ceiling for 1981, $5,000, plus the under-utilized deferrals for 1980, $4,000.

Example 3. Assume the same facts as in examples 1 and 2. In A's taxable year 1982, the year in which A will attain age 65, normal retirement age under the plan, A desires to defer the maximum amount possible under the plan. For 1982 the normal limitations of § 1.457–2(e) are applicable, and the maximum amount that A may defer is $5,000, assuming that A's salary for 1982 was again $20,000. The plan's catch-up provisions prescribed under § 1.457–2(f) are not applicable because 1982 is not a year ending before the year in which A attains normal retirement age.

[T.D. 7836, 47 FR 42338, Sept. 27, 1982]

§ 1.457–3 Tax treatment of participants where plan is not an eligible plan.

(a) **In general.** If a State (within the meaning of § 1.457–2(c)) provides for a deferral of compensation (after the effective date described in paragraph (c)) under any agreement or arrangement described in § 1.457–2(b) that is not an eligible plan within the meaning of § 1.457–2—

(1) Compensation deferred under the agreement or arrangement shall be includible in the gross income of the participant of beneficiary for the first taxable year in which there is no substantial risk of forfeiture (within the meaning of section 457(e)(3)) of the rights to such compensation,

(2) Earnings credited on the compensation deferred under the agreement or arrangement shall be includible in the gross income of the participant or beneficiary only when paid or made available, provided that the interest of the participant or beneficiary in the assets (including amounts deferred under the plan) of the entity sponsoring the plan is not senior to the entity's general creditors, and

(3) Amounts paid or made available under the plan to a participant or beneficiary shall be taxable to the participant or beneficiary under section 72, relating to annuities.

(b) **Exceptions.** Paragraph (a) does not apply with respect to—

(1) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

(2) An annuity plan or contract described in section 403,

(3) A qualified bond purchase plan described in section 405(a),

(4) That portion of any plan which consists of a transfer of property described in section 83, and

(5) That portion of any plan which consists of a trust to which section 402(b) applies.

(c) **Effective date.** This section is effective for taxable years beginning after December 31, 1981. For rules applicable in taxable years beginning after December 31, 1978, and before January 1, 1982, see § 1.457–4.

[T.D. 7836, 47 FR 42341, Sept. 27, 1982; 47 FR 46497, Oct. 19, 1982]

§ 1.457–4 Transitional rules.

(a) In general. Subject to the limitations described in paragraphs (b) and (c) of this section, amounts deferred (within the meaning of § 1.457–1(d)(3)) in taxable years beginning after December 31, 1978, and before January 1, 1982 under a plan described in § 1.457–2(b) (including an eligible plan within the meaning of § 1.457–2, but not including a plan described in section 457(e)(2) and § 1.457–3(b)) shall be includible in gross income only for the taxable year in which paid or otherwise made available to the participant or other beneficiary.

(b) General limitation. Except as described in paragraph (c) of this section, and excluding amounts deferred in taxable years beginning before January 1, 1979, compensation deferred under one or more plans described in paragraph (a) of this section is excludable from a participant's gross income under this section for a taxable year only to the extent it does not exceed the lesser of—

(1) $7,500, or

(2) 33⅓% of the participant's includible compensation (within the meaning of § 1.457–2(e)(2)) for the taxable year, reduced by any amount excludable from the participant's gross income for the taxable year under section 403(b) on account of contributions made by the State (within the meaning of § 1.457–2(c)). For purposes of this paragraph, compensation deferred under a plan shall be taken into account at its value in the plan year in which deferred. However, if the compensation deferred is subject to a substantial risk of forfeiture (as defined in section 457(e)(3)), such compensation shall be taken into account at its value in the plan year in which such compensation is no longer subject to a substantial risk of forfeiture.

(c) Limited catch-up. This paragraph (c) applies if all plans described in paragraph (a) of this section in which an individual is a participant are eligible plans within the meaning of § 1.457–2, and the participant's taxable year is a taxable year described in section 457(b)(3) and § 1.457–2(f). In such a case, compensation deferred under the plans for the taxable year is excluded from gross income under paragraph (a) of this section to the extent it does not exceed the amount determined under § 1.457–1(a)(2) or, as applicable, § 1.457–1(a)(3).

(d) Example. The provisions of this section may be illustrated by the following example:

Example. A is a participant in a State deferred compensation plan that is not an eligible plan within the meaning of § 1.457–2. The plan provides no limitations on the amount of compensation that may be deferred during any taxable year. For the taxable years 1979, 1980, and 1981 A has includible compensation of $40,000. In each of those years, A has deferred $10,000 of compensation. Under the transitional rules described in this section, $7,500 of A's deferrals in each year will be includible in gross income in the taxable year in which paid or made available to A or A's beneficiary. The remaining $2,500 of each year's deferrals ($10,000–$7,500) are includible in A's gross income for the deferral year. Thus, $2,500 is includible in A's gross income for each of the taxable years 1979, 1980, and 1981. The tax treatment of amounts deferred by A in taxable years after 1981 is described in § 1.457–3.

[T.D. 7836, 47 FR 42341, Sept. 27, 1982]

§ 1.458–10 Manner of and time for making election.

(a) Scope. For taxable years beginning after September 30, 1979, section 458 provides a special method of accounting for taxpayers who account for sales of magazines, paperbacks, or records using an accrual method of accounting. In order to use the special method of accounting under section 458, a taxpayer must make an election in the manner prescribed in this section. The election does not require the prior consent of the Internal Revenue Service. The election is effective for the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the prior consent of the Internal Revenue Service to revoke such election.

(b) Separate election for each trade or business. An election is made with respect to each trade or business of a taxpayer in connection with which qualified sales (as defined in section 458(b)(5)) of a category of merchandise were made. Magazines, paperbacks, and records are each treated as a separate category of merchandise. If qualified sales of two or more categories of merchandise are made in connection with the same trade or business, then solely for purposes of section 458, each category is treated as a separate trade or business. For example, if a taxpayer makes qualified sales of both magazines and paperbacks in the same trade or business, then solely for purposes of section 458, the qualified sales relating to magazines are considered one trade or business and the qualified sales relating to paperbacks are considered a separate trade or business. Thus, if the taxpayer wishes to account under section 458 for the qualified sales of both magazines and paperbacks, such taxpayer must make a separate election for each category.

(c) Manner of, and time for, making election. An election is made under section 458 and this section by filing a statement of election containing

the information described in paragraph (d) of this section with the taxpayer's income tax return for first taxable year for which the election is made. The election must be made no later than the time prescribed by law (including extensions) for filing the income tax return for the first taxable year for which the election is made. Thus, the election may not be filed with an amended income tax return after the prescribed date (including extensions) for filing the original return for such year.

(d) Required information. The statement of election required by paragraph (c) of this section must indicate that an election is being made under section 458(c) and must set forth the following information:

(1) The taxpayer's name, address, and identification number;

(2) A description of each trade or business for which an election is made;

(3) The first taxable year for which an election is made for each trade or business;

(4) The merchandise return period (as defined in section 458(b)(7)) for each trade or business for which an election is made;

(5) With respect to an election that applies to magazines, the amount of the adjustment computed under section 481(a) resulting from the change to the method of accounting described in section 458; and

(6) With respect to an election that applies to paperbacks or records, the initial opening balance (computed in accordance with section 458(e)) in the suspense account for each trade or business for which an election is made.

The statement of election should be made on a Form 3115 which need contain no information other than that required by this paragraph.

[T.D. 7628, 44 FR 33398, June 11, 1979]

Taxable Year for Which Deductions Taken

§ 1.461–1 General rule for taxable year of deduction.

(a) General rule—(1) Taxpayer using cash receipts and disbursements method. Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) Taxpayer using an accrual method. Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer

transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461–2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

(3) Other factors which determine when deductions may be taken. (i) Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year cannot be used to reduce the income of a subsequent year. A taxpayer may not take advantage in a return for a subsequent year of his failure to claim deductions in a prior taxable year in which such deductions should have been properly taken under his method of accounting. If a taxpayer ascertains that a deduction should have been claimed in a prior taxable year, he should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a deduction was improperly claimed in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. However, in a going business there are certain overlapping deductions. If these overlapping items do not materially distort income, they may be included in the years in which the taxpayer consistently takes them into account.

(ii) Where there is a dispute and the entire liability is contested, judgments on account of damages for patent infringement, personal injuries or other causes, or other binding adjudications, including decisions of referees and boards of review under workmen's compensation laws, are deductions from gross income when the claim is finally adjudicated or is paid, depending upon the taxpayer's method of accounting. However, see subparagraph (2) of this paragraph.

(iii) For special rules relating to certain deductions, see the following sections and the regulations thereunder: Section 1481, relating to accounting for amounts repaid in connection with renegotiation of a government contract; section 1341, relating to the computation of tax where the taxpayer repays a substantial amount received under a claim of right in a prior taxable year; section 165(e), relating to losses resulting from theft; and section 165(h), relating to an election of the year of deduction of disaster losses.

(4) Deductions attributable to certain foreign income. In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (b) of § 1.905–1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

(b) Special rule in case of death. A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and paragraph (a)(2) of § 1.443–1. In computing taxable income for such year, there shall be deducted only amounts properly deductible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, no deduction shall be allowed for amounts accrued only by reason of his death. For rules relating to the inclusion of items of partnership deduction, loss, or credit in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.

(c) Accrual of real property taxes—(1) In general. If the accrual of real property taxes is proper in connection with one of the methods of accounting described in section 446(c), any taxpayer using such a method of accounting may elect to accrue any real property tax, which is related to a definite period of time, ratably over that period in the manner described in this paragraph. For example, assume that such an election is made by a calendar-year taxpayer whose real property taxes, applicable to the period from July 1, 1955, to June 30, 1956, amount to $1,200. Under section 461(c), $600 of such taxes accrue in the calendar year 1955, and the balance accrues in 1956. For special rule in the case of certain contested real property taxes in respect of which the taxpayer transfers money or other property to provide for the satisfaction of the contested tax, see § 1.461–2. For general rules relating to deductions for taxes, see section 164 and the regulations thereunder.

(2) Special rules—(i) Effective date. Section 461(c) and this paragraph do not apply to any real property tax allowable as a deduction under the Internal Revenue Code of 1939 for any taxable year beginning before January 1, 1954.

(ii) If real property taxes which relate to a period prior to the taxpayer's first taxable year beginning on or after January 1, 1954, would, but for section 461(c), be deductible in such first taxable year, the portion of such taxes which applies to the prior period is deductible in such first taxable year (in addition to the amount allowable under section 461(c)(1)).

(3) When election may be made—(i) Without consent. A taxpayer may elect to accrue real property taxes ratably in accordance with section 461(c) and this paragraph without the consent of the Commissioner for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which the taxpayer incurs real property taxes. Such election must be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). An election may be made by the taxpayer for each separate trade or business (and for nonbusiness activities, if accounted for separately). Such an election shall apply to all real property taxes of the trade, business, or nonbusiness activity for which the election is made. The election shall be made in a statement submitted with the taxpayer's return for the first taxable year to which the election is applicable. The statement should set forth:

(a) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(b) The period of time to which the taxes are related; and

(c) The computation of the deduction for real property taxes for the first year of the election (or a summary of such computation).

(ii) With consent. A taxpayer may elect with the consent of the Commissioner to accrue real property taxes ratably in accordance with section 461(c) and this paragraph. A written request for permission to make such an election shall be submitted to the Commissioner of Internal Revenue, Washington, D.C. 20224, within 90 days after the beginning of the taxable year to which the election is first applicable, or before March 26, 1958, whichever date is later. The request for permission shall state:

(a) The name and address of the taxpayer;

(b) The trades or businesses, or nonbusiness activity, to which the election is to apply, and the method of accounting used therein;

(c) The taxable year to which the election first applies;

(d) The period to which the real property tax relate;

(e) The computation of the deduction for real property taxes for the first year of election (or a summary of such computation); and

(f) An adequate description of the manner in which all real property taxes were deducted in the year prior to the year of election.

(4) Binding effect of election. An election to accrue real property taxes ratably under section 461(c) is binding upon the taxpayer unless the consent of the Commissioner is obtained under section 446(e) and paragraph (e) of § 1.446–1 to change such method of deducting real property taxes. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 461(c) is applicable falls before March 25, 1958, consent is hereby given for the taxpayer to revoke an election previously made to accrue real property taxes in the manner prescribed by section 461(c). If the taxpayer revokes his election under the preceding sentence, he must, on or before March 25, 1958, notify the district director for the district in which the return was filed of such revocation. For any taxable year for which such revocation is applicable, an amended return reflecting such revocation shall be filed on or before March 25, 1958.

(5) Apportionment of taxes on real property between seller and purchaser. For apportionment of taxes on real property between seller and purchaser, see section 164(d) and the regulations thereunder.

(6) Examples. The provisions of this paragraph are illustrated by the following examples:

Example (1). A taxpayer on an accrual method reports his taxable income for the taxable year ending June 30. He elects to accrue real property taxes ratably for the taxable year ending June 30, 1955 (which is his first taxable year beginning on or after January 1, 1954). In the absence of an election under section 461(c), such taxes would accrue on January 1 of the calendar year to which they are related. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the fiscal years ending June 30, 1955, and June 30, 1956, are computed as follows:

Fiscal year ending June 30, 1955

July through December 1954	[1]None
January through June 1955 (6/12 of $1,600)	$800
Deduction for fiscal year ending June 30, 1955	800

[1] The taxes for 1954 were deductible in the fiscal year ending June 30, 1954, since such taxes accrued on January 1, 1954.

Fiscal year ending June 30, 1956

July through December 1955 (6/12 of $1,600) ..	$800
January through June 1956 (6/12 of $1,800)....	900
Deduction for fiscal year ending June 30, 1956	1,700

Example (2). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes would accrue on July 1 and are assessed for the 12-month period beginning on that date. The real property taxes assessed for the year ending June 30, 1954, are $1,200; $1,600 for the year ending June 30, 1955; and $1,800 for the year ending June 30, 1956. Deductions for such taxes for the calendar years 1954 and 1955 are computed as follows:

Year ending December 31, 1954

January through June 1954	[1]None
July through December 1954 (6/12 of $1,600) ..	$800
Deduction for year ending December 31, 1954	800

[1] The entire tax of $1,200 for the year ended June 30, 1954, was deductible in the return for 1953, since such tax accrued on July 1, 1953.

Year ending December 31, 1955

January through June 1955 (6/12 of $1,600)	$800
July through December 1955 (6/12 of $1,800) ..	900
Deduction for year ending December 31, 1955	1,700

Example (3). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes, which relate to the calendar year 1954, are accruable on December 1 of the preceding calendar year. No deduction for real property taxes is allowable for the taxable year 1954 since such taxes accrued in the taxable year 1953 under section 23(c) of the Internal Revenue Code of 1939.

Example (4). A taxpayer on an accrual method reports his taxable income for the taxable year ending March 31. He elects to accrue real property taxes ratably for the taxable year ending March 31, 1955. In the absence of an election under section 461(c), such taxes are accruable on June 1 of the calendar year to which they relate. The real property taxes are $1,200 for 1954; $1,600 for 1955; and $1,800 for 1956. Deductions for such taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

Fiscal year ending March 31, 1955

April through December 1954 (9/12 of $1,200)	$900
January through March 1955 (3/12 of $1,600) ..	400
Taxes accrued ratably in fiscal year ending March 31, 1955	1,800
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable year (3/12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,600

Fiscal year ending March 31, 1956

April through December 1955 (9/12 of $1,600)	$1,200
January through March 1956 (3/12 of $1,800) ..	450
Deduction for fiscal year ending March 31, 1956	1,650

Example (5). The facts are the same as in example (4) except that in June 1955, when the taxpayer pays his $1,600 real property taxes for 1955, he pays $400 of such amount under protest. Deductions for taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

Fiscal year ending March 31, 1955

April through December 1954 (9/12 of $1,200)	$900
January through March 1955 (3/12 of $1,200, that is, $1,600 minus $400 (the contested portion which is not properly accruable))	300
Taxes accrued ratably in fiscal year ending March 31, 1955	1,200
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable years (3/12 of $1,200)	300
Deduction for fiscal year ending March 31, 1955	1,500

Fiscal year ending March 31, 1956

April through December 1955 (9/12 of $1,200)	$900
January through March 1956 (3/12 of $1,800) ..	450
Taxes accrued ratably in fiscal year ending March 31, 1956	1,350
Contested portion of tax relating to period January through December 1955, paid in June 1955, and deductible, under section 461(f), for taxpayer's fiscal year ending March 31, 1956	400
Deduction for fiscal year ending March 31, 1956	1,750

(d) Limitation on acceleration of accrual of taxes. (1) Section 461(d)(1) provides that, in the case of a taxpayer whose taxable income is computed under an accrual method of accounting, to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes are to be treated as accruing at the time they would have accrued but for such action. Any such action which, but for the provisions of section 461(d) and this paragraph, would accelerate the time for accruing a tax is to be disregarded in determining the time for accruing such tax for purposes of the deduction allowed for such tax. Such action is to be disregarded not only with respect to a taxpayer (whose taxable income is computed under an accrual method of accounting) upon whom the tax is imposed at the time of the action, but also with respect to such a taxpayer upon whom the tax is imposed at any time subsequent to such action. Thus, in the case of a tax imposed on property, the acceleration of the time for accruing taxes is to be disregarded not only with respect to the taxpayer who owned the property at the time of such acceleration, but also with respect to any subsequent owner of the property whose taxable income is computed under an accrual method of accounting. Similarly, such action is to be disregarded with respect to all property

subject to such tax, even if such property is acquired after the action. Whenever the time for accruing taxes is to be disregarded in accordance with the provisions of this paragraph, the taxpayer shall accrue the tax at the time (original accrual date) the tax would have accrued but for such action, and shall, in the absence of any action of the taxing jurisdiction placing the time for accruing such tax at a time subsequent to the original accrual date, continue to accrue the tax as of the original accrual date for all future taxable years.

(2) For purposes of this paragraph—

(i) The term "a taxpayer whose taxable income is computed under an accrual method of accounting" means a taxpayer who, for Federal income tax purposes, accounts for any tax which is the subject of "any action" (as defined in subdivision (iii) of this subparagraph) under an accrual method of accounting. See section 446 and the regulations thereunder. If a taxpayer uses an accrual method as his overall method of accounting, it shall be presumed that he is "a taxpayer whose taxable income is computed under an accrual method of accounting." However, if the taxpayer establishes to the satisfaction of the district director that he has, for Federal income tax purposes, consistently accounted for such tax under the cash method of accounting, he shall be considered not to be "a taxpayer whose taxable income is computed under an accrual method of accounting."

(ii) The time for accruing taxes shall be determined under section 461 and the regulations in this section.

(iii) The term "any action" includes the enactment or reenactment of legislation, the adoption of an ordinance, the exercise of any taxing or administrative authority, or the taking of any other step, the result of which is an acceleration of the accrual event of any tax. The term also applies to the substitution of a substantially similar tax by either the original taxing jurisdiction or a substitute jurisdiction. However, the term does not include either a judicial interpretation, or an administrative determination by the Internal Revenue Service, as to the event which fixes the accrual date for the tax.

(iv) The term "any taxing jurisdiction" includes the District of Columbia, any State, possession of the United States, city, county, municipality, school district, or other political subdivision or authority, other than the United States, which imposes, assesses, or collects a tax.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). State X imposes a tax on intangible and tangible personal property used in a trade or business conducted in the State. The tax is assessed as of July 1, and becomes a lien as of that date. As a result of administrative and judicial decisions, July 1 is recognized as the proper date on which accrual method taxpayers may accrue their personal property tax for Federal income tax purposes. In 1961 State X, by legislative action, changes the assessment and lien dates from July 1, 1962, to December 31, 1961, for the property tax year 1962. The action taken by State X is considered to be "any action" of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the personal property tax imposed by State X, for the property tax year 1962, shall be treated as though it accrued on July 1, 1962.

Example (2). Assume the same facts as in example (1) except that State X repeals the personal property tax and in lieu thereof enacts a franchise tax which is imposed on the privilege of conducting a trade or business within State X, and is based on the value of intangible and tangible personal property used in the trade or business. The franchise tax is to be assessed and will become a lien as of December 31, 1961, for the franchise tax year 1962, and on December 31 for all subsequent franchise tax years. Since the franchise tax is substantially similar to the former personal property tax and since the enactment of the franchise tax has the effect of accelerating the accrual date of the personal property tax from July 1, 1962, to December 31, 1961, the action taken by State X is considered to be "any action" of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the franchise tax imposed by State X shall be treated as though it accrued on July 1, 1962, for the franchise tax year 1962, and on July 1 for all subsequent franchise tax years.

Example (3). Assume the same facts as in example (1) except that State X repealed the personal property tax and empowered the counties within the State to impose a personal property tax. Assuming the counties in State X subsequently imposed a personal property tax and chose December 31 of the preceding year as the assessment and lien date, the action of each of the counties would be considered to be "any action" of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action since it is immaterial whether the original taxing jurisdiction or a substitute jurisdiction took the action.

(4) Section 461(d)(1) shall not be applicable to the extent that it would prevent the taxpayer and all other persons, including successors in interest, from ever taking into account, for Federal income tax purposes, any tax to which that section would otherwise apply. For example, assume that State Y imposes a personal property tax on tangible personal property used in a trade or business conducted in the State during a calendar year. The tax is assessed as of February 1 of the year following the personal property tax year, and becomes a lien as of that date. As a result of administrative and judicial decisions, February 1 of the following year is recognized as the proper date on which accrual method taxpayers may ac-

crue the personal property tax for Federal income tax purposes. In 1962 State Y, by legislative action, changes the assessment and lien dates for the personal property tax year 1962 from February 1, 1963, to December 1, 1962, and to December 1 of the personal property tax year for all subsequent years. Corporation A, an accrual method taxpayer which uses the calendar year as its taxable year, pays the tax for 1962 on December 10, 1962. On December 15, 1962, the property which was taxed is completely destroyed and, on December 20, 1962, corporation A transfers all of its remaining assets to its shareholders, and is dissolved. Since corporation A is not in existence in 1963, and therefore could not take the personal property tax into account in computing its 1963 Federal income tax if February 1, 1963, is considered to be the time for accruing the tax, and no other person could ever take such tax into account in computing his Federal income tax, such tax shall be treated as accruing as of December 1, 1962. To the extent that any person other than the taxpayer may at any time take such tax into account in computing his taxable income, the provisions of section 461(d)(1) shall apply. Thus, upon the dissolution of a corporation or the termination of a partnership between the time which, but for the provisions of section 461(d)(1) and this paragraph, would be the time for accruing any tax which was the subject of "any action" (as defined in subdivision (iii) of subparagraph (2)), and the original accrual date, the corporation or the partnership would be entitled to a deduction for only that portion, if any, of such tax with respect to which it can establish, to the satisfaction of the district director, that no other taxpayer can properly take into account in computing his taxable income. However, to the extent that the corporation or partnership cannot establish, at the time of its dissolution or termination, as the case may be, that no other taxpayer would be entitled to take such tax into account in computing his taxable income, and it is subsequently determined that no other taxpayer is entitled to take such tax into account in computing his taxable income, the corporation or partnership may file a claim for refund for the year of its dissolution or termination (subject to the limitations prescribed in section 6511) and claim as a deduction therein the portion of such tax determined to be not deductible by any other taxpayer.

(5) Section 461(d) and this paragraph shall apply to taxable years ending after December 31, 1960.

(e) Dividends or interest paid by certain savings institutions on certain deposits or withdrawable accounts—(1) Deduction not allowable—(i) In general. Except as otherwise provided in this paragraph, pursuant to section 461(e) amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts (if such amounts paid or credited are withdrawable on demand subject only to customary notice to withdraw) by a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank shall not be allowed as a deduction for the taxable year to the extent such amounts are paid or credited for periods representing more than 12 months. The provisions of section 461(e) are applicable with respect to taxable years ending after December 31, 1962. Whether amounts are paid or credited for periods representing more than 12 months depends upon all the facts and circumstances in each case. For example, payments or credits which under all the facts and circumstances are in the nature of bona fide bonus interest or dividends paid or credited because a shareholder or depositor maintained a certain balance for more than 12 months, will not be considered made for more than 12 months, providing the regular payments or credits represent a period of 12 months or less. The nonallowance of a deduction to the taxpayer under section 461(e) and this subparagraph has no effect either on the proper time for reporting dividends or interest by a depositor or holder of a withdrawable account, or on the obligation of the taxpayer to make a return setting forth, among other things, the aggregate amounts paid to a depositor or shareholder under section 6049 (relating to returns regarding payments of interest) and the regulations thereunder. With respect to a short period (a taxable year consisting of a period of less than 12 months), amounts of dividends or interest paid or credited shall not be allowed as a deduction to the extent that such amounts are paid or credited for a period representing more than the number of months in such short period. In such a case, the rules contained in section 461(e) and this paragraph apply to the short period in a manner consistent with the application of such rules to a 12-month taxable year. Subparagraph (2) of this paragraph provides rules for computing amounts not allowed in the taxable year and subparagraph (3) provides rules for determining when such amounts are allowed. See section 7701(a)(19) and (32) and the regulations thereunder for the definitions of domestic building and loan association and cooperative bank.

(ii) Exceptions. The rule of nonallowance set forth in subdivision (i) of this subparagraph is not applicable to a taxpayer in the year in which it liquidates (other than following, or as part of, an acquisition of its assets in which the acquiring corporation, pursuant to section 381(a), takes into account certain items of the taxpayer, which for purposes of this paragraph shall be referred to as an acquisition described in section 381(a)). In addition, such rule of nonallowance is not applicable to a taxpayer which pays or credits grace interest or dividends to terminating depositors or shareholders, provided the total amount of the grace interest or dividends paid or credited during the payment or crediting period (for example, a quarterly or semiannual period) does not exceed 10 percent of the total amount of the interest or dividends paid or credited during such period, computed without regard to the grace interest or dividends. For example, providing the 10 percent limitation is met, the rule of nonallowance does not apply in a case in which a calendar year taxpayer, with regular interest payment dates of January 1, April 1, July 1, and October 1, pays grace interest for the period beginning October 1 to a depositor who terminates his account on December 10.

(2) Computation of amounts not allowed as a deduction—(i) Method of computation. The amount of the dividends or interest to which subparagraph (1) of this paragraph applies, which is not allowed as a deduction, shall be computed under the rules of this subparagraph. The amount which is not allowed as a deduction is the difference between the total amount of dividends or interest paid or credited to that class of accounts with respect to which a deduction is not allowed under subparagraph (1) of this paragraph during the taxable year (or short period, if applicable) and an amount which bears the same ratio to such total as the number 12 (or number of months in the short period) bears to the number of months with respect to which such amounts of dividends or interest are paid or credited.

(ii) Examples. The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). X Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits dividends on its withdrawable accounts quarterly on the first day of the quarter following the quarter with respect to which they are earned. X changes the time of crediting dividends commencing with the credit for the fourth quarter of 1964. Such credit and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change X's credits for the year 1964 are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
4th quarter, 1963	Jan. 1	$250,000
1st quarter, 1964	Apr. 1	300,000
2d quarter, 1964	July 1	300,000
3d quarter, 1964	Oct. 1	300,000
4th quarter, 1964	Dec. 31	350,000
Total dividends credited		1,500,000

Since the change in the time of crediting dividends results in the crediting in 1964 of amounts of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of $1,200,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year ($1,500,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, $300,000 ($1,500,000 minus $1,200,000) is not allowed as a deduction in 1964.

Example (2). Y Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits dividends on its withdrawable accounts on the basis of a semiannual period on March 31 and September 30 of each year. Y changes the period with respect to which credits are made from the semiannual period to the quarterly basis, commencing with the last quarter in 1964. The credit for this last quarter and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change, Y's credits for the year 1964 are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
6-month period ending Mar. 31, 1964	Mar. 31	$300,000
6-month period ending Sept. 30, 1964	Sept. 30	400,000
4th quarter, 1964	Dec. 31	200,000
Total dividends credited		900,000

Since the change in the basis of crediting dividends results in a crediting in 1964 of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of $720,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year ($900,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, $180,000 ($900,-000 minus $720,000) is not allowed as a deduction in 1964.

Example (3). Z Association, a domestic building and loan association regularly files its return on the basis of a fiscal year ending on the last day of February and regularly credits dividends on its withdrawable accounts quarterly on the last day of the quarter with respect to which they are earned. Z receives approval from the Commissioner of Internal Revenue to change its accounting period to a calendar year and effects the change by filing a return for a short period ending on December 31, 1964. Dividend credits for the short period beginning on March 1 and ending on December 31, 1964, are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
January–March 1964	Mar. 31	$250,000
April–June 1964	June 30	300,000
July–September 1964	Sept. 30	300,000
October–December 1964	Dec. 31	350,000
Total dividends credited		1,200,000

Since the change of accounting period results in amounts of dividends credited ($1,200,000) representing periods totaling 12 months (January through December 1964), and such periods represent more than the number of months (10) in the short period, an amount shall not be allowed as a deduction in such short period which is in excess of $1,000,000, which is the amount which bears the same ratio to the amount of dividends credited in the short period ($1,200,000) as the number of months (10) in the short period bears to the number of months (12) with respect to which such dividends are credited. Thus, $200,000 ($1,200,000 minus $1,000,000) is not allowed as a deduction in the short period.

(3) **When amounts allowable.** The amount of dividends or interest not allowed as a deduction under subparagraph (1) of this paragraph shall be allowed as follows (subject to the limitation that the total of the amounts so allowed shall not exceed the amount not allowed under subparagraph (1)):

(i) Such amount shall be allowed as a deduction in a later taxable year or years subject to the limitation that, when taken together with the deductions otherwise allowable in the later taxable year or years, it does not bring the deductions for any later taxable year to a total representing a period of more than 12 months (or number of months in the short period, if applicable). However, in any event, an amount otherwise allowable under subdivision (ii) of this subparagraph shall be allowed notwithstanding the fact that it may bring the deductions allowable to a total representing a period of more than 12 months (or number of months in the short period, if applicable).

(ii) In any case in which it is established to the satisfaction of the Commissioner that the taxpayer does not intend to avoid taxes, one-tenth of such amount shall be allowed as a deduction in each of the 10 succeeding taxable years—

(a) Commencing with the taxable year for which such amount is not allowed as a deduction under subparagraph (1), or

(b) In the case of such amount not allowed for a taxable year ending before July 1, 1964, commencing with either the first or second taxable year after the taxable year for which such amount is not allowed as a deduction under subparagraph (1) if the taxpayer has not taken a deduction on his return, or filed a claim for credit or refund, in respect of such amount under (a).

Normally, if the deduction not allowed under subparagraph (1) is a result of a change, not requested by the taxpayer, in the taxpayer's annual accounting period or dividend or interest payment or crediting dates solely as a consequence of a requirement of a Federal or State regulatory authority, or if the deduction is not allowed solely as a result of the taxpayer being a party to an acquisition to which section 381(a) applies, the Commissioner will permit the allowance of the amount not allowed in the manner provided in this subdivision. Nothing set forth in this subdivision shall be construed as permitting the allowance of a credit or refund for any year which is barred by the limitations on credit or refund provided by section 6511.

(iii) If the total of the amounts, if any, allowed under subdivisions (i) and (ii) of this subparagraph before the taxable year in which the taxpayer liquidates or otherwise ceases to engage in trade or business is less than the amount not allowed under subparagraph (1), there shall be allowed a deduction in such taxable year for the difference between the amount not allowed under subparagraph (1) and the amounts allowed, if any, as deductions under subdivisions (i) and (ii) unless the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a) (relating to carryovers in certain corporate acquisitions). If the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a), the acquiring corporation shall succeed to and take into account the balance of the amounts not allowed on the same basis as the taxpayer, had it not ceased to engage in business.

[T.D. 6500, 25 FR 11720, Nov. 26, 1960, as amended by T.D. 6520, 25 FR 13692, Dec. 24, 1960; T.D. 6710, 29 FR 3473, March 18, 1964; T.D. 6735, 29 FR 6494, May 19, 1964; T.D. 6772, 29 FR 15753, Nov. 24, 1964; T.D. 6917, 32 FR 6682, May 2, 1967]

§ 1.461–2 Timing of deductions in certain cases where asserted liabilities are contested.

(a) General rule—(1) Taxable year of deduction. If—

(i) The taxpayer contests an asserted liability,

(ii) The taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(iii) The contest with respect to the asserted liability exists after the time of the transfer, and

(iv) But for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable), then the deduction with respect to the contested amount shall be allowed for the taxable year of the transfer.

(2) **Exception.** Subparagraph (1) of this paragraph shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, including a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

(3) **Refunds includible in gross income.** If any portion of the contested amount which is deducted under subparagraph (1) of this paragraph for the taxable year of transfer is refunded when the contest is settled, such portion is includible in gross income except as provided in § 1.111–1, relating to recovery of certain items previously deducted or credited. Such refunded amount is includible in gross income for the taxable year of receipt, or for an earlier taxable year if properly accruable for such earlier year.

(4) **Examples.** The provisions of this paragraph are illustrated by the following examples:

Example (1). X Corporation, which uses an accrual method of accounting, in 1964 contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. In 1968, the contest is settled and X receives a refund of $5. X deducts $100 for the taxable year 1964, and includes $5 in gross income for the taxable year 1968 (assuming § 1.111–1 does not apply to such amount). If in 1964 X pays only $80 to the taxing authority, X deducts only $80 for 1964. The result would be the same if X Corporation used the cash method of accounting.

Example (2). Y Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. Y's real property taxes are assessed and become a lien on December 1, but are not payable until March 1 of the following year. On December 10, 1964, Y contests $20 of the $100 asserted real property tax which was assessed and became a lien on December 1, 1964. On March 1, 1965, Y pays the entire $100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of $5. Y deducts $80 for the taxable year 1964, deducts $20 for the taxable year 1965, and includes $5 in gross income for the taxable year 1968 (assuming § 1.111–1 does not apply to such amount).

(b) **Production costs—(1) In general; asserted liability.** For purposes of paragraph (a)(1) of this section, the term "asserted liability" means an item with respect to which, but for the existence of any contest in respect of such item, a deduction would be allowable under an accrual method of accounting. For example, a notice of a local real estate tax assessment and a bill received for services may represent asserted liabilities.

(2) **Definition of the term "contest".** Any contest which would prevent accrual of a liability under section 461(a) shall be considered to be a contest in determining whether the taxpayer satisfies paragraph (a)(1)(i) of this section. A contest arises when there is a bona fide dispute as to the proper evaluation of the law or the facts necessary to determine the existence or correctness of the amount of an asserted liability. It is not necessary to institute suit in a court of law in order to contest an asserted liability. An affirmative act denying the validity or accuracy, or both, of an asserted liability to the person who is asserting such liability, such as including a written protest with payment of the asserted liability, is sufficient to commence a contest. Thus, lodging a protest in accordance with local law is sufficient to contest an asserted liability for taxes. It is not necessary that the affirmative act denying the validity or accuracy, or both, of an asserted liability be in writing if, upon examination of all the facts and circumstances, it can be established to the satisfaction of the Commissioner that a liability has been asserted and contested.

(3) **Example.** The provisions of this paragraph are illustrated by the following example:

Example. O Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. O receives a large shipment of typewriter ribbons from S Company on January 30, 1964, which O pays for in full on February 10, 1964. Subsequent to their receipt, several of the ribbons prove defective because of inferior materials used by the manufacturer. On August 9, 1964, O orally notifies S and demands refund of the full purchase price of the ribbons. After negotiations prove futile and a written demand is rejected by S, O institutes an action for the full purchase price. For purposes of paragraph (a)(1)(i) of this section, S has asserted a liability against O which O contests on August 9, 1964. O deducts the contested amount for 1964.

(c) **Transfer to provide for the satisfaction of an asserted liability—(1) In general.** A taxpayer may provide for the satisfaction of an asserted liability by transferring money or other property beyond his control (i) to the person who is asserting the liability, (ii) to an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) that the money or other property be delivered in accordance with the settlement of the contest, or (iii) to an escrowee or trustee pursuant to an order of the United States, any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or a court that the money or other property be deliv-

ered in accordance with the settlement of the contest. A taxpayer may also provide for the satisfaction of an asserted liability by transferring money or other property beyond his control to a court with jurisdiction over the contest. Purchasing a bond to guarantee payment of the asserted liability, an entry on the taxpayer's books of account, and a transfer to an account which is within the control of the taxpayer are not transfers to provide for the satisfaction of an asserted liability. In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.

(2) Examples. The provisions of this paragraph are illustrated by the following examples:

Example (1). M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M establishes a separate bank account in its own name. M then transfers $5,000 from its general account to such separate account. Such transfer does not qualify as a transfer to provide for the satisfaction of an asserted liability because M has not transferred the money beyond its control.

Example (2). M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M transfers $5,000 to an irrevocable trust pursuant to a written agreement among the trustee, M (the taxpayer), and L (the person who is asserting the liability) that the money shall be held until the contest is settled and then disbursed in accordance with the settlement. Such transfer qualifies as a transfer to provide for the satisfaction of an asserted liability.

(d) Contest exists after transfer. In order for a contest with respect to an asserted liability to exist after the time of transfer, such contest must be pursued subsequent to such time. Thus, the contest must have been neither settled nor abandoned at the time of the transfer. A contest may be settled by a decision, judgment, decree, or other order of any court of competent jurisdiction which has become final, or by written or oral agreement between the parties. For example, Z Corporation, which uses an accrual method of accounting, in 1964 contests a $100 asserted liability. In 1967 the contested liability is settled as being $80 which Z accrues and deducts for such year. In 1968 Z pays the $80. Section 461(f) does not apply to Z with respect to the transfer because a contest did not exist after the time of such transfer.

(e) Deduction otherwise allowed—(1) In general. The existence of the contest with respect to an asserted liability must prevent (without regard to section 461(f)) and be the only factor preventing a deduction for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier taxable year for which such amount would be accruable) to provide for the satisfaction of such liability. Nothing in section 461(f) or this section shall be construed to give rise to a deduction since section 461(f) and this section relate only to the timing of deductions which are otherwise allowable under the Code.

(2) Example. The provisions of this paragraph are illustrated by the following example:

Example. A, an individual, makes a gift of certain property to B, an individual. A pays the entire amount of gift tax assessed against him but contests his liability for such tax. Section 275(a)(3) provides that gift taxes are not deductible. A does not satisfy the requirement of paragraph (a)(1)(iv) of this section since a deduction would not be allowed for the taxable year of the transfer even if A did not contest his liability for such tax.

(f) Effective date. Paragraphs (a) through (e) of this section apply to transfers of money or other property made in taxable years beginning after December 31, 1953, and ending after August 16, 1954.

(g) Election as to transfers in taxable years beginning before January 1, 1964—(1) Statutory provisions. Section 223(c) of the Revenue Act of 1964 (78 Stat. 76) provides as follows:

SEC. 223. **Timing of deductions in certain cases where asserted liabilities are contested.**

* * * * *

(c) Election as to transfers in taxable years beginning before January 1, 1964. (1) The amendments made by subsection (a) shall not apply to any transfer of money or other property described in subsection (a) made in a taxable year beginning before January 1, 1964, if the taxpayer elects, in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, to have this paragraph apply. Such an election—

(A) Must be made within one year after the date of the enactment of this Act,

(B) May not be revoked after the expiration of such one-year period, and

(C) Shall apply to all transfers described in the first sentence of this paragraph (other than transfers described in paragraph (2)).

In the case of any transfer to which this paragraph applies, the deduction shall be allowed only for the taxable year in which the contest with respect to such transfer is settled.

(2) Paragraph (1) shall not apply to any transfer if the assessment of any deficiency which would result from the application of the election in respect of such transfer is, on the date of the election under paragraph (1), prevented by the operation of any law or rule of law.

(3) If the taxpayer makes an election under paragraph (1), and if, on the date of such election, the assessment of any deficiency which results from the application of the election in respect of any transfer is not prevented by the operation of any law or rule of law, the period within which assessment of such deficiency may be made shall not expire earlier than 2 years after the date of the enactment of this Act.

(2) In general. Except as provided in subparagraph (3) of this paragraph, section 461(f) of the Internal Revenue Code of 1954 and the last two sentences of section 43 of the Internal Revenue Code of 1939, as added by section 223(a) of the Revenue Act of 1964, shall not apply to any transfers of money or other property described in either such section which are made in taxable years beginning before January 1, 1964, if the taxpayer makes a valid election, in the manner and within the time provided in subparagraph (4) of this paragraph, to have this paragraph apply to such transfers. In the case of any transfer to which this paragraph applies, the deduction with respect to the contested amount shall be allowed only for the taxable year in which the contest with respect to such transfer is settled.

(3) Transfers covered. A valid election under this paragraph shall apply to all transfers of money or other property described in section 461(f) of the 1954 Code or the last two sentences of section 43 of the 1939 Code made in taxable years beginning before January 1, 1964, except that such election shall not apply to any such transfer if the assessment of any deficiency which would result from the application of such election in respect of such transfer is, on the date such election is made, prevented by the operation of any law or rule of law.

(4) Time and manner of making election. (i) The taxpayer shall make the election referred to in subparagraph (2) of this paragraph by filing a statement, containing the information required by subdivision (ii) of this subparagraph, with the district director with whom he files his income tax return for the taxable year in which the election is made. The election must be made on or before February 26, 1965, and shall be irrevocable after such date. A copy of the statement of election shall be attached to the taxpayer's income tax return or claim for refund for the taxable year in which the contest is settled; except that if, before the time the election is made, the taxpayer filed an income tax return or a claim for refund for the taxable year in which the contest was settled, and if, after the time the election is made, such taxpayer does not file an amended income tax return or claim for refund for such year, then such taxpayer shall provide a copy of the statement of election to the district director with whom he filed his income tax return or claim for refund for the taxable year in which the contest was settled. In addition, the taxpayer shall provide copies of the statement of election to the district directors with whom he filed his income tax returns for the taxable years of the transfers with respect to which the election is made no later than 30 days after making such election.

(ii) The statement referred to in subdivision (i) of this subparagraph shall contain the following information:

(a) The name, address, and taxpayer account number of the taxpayer;

(b) A statement that the taxpayer elects, under section 223(c) of the Revenue Act of 1964, not to have the amendments made by section 223(a) of such Act apply to any transfers described in section 461(f) of the Internal Revenue Code of 1954 or the last two sentences of section 43 of the Internal Revenue Code of 1939 made by him in taxable years beginning before January 1, 1964;

(c) The amount and date of each transfer described in such sections made in a taxable year beginning before January 1, 1964, to which the election under this paragraph applies; and

(d) The district director with whom the taxpayer's return was filed for each taxable year affected by the election under this paragraph.

(5) Period of assessment extended. If the taxpayer makes a valid election under this paragraph, and if, on the date of such election, the assessment of any deficiency which results from the application of the election in respect of any transfer is not prevented by the operation of any law or any rule of law, the period within which assessment of such deficiency may be made shall not expire before February 26, 1966, and such election shall be considered as a consent to such extension.

(6) Example. The provisions of this paragraph are illustrated by the following example:

Example. Z Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. Z contests $20 of the $100 real property tax liability asserted against it for each of the years 1958 through 1963 but pays the entire $100 in each such year. Z does not contest any other asserted liabilities in the years 1958 through 1963. Z deducts $100 for each of the years 1958 through 1963 and for each of such years files its income tax return on March 15 of the following year. On October 1, 1964, Z makes a valid election under this paragraph. The contests with respect to the real property taxes for each of the years 1958 through 1963 are settled in 1967. Assuming that the assessment of any deficiencies which would result from the application of such election to the transfers in the taxable years 1958, 1959, and 1960 are, on October 1, 1964, prevented by the operation of section 6501, the election under this paragraph does not apply to the transfers made in such years. Since the assessment of any deficiencies which would result from the application of such election to the transfers in the taxable years 1961, 1962, and 1963 are not, on October 1, 1964, prevented by the operation of section 6501, the election under this paragraph does apply to the transfers

made in such years. Thus, Z deducts $60 (that is, $20 of the 1961 transfer, $20 of the 1962 transfer, and $20 of the 1963 transfer) for the taxable year 1967 and files amended returns for taxable years 1961, 1962, and 1963, deducting only $80 rather than $100 in each such year. The period within which the assessment of any deficiencies may be made which result from the application of such election to the transfers in the taxable years 1961, 1962, and 1963 shall not expire before February 26, 1966. The result would be the same if Z Corporation used the cash method of accounting.

(h) Certain other transfers in taxable years beginning before January 1, 1964—(1) Statutory provisions. Section 223(d) of the Revenue Act of 1964 (78 Stat. 77) provides as follows:

SEC. 223. Timing of deductions in certain cases where asserted liabilities are contested.

* * * * *

(d) Certain other transfers in taxable years beginning before January 1, 1964. The amendments made by subsection (a) shall not apply to any transfer of money or other property described in subsection (a) made in a taxable year beginning before January 1, 1964, if—

(1) No deduction has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, and

(2) Refund or credit of any overpayment which would result from the application of such amendments to such transfer is prevented by the operation of any law or rule of law.

In the case of any transfer to which this subsection applies, the deduction shall be allowed for the taxable year in which the contest with respect to such transfer is settled.

(2) Deduction allowed in year contest is settled. Section 461(f) of the Internal Revenue Code of 1954 and the last two sentences of section 43 of the Internal Revenue Code of 1939, as added by section 223(a) of the Revenue Act of 1964, shall not apply to any transfer of money or other property described in either such section which is made in a taxable year beginning before January 1, 1964, if—

(i) No deduction has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, and

(ii) Refund or credit of any overpayment which would result from the application of section 461(f) of the Internal Revenue Code of 1954 or the last two sentences of section 43 of the Internal Revenue Code of 1939 to such transfer is prevented by the operation of any law or rule of law.

In the case of any transfer to which this subparagraph applies, the deduction with respect to the contested amount shall be allowed only for the taxable year in which the contest with respect to such transfer is settled. Thus, if, at any time when a refund or credit of any overpayment, which would result from the application of paragraph (a)(1) of this section to a transfer of money or other property described in such paragraph (a)(1) made in a taxable year beginning before January 1, 1964, is prevented by the operation of any law or rule of law, no deduction has been allowed in respect of such transfer for any taxable year before the taxable year in which the contest with respect to such transfer is settled, then a deduction shall be allowed to the taxpayer for the taxable year in which such contest is settled.

(3) Example. The provisions of this paragraph are illustrated by the following example:

Example. R Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. In 1962, R contests $20 of a $100 asserted real property tax liability but pays the entire $100 to the taxing authority. R deducts $80 for the taxable year 1962. R files its income tax return for 1962 on March 15, 1963. In 1967, the contested tax is settled as being $100. Assuming that R did not deduct such contested $20 for any taxable year prior to 1967, and that a refund or credit of any overpayment which would result from the application of paragraph (a)(1) of this section to the transfer of such $20 in 1962 is prevented by the operation of section 6501, paragraph (a)(1) of this section does not apply to the transfer of such $20 in 1962, and R deducts such $20 for the taxable year 1967. The result would be the same if R Corporation used the cash method of accounting.

[T.D. 6772, 29 FR 15753, Nov. 24, 1964]

§ 1.461–3T Questions and answers relating to the effective dates of section 461(h) (temporary).

Q–1. What is the effective date of section 461(h)?

A–1. Except as otherwise provided in this section, section 461(h) applies to amounts that would be allowable as deductions after July 18, 1984, under the law in effect before the enactment of section 461(h) ("cut-off method"). See A–2 of this section for alternative effective dates that may be elected by a taxpayer and A–12 of this section for the effective date applicable to the accrual of interest expense. The following example illustrates the effective date provided in the first sentence of this A–1.

Example—(1) Facts. X corporation, a calendar year, accrual method taxpayer, has been a self-insurer with respect to workers' compensation claims since 1977. Before July 19, 1984, X accrues workers' compensation liabilities for the taxable year in which the award is determined by the applicable state commission. In addition, workers' compensation liabilities are not inventoriable costs of X under § 1.471–3 or § 1.471–11(c)(2). For the taxable year ending December 31, 1983, X accrues a liability to employee A in the amount of $12,000 based on a determination by the state commission that occurred during 1983. X pays A $6,000 on both March 15, 1984, and November 15, 1984, in complete satisfaction of the workers' compensation liability. On May 15, 1984, the state commission determines that X is liable to pay B $8,000 as

workers' compensation, and on December 15, 1984, the state commission determines that X is liable to pay C $4,000 as workers' compensation. The liabilities to B and C remain unpaid as of December 31, 1984. The exception provided in section 461(h)(3)(A) for certain recurring items does not apply to workers' compensation liabilities.

(2) Cut-off method. If X does not elect the alternative effective dates provided in A–2 of this section, the cut-off method applies to the workers' compensation liabilities. Under the cut-off method, the $12,000 liability to A is deductible under the law in effect before the enactment of section 461(h) for the taxable year ending December 31, 1983. The $8,000 liability to B is deductible under the law in effect before the enactment of section 461(h) for the taxable year ending December 31, 1984. The $4,000 liability to C is subject to section 461(h) and is not deductible until paid. Because the full amount of the liabilities to A and B is deductible under the law in effect before the enactment of section 461(h), no deduction is permitted when those liabilities are paid.

Q–2. What elections are available to a taxpayer with respect to the effective dates of section 461(h)?

A–2. A taxpayer may elect to treat the changes in the timing of deductions required by section 461(h) as a change in method of accounting initiated by the taxpayer and deemed made with the consent of the Commissioner. A taxpayer making this election must further elect for the change in method of accounting to be applicable either to—

(a) Taxable years ending after July 18, 1984, but, in the case of a taxable year that includes July 19, 1984 ("taxable year of change"), only to the portion of such taxable year that occurs after July 18, 1984 ("part-year change in method"); or

(b) Taxable years ending after July 18, 1984 ("full-year change in method").

If an election under this A–2 is not properly made in accordance with this section, the effective date provided in A–1 of this section (the cut-off method) shall apply.

Q–3. What items are subject to the elections described in A–2 of this section?

A–3. (a) With respect to any separate trade or business of a taxpayer, a part-year change in method may be elected for one or more types of items incurred in such separate trade or business. If the part-year change in method is elected with respect to a type of item in a separate trade or business, the election applies to the entire amount of each item of that type incurred in that trade or business. If the part-year change in method is elected with respect to one or more types of items in a separate trade or business, the other types of items in such trade or business with respect to which the part-year change in method is not elected are subject to the cut-off method. A taxpayer may elect a part-year change in method with respect to a type of item incurred in one trade or business and not with respect to the same type of item incurred in a separate trade or business.

(b) With respect to any separate trade or business of a taxpayer, a full-year change in method may be elected for all items incurred in such separate trade or business. If the full-year change in method is elected for a trade or business, the election applies to the entire amount of all items of all types incurred in the trade or business. Thus, an election to use a full-year change in method for a trade or business precludes the use of the part-year change in method or the cut-off method with respect to any item incurred in the trade or business. A taxpayer may, however, elect a full-year change in method for one trade or business and not for a separate trade or business.

(c) For purposes of this section, a taxpayer is engaged in separate trades or businesses (whether or not different methods of accounting are used for such trades or businesses) if, and only if, the trades or businesses are separate and distinct within the meaning of § 1.446–1(d).

(d) For purposes of this section, items are to be classified by type in a manner that results in classifications that are no less inclusive than the classifications of production costs provided in the full-absorption regulations of § 1.471–11(b) and (c), whether or not the taxpayer is required to maintain inventories.

(e) The following example illustrates the provisions of this A–3:

Example—(1) Facts. Y corporation, a calendar year, accrual method taxpayer, is engaged in a personal service business and a manufacturing business that are separate and distinct trades or businesses within the meaning of § 1.446–1(d). During the taxable year ending December 31, 1984, the personal service business of Y incurs advertising expenses and insurance costs, and the manufacturing business of Y incurs advertising expenses, insurance costs and research and experimental expenses.

(2) Part-year change in method. (i) Y may elect the part-year change in method with respect to a type of item incurred in either trade or business without electing the part-year change in method with respect to other types of items incurred in the same trade or business. Thus, Y may elect the part-year change in method with respect to the advertising expenses incurred in the personal service business without electing the part-year change in method with respect to the insurance costs incurred in the personal service business.

(ii) Y may also elect the part-year change in method with respect to a type of item incurred in either trade or business without electing the part-year change in method with respect to items of the same type incurred in the other trade or business. Thus, Y may elect the part-year change in method with respect to the advertising expenses or the insurance costs incurred in the personal service business without electing the part-year

change in method with respect to the advertising expenses or the insurance costs incurred in the manufacturing business.

(3) **Full-year change in method.** (i) If Y elects the full-year change in method for either trade or business, the election applies to all items incurred in that trade or business. Thus, if Y elects the full-year change in method for the manufacturing business, the election applies to the advertising expenses, insurance costs and research and experimental expenses.

(ii) Y may elect the full-year change in method for either trade or business without electing the full-year change in method for the other trade or business. Thus, Y may elect the full-year change in method for the manufacturing business without electing the full-year change in method for the personal service business.

Q–4. What is the effect of electing a part-year change in method or a full-year change in method?

A–4. (a) An election to use a part-year change in method or a full-year change in method shall be treated for purposes of section 446(e) as a change in method of accounting initiated by the taxpayer and deemed made with the consent of the Commissioner.

(b) In the case of a part-year change in method, the change in method of accounting occurs on July 19, 1984, and a section 481(a) adjustment for each type of item is determined as of that date (i.e., for purposes of computing the section 481(a) adjustment, the first day of the taxable year of change is July 19, 1984, and the last day of the preceding taxable year is July 18, 1984). Although July 18, 1984, is treated as the last day of a taxable year for purposes of computing the section 481(a) adjustment, an election to use a part-year change in method does not terminate the taxable year of change for any other purpose.

(c) In the case of a full-year change in method, the change in method of accounting occurs on the first day of the taxable year that includes July 19, 1984 ("taxable year of change"), and the section 481(a) adjustment is determined as of that date.

(d) The following example illustrates the provisions of this A–4:

Example—(1) Facts. Assume the same facts as provided in the example contained in A–1 of this section.

(2) **Part-year change in method.** (i) If X elects to use a part-year change in method with respect to employee benefits (a type of item that includes workers' compensation liabilities under § 1.471–11(c)(2)(iii)(c)), the $12,000 liability to A is deductible under the law in effect before the enactment of section 461(h) for the taxable year ending December 31, 1983. In addition, the $8,000 liability to B is deductible under the law in effect before the enactment of section 461(h) for the taxable year ending December 31, 1984. The $6,000 paid to A on November 15, 1984, and the $8,000 paid to B in a later taxable year are deductible under section 461(h) for the taxable year in which paid. The $4,000 liability to C is not deductible for the taxable year ending December 31, 1984, but, instead, is deductible under section 461(h) for the taxable year in which paid.

(ii) A section 481(a) adjustment of $14,000 (determined as of July 19, 1984) is required and ordinarily is to be taken into account ratably for X's 1984, 1985 and 1986 taxable years (see A–9 of this section).

(3) **Full-year change in method.** (i) If X elects to use a full-year change in method, the $12,000 liability to A is deductible under the law in effect before the enactment of section 461(h) for the taxable year ending December 31, 1983. In addition, the $6,000 amounts paid to A on March 15, 1984, and November 15, 1984, are deductible under section 461(h) for the taxable year ending December 31, 1984. The liabilities to B and C are not deductible for the taxable year ending December 31, 1984, but, instead, are deductible under section 461(h) for the taxable year in which paid.

(ii) A section 481(a) adjustment of $12,000 (determined as of January 1, 1984, the first day of the taxable year of change) is required and ordinarily is to be taken into account ratably for X's 1984, 1985 and 1986 taxable years (see A–9 of this section).

Q–5. How does a taxpayer elect to use a part-year change in method or a full-year change in method?

A–5. (a) The election to use a part-year change in method or a full-year change in method is irrevocable and must be made by attaching a statement (hereafter "Election Statement") to the taxpayer's timely filed Federal income tax return for the taxable year that includes July 19, 1984 ("taxable year of change"). If the taxpayer has filed a return for the taxable year of change on or before June 19, 1985, the taxpayer may make the election by attaching the Election Statement to a return, as amended, or an amended return for such year provided that the return or amended return is filed on or before August 19, 1985.

(b) The Election Statement shall include the following information—

(1) The legend "Election under § 1.461–3T" typed or legibly printed at the top of the first page;

(2) The taxpayer's name, address and taxpayer identification number;

(3) An identification of the election as either a part-year or full-year change in method;

(4) The dates on which the taxable year of change begins and ends;

(5) Whether the electing taxpayer is subject to any of the conditions listed in section 4.01 of Rev.Proc. 84–74, 1984–44 I.R.B. 15, at the time the Election Statement is filed, and, if so, a description of each such condition;

(6) Whether the electing taxpayer has an application for change in accounting method pending with the Internal Revenue Service at the time the Election Statement is filed, and, if so, the type of change requested in each application;

(7) Whether the electing taxpayer has a request for a ruling or technical advice pertaining to any

accounting method pending with the Internal Revenue Service at the time the Election Statement is filed, and, if so, a description of the issue involved in each request;

(8) If the electing taxpayer is a member of an affiliated group filing a consolidated return for the taxable year of change, the information required in paragraph (b)(5), (6), and (7) of this A–5 for each member of the group that is not an electing taxpayer (if more than one member of the group is an electing taxpayer, this information may be provided in a separate statement that is attached to the consolidated return and incorporated by reference in each Election Statement);

(9) For each type of item with respect to which an election of a part-year change in method is to apply—

(i) A description of the type of item;

(ii) Whether the method of accounting for the type of item has been used for two taxable years or less, and, if so, the number of years;

(iii) Whether the type of item includes inventoriable costs within the meaning of § 1.471–3 or § 1.471–11 or costs that must be capitalized;

(iv) The amount of the section 481(a) adjustment for the type of item; and

(v) The amount of the section 481(a) adjustment for the type of item that is attributable to the taxable year immediately preceding the taxable year of change (see paragraph (c) of A–9 of this section); and

(10) If the election is a full-year change in method—

(i) Whether the method of accounting being changed has been used for two taxable years or less, and, if so, the number of years;

(ii) Whether any of the types of items that are subject to the election include inventoriable costs within the meaning of § 1.471–3 or § 1.471–11 or costs that must be capitalized, and, if so, a description of each such type of item;

(iii) The amount of the section 481(a) adjustment required by the change in method of accounting; and

(iv) The amount of the section 481(a) adjustment that is attributable to the taxable year immediately preceding the taxable year of change (see paragraph (c) of A–9 of this section).

(c) If a taxpayer elects to use a part-year change in method or a full-year change in method with respect to a separate trade or business (as defined in paragraph (c) of A–3 of the section), but does not make the same election with respect to all trades or business, separate Election Statement containing the information specified in paragraph (b) of this A–5 is required for each separate trade or business with respect to which an election is made. In addition, the separate Election Statement shall describe the nature of the trade or business.

Q–6. If a taxpayer elects to use either a part-year change in method or a full-year change in method, how does the recurring item exception apply?

A–6. If, with respect to a type of item, the taxpayer elects to use a part-year change in method or a full-year change in method and also adopts the recurring item exception of section 461(h)(3) as a method of accounting for the taxable year of change (see A–7 of the section), the following rules apply:

(a) An amount that was taken into account under the taxpayer's method of accounting for a taxable year preceding the taxable year of change and that would have been taken into account under the recurring item exception for the same taxable year preceding the taxable year of change shall not be taken into account in computing the taxable income of the taxpayer under the taxpayer's new method of accounting. An amount would have been taken into account under the recurring item exception for a taxable year preceding the taxable year of change if all elements of the recurring item exception were satisfied for any taxable year preceding the taxable year of change.

(b) If, under paragraph (a) of this A–6, an amount is not permitted to be taken into account under the taxpayer's new method of accounting, the amount shall not be taken into account in computing the amount of the section 481(a) adjustment.

(c) For purposes of the A–6, in the case of a part-year change in method, the recurring item exception and the rules of paragraph (a) and (b) of this A–6 shall be applied as if the portion of the taxable year of change that precedes July 19, 1984, were a separate taxable year preceding the taxable year of change, except as provided below with respect to the determination of whether an item is material and whether a more proper match with income will result. Thus, in the case of a part-year change in method, an amount would have been taken into account under the recurring item exception for a taxable year preceding the taxable year of change if all elements of the recurring item exception were satisfied for any taxable year pre-

ceding the taxable year of change or for the portion of the taxable year of change that precedes July 19, 1984. In determining whether economic performance occurs within the shorter of (1) a reasonable period after the close of the portion of the taxable year of change that precedes July 19, 1984, or (2) 8 ½ months after the close of such portion of the taxable year of change, the last day of the taxable year is to be considered July 18, 1984, and the 8 ½ month period does not extend beyond March 31, 1985. In determining whether an item is a material item, and in determining whether the accrual of an item in the portion of the taxable year of change that precedes July 19, 1984, results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs, all items of income, gain, loss, deduction, or credit for the entire taxable year that includes July 18, 1984, shall be considered.

(d) The following examples illustrate the principles of this A–6:

Example (1)—(i) Facts. V corporation, a calendar year, accrual method taxpayer, properly elects to use a full-year change in method and adopts the recurring item exception as a method of accounting for items of type 1. For the taxable year ending December 31, 1983, V incurs A, an item of type 1, under the law in effect before the enactment of section 461(h). Economic performance with respect to item A occurs on August 1, 1984. In addition, all the elements of the recurring item exception are satisfied with respect to item A for the taxable year ending December 31, 1983.

(ii) Full-year change in method. Under the law in effect before the enactment of section 461(h), V takes item A into account for the taxable year ending December 31, 1983. Even though economic performance occurs with respect to item A in the taxable year ending December 31, 1984, the item is not taken into account a second time because, under the recurring item exception, the item would have been taken into account for the taxable year ending December 31, 1983. Since there is no duplication or omission with respect to item A by reason of the change in method of accounting, V will not take A into account in computing the section 481(a) adjustment.

Example (2)—(i) Facts. W corporation, a calendar year, accrual method taxpayer, properly elects to use a part-year change in method for items of type 2 and adopts the recurring item exception as a method of accounting for items of type 2. The books and records of W indicate that, under the law in effect before the enactment of section 461(h), B, an item of type 2, was incurred during the taxable year ending December 31, 1984, and before July 19, 1984. Economic performance with respect to item B occurs on August 1, 1984. Income with respect to item B is properly accounted for after July 18, 1984, but during the taxable year ending December 31, 1984. In addition, all the other elements of the recurring item exception are satisfied with respect to item B as of July 18, 1984.

(ii) Part-year change in method. Under the law in effect before the enactment of section 461(h), W takes item B into account for the taxable year ending December 31, 1984. Even though economic performance occurs with respect to item B after July 18, 1984, and even though income with respect to item B is accounted for after July 18, 1984, the item is not taken into account a second time because, under the recurring item exception, the item would have been taken into account for the portion of the taxable year that precedes July 19, 1984. Since there is no duplication or omission with respect to item B by reason of the change in method of accounting, W will not take item B into account in computing the section 481(a) adjustment. The result provided in this example would be the same even though economic performance with respect to item B occurred on February 1, 1985, provided that such date is within the reasonable period specified in section 461(h)(3)(A)(ii).

Q–7. How does a taxpayer adopt the recurring item exception of section 461(h)(3) as a method of accounting?

A–7. (a) The recurring item exception of section 461(h)(3) is a method of accounting that must be consistently applied with respect to a type of item from one taxable year to the next in order to clearly reflect income. Except as otherwise provided in paragraph (b) of this A–7 (relating to the adoption of the recurring item exception for the taxable year that includes July 19, 1984), the rules of section 446(e) and § 1.446–1(e) apply to changes to or from the recurring item exception as a method of accounting for a type of item.

(b) For the taxable year that includes July 19, 1984, a taxpayer need not obtain the Commissioner's consent to adopt the recurring item exception as a method of accounting for a type of item, but must instead—

(1) Account for the type of item on its return for such taxable year by using the recurring item exception as a method of accounting (see paragraph (a) of A–6 of this section for the manner in which the recurring item exception applies to those types of items with respect to which the taxpayer elects to use a part-year or full-year change in method); and

(2) Identify on a statement attached to the return for such taxable year each trade or business with respect to which the recurring item exception is adopted and, unless the recurring item exception is adopted with respect to all types of items (as defined in paragraph (d) of A–3 of this section) incurred in the trade or business (in which case the attached statement must so indicate), the types of items with respect to which the recurring item exception is adopted.

Q–8. If a taxpayer elects to use either a part-year change in method or a full-year change in method, how is the section 481(a) adjustment calculated?

A–8. (a) If a taxpayer elects to use a part-year change in method, the section 481(a) adjustment is calculated as follows:

(1) If the taxpayer elects to use a part-year change in method for more than one trade or business, or with respect to more than one type of item, a separate section 481(a) adjustment is required for each type of item incurred in each separate trade or business.

(2) For each type of item, the section 481(a) adjustment is determined as of July 19, 1984, and may be computed in the following manner. First, a hypothetical section 481(a) adjustment is calculated as if section 461(h) became effective as of the first day of the taxable year that follows the taxable year of change (as defined in paragraph (a) of A–2 of this section). This amount is reduced by the amount of items incurred during the taxable year of change and after July 18, 1984, under the law in effect before the enactment of section 461(h) and increased by the amount of items incurred during the taxable year of change and after July 18, 1984, under the law in effect after the enactment of section 461(h). For an example of the computation of the section 481(a) adjustment, see the example contained in paragraph (b) of A–10 of this section.

(b) If a taxpayer elects to use a full-year change in method for more than one separate trade or business, a separate section 481(a) adjustment must be determined for each trade or business as of the first day of the taxable year of change (as defined in paragraph (c) of A–4 of this section).

(c) A taxpayer must maintain adequate books and records so that the Service may, upon examination, verify the calculation of the section 481(a) adjustment.

Q–9. If a taxpayer elects to use either a part-year change in method or a full-year change in method, how are the separate section 481(a) adjustments taken into account?

A–9. (a) Except as otherwise provided in paragraph (b) of this A–9, a taxpayer who elects either a part-year change in method or a full-year change in method shall take into account one-third of any separate section 481(a) adjustment (determined in accordance with A–8 of this section) in the taxable year of change and one-third of such adjustment in each of the two immediately succeeding taxable years.

(b) Any separate section 481(a) adjustment shall be taken into account in fewer than three taxable years in the following cases:

(1) If 75% or more of the section 481(a) adjustment is attributable to the taxable year immediately preceding the taxable year of change, the amount of the adjustment attributable to the taxable year immediately preceding the taxable year of change shall be taken into account in the taxable year of change and, except as otherwise provided in paragraph (b)(2) of this A–9, one-half of the remaining section 481(a) adjustment shall be taken into account in each of the two immediately succeeding taxable years.

(2) If the taxpayer has employed the same method of accounting with respect to the type of item or for the trade or business for only the two taxable years immediately preceding the taxable year of change, one-half of the section 481(a) adjustment, or, if greater, the amount determined under paragraph (b)(1) of this A–9, is to be taken into account in the taxable year of change and the remaining section 481(a) adjustment is to be taken into account in the immediately succeeding taxable year.

(3) The taxpayer shall take into account, in the taxable year in which the taxpayer dies or ceases to engage in the trade or business to which the section 481(a) adjustment relates, the balance of the adjustment not previously taken into account. For purposes of the preceding sentence, a taxpayer is not considered to have ceased to engage in a trade or business if the cessation is the result of a transaction to which section 381 of the Code applies, but in that case the acquiring corporation shall continue to be subject to the provisions of this A–9.

(4) If the taxpayer is a cooperative within the meaning of section 1381(a) of the Code, the total amount of the section 481(a) adjustment is to be taken into account in the taxable year of change.

(c) For purposes of this A–9, the taxable year immediately preceding the taxable year of change is the last taxable year of the taxpayer ending before July 19, 1984. The amount of the section 481(a) adjustment attributable to the taxable year immediately preceding the taxable year of change is the excess of (1) the amount of the section 481(a) adjustment (determined under A–8 of this section), over (2) the amount of the adjustment that would have been required under section 481(a) if the same change in method of accounting had been made in the taxable year immediately preceding the taxable year of change. If a taxpayer's books and records do not contain sufficient information to compute the section 481(a) adjustment attributable to the taxable year immediately preceding the taxable year of change, the taxpayer must reasonably estimate the amount of such adjustment and must include the following statement as part of the Election Statement:

(1) The books and records of (name of taxpayer) do not contain sufficient information to permit a computation of the section 481(a) adjustment attributable to the taxable year immediately preceding the taxable year of change.

(2) Based on the information contained in the books and records, (indicate "75% or more" or "less than 75%" as the case may be) of the section 481(a) adjustment is attributable to the taxable year immediately preceding the taxable year of change.

For the penalties of perjury applicable to this statement, see section 6065 and the declaration of the taxpayer included on the return.

Q–10. If a taxpayer elects to use a part-year change in method with respect to a type of item, how is the amount of an item of that type taken into account in computing taxable income for the taxable year of change?

A–10. (a) If a taxpayer elects to use a part-year change in method with respect to a type of item, the amount of an item of that type is taken into account in computing taxable income for the taxable year of change in accordance with the following rules:

(1) If the taxpayer can determine that, under the law in effect before the enactment of section 461(h), the amount was incurred during the taxable year of change and before July 19, 1984, the amount is taken into account for the taxable year of change.

(2) If, under the law in effect before the enactment of section 461(h), the amount was incurred during the taxable year of change, but the taxpayer cannot determine whether the amount was so incurred before July 19, 1984, or after July 18, 1984, a portion of the amount is taken into account under this paragraph (a)(2) for the taxable year of change. The portion taken into account under this paragraph (a)(2) is the entire amount of the item multiplied by a fraction, the numerator of which is the number of days in the taxable year of change that precede July 19, 1984, and the denominator of which is the total number of days in such year (*e.g.*, in the case of a calendar taxable year, the fraction is $^{200}/_{366}$ or .55 if rounded).

(3) If the taxpayer can determine that, under the law in effect after the enactment of section 461(h), the amount was incurred during the taxable year of change and after July 18, 1984, the amount is taken into account for the taxable year of change.

(4) If, under the law in effect after the enactment of section 461(h), the amount was incurred during the taxable year of change, but the taxpayer cannot determine whether the amount was so incurred before July 19, 1984, or after July 18, 1984, a portion of the amount is taken into account under this paragraph (a)(4) for the taxable year of change. The portion taken into account under this paragraph (a)(4) is the entire amount of the item multiplied by a fraction, the numerator of which is the number of days in the taxable year of change that follow July 18, 1984, and the denominator of which is the total number of days in such year (*e.g.*, in the case of a calendar taxable year, the fraction is $^{166}/_{366}$ or .45 if rounded).

(5) The amount taken into account with respect to the item for the taxable year of change equals the amount, if any, determined under paragraph (a)(1) or paragraph (a)(2) of this A–10, plus the amount, if any, determined under paragraph (a)(3) or paragraph (a)(4) of this A–10.

(6) If a taxpayer maintains books and records that permit a determination of amounts incurred as of the end of a calendar month or calendar quarter but do not permit a determination of whether amounts were incurred before July 19, 1984, or after July 18, 1984, the proration rules of paragraph (a)(2) and paragraph (a)(4) of this A–10 may be applied at the election of the taxpayer by treating the calendar month or calendar quarter as the taxable year.

(7) The rules of paragraphs (a)(1) through (a)(6) of this A–10 are to be applied in determining the amount of each separate section 481(a) adjustment under paragraph (a) of A–8 of this section.

(b) The following example illustrates the principles of paragraph (a) of this A–10.

Example—(1) Facts. Z corporation, a calendar year, accrual method taxpayer, properly elects to use a part-year change in method with respect to items of type 1 and type 2, Z can determine that, under the law in effect before the enactment of section 461(h), items of type 1 in the amount of $12,000 were incurred during the taxable year ending December 31, 1984, $10,000 of which were so incurred before July 19, 1984, and $2,000 of which were so incurred after July 18, 1984. Of the items of type 1 in the amount of $12,000, Z can determine that, under the law in effect after the enactment of section 461(h), items in the amount of $7,000 were incurred during the taxable year ending December 31, 1984, and after July 18, 1984. The books and records of Z also indicate that as of December 31, 1984, the remaining items of type 1 in the amount of $5,000 had not been incurred under the law in effect after the enactment of section 461(h). The recurring item exception does not apply to items of type 1.

The books and records of Z also indicate that, under the law in effect before the enactment of section 461(h), items of type 2 in the amount of $15,000 were incurred during the taxable year ending December 31, 1984, but Z cannot determine whether the items were so incurred before July 19, 1984, or after July 18, 1984. Of the items of type 2 in the amount of $15,000, Z can determine that, under the law in effect after the enactment of section 461(h), items in the amount of $12,000 were incurred during the taxable year ending December 31, 1984, but Z

cannot determine whether the items were so incurred before July 19, 1984, or after July 18, 1984. The books and records of Z also indicate that, as of December 31, 1984, the remaining items of type 2 in the amount of $3,000 had not been incurred under the law in effect after the enactment of section 461(h). The recurring item exception does not apply to items of type 2.

(2) Part-year change in method. In computing taxable income for the taxable year ending December 31, 1984, Z takes into account items of type 1 in the amount of $17,000. Of this $17,000 amount, items in the amount of $10,000 are taken into account under paragraph (a)(1) of this A–10 and items in the amount of $7,000 are taken into account under paragraph (a)(3) of this A–10. Under paragraph (a)(2) of A–8 of this section, a section 481(a) adjustment of $10,000 is required with respect to items of type 1 ($5,000 end of year adjustment, decreased by $2,000 for the amount of items incurred during the taxable year of change and after July 18, 1984, under the law in effect before the enactment of section 461(h) and increased by $7,000 for the amount of items incurred during the taxable year of change and after July 18, 1984, under the law in effect after the enactment of section 461(h)).

In addition, in computing taxable income for the taxable year ending December 31, 1984, Z takes into account items of type 2 in the amount of $13,640. Of this $13,640 amount, items in the amount of $8,197 ($15,000×200/366) are taken into account under paragraph (a)(2) of this A–10 and items in the amount of $5,443 ($12,000×166/366) are taken into account under paragraph (a)(4) of this A–10. Under paragraph (a)(2) of A–8 of this section, a section 481(a) adjustment of $1,640 is required with respect to items of type 2 ($3,000 end of year adjustment reduced by $6,803 for the amount of items incurred during the taxable year of change and after July 18, 1984, under the law in effect before the enactment of section 461(h) and increased by $5,443 for the amount of items incurred during the taxable year of change and after July 18, 1984, under the law in effect after the enactment of section 461(h)).

Q–11. If a taxpayer does not elect to use a full-year change in method or a part-year change in method with respect to a type of item, how is the amount of an item of such type taken into account in computing taxable income?

A–11. (a) If a taxpayer does not elect to use a full-year change in method or a part-time change in method with respect to a type of item (*i.e.*, the cut-off method applies to the type of item), the amount of an item of that type is taken into account in computing taxable income in accordance with the following rules:

(1) If the taxpayer can determine that, under the law in effect before the enactment of section 461(h), the amount was incurred before July 19, 1984, the amount is taken into account for the taxable year in which so incurred.

(2) If the taxpayer can determine that, under the law in effect before the enactment of section 461(h), the amount was incurred after July 18, 1984, the amount is taken into account for the taxable year in which incurred under the law in effect after the enactment of section 461(h).

(3) If, under the law in effect before the enactment of section 461(h), the amount was incurred during the taxable year that includes July 19, 1984, but the taxpayer cannot determine whether the amount was so incurred before July 19, 1984, or after July 18, 1984—

(i) The amount is taken into account for the taxable year in which incurred under the law in effect after the enactment of section 461(h); or

(ii) At the taxpayer's election, the amount is taken into account under paragraph (a)(4) of this A–11.

(4) An amount is taken into account under this paragraph (a)(4) as follows:

(i) A portion of the amount equal to the entire amount of the item multiplied by a fraction, the numerator of which is the number of days in such taxable year that precede July 19, 1984, and the denominator of which is the total number of days in such year (*e.g.*, in the case of a calendar year, the fraction is 200/366 or .55 if rounded) is taken into account for the taxable year that includes July 19, 1984.

(ii) The remainder of the amount is taken into account for the taxable year or years (which may include the taxable year that includes July 19, 1984) that include all or a part of the adjustment period (as defined in paragraph (a)(5) of this A–11). The amount taken into account for a taxable year that includes all or a part of the adjustment period is the amount not taken into account under paragraph (a)(4)(i) of this A–11 multiplied by a fraction, the numerator of which is the number of days in the adjustment period that occur during the taxable year and the denominator of which is the total number of days in the adjustment period.

(5) For purposes of paragraph (a)(4)(ii) of this A–11, the adjustment period is the period that begins on the day following the last day of the transition period and that is equal in duration to the period that begins on July 19, 1984, and ends on the last day of the taxable year that includes July 19, 1984. For this purpose, the transition period is the period that begins on August 1, 1984, and is equal in duration to the number of full months that typically elapse (determined on a reasonable and consistent basis) between the date an item of that type is incurred under the law in effect before the enactment of section 461(h) and the date such an item is incurred under the law in effect after the enactment of section 461(h).

(b) The following example illustrates the principles of paragraph (a) of this A–11.

Example—(1) *Facts.* Assume the same facts as provided in the example contained in paragraph (b) of A-10 of this section, except that Z does not elect a part-year change in method with respect to items of type 1 and type 2. In addition, assume that the items of type 1 in the amount of $7,000 that were incurred during the taxable year ending December 31, 1984, and after July 18, 1984, under the law in effect after the enactment of section 461(h) were among the items of type 1 in the amount of $10,000 that were incurred during the taxable year ending December 31, 1984, and before July 19, 1984, under the law in effect before the enactment of section 461(h). Finally, assume that the transition period for items of type 2 is one month, beginning on August 1, 1984, and ending on August 31, 1984. Thus, the adjustment period for items of type 2 begins on September 1, 1984, and ends on February 13, 1985.

(2) *Cut-off method.* In computing taxable income for the taxable year ending December 31, 1984, Z takes into account items of type 1 in the amount of $10,000 under paragraph (a)(1) of this A-11. No additional amount is taken into account when the items taken into account under the preceding sentence are incurred under the law in effect after the enactment of section 461(h). Thus, neither the amount of items so incurred during the taxable year ending December 31, 1984 ($7,000), nor the amount of items to be incurred in a later taxable year ($3,000) are taken into account under the law in effect after the enactment of section 461(h). In addition, the items of type 1 in the amount of $2,000 that were incurred during the taxable year ending December 31, 1984, and after July 18, 1984, under the law in effect before the enactment of section 461(h), are not to be taken into account for the taxable year ending December 31, 1984, but, instead, are to be taken into account under paragraph (a)(2) of this A-11 for the taxable year in which incurred under the law in effect after the enactment of section 461(h).

If Z does not elect the rules contained in paragraph (a)(4) of this A-11 for all items of type 2, in computing taxable income for the taxable year ending December 31, 1984, Z takes into account items of type 2 in the amount of $12,000 under paragraph (a)(3)(i) of this A-11. The remaining items of type 2 in the amount of $3,000 are to be taken into account under paragraph (a)(3)(i) of this A-11 for the taxable year in which incurred under the law in effect after the enactment of section 461(h).

If Z elects the rules contained in paragraph (a)(4) of this A-11 for all items of type 2, in computing taxable income for the taxable year ending December 31, 1984, Z takes into account items of type 2 in the amount of $13,197. The remaining items of type 2 in the amount of $1,803 are taken into account for the taxable year ending December 31, 1985. These amounts are determined as follows:

(i) Under paragraph (a)(4)(i) of this A-11, items of type 2 in the amount of $8,197 ($15,000×200/366) are taken into account for the taxable year ending December 31, 1984.

(ii) Under paragraph (a)(5) of this A-11, the one month transition period begins on August 1, 1984, and ends on August 31, 1984, and the adjustment period begins on September 1, 1984, and ends on February 13, 1985. Thus, 122 days (the number of days from September 1, 1984, through December 31, 1984) of the 166 day adjustment period occur in the taxable year ending December 31, 1984. Under paragraph (a)(4)(ii) of this A-11, items of type 2 in the amount of $5,000 ($6,803×122/166) are taken into account for the taxable year ending December 31, 1984.

(iii) The remaining 44 days of the 166 day adjustment period occur in the taxable year ending December 31, 1985. Under paragraph (a)(4)(ii) of this A-11, items of type 2 in the amount of $1,803 ($6,803×44/166) are taken into account for the taxable year ending December 31, 1985.

Q-12. What is the effective date of section 461(h) with respect to the accrual of interest expense?

A-12. Section 461(h) applies to interest accruing under any obligation (whether or not evidenced by a debt instrument) if the obligation (a) is incurred in any transaction occurring after June 8, 1984, and (b) is not incurred under a written contract which was binding on March 1, 1984, and at all times thereafter until the obligation is incurred. Interest accruing under an obligation described in the preceding sentence is subject to section 461(h) even if the interest accrues before July 19, 1984. Similarly, interest accruing under any obligation incurred in a transaction occurring before June 9, 1984, (or under a written contract which was binding on March 1, 1984, and at all times thereafter until the obligation is incurred) is not subject to section 461(h) even to the extent the interest accrues after July 18, 1984.

Q-13. How do section 461(h) and this section affect taxpayers subject to any of the conditions listed in section 4.01 of Rev.Proc. 84-74, 1984-44 I.R.B. 15?

A-13. An accrual method taxpayer that is subject to any of the conditions listed in section 4.01 of Rev.Proc. 84-74, 1984-44 I.R.B. 15, on the date a return is filed for the taxable year that includes July 19, 1984, may be required to change its method of accounting for a taxable year preceding the taxable year that includes July 19, 1984. If a change is required, such change shall be taken into account in applying the rules of this section.

[T.D. 8024, 50 FR 20749, May 20, 1985]

§ 1.461(h)-4T Questions and answers relating to the economic performance requirement for certain employee benefits (temporary).

Q-1: What is the relationship between the economic performance requirement of section 461(h) and sections 404 and 419?

A-1: Section 404 provides that contributions paid and compensation paid or incurred with respect to a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits will be deductible only to the extent that they satisfy the requirements of section 162 or 212. Section 419 provides that contributions paid or accrued with respect to a "welfare benefit fund" (as defined in section 419(e) and Q&A-3 of § 1.419-1T) will be deductible only to

the extent that they satisfy the requirements of section 162 or 212. In the case of an accrual method taxpayer, a contribution or compensation satisfies the requirements of section 162 or 212 only to the extent that the all events test (as defined in section 461(h)(4)) and the economic performance requirement of section 461(h)(1) are satisfied. In the case of a contribution or compensation subject to section 404 or 419, pursuant to the authority under section 461(h)(2), economic performance occurs (a) in the case of a plan subject to section 404, either as the contribution is made under the plan or, if section 404(a)(5) is applicable, as an amount attributable to such contribution is includible in the gross income of an employee (or, if section 404(d) applies, a nonemployee); or (b) in the case of a welfare benefit fund, as a contribution is made to the welfare benefit fund. Solely for purposes of section 461(h), in the case of an employer's taxable year ending on or after July 18, 1984, and on or before March 21, 1986 contributions made to a welfare benefit fund after the end of such taxable year and on or before March 21, 1986 shall be deemed to have been made on the last day of such taxable year.

[T.D. 8073, 51 FR 4329, Feb. 4, 1986; T.D. 8073, 51 FR 11303, April 2, 1986]

§ 1.463–1T Transitional rule for vested accrued vacation pay (temporary).

(a) Introduction. Section 91(i) of the Tax Reform Act of 1984 provides a transitional rule for the election under section 463, relating to accrual of vacation pay. Section 91(i) applies only in the case of taxpayers with respect to which a deduction was allowable (other than under section 463) for vested accrued vacation pay for the last taxable year ending on or before July 18, 1984.

(b) Election under transitional rule. A taxpayer described in paragraph (a) of this section that makes an election under section 463 for the first taxable year ending after July 18, 1984, shall compute the opening balance of the account described in section 463(a)(1) ("accrual account") with respect to such vacation pay under the rules provided in paragraph (e)(3) of this section.

(c) Multiple vacation pay accounts within a single trade or business. **(1)** An election under section 463 must be made with respect to all vacation pay accounts maintained by the taxpayer within a single trade or business whether the liability is for vested accrued vacation pay or for vacation pay that is contingent.

(2) If a taxpayer has elected, in a taxable year ending on or before July 18, 1984, to treat contingent vacation pay with respect to a single trade or business under section 463, the taxpayer may elect, under the provisions of section 91(i) of the Tax Reform Act of 1984, to treat vested accrued vacation pay with respect to the same trade or business under section 463. However, no election may be made with respect to vacation pay for which a prior section 463 election was made and that is accounted for under section 463.

(d) Time for making election. A taxpayer described in paragraph (a) of this section that makes an election under section 463 for the first taxable year ending after July 18, 1984, must make the election on or before the due date (determined with regard to extensions) for filing the taxpayer's income tax return for such taxable year. However, if the taxpayer's income tax return was filed for the first taxable year ending after July 18, 1984, prior to March 6, 1986, the taxpayer must make the election by the later of the due date (determined with regard to extensions) for filing the taxpayer's income tax return, or May 5, 1986. In this case, the election must be made by filing an amended return (showing adjustments, if any) for such year and attaching the statement required by paragraph (e) of this section on or before the later of the due date (determined with regard to extensions) for filing the taxpayer's income tax return, or May 5, 1986.

(e) Manner of making election. A taxpayer must make the election described in paragraph (b) of this section by attaching a statement to the taxpayer's income tax return for the first taxable year ending after July 18, 1984. The statement must indicate that the taxpayer is electing to apply the provisions of section 463 with respect to vested accrued vacation pay for the taxpayer's first taxable year ending after July 18, 1984. The statement must contain the following information:

(1) The taxpayer's name and a description of the vacation pay plans to which the election applies.

(2) If a taxpayer has more than one trade or business and is not making the election with respect to all trades or businesses, a description of the trades or businesses to which the election applies.

(3) The opening balance in the taxpayer's accrual account. This balance equals the amount determined as if the taxpayer had maintained an account for the last taxable year ending on or before July 18, 1984, representing the taxpayer's liability

for vested accrued vacation pay earned by employees before the close of the last taxable year ending on or before July 18, 1984, and payable during that taxable year or within 12 months following the close of that taxable year. If the taxpayer's liability for vacation pay includes both vested accrued vacation pay and vacation pay the liability for which is contingent, the amount in the opening balance of the accrual account that represents the taxpayer's liability for contingent vacation pay is to be determined under the rules provided in section 463(b)(2).

(4) The opening balance in the taxpayer's suspense account. This balance equals the amount determined under paragraph (e)(3) of this section less the portion allowed as deductions under section 162 for prior taxable years for vacation pay earned but not paid at the close of the last taxable year ending on or before July 18, 1984.

(f) **Vested accrued vacation pay.** For purposes of paragraphs (a) through (e) of this section, "vested accrued vacation pay" means any amount allowable as a deduction under section 162(a) for a taxable year with respect to vacation pay of employees of the taxpayer (determined without regard to section 463). For purposes of this section, vacation pay will be considered vested accrued vacation pay even though there is a limit or ceiling on the amount of vacation pay an employee is entitled to as of the close of any plan year.

For example, if under a vacation pay plan an employee may accumulate no more than 40 days of vacation leave by the end of any plan year and any unused days in excess of 40 days are forfeited, the taxpayer is considered to have vested accrued vacation pay (even though the plan is not fully vested) and may make an election under the transitional rule.

[T.D. 8073, 51 FR 4329, Feb. 4, 1986; 51 FR 11303, April 2, 1986]

§ 1.465–1T Aggregation of certain activities (temporary).

(a) **General rule.** A partner in a partnership or an S corporation shareholder may aggregate and treat as a single activity—

(1) The holding, production, or distribution of more than one motion picture film or video tape by the partnership or S corporation,

(2) The farming (as defined in section 464(e)) of more than one farm by the partnership or S corporation,

(3) The exploration for, or exploitation of, oil and gas resources with respect to more than one oil and gas property by the partnership or S corporation, or

(4) The exploration for, or exploitation of, geothermal deposits (within the meaning of section 613(e)(3)) with respect to more than one geothermal property by the partnership or S corporation.

Thus, for example, if a partnership or S corporation is engaged in the activity of exploring for, or exploiting, oil and gas resources with respect to 10 oil and gas properties, a partner or S corporation shareholder may aggregate those properties and treat the aggregated oil and gas activities as a single activity. If that partnership or S corporation also is engaged in the activity of farming with respect to two farms, the partner or shareholder may aggregate the farms and treat the aggregated farming activities as a single separate activity. Except as provided in section 465(c)(2)(B)(ii), the partner or shareholder cannot aggregate the farming activity with the oil and gas activity.

(b) **Effective date.** This section shall apply to taxable years beginning after December 31, 1983 and before January 1, 1985.

[T.D. 8012, 50 FR 9614, March 11, 1985]

§ 1.466–1 Method of accounting for the redemption cost of qualified discount coupons.

(a) **Introduction.** Section 466 permits taxpayers who elect to use the method of accounting description in section 466 to deduct the redemption cost (as defined in paragraph (b) of this section) of qualified discount coupons (as defined in paragraph (c) of this section) outstanding at the end of the taxable year and redeemed during the redemption period (within the meaning of paragraph (d)(2) of this section) in addition to the redemption cost of qualified discount coupons redeemed during the taxable year which were not deducted for a prior taxable year. For the taxable year in which the taxpayer first uses this method of accounting, the taxpayer is not allowed to deduct the redemption costs of qualified discount coupons redeemed during the taxable year that would have been deductible for the prior taxable year had the taxpayer used this method of accounting for such prior year. (See paragraph (e) of this section for rules describing how this amount should be taken into account.) A taxpayer must use the accrual method of accounting for any trade or business for which an election is made under section 466. Furthermore, the taxpayer must make an election

in accordance with the rules in section 466(d) and § 1.466–3 for that trade or business. The method of accounting in section 466 is applicable only to the taxpayer's redemption of qualified discount coupons. Section 466 does not apply to trading stamps or premium coupons, which are subject to the method of accounting in § 1.451–4, or to discount coupons that are not qualified discount coupons.

(b) Redemption costs—(1) Costs deductible under section 466. The deduction allowed by section 466 applies only to the redemption cost of qualified discount coupons. The term "redemption cost" means an amount equal to:

(i) The lesser of:

(A) The amount of the discount stated on the coupon, or

(B) The cost incurred by the taxpayer for paying the discount; plus

(ii) The amount payable to the retailer (or other person redeeming the coupon from the person receiving the price discount) for services in redeeming the coupon.

The amount payable to the retailer or other person for services in redeeming the coupon is allowed only if the amount payable is stated on the coupon.

(2) Costs not deductible under section 466. The term "redemption cost" includes only the amounts stated in paragraph (b)(1) of this section. Amounts other than those mentioned in paragraph (b)(1) of this section cannot be deducted under the method of accounting described in section 466 even though such amounts are incurred in relation to the redemption of qualified discount coupons. Therefore, those amounts must be taken into account as if section 466 did not apply. Examples of such amounts are fees paid to the redemption center or clearinghouse and amounts payable to the retailer in excess of the amount stated on the coupon.

(c) Qualified discount coupons—(1) General rule. In order for a discount coupon (as defined in paragraph (c)(2)(i) of this section) to be considered a qualified discount coupon, all of the following requirements must be met:

(i) The coupon must have been issued by and must be redeemable by the taxpayer;

(ii) The coupon must allow a discount on the purchase price of merchandise or other tangible personal property;

(iii) The face amount of the coupon must not exceed five dollars;

(iv) The coupon, by its terms, may not be used with other coupons to bring about a price discount reimbursable by the issuer of more than five dollars with respect to any item; and

(v) There must exist a redemption chain (as defined in paragraph (c)(2)(ii) of this section) with respect to the coupon.

(2) Definitions—(i) Discount coupon. A discount coupon is a sales promotion device used to encourage the purchase of a specific product by allowing a purchaser of that product to receive a discount on its purchase price. The term "discount coupon" does not include trading stamps or premium coupons, which are subject to the method of accounting in § 1.451–4. A discount coupon may or may not be issued as part of a prior purchase. A discount coupon normally entitles its holders to receive nothing more than a reduction in the sales price of one of the issuer's products. The discount may be stated in terms of a cash amount, a percentage or fraction of the purchase price, a "two for the price of one" deal, or any other similar provision. A discount coupon need not be printed on paper in the form usually associated with coupons; it may be a token or other object so long as it functions as a coupon.

(ii) Redemption chain. A redemption chain exists when the issuer redeems the coupon from some person other than the customer who used the coupon to receive the price discount. Thus, in order to be treated as a qualified discount coupon, the coupon must not be issued by the person that initially redeems the coupon from the customer. For purposes of determining whether a redemption chain exists, corporations that are members of the same controlled group of corporations (as defined in section 1563(a)) as the issuer of the coupon shall be treated as the issuer. Thus, if the issuer of the coupon and the retailer that initially redeems the coupon from the customer are members of the same controlled group of corporations, the coupon shall not be treated as a qualified discount coupon.

(d) Deduction for coupons redeemed during the redemption period—(1) General rule. Two special conditions must be met before the cost of redeeming qualified discount coupons during the redemption period can be deducted from the taxpayer's gross income for the taxable year preceding the redemption period. First, the qualified discount coupons must have been outstanding at the

close of such taxable year. Second, the qualified discount coupons must have been received by the taxpayer before the close of the redemption period for that taxable year.

(2) **Redemption period.** The taxpayer can select any redemption period so long as the period does not extend longer than 6 months after the close of the taxpayer's taxable year. A change in the redemption period so selected shall be treated as a change in method of accounting.

(3) **Coupons received.** The deduction provided for in section 466(a)(1) is limited to the redemption costs associated with coupons that are actually received by the taxpayer within the redemption period. For purposes of this paragraph, if the issuer uses a redemption agent or clearinghouse to group, count, and verify coupons after they have been redeemed by a retailer, the coupons received by the redemption agent or clearinghouse will be considered to have been received by the issuer. Nothing in section 466, however, allows deductions to be made on the basis of estimated redemptions, whether such estimates are made by either the issuer or some other party.

(e) **Transitional adjustment—(1) In general.** An election to change from some other method of accounting for the redemption of discount coupons to the method of accounting described in section 466 is a change in method of accounting that requires a transitional adjustment. Unless the taxpayer can qualify for a waiver of the suspense account requirement as provided for in section 373(c) of the Revenue Act of 1978 (92 Stat. 2865), the taxpayer should compute the transitional adjustment described in section 481(a)(2) according to the rules contained in this section. This adjustment should be taken into account according to the special rules in subsections (e) and (f) of section 466.

(2) **Net increase in taxable income.** In the case of a transitional adjustment that would result in a net increase in taxable income under section 481(a)(2) for the year of change, that increase should be taken into income over a ten-year period consisting of the year of change and the immediately succeeding nine taxable years. For example, assume that A, a calendar year taxpayer, makes an election to use the method of accounting described in section 466 for the year 1980 and for subsequent years. Assume further that the amount of the transitional adjustment computed under section 481(a)(2) would result in a net increase in taxable income of $100 for 1980. Under these facts, A should increase taxable income for 1980 and each of the next nine taxable years by $10.

(3) **Suspense account—(i) In general.** In the case of a transitional adjustment that would result in a net decrease in taxable income under section 481(a)(2) for the year of change, in lieu of applying section 481, the taxpayer must establish a separate suspense account for each trade or business for which the taxpayer has made an election to use section 466. The computation of the initial opening balance in the suspense account is described in paragraph (e)(3)(ii)(A) of this section. An initial adjustment to gross income for the year of election is described in paragraph (e)(3)(ii)(B) of this section. Annual adjustments to the suspense account are described in paragraph (e)(3)(iii)(A) of this section, and gross income adjustments are described in paragraph (e)(3)(iii)(B) of this section. Examples are provided in paragraph (e)(4) of this section. The effect of the suspense account is to defer some part of, or all of, the deduction of the transitional adjustment until the taxpayer no longer redeems discount coupons in connection with the trade or business to which the suspense account relates.

(ii) **Establishing a suspense account**—(A) Initial opening balance. To compute the initial opening balance of the suspense account for the first taxable year for which the election to use section 466 is effective, the taxpayer must determine the dollar amount of the deduction that would have been allowed for qualified discount coupon redemption costs during the redemption period for each of the three immediately preceding taxable years had the election to use section 466 been in effect for those years. The initial opening balance of the suspense account is the largest such dollar amount reduced by the sum of the adjustments attributable to the change in method of accounting that increase income for the year of change.

(B) Initial year adjustment. If, in computing the initial opening balance, the largest dollar amount of deduction that would have been allowed in any of the three prior years exceeds the actual cost of redeeming qualified discount coupons received during the redemption period following the close of the year immediately preceding the year of election, the excess is included in income in the year of election. Section 481(b) does not apply to this increase in gross income.

(iii) **Annual adjustments**—(A) Adjustment to the suspense account. Adjustments are made to the suspense account each year to account for fluctuations in coupon redemptions. To compute

the annual adjustment, the taxpayer must determine the amount to be deducted under section 466(a)(1) for the taxable year. If the amount is less than the opening balance in the suspense account for the taxable year, the balance in the suspense account is reduced by the difference. Conversely, if such amount is greater than the opening balance in the suspense account for the taxable year, the account is increased by the difference (but not to an amount in excess of the initial opening balance described in paragraph (e)(3)(ii) of this section). Therefore, the balance in the suspense account will never be greater than the initial opening balance in the suspense account determined in paragraph (e)(3)(ii) of this section. However, the balance in the suspense account after adjustments may be less than this initial opening balance in the suspense account.

(B) Gross income adjustments. Adjustments to the suspense account for years subsequent to the year of the election also produce adjustments in the taxpayer's gross income. Adjustments which reduce the balance in the suspense account reduce gross income for the year in which the adjustment to the suspense account is made. Adjustments which increase the balance in the suspense account increase gross income for the year in which the adjustment to the suspense account is made.

(4) Examples. (i) The provisions of paragraph (e)(3) of this section may be illustrated by the following examples:

Example (1). Assume that the issuer of qualified discount coupons makes a timely election under section 466 for its taxable year ending December 31, 1979, and does not select a coupon redemption period shorter than the statutory period of 6 months. Assume further that the taxpayer's qualified discount coupon redemption costs in the first 6 months of 1977, 1978, and 1979 were $7, $13, and $8 respectively, and that the accounting change adjustments that increase income for 1979 are $10. Since the accounting change adjustment that increases income for 1979, ($10), is greater than the taxpayer's discount coupon redemptions during the first 6 months of 1979 ($8), the net section 481(a)(2) adjustment for the year of change results in a positive adjustment. Because of this, a suspense account is not required. The taxpayer should instead follow the rules in section 466(f) and in paragraph (e)(2) of this section in order to take this positive transitional adjustment into account.

Example (2). Assume the same facts as in example (1), except that the sum of the accounting change adjustments that increase income for 1979 is equal to $2. Under these facts the initial opening balance in the suspense account on January 1, 1979 would be $11 (that is, the largest dollar amount of qualified coupon redemption costs in the pertinent years ($13), reduced by the sum of the accounting change adjustments that increase income in the year of change ($2)). Since the coupon redemption costs taken into account in determining the initial opening balance ($13 in 1979) exceed the actual redemption costs in the first 6 months of the taxable year for which the election is first effective ($8 in 1979), the excess of $5 is added to gross income for the year of election (1979).

Example (3). Assume, in addition to the facts of example (2), that coupon redemption costs during the redemption period for the 1979 taxable year are $7. Since the qualifying redemption costs ($7) during the redemption period for the taxable year are less than the opening balance in the suspense account ($11) the taxpayer must reduce the suspense account balance by the difference ($4). The taxpayer is also allowed to take a deduction equal to the amount of this adjustment to the suspense account. Thus, the net amount deductible for the 1979 taxable year after taking into account the coupon redemptions during the redemption period, the amount deductible because of the decrease in the suspense account, and the initial year adjustment determined in example (2) is $6 ($7+$4–$5).

Example (4). Assume, in addition to the facts of example (3), that coupon redemption costs during the redemption period for the 1980 taxable year are $10. Since the qualifying redemption costs during the redemption period for the taxable year ($10) exceed the opening balance of the suspense account at the beginning of the taxable year ($7), the suspense account must be increased by the difference ($3). The taxpayer must also include $3 in gross income for the taxable year. Thus, the net amount deductible for the 1980 taxable year is $7 ($10–$3).

Example (5). Assume, in addition to the facts of example (4), that coupon redemption costs during the redemption period for the 1981 taxable year are $12. Since the qualifying redemption costs for the 1961 taxable year ($12) exceed the opening balance of the suspense account at the beginning of the taxable year ($10), the suspense account must be increased by the difference ($2) but not above the initial opening balance ($11). Thus, the taxpayer will increase the balance by $1. The taxpayer must also include $1 in gross income for the taxable year. Thus, the net amount deductible for the 1981 taxable year is $11 ($12–$1).

(ii) The following table summarizes examples (2) through (5):

	Years ending Dec. 31—					
	1977	1978	1979	1980	1981	1982
Facts:						
Actual coupon redemption costs in first six months	$7	$13	$8	$7	$10	$12
Accounting change adjustments that increase income in year of change	.....	.....	2	.....	.....	.....
Net adjustment decreasing income in year of change under sec. 481(a)(2)	.....	.....	6	.....	.....	.....
Adjustment to suspense account:						
Opening balance	.....	.....	11	7	10	11
Addition to account	.....	.....	.....	3	1	.....
Reduction to account	.....	.....	(4)	.....	.....	.....

	Years ending Dec. 31— 1977	1978	1979	1980	1981	1982
Opening balance for next year	.....	.....	7	10	11	.....
Amount deductible:						
Initial year adjustment	.....	.....	(5)	.....	.....	.....
Amount of deductible as actual coupon redemptions during redemption period	.....	.....	7	10	12	.....
Adjustment for increase in suspense account	.....	.....	.....	(3)	(1)	.....
Adjustment for decrease in suspense account	.....	.....	4	.....	.....	.....
Net amount deductible for the year for coupons redeemed during the redemption period	.....	.....	6	7	11	.....

(f) Subchapter C transactions—(1) General rule. If a transfer of substantially all the assets of a trade or business in which discount coupons are redeemed is made to an acquiring corporation, and if the acquiring corporation determines its bases in these assets, in whole or part, with reference to the basis of these assets in the hands of the transferor, then for the purposes of section 466(e) the principles of section 381 and § 1.381(c)(4)–1 will apply. The application of this rule is not limited to the transactions described in section 381(a). Thus, the rule also applies, for example, to transactions described in section 351.

(2) Special rules. If, in the case of a transaction described in paragraph (f)(1) of this section, an acquiring corporation acquires assets that were used in a trade or business that was not subject to a section 466 election from a transferor that is owned or controlled directly (or indirectly through a chain of corporations) by the same interests, and if the acquiring corporation uses the acquired assets in a trade or business for which the acquiring corporation later makes an election to use section 466, then the acquiring corporation must establish a suspense account by taking into account not only its own experience but also the transferor's experience when the transferor held the assets in its trade or business. Furthermore, the transferor is not allowed a deduction for qualified discount coupons redeemed after the date of the transfer attributable to discount coupons issued by the transferor before the date of the transfer. Such redemptions shall be considered to be made by the acquiring corporation.

(3) Example. The provisions of paragraph (f)(2) of this section may be illustrated by the following example:

Example. Corporation S, a calendar year taxpayer, is a wholly owned subsidiary of Corporation P, a calendar year taxpayer. On December 31, 1982, S acquires from P substantially all of the assets used in a trade or business in which qualified discount coupons are redeemed. P had not made an election under section 466 with respect to the redemption costs of the qualified discount coupons issued in connection with that trade or business. S makes an election to use section 466 for its taxable year ending December 31, 1983, for the trade or business in which the acquired assets are used, and selects a redemption period of 6 months. Assume that P's qualified discount coupon redemption costs in the first 6 months of 1981 and 1982 were $120 and $140 respectively. Assume further that S's qualified discount coupon redemption costs in the first 6 months of 1983 were $130, and that there are no accounting change adjustments that increase income with respect to the election. S must establish a suspense account by taking into account the largest dollar amount of deductions that would have been allowed under section 466(a)(1) for the 3 immediately preceding taxable years of P, including both P's and S's experience with respect to costs actually incurred during the redemption periods relating to those years. Thus, the initial opening balance of S's suspense account is $140. S must also make an initial year adjustment of $10 ($140–$130), which S must include in income for S's taxable year ending December 31, 1983. P may not take a deduction for the qualified coupon redemptions made after December 31, 1982, that are attributable to coupons issued by P before December 31, 1982. Thus, none of the $130 qualified discount coupon redemption costs incurred by S during the first six months of 1983 may be deducted by P.

[T.D. 8022, 50 FR 18474, May 1, 1985; as amended by 50 FR 21046, May 22, 1985]

§ 1.466–2 Special protective election for certain taxpayers.

(a) General rule. Section 373(c) of the Revenue Act of 1978 (92 Stat. 2865) allows certain taxpayers, who in prior years have accounted for discount coupons under a method of accounting reasonably similar to the method described in § 1.451–4, to elect to treat that method of accounting as a proper one for those prior years. There are several differences between this protective election and the section 466(d) election. First, the protective election applies only to a single continuous period of taxable years the last year of which ends before January 1, 1979. Second, an otherwise qualifying protective election may apply to coupons which are discount coupons but which would not be treated as qualified discount coupons under Code section 466. Third, certain expenses such as the cost of redemption center service fees, and amounts that are payable

to the retailer (or other person redeeming the coupons from the person receiving the price discount) for services in redeeming the coupons but that are not stated on the coupon, can be subtracted from gross receipts for prior years covered by a protective election (if treated as deductible under the accounting method for such years), even though such expenses would not be deductible under Code section 466.

(b) Requirements. In order to qualify for this special protective election, the following conditions must be met:

(1) For a continuous period of one or more prior taxable years (the last year of which ends before Jan. 1, 1979), the taxpayer must have used a method of accounting for discount coupons that is reasonably similar to the method provided in § 1.451–4 or its predecessors under the Internal Revenue Code of 1954;

(2) The taxpayer must make an election under section 466 of the Internal Revenue Code of 1954 according to the rules contained in § 1.466–3 for its first taxable year ending after December 31, 1978; and

(3) The taxpayer must make an election under section 373(c) of the Revenue Act of 1978 according to the rules contained in § 1.466–4 for its first taxable year ending after December 31, 1978.

(c) Amount to be subtracted from gross receipts. The amount the taxpayer may subtract under this section for the redemption costs of coupons shall include only:

(1) Costs of the type permitted by § 1.451–4 to be included in the estimated average cost of redeeming coupons, plus

(2) Any amount designated or referred to on the coupon payable by the taxpayer to the person who allowed the discount on a sale by such person to the user of the coupon.

Nothing in this paragraph shall allow an item to be deducted more than once.

(d) Right to amend prior tax returns. This paragraph applies only to those taxpayers who have agreed in a prior year to discontinue the use of the method of accounting described in § 1.451–4 for discount coupon redemptions. If the taxpayer used such method of accounting on the original return filed for the prior taxable year, and if any such year is not closed under the statute of limitations or by reason of a closing agreement with the Internal Revenue Service, a taxpayer who has made a protective election may file an amended return and a claim for refund for such years. In this amended return, the taxpayer should account for its discount coupon redemptions, according to the method of accounting described in § 1.451–4. This is not to be construed, however, to abrogate in any way the rules regarding the close of taxable years due to the statute of limitations or a binding closing agreement between the Internal Revenue Service and the taxpayer.

(e) Suspense account not required. If the following three conditions are satisfied, the taxpayer need not establish the suspense account otherwise required by section 466(e). First, the taxpayer must make a timely election under these rules to protect prior years. Second, the method of accounting used in those years must have been used for all discount coupons issued by the taxpayer in those years in all the taxpayer's separate trades or businesses in which coupons were issued. Third, either before or after an amendment to the taxpayer's tax returns as described in paragraph (d) of this section, a method of accounting reasonably similar to the method of accounting described in § 1.451–4 must have been used for the taxable year ending on or before December 31, 1978. If these conditions are met, the taxpayer will treat the election of the method under section 466 as a change in method of accounting to which the rules in section 481 and the regulations thereunder apply.

(f) Definition: reasonably similar. For purposes of paragraphs (b)(1) and (e) of this section, a taxpayer will be considered to have used a method of accounting for discount coupons that is "reasonably similar" to the method of accounting provided in § 1.451–4 if the taxpayer followed the method of accounting described in § 1.451–4 as if that method were a valid method of accounting for discount coupon redemptions.

[T.D. 8022, 50 FR 18476, May 1, 1985]

§ 1.466–3 Manner of and time for making election under section 466.

(a) In general. Section 466 provides a special method of accounting for accrual basis taxpayers who issue qualified discount coupons (as defined in section 466(b)). In order to use the special method under section 466, a taxpayer must make an election with respect to the trade or business in connection with which the qualified discount coupons are issued. If a taxpayer issues qualified discount coupons in connection with more than one trade or business, the taxpayer may use the special method of accounting under section 466 only with respect to the qualified discount coupons

issued in connection with a trade or business for which an election is made. The election must be made in the manner prescribed in this section. The election does not require the prior consent of the Internal Revenue Service. An election under section 466 is effective for the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the prior consent of the Internal Revenue Service to revoke such election.

(b) Manner of and time for making election—(1) General rule. Except as provided in paragraph (b)(2) of this section, an election is made under section 466 and this section by filing a statement of election containing the information described in paragraph (c) of this section with the taxpayer's income tax return for the taxpayer's first taxable year for which the election is made. The election must be made not later than the time prescribed by law (including extensions thereof) for filing the income tax return for the first taxable year for which the election is made. Thus, the election may not be made for a taxable year by filing an amended income tax return after the time prescribed (including extensions) for filing the original return for such year.

(2) Transitional rule. If the last day of the time prescribed by law (including extensions thereof) for filing a taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, falls before December 3, 1979, and the taxpayer does not make an election under section 466 with respect to such taxable year in the manner prescribed by paragraph (b)(1) of this section, an election is made under section 466 and this section with respect to such taxable year if—

(i) Within the time prescribed by law (including extensions thereof) for filing the taxpayer's income tax return for such taxable year, the taxpayer has made a reasonable effort to notify the Commissioner of the taxpayer's intent to make an election under section 466 with respect to such taxable year, and

(ii) Before January 2, 1980, the taxpayer files a statement of election containing the information described in paragraph (c) of this section to be associated with the taxpayer's income tax return for such taxable year.

For purposes of paragraph (b)(2)(i) of this section, a reasonable effort to notify the Commissioner of an intent to make an election under section 466 with respect to a taxable year includes the timely filing of an income tax return for such taxable year if the taxable income reported on the return reflects a deduction for the redemption costs of qualified discount coupons as determined under section 466(a).

(c) Required information. The statement of election required by paragraph (b) of this section must indicate that the taxpayer (identified by name, address, and taxpayer identification number) is making an election under section 466 and must set forth the following information:

(1) A description of each trade or business for which the election is made;

(2) The first taxable year for which the election is made;

(3) The redemption period (as defined in section 466(c)(2)) for each trade or business for which the election is made;

(4) If the taxpayer is required to establish a suspense account under section 466(e) for a trade or business for which the election is made, the initial opening balance of such account (as defined in section 466(e)(2)) for each such trade or business; and

(5) In the case of an election under section 466 that results in a net increase in taxable income under section 481(a)(2), the amount of such net increase.

The statement of election should be made on a Form 3115, which need contain no information other than that required by this paragraph or paragraph (c) of § 1.466–4.

[T.D. 8022, 50 FR 18477, May 1, 1985]

§ 1.466–4 Manner of and time for making election under section 373(c) of the Revenue Act of 1978.

(a) In general. Section 373(c)(2) of the Revenue Act of 1978 (92 Stat. 2865) provides an election for taxpayers who satisfy the requirements of section 373(c)(2)(A)(i) and (ii) of the Act. The election is made with respect to a method of accounting for the redemption costs of discount coupons used by the electing taxpayer in a continuous period of one or more taxable years ending before January 1, 1979. The election must be made in the manner prescribed by this section. The election does not require the prior consent of the Internal Revenue Service.

(b) Manner of and time for making election—(1) General rule. Except as provided in paragraph (b)(2) of this section, the election under section 373(c) of the Revenue Act of 1978 is made by filing a statement of election containing the infor-

mation described in paragraph (c) of this section with the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978. The election must be made not later than the time prescribed by law (including extensions thereof) for filing the income tax return for the taxpayer's first taxable year ending after December 31, 1978. Thus, the election may not be made with an amended income tax return for such year filed after the time prescribed (including extensions) for filing the original return.

(2) Transitional rule. If the last day of the time prescribed by law (including extensions thereof) for filing a taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, falls before December 3, 1979, and the taxpayer does not make an election in the manner prescribed by paragraph (b)(1) of this section, an election is made under section 373(c) of the Act and this section with respect to a continuous period if—

(i) Within the time prescribed by law (including extensions thereof) for filing the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978, the taxpayer has made a reasonable effort to notify the Commissioner of the taxpayer's intent to make election under section 373(c) of the Act with respect to the continuous period, and

(ii) Before January 2, 1980, the taxpayer files a statement of election containing the information described in paragraph (c) of this section to be associated with the taxpayer's income tax return for the taxpayer's first taxable year ending after December 31, 1978.

(c) Required information. The statement of election required by paragraph (b) of this section must indicate that the taxpayer (identified by name, address, and taxpayer identification number) is making an election under section 373(c) of the Revenue Act of 1978 and must set forth the taxable years in the continuous period for which the election is made. The statement of election should be made on the same Form 3115 on which the taxpayer has made a statement of election under section 466. The Form 3115 need contain no information other than that required by this paragraph or paragraph (c) of § 1.466–3.

[T.D. 8022, 50 FR 18478, May 1, 1985]

§ 1.468A–0 Nuclear decommissioning costs; table of contents.

This section lists the paragraphs contained in §§ 1.468A-1 through 1.468A-8.

(j) Special rule permitting payments to a nuclear decommissioning fund before receipt of an initial or revised ruling amount applicable to a taxable year.

§ 1.468A-4 Treatment of nuclear decommissioning fund.

(a) In general.

(b) Modified gross income.

(c) Special rules.

(1) Period for computation of modified gross income.

(2) Gain or loss upon distribution of property by a fund.

(3) Denial of credits against tax.

(4) Other corporate taxes inapplicable.

(d) Treatment as corporation for purposes of subtitle F.

§ 1.468A-5 Nuclear decommissioning fund—miscellaneous provisions.

(a) Qualification requirements.

(1) In general.

(2) Limitation on contributions.

(3) Limitation on use of fund.

(i) In general.

(ii) Terms defined.

(b) Prohibitions against self-dealing.

(1) In general.

(2) Self-dealing defined.

(3) Disqualified person defined.

(c) Disqualification of nuclear decommissioning fund.

(1) In general.

(2) Exception to disqualification.

(i) In general.

(ii) Excess contribution defined.

(iii) Taxation of income attributable to an excess contribution.

(3) Effect of disqualification.

(d) Termination of nuclear decommissioning fund upon substantial completion of decommissioning.

(1) In general.

(2) Substantial completion of decommissioning defined.

§ 1.468A-6 Disposition of an interest in a nuclear power plant. [Reserved]

§ 1.468A-7 Manner of and time for making election.

(a) In general.

(b) Required information.

§ 1.468A-8 Effective date and transitional rules.

(a) Effective date.

(1) In general.

(2) Cut-off method applicable to electing taxpayers.

(b) Transitional rules.

(1) Time for filing request for schedule of ruling amounts.

(2) Manner of and time for making contributions to a nuclear decommissioning fund.

(3) Manner of and time for making election.

(4) Determination of cost of service limitation.

(5) Assumptions and determinations to be used in determining ruling amounts.

(6) Exception to level funding limitation.

(7) Determination of qualifying percentage.

(8) Limitation on payments to a nuclear decommissioning fund.

(9) Denial of interest on overpayment.

(10) Determination of addition to tax for failure to pay estimated tax.

[T.D. 8184, 53 FR 6804, March 2, 1988]

§ 1.468A–1 Nuclear decommissioning costs; general rules.

(a) Introduction. Section 468A provides an elective method for taking into account nuclear decommissioning costs for Federal income tax purposes. In general, an eligible taxpayer that elects the application of section 468A pursuant to the rules contained in § 1.468A-7 is allowed a deduction (as determined under § 1.468A-2) for the taxable year in which the taxpayer makes a cash payment to a nuclear decommissioning fund. Taxpayers using an accrual method of accounting that do not elect the application of section 468A are not allowed a deduction for nuclear decommissioning costs prior to the taxable year in which economic performance occurs with respect to such costs (see section 461(h)).

(b) Definitions. The following terms are defined for purposes of §§ 1.468A-1 through 1.468A-5, 1.468A-7 and 1.468A-8:

(1) The term "eligible taxpayer" means any taxpayer that possesses a qualifying interest in a nuclear power plant (including a nuclear power plant that is under construction).

(2) The term "qualifying interest" means—

(i) A direct ownership interest; and

(ii) A leasehold interest in any portion of a nuclear power plant if—

(A) The holder of the leasehold interest is subject to the jurisdiction of a public utility commission with respect to such portion of the nuclear power plant;

(B) The holder of the leasehold interest is primarily liable under Federal or State law for decommissioning such portion of the nuclear power plant; and

(C) No other person establishes a nuclear decommissioning fund with respect to such portion of the nuclear power plant.

A direct ownership interest includes an interest held as a tenant in common or joint tenant, but does not include stock in a corporation that owns a nuclear power plant or an interest in a partner-

ship that owns a nuclear power plant. Thus, in the case of a partnership that owns a nuclear power plant, the election under section 468A must be made by the partnership and not by the partners. In the case of an unincorporated organization described in § 1.761-2(a)(3) that elects under section 761(a) to be excluded from the application of subchapter K, each taxpayer that is a co-owner of the nuclear power plant is eligible to make a separate election under section 468A.

(3) The term "nuclear decommissioning fund" means a fund that satisfies the requirements of § 1.468A.-5.

(4) The term "nuclear power plant" means any nuclear power reactor that is used predominantly in the trade or business of the furnishing or sale of electric energy, if the rates for such furnishing or sale, as the case may be, have been established or approved by a public utility commission. Each unit (i.e., nuclear reactor) located on a multi-unit site is a separate nuclear power plant.

(5) The term "nuclear decommissioning costs" or "decommissioning costs" means all otherwise deductible expenses to be incurred in connection with the entombment, decontamination, dismantlement, removal and disposal of the structures, systems and components of a nuclear power plant that has permanently ceased the production of electric energy. Such term includes all otherwise deductible expenses to be incurred in connection with the preparation for decommissioning, such as engineering and other planning expenses, and all otherwise deductible expenses to be incurred with respect to the plant after the actual decommissioning occurs, such as physical security and radiation monitoring expenses. Such term does not include otherwise deductible expenses to be incurred in connection with the disposal of spent nuclear fuel under the Nuclear Waste Policy Act of 1982 (Pub. L. 97-425). An expense is otherwise deductible for purposes of this paragraph (b)(5) if it would be deductible under chapter 1 of the Internal Revenue Code without regard to section 280B.

(6) The term "public utility commission" means any State or political subdivision thereof, any agency, instrumentality or judicial body of the United States, or any judicial body, commission or other similar body of the District of Columbia or of any State or any political subdivision thereof that establishes or approves rates for the furnishing or sale of electric energy.

(7) The term "ratemaking proceeding" means any proceeding before a public utility commission in which rates for the furnishing or sale of electric energy are established or approved. Such term includes a generic proceeding that applies to two or more taxpayers that are subject to the jurisdiction of a single public utility commission.

(c) Special rules applicable to certain experimental nuclear facilities. (1) The owner of a qualifying interest in an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b) of this section if—

(i) Such person is engaged in the trade or business of the furnishing or sale of electric energy;

(ii) The rates charged for electric energy furnished or sold by such person are established or approved by a public utility commission; and

(iii) The cost of decommissioning the facility is included in the cost of service of such person.

(2) An owner of stock in a corporation that owns an experimental nuclear facility possesses a qualifying interest in a nuclear power plant for purposes of paragraph (b)(1) of this section if—

(i) Such stockholder satisfies the conditions of paragraph (c)(1) (i) through (iii) of this section; and

(ii) The corporation that directly owns the facility is not engaged in the trade or business of the furnishing or sale of electric energy.

(3) For purposes of this paragraph (c), an experimental nuclear facility is a nuclear power reactor that is used predominantly for the purpose of conducting experimentation and research.

[T.D. 8805, 53 FR 6805, March 3, 1988]

§ 1.468A–2 Treatment of electing taxpayer.

(a) In general. An eligible taxpayer that elects the application of section 468A pursuant to the rules contained in § 1.468A-7 (an "electing taxpayer") is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment as provided in paragraph (c) of this section) to a nuclear decommissioning fund. The amount of the deduction for any taxable year equals the total amount of cash payments made (or deemed made) by the electing taxpayer to a nuclear decommissioning fund (or nuclear decommissioning funds) during such taxable year. A payment may not be made (or deemed made) to a nuclear decommissioning fund before the first taxable year in which all of the following conditions are satisfied:

(1) The construction of the nuclear power plant to which the nuclear decommissioning fund relates has commenced.

(2) Nuclear decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates are included in the taxpayer's cost of service for ratemaking purposes (see paragraph (b) of this section).

(3) A ruling amount is applicable to the nuclear decommissioning fund (see § 1.468A-3).

(b) Limitation on payments to a nuclear decommissioning fund—(1) In general. For purposes of paragraph (a) of this section, the maximum amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year shall not exceed the lesser of:

(i) The cost of service amount applicable to the nuclear decommissioning fund for such taxable year (as defined in paragraph (b)(2) of this section); or

(ii) The ruling amount applicable to the nuclear decommissioning fund for such taxable year (as determined under § 1.468A-3).

If the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of this paragraph (b)(1), the excess is not deductible by the electing taxpayer. In addition, see paragraph (c) of § 1.468A-5 for rules which provide that the Internal Revenue Service may disqualify a nuclear decommissioning fund if the amount of cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceeds the limitation of this paragraph (b)(1).

(2) Cost of service amount. (i) For purposes of section 468A and the regulations thereunder, the "cost of service amount applicable to a nuclear decommissioning fund for a taxable year" is the amount of decommissioning costs included in the electing taxpayer's cost of service for ratemaking purposes for such taxable year. Decommissioning costs are included in cost of service for a taxable year only to the extent such costs are directly or indirectly charged to customers of the taxpayer by reason of electric energy consumed during such taxable year or are otherwise required to be included in the taxpayer's income under section 88 and the regulations thereunder.

(ii) Except as otherwise provided in paragraph (b)(4)(i) of § 1.468A-8 (relating to a special transitional rule), decommissioning costs shall generally not be considered included in cost of service for purposes of this section unless—

(A) The order or opinion of the applicable public utility commission identifies the amount of decommissioning costs that is included in cost of service for ratemaking purposes; or

(B) The written records of the ratemaking proceeding clearly and unambiguously indicate the amount of decommissioning costs that is included in cost of service for ratemaking purposes.

(iii) Except as otherwise provided in paragraph (f)(2) of this section (relating to a special rule that applies to certain retroactive adjustments to interim rate orders), orders or opinions of a public utility commission that are issued after the close of any taxable year shall not be considered in determining the amount of decommissioning costs included in cost of service for such taxable year.

(iv) If a taxpayer possesses a qualifying interest in two or more nuclear power plants that are the subject of a single ratemaking proceeding, the amount of decommissioning costs included in cost of service pursuant to such ratemaking proceeding must be allocated among such nuclear power plants. Such allocation must be reasonable and consistent, and must take into account the assumptions and determinations, if any, used by the public utility commission in establishing or approving the amount of decommissioning costs included in cost of service.

(c) Deemed payment rules. (1) The amount of any cash payment made by an electing taxpayer to a nuclear decommissioning fund on or before the 15th day of the third calendar month after the close of any taxable year (the "deemed payment deadline date") shall be deemed made during such taxable year if the electing taxpayer irrevocably designates the amount as relating to such taxable year on its timely filed Federal income tax return for such taxable year (see paragraph (b)(4)(iv) of § 1.468A-7 for rules relating to such designation).

(2) The amount of any cash payment made by a customer of an electing taxpayer to a nuclear decommissioning fund of such electing taxpayer shall be deemed made by the electing taxpayer if the amount is included in the gross income of the electing taxpayer in the manner prescribed by section 88 and § 1.88-1.

(d) Treatment of distributions—(1) In general. Except as otherwise provided in paragraph (d)(2) of this section, the amount of any actual or deemed distribution from a nuclear decommissioning fund shall be included in the gross income of the electing taxpayer for the taxable year in which

the distribution occurs. The amount of any distribution of property equals the fair market value of the property on the date of the distribution. A distribution from a nuclear decommissioning fund shall include an expenditure from the fund or the use of the fund's assets—

(i) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the fund relates; and

(ii) To pay administrative costs and other incidental expenses of the fund.

See paragraphs (c) and (d) of § 1.468A-5 for rules relating to the deemed distribution of the assets of a nuclear decommissioning fund in the case of a disqualification or termination of the fund.

(2) Exceptions to inclusion in gross income—(i) Payment of administrative costs and incidental expenses. The amount of any payment by a nuclear decommissioning fund for administrative costs or other incidental expenses of such fund (as defined in paragraph (a)(3)(ii)(A) of § 1.468A-5) shall not be included in the gross income of the electing taxpayer unless such amount is paid to the electing taxpayer (in which case the amount of the payment is included in the gross income of the electing taxpayer under section 61).

(ii) Withdrawals of excess contributions. The amount of a withdrawal of an excess contribution (as defined in paragraph (c)(2)(ii) of § 1.468A-5) by an electing taxpayer pursuant to the rules of paragraph (c)(2) of § 1.468A-5 shall not be included in the gross income of the electing taxpayer. See paragraph (b)(1) of this section, which provides that the payment of such amount to the nuclear decommissioning fund is not deductible by the electing taxpayer.

(iii) Actual distributions of amounts included in gross income as deemed distributions. If the amount of a deemed distribution is included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurs, no further amount is required to be included in gross income when the amount of the deemed distribution is actually distributed by the nuclear decommissioning fund. The amount of a deemed distribution is actually distributed by a nuclear decommissioning fund as the first actual distributions are made by the nuclear decommissioning fund on or after the date of the deemed distribution.

(e) Deduction when economic performance occurs. An electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs no earlier than the taxable year in which economic performance occurs with respect to such costs (see section 461 (h)(2)). The amount of nuclear decommissioning costs that is deductible under this paragraph (e) is determined without regard to section 280B (see paragraph (b)(5) of § 1.468A-1). A deduction is allowed under this paragraph (e) whether or not a deduction was allowed with respect to such costs under section 468A(a) and paragraph (a) of this section for an earlier taxable year (see paragraph (a)(2) of § 1.468A-8, however, for the effective date applicable to this paragraph (e)).

(f) Effect of interim rate orders and retroactive adjustments to such orders—(1) In general. (i) The amount of decommissioning costs included in cost of service for any taxable year that ends before the date of a retroactive adjustment to an interim rate order or interim determination of a public utility commission shall include amounts authorized pursuant to such interim rate order or interim determination unless a taxpayer elects the application of paragraph (f)(2) of this section for such taxable year. For purposes of this paragraph (f), a retroactive adjustment occurs on the effective date of the revised rate schedule that implements the retroactive adjustment.

(ii) If a retroactive adjustment to an interim rate order or interim determination reduces the amount of decommissioning costs included in cost of service for one or more taxable years ending before the date of the adjustment, the amount of such reduction must be subtracted from the amount of decommissioning costs included in cost of service (as determined under paragraph (b)(2) of this section) for one or more taxable years ending on or after the date of the adjustment. For this purpose, the amount of such reduction must be taken into account in the following manner:

(A) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for one taxable year ending before the date of the adjustment, the total amount of the reduction must be taken into account for the taxable year that includes the date of the adjustment.

(B) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for two taxable years ending before the date of the adjustment, at least one-half of the total amount of the reduction must be taken into

account for the first taxable year ending on or after the date of the adjustment and the total amount of the reduction must be taken into account over the first two taxable years ending on or after the date of the adjustment.

(C) If the retroactive adjustment reduces the amount of decommissioning costs included in cost of service for three or more taxable years ending before the date of the adjustment, at least one-third of the total amount of the reduction must be taken into account for the first taxable year ending on or after the date of the adjustment, at least two-thirds of the total amount of the reduction must be taken into account over the first two taxable years ending on or after the date of the adjustment, and the total amount of the reduction must be taken into account over the first three taxable years ending on or after the date of the adjustment.

(2) Special rule permitting withdrawal of excess contribution that results from retroactive adjustment to interim rate order. (i) If a retroactive adjustment that reduces the amount of decommissioning costs included in cost of service for a taxable year occurs on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for such taxable year, a taxpayer may elect the application of this paragraph (f)(2) for such taxable year by—

(A) Including in the amount of decommissioning costs included in cost of service for such taxable year only the amount of decommissioning costs authorized for such taxable year under the retroactive adjustment; and

(B) Withdrawing any excess contribution that results from such treatment in accordance with the rules of paragraph (c)(2) of § 1.468A-5.

(ii) If a taxpayer elects the application of this paragraph (f)(2) for any taxable year, the retroactive adjustment shall not be treated for purposes of paragraph (f)(1)(ii) of this section as a reduction in the amount of decommissioning costs included in cost of service for such taxable year.

(3) Revised schedule of ruling amounts. If the rules provided in this paragraph (f) result in a cost of service amount applicable to a nuclear decommissioning fund for any taxable year that is less than the cost of service amount applicable to the nuclear decommissioning fund for the immediately preceding taxable year, the taxpayer must request a revised schedule of ruling amounts on or before the deemed payment deadline date for the taxable year in which the retroactive adjustment occurs. The first taxable year to which the revised schedule of ruling amount applies shall be the taxable year in which the retroactive adjustment occurs.

(4) Example. The following example illustrates the application of the principles of this paragraph (f):

Example. (i) X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X. During 1989, X is authorized pursuant to an interim rate order issued by the public utility commission of State A to collect nuclear decommissioning costs of $500,000 per year beginning on January 1, 1990. On May 1, 1992, the public utility commission of State A issues a final rate order that is effective on July 1, 1992. The final rate order authorizes X to collect decommissioning costs of $400,000 per year and requires X to refund to the ratepayers of State A excess decommissioning costs of $250,000 collected between January 1, 1990, and July 1, 1992.

(ii) If X elects the application of paragraph (f)(2) of this section for the 1991 taxable year, the amount of decommissioning costs included in cost of service for such taxable year is $400,000. If X made a contribution of $500,000 to a nuclear decommissioning fund for the 1991 taxable year, X must withdraw $100,000 from the nuclear decommissioning fund on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the 1991 taxable year (see paragraph (c)(2) of § 1.468A-5).

(iii) In addition, under paragraph (f)(1)(i) of this section, the amount of decommissioning costs included in cost of service for the 1990 taxable year is $500,000, and, under paragraph (f)(1)(ii) of this section, the amount of decommissioning costs included in cost of service for the 1992 taxable year is $300,000. Because the cost of service amount for the 1991 taxable year ($400,000) is less than the cost of service amount for the 1990 taxable year ($500,000), paragraph (f)(3) of this section applies and X must file a request for a revised schedule of ruling amounts for the period beginning with the 1992 taxable year on or before March 15, 1993.

(iv) Alternatively, if X does not elect the application of paragraph (f)(2) section, the amount of decommissioning costs included in cost of service for the 1990 and 1991 taxable years is $500,000, and, under paragraph (f)(1)(ii) of this section, the amount of decommissioning costs included in cost of service for the 1992 taxable year may not exceed $300,000. Because the cost of service amount for the 1992 taxable year is less than the cost of service amount for the 1991 taxable year, paragraph (f)(3) of this section applies and X must file a request for a revised schedule of ruling amounts for the period beginning with the 1992 taxable year on or before March 15, 1993. [T.D. 8184, 53 FR 6806, March 3, 1988]

§ 1.468A–3 Ruling amount.

(a) In general. (1) Except as otherwise provided in paragraph (j) of this section, an electing taxpayer is allowed a deduction under section 468A(a) for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund only if the taxpayer has received a schedule of ruling amounts for the nuclear decommissioning fund that includes a ruling amount for such taxable

year. Except as provided in paragraph (a) (4) or (5) of this section, a schedule of ruling amounts for a nuclear decommissioning fund ("schedule of ruling amounts") is a ruling (within the meaning of paragraph (a)(2) of § 601.201) specifying the annual payments ("ruling amounts") that, over the taxable years remaining in the "funding period" as of the date the schedule first applies, will result in a projected balance of the nuclear decommissioning fund as of the last day of the funding period equal to (and in no event greater than) the "amount of decommissioning costs allocable to the fund." The projected balance of a nuclear decommissioning fund as of the last day of the funding period shall be calculated by taking into account the fair market value of the assets of the fund as of the first day of the first taxable year to which the schedule of ruling amounts applies and the estimated rate of return to be earned by the assets of the fund after payment of the estimated administrative costs and incidental expenses to be incurred by the fund (as defined in paragraph (a)(3)(ii)(A) of § 1.468A-5), including all Federal, State and local income taxes to be incurred by the fund (the "after-tax rate of return"). See paragraph (c) of this section for a definition of funding period and paragraph (d) of this section for guidance with respect to the amount of decommissioning costs allocable to a fund.

(2) To the extent consistent with the principles and provisions of this section, each schedule of ruling amounts shall be based on the reasonable assumptions and determinations used by the applicable public utility commission(s) in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes, taking into account amounts that are otherwise required to be included in the taxpayer's income under section 88 and the regulations thereunder. Thus, for example, each schedule of ruling amounts shall be based on the public utility commission's reasonable assumptions concerning—

(i) The after-tax rate of return to be earned by the amounts collected for decommissioning;

(ii) The total estimated cost of decommissioning the nuclear power plant (see paragraph (d)(2) of this section); and

(iii) The frequency of contributions to a nuclear decommissioning fund for a taxable year (e.g., monthly, quarterly, semi-annual or annual contributions).

(3) The Internal Revenue Service shall provide a schedule of ruling amounts that is identical to the schedule of ruling amounts proposed by the taxpayer in connection with the taxpayer's request for a schedule of ruling amounts (see paragraph (h)(2)(viii) of this section), but no schedule of ruling amounts shall be provided unless the taxpayer's proposed schedule of ruling amounts is consistent with the principles and provisions of this section. If a proposed schedule of ruling amounts is not consistent with the principles and provisions of this section, the taxpayer may propose an amended schedule of ruling amounts that is consistent with such principles and provisions.

(4) If, in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes, the applicable public utility commission uses an estimated cost of decommissioning that is based on price levels in effect at the time of the ratemaking proceeding (i.e., the public utility commission does not estimate the cost of decommissioning in future dollars), the Internal Revenue Service may, in its discretion, provide a formula or method for determining a schedule of ruling amounts (rather than a schedule specifying a dollar amount for each taxable year) that is consistent with the principles and provisions of this section. See paragraph (i)(1)(ii) of this section for a special rule relating to the mandatory review of ruling amounts that are determined pursuant to a formula or method.

(5) The Internal Revenue Service may, in its discretion, provide a schedule of ruling amounts that is determined on a basis other than the rules of paragraphs (a) through (g) of this section if—

(i) In connection with its request for a schedule of ruling amounts, the taxpayer explains the need for special treatment and sets forth an alternative basis for determining the schedule of ruling amounts; and

(ii) The Internal Revenue Service determines that special treatment is consistent with the purpose of section 468A.

(b) Level funding limitation. (1) Except as otherwise provided in paragraph (b)(4) of this section and paragraph (b)(6) of § 1.468A-8 (relating to a special transitional rule), the ruling amount specified in a schedule of ruling amounts for any taxable year in the level funding limitation period shall not be less than the ruling amount specified in such schedule for any earlier taxable year.

(2) For purposes of this section, the level funding limitation period for a nuclear decommissioning fund is the period that—

(i) Begins on the first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund (see paragraph (a) of § 1.468A-2 for rules relating to the first taxable year for which a payment may be made (or deemed made) to a nuclear decommissioning fund); and

(ii) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraphs (e) (2) and (4) of this section).

(3) The ruling amount specified in a schedule of ruling amounts for a taxable year after the end of the level funding limitation period may be less than the ruling amount specified in such schedule for an earlier taxable year.

(4) The ruling amount specified in a schedule of ruling amounts for the last taxable year in the level funding limitation period may be less than the ruling amount specified in such schedule for any earlier taxable year if the applicable public utility commission assumes for cost of service purposes that decommissioning costs will be included in cost of service for only a portion of the last taxable year in the level funding limitation period. The ruling amount for the last taxable year in the level funding limitation period, however, may not be less than the amount that bears the same relationship to the ruling amount for the preceding taxable year as the period for which decommissioning costs will be included in cost of service for such last taxable year bears to one year.

(c) **Funding period—(1) General rule.** For purposes of this section, the funding period for a nuclear decommissioning fund is the period that—

(i) Begins on the first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund (see paragraph (a)(1) § 1.468A-2 for rules relating to the first taxable year for which a payment may be made (or deemed made) to a nuclear decommissioning fund); and

(ii) Ends on the later of—

(A) The last day of the taxable year that includes the estimated date on which decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's cost of service for ratemaking purposes (see paragraph (e)(1) of this section); or

(B) The last day of the taxable year that includes the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e)(2) of this section).

(2) **Examples.** The following examples illustrate the application of the principles of paragraphs (a), (b) and (c) of this section:

Example (1). (i) X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by power plants owned by X. On March 15, 1995, X commences the construction of a nuclear power plant in State A. On May 15, 1995, the public utility commission of State A issues a final rate order for the four-year period beginning on January 1, 1995, that authorizes X to collect decommissioning costs from ratepayers residing in State A. For the 1995 taxable year, X is authorized to collect decommissioning costs of $500,000, and, for each taxable year during the remainder of the period to which the rate order applies, X is authorized to collect decommissioning costs in an amount equal to 105 percent of the amount authorized to be collected for the preceding taxable year.

(ii) In determining the amount of decommissioning costs to be collected from ratepayers residing in State A, the public utility commission assumes that (A) decommissioning costs will be included in cost of service for each taxable year in the period that begins with 1995 and ends with 2025 and (B) decommissioning costs collected pursuant to subsequent rate orders will increase in the same manner as amounts collected pursuant to the rate order issued on May 15, 1995. In addition, in determining the rate of return to be earned by X with respect to the nuclear power plant, the public utility commission assumes that the nuclear power plant will be included in rate base for each year in the period that begins with 2000 and ends with 2025.

(iii) X requests a schedule of ruling amounts in accordance with the rules of paragraph (h) of this section for the period beginning with the 1995 taxable year. In determining the level funding limitation period and the funding period, the Internal Revenue Service shall assume that a deductible payment will be made to a nuclear decommissioning fund for the 1995 taxable year. Thus, under paragraph (b) of this section, the level funding limitation period begins on January 1, 1995, and ends on December 31, 2025. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1995, and ends on December 31, 2025.

(iv) In its request for a schedule or ruling amounts, X proposes a ruling amount for each taxable year in the funding period that corresponds to the projected cost of service amount for such taxable year. If (A) the assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service are reasonable and (B) the amounts collected pursuant to the proposed schedule, combined with the after-tax earnings on such amounts, will result in a projected balance of the nuclear decommissioning fund as of December 31, 2025, equal to the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the initial schedule of ruling amounts shall equal the ruling amount proposed by X in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for the 1995 taxable year would be $500,000, and the ruling amount for each subsequent taxable year would be 105 percent of the ruling amount for the preceding taxable year.

Example (2). (i) Assume the same facts as in Example (1), except that on May 15, 1995, the public utility commission of State A issues a final rate order for the four-year period beginning on January 1, 1995, that authorizes X to collect decommissioning costs of $600,000 per year from ratepayers residing in State A. In determining the amount of decommissioning costs to be collected from ratepayers residing in State A, the public utility commission assumes that decommissioning costs of $600,000 will be collected for each taxable year in the period that begins with 1995 and ends with 2004 and that decommissioning costs of $200,000 will be collected for each taxable year in the period that begins with 2005 and ends with 2025.

(ii) X requests a schedule of ruling amounts in accordance with the rules of paragraph (h) of this section for the period beginning with the 1995 taxable year. In determining the level funding limitation period and the funding period, the Internal Revenue Service shall assume that a deductible payment will be made to a nuclear decommissioning fund for the 1995 taxable year. Thus, under paragraph (b) of this section, the level funding limitation period begins on January 1, 1995, and ends on December 31, 2025. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1995, and ends on December 31, 2025.

(iii) In its request for a schedule of ruling amounts, X proposes a ruling amount for each taxable year in the funding period that corresponds to the projected cost of service amount for such taxable year. A schedule of ruling amounts based on the projected cost of service amount would be inconsistent with the level funding limitation of paragraph (b) of this section because the projected cost of service amount for 2005 is less than the projected cost of service amount for 2004. Consequently, under paragraph (a)(3) of this section, no schedule of ruling amounts shall be provided to X unless X proposes an amended schedule of ruling amounts that is consistent with the level funding limitation and the other principles and provisions of this section.

(iv) Assume that X proposes an amended schedule of ruling amounts that provides for ruling amounts of $400,000 for each taxable year in the funding period. If (A) the schedule of ruling amounts proposed by X is based on the reasonable assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service and (B) the amounts collected pursuant to the proposed schedule, combined with the after-tax earnings on such amounts, will result in a projected balance of the nuclear decommissioning fund as of December 31, 2025, equal to the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the initial schedule of ruling amounts shall equal the ruling amount proposed by X in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for the 1995 taxable year and for each subsequent taxable year through 2025 would be $400,000.

(v) Under section 468A(b) and paragraph (b)(1) of § 1.468A-2, the maximum amount of cash payments that X can make to a nuclear decommissioning fund for any taxable year shall not exceed the lesser of (A) the cost of service amount for such taxable year or (B) the ruling amount for such taxable year. If the projected cost of service amount that was assumed in determining rates under the rate order that was issued on May 15, 1995, is the actual cost of service amount for each taxable year in the funding period and the ruling amounts provided in the initial schedule of ruling amounts are not changed by a subsequent schedule of ruling amounts, then X would be allowed to make a deductible contribution of $400,000 to a nuclear decommissioning fund for each taxable year in the period that begins with 1995 and ends with 2004 and to make a deductible contribution of $200,000 to such nuclear decommissioning fund for each taxable year in the period that begins with 2005 and ends with 2025.

Example (3). (i) Y corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by power plants owned by Y. On June 1, 1990, a nuclear power plant owned by Y began commercial operations in State B. In the first ratemaking proceeding in which the nuclear power plant was included in rate base, the public utility commission of State B assumed that the nuclear power plant would be included in rate base for each year in the period that began with 1990 and ended with 2020. In addition, for each taxable year in the period that began with 1990 and ended with 2017, Y made a deductible contribution of $750,000 to a nuclear decommissioning fund established by Y. The $750,000 contribution equalled the cost of service amount and the ruling amount for each taxable year in the 28-year period.

(ii) On August 30, 2017, the public utility commission of State B issues a final rate order for the six-year period beginning on January 1, 2018, that authorizes Y to collect decommissioning costs of: (A) $500,000 for 2018, 2019 and 2020; (B) $1,500,000 for 2021; (C) $1,000,000 for 2022; and (D) $750,000 for 2023. In determining the amount of decommissioning costs to be collected from ratepayers residing in State B, the public utility commission assumes that decommissioning costs will no longer be included in cost of service after 2023. In addition, in determining the rate of return to be earned by Y with respect to the nuclear power plant, the public utility commission assumes that the nuclear power plant will no longer be included in rate base after 2020.

(iii) Under paragraph (i)(1)(iii) of this section, Y is required to request a revised schedule of ruling amounts on or before March 15, 2019. Assume that Y makes a timely request for a revised schedule of ruling amounts in accordance with the rules of paragraph (h) of this section. In its request, Y proposes a ruling amount for each taxable year in the period that begins with 2018 and ends with 2023 that corresponds to the amount of decommissioning costs to be included in cost of service under the rate order of August 30, 2017.

(iv) Under paragraph (b) of this section, the level funding limitation period begins on January 1, 1990, and ends on December 31, 2020. Under paragraph (c)(1) of this section, the funding period begins on January 1, 1990, and ends on December 31, 2023.

(v) If (A) the assumptions and determinations used by the public utility commission in establishing the amount of decommissioning costs to be included in cost of service are reasonable and (B) the projected balance of the nuclear decommissioning fund as of December 31, 2023 (taking into account the fair market value of the assets of the fund as of January 1, 2018, and the estimated after-tax rate of return to be earned by the assets of the fund) will equal the amount of decommissioning costs allocable to the fund, then, under paragraph (a)(3) of this section, each ruling amount in the revised schedule of ruling amounts shall equal the ruling amount proposed by Y in connection with its request for a schedule of ruling amounts. Thus, the ruling amount for 2018, 2019 and 2020 would be $500,000, the ruling amount for 2021 would be $1,500,000, the ruling amount for 2022 would be $1,000,000 and the ruling amount for 2023 would be $750,000.

(vi) Although the ruling amount specified in the revised schedule of ruling amounts for 2018, 2019 and 2020 is less than a ruling amount specified in a prior schedule of ruling amounts for years prior to 2018, the revised schedule of ruling amounts is consistent with the level funding limitation. Under paragraph (i)(3) of this section, a ruling amount specified in a

revised schedule of ruling amounts for any taxable year in level funding limitation period may be less than one or more ruling amounts specified in a prior schedule of ruling amounts for a prior taxable year. In addition, although the ruling amount specified in the revised schedule of ruling amounts for 2022 and 2023 is less than a ruling amount specified in such schedule for a prior taxable year, the revised schedule of ruling amounts is consistent with the level funding limitation because the level funding limitation period ends on December 31, 2020.

(d) Decommissioning costs allocable to a fund. The amount of decommissioning costs allocable to a nuclear decommissioning fund is determined for purposes of this section by applying the following rules and definitions:

(1) General rule. The amount of decommissioning costs allocable to a nuclear decommissioning fund is the taxpayer's share of the total estimated cost of decommissioning the nuclear power plant to which the fund relates, multiplied by the qualifying percentage.

(2) Total estimated cost of decommissioning. (i) Except as otherwise provided in paragraph (d)(2)(ii) of this section, the total estimated cost of decommissioning a nuclear power plant is the reasonably estimated cost of decommissioning used by the applicable public utility commission in establishing or approving the amount of decommissioning costs to be included in cost of service for ratemaking purposes. If, in establishing or approving the amount of decommissioning costs to be included in cost of service, the public utility commission uses an estimated cost of decommissioning that is equal to a generic estimate of the cost of decommissioning as determined by the Nuclear Regulatory Commission (or an estimated cost that is based on the generic estimate adjusted for inflation), the Internal Revenue Service may, at its discretion, accept such amount as a reasonable estimate of the cost of decommissioning. In addition, if the estimated costs used by the applicable public utility commission are expected to be paid in any taxable year other than the taxable year that includes the last day of the funding period or the immediately succeeding taxable year, such costs must be adjusted (increased or decreased, as the case may be) by discounting or compounding such costs at the after-tax rate of return from the date such costs are expected to be paid to the last day of the funding period.

(ii) If, in establishing or approving the amount of decommissioning costs to be included in cost of service, the applicable public utility commission assumes a projected balance of amounts set aside for decommissioning (whether or not such amounts are provided by a nuclear decommissioning fund) that is less than the total estimated cost of decommissioning assumed by the public utility commission, the total estimated cost of decommissioning for purposes of determining the schedule of ruling amounts shall equal the projected balance of amounts set aside for decommissioning that was assumed by the public utility commission.

(3) Taxpayer's share. The taxpayer's share of the total estimated cost of decommissioning a nuclear power plant equals the total estimated cost of decommissioning such nuclear power plant multiplied by the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents (see paragraph (b)(2) of § 1.468A-1 for circumstances in which a taxpayer possesses a qualifying interest in a nuclear power plant).

(4) Qualifying percentage. (i) Except as otherwise provided in paragraph (b)(7)(iii) of § 1.468A-8 (relating to a special transitional rule), the qualifying percentage for any nuclear decommissioning fund is equal to the fraction, the numerator of which is the number of taxable years in the estimated period for which the nuclear decommissioning fund is to be in effect and the denominator of which is the number of taxable years in the estimated useful life of the applicable nuclear power plant.

(ii) Except as otherwise provided in paragraph (b)(7) (i) or (ii) of § 1.468A-8 (relating to special transitional rules), the estimated period for which a nuclear decommissioning fund is to be in effect—

(A) Begins on the later of—

(*1*) The first day of the first taxable year for which a deductible payment is made (or deemed made) to such nuclear decommissioning fund; or

(*2*) The first day of the taxable year that includes the date the nuclear power plant to which such nuclear decommissioning fund relates begins commercial operations; and

(B) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant to which such nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e) (3) and (4) of this section).

(iii) Except as otherwise provided in paragraph (b)(7)(ii) of § 1.468A-8 (relating to a special transitional rule), the estimated useful life of a nuclear power plant.

(A) Begins on the first day of the taxable year that includes the date that the nuclear power plant begins commercial operations; and

(B) Ends on the last day of the taxable year that includes the estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes (see paragraph (e) (3) and (4) of this section).

(e) Determination of estimated dates. (1) For purposes of paragraph (c)(1)(ii)(A) of this section (relating to the funding period), the estimated date on which decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's cost of service for ratemaking purposes is determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts.

(2) For purposes of paragraphs (b)(2)(ii) and (c)(1)(ii)(B) of this section (relating to the level funding limitation period and the funding period), the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes is determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts.

(3) For purposes of paragraph (d)(4) (ii)(B) and (iii)(B) of this section (relating to the qualifying percentage), the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base for ratemaking purposes is determined under the ratemaking assumptions used by the applicable public utility commission in establishing or approving rates during the first ratemaking proceeding in which the nuclear power plant was included in the taxpayer's rate base.

(4) For purposes of this section, in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of § 1.468A-1, the date corresponding to "the estimated date on which the nuclear power plant to which the nuclear decommissioning fund relates will no longer be included in the taxpayer's rate base" will be determined upon the basis of all the facts and circumstances in a manner consistent with the provisions of this section and section 468A of the Code.

(f) Special rules in the case of rates established or approved by two or more public utility commissions. If two or more public utility commissions establish or approve rates for electric energy generated by a single nuclear power plant, the following rules shall apply in determining the schedule of ruling amounts for the nuclear decommissioning fund that relates to such nuclear power plant.

(1) A schedule of ruling amounts shall be separately determined pursuant to the rules of paragraphs (a) through (e) of this section for each public utility commission that has determined the amount of decommissioning costs to be included in cost of service for ratemaking purposes with respect to such nuclear power plant (see paragraph (g) of this section).

(2) The separate determination with respect to a public utility commission shall be based on the reasonable assumptions and determinations used by such public utility commission and shall take into account only that portion of the total estimated cost of decommissioning the nuclear power plant that is properly allocable to the ratepayers whose rates are established or approved by such public utility commission.

(3) The ruling amount applicable to the nuclear decommissioning fund for any taxable year is the sum of the ruling amounts for such taxable year determined under the separate schedules of ruling amounts.

(4) The schedule of ruling amounts for the nuclear decommissioning fund is the schedule of the ruling amounts determined under paragraph (f)(3) of this section.

(g) Requirement of determination by public utility commission of decommissioning costs to be included in cost of service. The Internal Revenue Service shall not provide a taxpayer with a schedule of ruling amounts for any nuclear decommissioning fund unless a public utility commission that establishes or approves rates for electric energy generated by the nuclear power plant to which the nuclear decommissioning fund relates has—

(1) Determined the amount of decommissioning costs of such nuclear power plant to be included in the taxpayer's cost of service for ratemaking purposes; and

(2) Disclosed the after-tax return and any other assumption and determinations used in establishing or approving such amount for any taxable year beginning on or after January 1, 1987.

(h) Manner of requesting schedule of ruling amounts—(1) In general. (i) In order to receive a ruling amount for any taxable year, a taxpayer

must file a request for a schedule of ruling amounts that complies with the requirements of this paragraph (h), the applicable procedural rules set forth in paragraph (e) of § 601.201 (Statement of Procedural Rules) and the requirements of any applicable revenue procedure that is in effect on the date the request is filed.

(ii) A separate request for a schedule of ruling amounts is required for each nuclear decommissioning fund established by a taxpayer (see paragraph (a) of § 1.468A-5 for rules relating to the number of nuclear decommissioning funds that a taxpayer can establish).

(iii) A request for a schedule of ruling amounts must not contain a request for a ruling on any other issue, whether the issue involves section 468A or another section of the Internal Revenue Code.

(iv) In the case of an affiliated group of corporations that join in the filing of a consolidated return, the common parent of the group may request a schedule of ruling amounts for each member of the group that possesses a qualifying interest in the same nuclear power plant by filing a single submission with the Internal Revenue Service.

(v) A request for a schedule of ruling amounts must be mailed or delivered to the Internal Revenue Service, Associate Chief Counsel (Technical), Attention CC:C:2:6, 1111 Constitution Avenue, NW., Washington, DC 20224.

(vi) Except as otherwise provided in paragraph (b)(1) of § 1.468A-8, the Internal Revenue Service shall not provide or revise a ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date (as defined in paragraph (c)(1) of § 1.468A-2) for such taxable year. In determining the date when a request is filed, the principles of sections 7502 and 7503 shall apply.

(vii) Except as provided in paragraph (h)(1)(viii) of this section, a request for a schedule of ruling amounts shall be considered filed only if such request complies substantially with the requirements of this paragraph (h).

(viii) If a request does not comply substantially with the requirements of this paragraph (h), the Internal Revenue Service shall notify the taxpayer of this fact. If the information or materials necessary to comply substantially with the requirements of this paragraph (h) are provided to the Internal Revenue Service within 60 days after such notification, the request shall be considered filed on the date of original submission. If the information or materials necessary to comply substantially with the requirements of this paragraph (h) are not provided within 60 days after such notification, the request shall be considered filed on the date that all information or materials necessary to comply substantially with the requirements of this paragraph (h) are provided.

(2) **Information required.** A request for a schedule of ruling amounts must contain the following information:

(i) The taxpayer's name, address and taxpayer identification number.

(ii) Whether the request is for an initial schedule of ruling amounts, a mandatory review of the schedule of ruling amounts (see paragraph (i)(1) of this section) or an elective review of the schedule of ruling amounts (see paragraph (i)(2) of this section).

(iii) The name and location of the nuclear power plant with respect to which a schedule of ruling amounts is requested.

(iv) A description of the taxpayer's qualifying interest in the nuclear power plant and the percentage of such nuclear power plant that the qualifying interest of the taxpayer represents.

(v) An identification of each public utility commission that establishes or approves rates for the furnishing or sale by the taxpayer of electric energy generated by the nuclear power plant, and, for each public utility commission identified—

(A) Whether the public utility commission has determined the amount of decommissioning costs to be included in the taxpayer's cost of service for ratemaking purposes; and

(B) Whether a proceeding is pending before the public utility commission that may result in an increase or decrease in the amount of decommissioning costs to be included in cost of service.

(vi) For each public utility commission that has determined the amount of decommissioning costs to be included in the taxpayer's cost of service for ratemaking purposes—

(A) The amount of decommissioning costs that are to be included in the taxpayer's cost of service for each taxable year under the current determination and amounts that otherwise are required to be included in the taxpayer's income under section 88 and the regulations thereunder;

(B) A description of the assumptions, estimates and other factors that were used in determining the amounts described in paragraph (h)(2)(vi)(A) of this section, including each of the following if applicable—

(*1*) A description of the proposed method of decommissioning the nuclear power plant (for example, prompt removal/dismantlement, safe storage entombment with delayed dismantlement, or safe storage mothballing with delayed dismantlement);

(*2*) The estimated year in which substantial decommissioning costs will first be incurred;

(*3*) The estimated year in which the decommissioning of the nuclear power plant will be substantially complete (see paragraph (d)(2) of § 1.468A-5 for a definition of substantial completion of decommissioning);

(*4*) The total estimated cost of decommissioning expressed in current dollars (i.e., based on price levels in effect at the time of the current determination);

(*5*) The total estimated cost of decommissioning expressed in future dollars (i.e., based on anticipated price levels when expenses are expected to be paid);

(*6*) For each taxable year in the period that begins with the year specified in paragraph (h)(2)(vi)(B)(*2*) of this section ("the estimated year in which substantial decommissioning costs will first be incurred") and ends with the year specified in paragraph (h)(2)(vi)(B)(*3*) of this section ("the estimated year in which the estimated year in which the decommissioning of the nuclear power plant will be substantially complete"), the estimated cost of decommissioning expressed in future dollars;

(*7*) A description of the methodology used in converting the estimated cost of decommissioning expressed in current dollars to the estimated cost of decommissioning expressed in future dollars;

(*8*) The assumed after-tax rate of return to be earned by the amounts collected for decommissioning (if two or more after-tax rates of return are assumed by the public utility commission, each assumed after-tax rate of return and the amounts collected for decommissioning to which each assumed after-tax rate of return applies);

(*9*) The proposed period over which decommissioning costs will be included in the cost of service of the taxpayer and the projected amount that will be included in cost of service for each taxable year in the proposed period;

(*10*) The estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes as determined under the ratemaking assumptions that were used to determine the last rates (whether interim or final) that were established or approved by the applicable public utility commission prior to the filing of the current request for a schedule of ruling amounts (or a corresponding date in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of § 1.468A-1; see paragraph (e)(4) of this section); and

(*11*) The estimated date on which the nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes as determined under the ratemaking assumptions that were used by the applicable public utility commission in establishing or approving rates during the first ratemaking proceeding in which the nuclear power plant was included in the taxpayer's rate base (or a corresponding date in the case of a taxpayer whose interest in the nuclear power plant is described in paragraph (b)(2)(ii) of § 1.468A-1; see paragraph (e)(4) of this section);

(C) A copy of such portions of any order or opinion of the public utility commission as pertain to the commission's most recent determination of the amount of decommissioning costs to be included in cost of service; and

(D) A copy of each engineering or cost study that was relied on or used by the taxpayer or the public utility commission in determining the amount of decommissioning costs to be included in the taxpayer's cost of service under the current determination.

(vii) For each proceeding pending before a public utility commission that may result in an increase or decrease in the amount of decommissioning costs to be included in the taxpayer's cost of service—

(A) A description of the stage of the proceeding;

(B) The amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service for each taxable year;

(C) A description of the assumptions, estimates and other factors that were used in determining the amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service for each taxable year, including each of the

items described in paragraph (h)(2)(vi)(B) of this section if applicable; and

(D) A copy of each engineering or cost study that was relied on or used by the taxpayer or the public utility commission in determining the amount of decommissioning costs that are proposed to be included in the taxpayer's cost of service.

(viii) A proposed schedule of ruling amounts for each taxable year remaining in the funding period as of the date the schedule of ruling amounts will first apply.

(ix) A description of the assumptions, estimates and other factors that were used in determining the proposed schedule of ruling amounts, including each of the following if applicable—

(A) The level funding limitation period (as such term is defined in paragraph (b)(2) of this section);

(B) The funding period (as such term is defined in paragraph (c) of this section);

(C) The assumed after-tax rate of return to be earned by the assets of the nuclear decommissioning fund;

(D) The fair market value of the assets (if any) of the nuclear decommissioning fund as of the first day of the first taxable year to which the schedule of ruling amounts will apply;

(E) The amount expected to be earned by the assets of the nuclear decommissioning fund (based on the after-tax rate of return applicable to the fund) over the period that begins on the first day of the first taxable year to which the schedule of ruling amounts will apply and ends on the last day of the funding period;

(F) The amount of decommissioning costs allocable to the nuclear decommissioning fund (as determined under paragraph (d) of this section);

(G) The total estimated cost of decommissioning (as such term is defined in paragraph (d)(2) of this section);

(H) The taxpayer's share of the total estimated cost of decommissioning (as such term is defined in paragraph (d)(3) of this section);

(I) The qualifying percentage (as such term is defined in paragraph (d)(4)(i) of this section);

(J) The estimated period for which the nuclear decommissioning fund is to be in effect (as such term is defined in paragraph (d)(4)(ii) of this section); and

(K) The estimated useful life of the nuclear power plant (as such term is defined in paragraph (d)(4)(iii) of this section).

(x) If the request is for a revised schedule of ruling amounts, the after-tax rate of return earned by the assets of the nuclear decommissioning fund for each taxable year in the period that begins with the date of the initial contribution to the fund and ends with the first day of the first taxable year to which the revised schedule of ruling amounts applies.

(xi) If applicable, an explanation of the need for a schedule of ruling amounts determined on a basis other than the rules of paragraphs (a) through (g) of this section and a description of an alternative basis for determining a schedule of ruling amounts (see paragraph (a)(5) of this section).

(xii) Any other information required by the Internal Revenue Service that may be necessary or useful in determining the schedule of ruling amounts.

(3) **Administrative procedures.** The Internal Revenue Service may prescribe administrative procedures that supplement the provisions of paragraph (h) (1) and (2) of this section. In addition, the Internal Revenue Service may, in its discretion, waive the requirements of paragraph (h) (1) and (2) of this section under appropriate circumstances.

(i) **Review and revision of schedule of ruling amounts—(1) Mandatory review.** (i) Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (h) of this section must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the 10th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received. The first taxable year to which the revised schedule of ruling amounts applies shall be the 10th taxable year that begins after the taxable year in which the most recent schedule of ruling amounts was received.

(ii) Any taxpayer that has obtained a formula or method for determining a schedule of ruling amounts (see paragraph (a)(4) of this section) must file a request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the 5th taxable year that begins after the taxable year in which the most recent formula or method was received. The first taxable year to which the revised schedule of ruling amounts applies (whether or not the ruling amounts continue

to be determined pursuant to a formula or method) shall be the 5th taxable year that begins after the taxable year in which the most recent formula or method was received.

(iii) A taxpayer is required to request a revised schedule of ruling amounts for a nuclear decommissioning fund If—

(A) Any public utility commission that establishes or approves rates for the furnishing or sale of electric energy generated by a nuclear power plant to which the nuclear decommissioning fund relates—

(1) Increases the proposed period over which decommissioning costs of such nuclear power plant will be included in cost of service for ratemaking purposes;

(2) Adjusts the estimated date on which such nuclear power plant will no longer be included in the taxpayer's rate base for ratemaking purposes; or

(3) Reduces the amount of decommissioning costs to be included in cost of service for any taxable year; and

(B) The taxpayer's most recent request for a schedule of ruling amounts did not provide notice to the Internal Revenue Service of such action by the public utility commission.

(iv) If a taxpayer is required to request a revised schedule of ruling amounts by reason of an action described in paragraph (i)(1)(iii) of this section, the taxpayer must file the request for a revised schedule of ruling amounts on or before the deemed payment deadline date for the first taxable year in which rates that reflect such action become effective. The first taxable year to which the revised schedule of ruling amounts applies shall be the first taxable year in which such rates become effective.

(v) A request for a schedule of ruling amounts required by this paragraph (i)(1) must be made in accordance with the rules of paragraph (h) of this section. If a taxpayer does not properly file a request for a revised schedule of ruling amounts by the date provided in paragraph (i)(1) (i), (ii) or (iv) of this section (whichever is applicable), the taxpayer's ruling amount for the first taxable year to which the revised schedule of ruling amounts would have applied and for all succeeding taxable years until a new schedule is obtained shall be zero, unless, in its discretion, the Internal Revenue Service provides otherwise in such new schedule of ruling amounts.

(vi) See paragraph (f)(3) of § 1.468A-2 for the application of the rules in paragraph (i)(1) (iii), (iv), and (v) of this section in the case of certain retroactive adjustments to interim rate orders.

(2) **Elective review.** Any taxpayer that has obtained a schedule of ruling amounts pursuant to paragraph (h) of this section can request a revised schedule of ruling amounts. Such a request must be made in accordance with the rules of paragraph (h) of this section; thus, the Internal Revenue Service shall not provide a revised ruling amount applicable to a taxable year in response to a request for a schedule of ruling amounts that is filed after the deemed payment deadline date for such taxable year (see paragraph (h)(1)(vi) of this section).

(3) **Determination of revised schedule of ruling amounts.** A revised schedule of ruling amounts for a nuclear decommissioning fund shall be determined under this section without regard to any schedule of ruling amounts for such nuclear decommissioning fund that was issued prior to such revised schedule. Thus, a ruling amount specified in a revised schedule of ruling amounts for any taxable year in the level funding limitation period can be less than one or more ruling amounts specified in a prior schedule of ruling amounts for a prior taxable year.

(j) **Special rule permitting payments to a nuclear decommissioning fund before receipt of an initial or revised ruling amount applicable to a taxable year.** (1) If an electing taxpayer has filed a timely request for an initial or revised ruling amount for a taxable year beginning on or after January 1, 1987, and does not receive the ruling amount on or before the deemed payment deadline date for such taxable year, the taxpayer may make a payment to a nuclear decommissioning fund on the basis of the ruling amount proposed in the taxpayer's request. Thus, under the preceding sentence, an electing taxpayer may make a payment to a nuclear decommissioning fund for such taxable year that does not exceed the lesser of—

(i) The cost of service amount applicable to the nuclear decommissioning fund for such taxable year; or

(ii) The ruling amount proposed by the taxpayer for such taxable year in a timely filed request for a schedule of ruling amounts.

(2) If an electing taxpayer makes a payment to a nuclear decommissioning fund for any taxable year pursuant to paragraph (j)(1) of this section and the ruling amount that is provided by the

Internal Revenue Service is greater than the ruling amount proposed by the taxpayer for such taxable year, the taxpayer is not allowed to make an additional payment to the fund for such taxable year after the deemed payment deadline date for such taxable year.

(3) If—(i) An electing taxpayer makes a payment to a nuclear decommissioning fund for any taxable year pursuant to paragraph (j)(1) of this section,

(ii) The ruling amount that is provided by the Internal Revenue Service is less than the ruling amount proposed by the taxpayer for such taxable year, and

(iii) As a result, there is an excess contribution (as defined in paragraph (c)(2)(ii) of § 1.468A-5) for such taxable year,

Then the amount of the excess contribution is not deductible (see paragraph (b)(1) of § 1.468A-2) and must be withdrawn by the taxpayer pursuant to the rules of paragraph (c)(2)(i) of § 1.468A-5. Thus, an electing taxpayer that files a return based on a payment made pursuant to paragraph (j)(1) of this section should file an amended return if an excess contribution results when the ruling amount is issued for such taxable year.

[T.D. 8184, 53 FR 6808, March 3, 1988]

§ 1.468A-4 Treatment of nuclear decommissioning fund.

(a) In general. A nuclear decommissioning fund is subject to tax on all of its modified gross income (as defined in paragraph (b) of this section) for any taxable year at a single rate equal to the maximum rate in effect under section 11(b) (determined without regard to any rate that is added to the otherwise applicable rate in order to offset the effect of the graduated rate schedule). Such tax is in lieu of any other tax that may be imposed under subtitle A of the Internal Revenue Code on the income earned by the assets of the nuclear decommissioning fund.

(b) Modified gross income. For purposes of this section, the term "modified gross income" means gross income as defined under section 61 computed with the following modifications:

(1) The amount of any payment to the nuclear decommissioning fund with respect to which a deduction is allowed under section 468A(a) is excluded from gross income.

(2) A deduction is allowed for the amount of administrative costs and other incidental expenses of the nuclear decommissioning fund (including taxes, legal expenses, accounting expenses, actuarial expenses and trustee expenses, but not including decommissioning costs) that are otherwise deductible and that are paid by the nuclear decommissioning fund to any person other than the electing taxpayer. An expense is otherwise deductible for purposes of this paragraph (b)(2) if it would be deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. For example, because Federal income taxes are not deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation, the tax imposed by section 468A(e)(2) and paragraph (a) of this section is not deductible in determining the modified gross income of a nuclear decommissioning fund. Similarly, because certain expenses allocable to tax-exempt interest income are not deductible under section 265 of the Internal Revenue Code in determining the taxable income of a corporation, such expenses are not deductible in determining the modified gross income of a nuclear decommissioning fund.

(3) A deduction is allowed for the amount of otherwise deductible losses that are sustained by the nuclear decommissioning fund in connection with the sale, exchange or worthlessness of an investment described in paragraph (a)(3)(i)(C) of § 1.468A-5. A loss is otherwise deductible for purposes of this paragraph (b)(3) if such a loss would be deductible by a corporation under section 165 (f) or (g) and sections 1211(a) and 1212(a).

(4) A deduction is allowed for the amount of an otherwise deductible net operating loss of the nuclear decommissioning fund. For purposes of this paragraph (b), the net operating loss of a nuclear decommissioning fund for a taxable year is the amount by which the deductions allowable under paragraph (b) (2) and (3) of this section exceed the gross income of the nuclear decommissioning fund computed with the modification described in paragraph (b)(1) of this section. A net operating loss is otherwise deductible for purposes of this paragraph (b)(4) if such a net operating loss would be deductible by a corporation under section 172(a).

(c) Special rules—(1) Period for computation of modified gross income. The modified gross income of a nuclear decommissioning fund must be computed on the basis of the taxable year of the electing taxpayer. If an electing taxpayer changes its taxable year, each nuclear decommissioning fund of the electing taxpayer must change to the new taxable year. See section 442 and § 1.442-1

for rules relating to the change to a new taxable year.

(2) Gain or loss upon distribution of property by a fund. A distribution of property by a nuclear decommissioning fund (whether an actual distribution or a deemed distribution) shall be considered a disposition of property by the nuclear decommissioning fund for purposes of section 1001. In determining the amount of gain or loss from such disposition, the amount realized by the nuclear decommissioning fund shall be the fair market value of the property on the date of disposition.

(3) Denial of credits against tax. The tax imposed on the modified gross income of a nuclear decommissioning fund under paragraph (a) of this section is not to be reduced or offset by any credits against tax provided by part IV of subchapter A of chapter 1 of the Internal Revenue Code other than the credit provided by section 31(c) for amounts withheld under section 3406 (back-up withholding).

(4) Other corporate taxes inapplicable. Although the modified gross income of a nuclear decommissioning fund is subject to tax at a rate equal to the maximum rate in effect under section 11(b) (determined without regard to any rate that is added to the otherwise applicable rate in order to offset the effect of the graduated rate schedule), a nuclear decommissioning fund is not subject to the other taxes imposed on corporations under subtitle A of the Internal Revenue Code. For example, a nuclear decommissioning fund is not subject to the alternative minimum tax imposed by section 55, the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, and the alternative tax imposed on a corporation under section 1201(a).

(d) Treatment as corporation for purposes of subtitle F. For purposes of subtitle F of the Internal Revenue Code and the regulations thereunder, a nuclear decommissioning fund is to be treated as if it were a corporation and the tax imposed by section 468A(e)(2) and paragraph (a) of this section is to be treated as a tax imposed by section 11. Thus, for example, the following rules apply:

(1) A nuclear decommissioning fund must file a return with respect to the tax imposed by section 468A(e)(2) and paragraph (a) of this section for each taxable year (or portion thereof) that the fund is in existence even though no amount is included in the gross income of the fund for such taxable year. The return is to be made on Form 1120-ND in accordance with the instructions relating to such form. For purposes of this paragraph (d)(1), a nuclear decommissioning fund is in existence for the period that—

(i) Begins on the date that the first deductible payment is actually made to such nuclear decommissioning fund; and

(ii) Ends on the date of termination (see paragraph (d) of § 1.468A-5), the date that the entire fund is disqualified (see paragraph (c) of § 1.468A-5), or the date that the electing taxpayer disposes of its entire qualifying interest in the nuclear power plant to which the nuclear decommissioning fund relates, whichever is applicable.

(2) For each taxable year of the nuclear decommissioning fund, the return described in paragraph (d)(1) of this section must be filed on or before the 15th day of the third month following the close of such taxable year unless the nuclear decommissioning fund is granted an extension of time for filing under section 6081. If such an extension is granted for any taxable year, the return for such taxable year must be filed on or before the extended due date for such taxable year. In no event will the filing of the initial return of a nuclear decommissioning fund be required before January 6, 1987.

(3) A nuclear decommissioning fund must provide its employer identification number on returns, statements and other documents as required by the forms and instructions relating thereto. The employer identification number is obtained by filing a Form SS-4 in accordance with the instructions relating thereto.

(4) A nuclear decommissioning fund must make payments of estimated tax during its taxable year as provided in section 6154(b) if its estimated tax for such taxable year can reasonably be expected to be $40 or more. For purposes of section 6154 and this section, the estimated tax of a nuclear decommissioning fund for any taxable year is the amount that the nuclear decommissioning fund estimates as the amount of tax imposed by section 468A(e)(2) and paragraph (a) of this section for such taxable year.

(5) A nuclear decommissioning fund must deposit all payments of tax imposed by section 468A(e)(2) and paragraph (a) of this section (including any payments of estimated tax) with an authorized government depositary in accordance with § 1.6302-1.

(6) A nuclear decommissioning fund is subject to the addition to tax imposed by section 6655 in

case of a failure to pay estimated income tax. For purposes of section 6655 and this section—

(i) The tax with respect to which the amount of the underpayment is computed in the case of a nuclear decommissioning fund is the tax imposed by section 468A(e)(2) and paragraph (a) of this section; and

(ii) A nuclear decommissioning fund is to be considered a large corporation under section 6655(i) if such nuclear decommissioning fund had modified gross income (as defined in paragraph (b) of this section) of $1,000,000 or more for any taxable year during the testing period.

[T.D. 8184, 53 FR 6814, March 3, 1988]

§ 1.468A–5 Nuclear decommissioning fund qualification requirements; prohibitions against self-dealing; disqualification of nuclear decommissioning fund; termination of fund upon substantial completion of decommissioning.

(a) Qualification requirements—(1) In general. (i) A nuclear decommissioning fund must be established and maintained at all times in the United States pursuant to an arrangement that qualifies as a trust under State law. Such trust must be established for the exclusive purpose of providing funds for the decommissioning of one or more nuclear power plants, but a single trust agreement may establish multiple funds for such purpose. Thus—

(A) Two or more nuclear decommissioning funds can be established and maintained pursuant to a single trust agreement; and

(B) One or more funds that are to be used for the decommissioning of a nuclear power plant and that do not qualify as nuclear decommissioning funds under this paragraph (a) (nonqualified decommissioning funds) can be established and maintained pursuant to a trust agreement that governs one or more nuclear decommissioning funds.

(ii) A separate nuclear decommissioning fund is required for each electing taxpayer and for each nuclear power plant with respect to which an electing taxpayer possesses a qualifying interest. The Internal Revenue Service shall issue a separate schedule of ruling amounts with respect to each nuclear decommissioning fund and each nuclear decommissioning fund must file a separate income tax return even if other nuclear decommissioning funds or nonqualified decommissioning funds are established and maintained pursuant to the trust agreement governing such fund or the assets of other nuclear decommissioning funds or nonqualified decommissioning funds are pooled with the assets of such fund.

(iii) The assets of two or more nuclear decommissioning funds (whether or not established pursuant to a single trust agreement) can be pooled for the purpose of investing the assets in property described in paragraph (a)(3)(i)(C) of this section if and only if—

(A) The trustee of each nuclear decommissioning fund separately accounts for the contributions, earnings, expenses, and distributions of such fund;

(B) The earnings and expenses are reasonably apportioned among such nuclear decommissioning funds; and

(C) The books and records of such funds enable the Internal Revenue Service to verify that the requirements of section 468A and §§ 1.468A-1 through 1.468A-5, 1.468A-7 and 1.468A-8 are satisfied with respect to each nuclear decommissioning fund.

(iv) The assets of nonqualified decommissioning funds can be pooled with the assets of one or more nuclear decommissioning funds for the purpose of investing the assets in property described in paragraph (a)(3)(i)(C) of this section if and only if the requirements of paragraph (a)(1)(iii) (A) and (C) of this section are satisfied and earnings and expenses are reasonably apportioned among the pooled funds.

(v) An electing taxpayer can maintain only one nuclear decommissioning fund for each nuclear power plant with respect to which the taxpayer elects the application of section 468A. If a nuclear power plant is subject to the ratemaking jurisdiction of two or more public utility commissions and any such public utility commission requires a separate fund to be maintained for the benefit of ratepayers whose rates are established or approved by the public utility commission, the separate funds maintained for such plant (whether or not established and maintained pursuant to a single trust agreement) shall be considered a single nuclear decommissioning fund for purposes of section 468A and §§ 1.468A-1 through 1.468A-5, 1.468A-7 and 1.468A-8. Thus, for example, the Internal Revenue Service shall issue one schedule of ruling amounts with respect to such nuclear power plant (see paragraph (f) of § 1.468A-3), the nuclear decommissioning fund must file a single income tax return (see paragraph (d)(1) of § 1.468A-4), and, if the Internal Revenue Service

disqualifies the nuclear decommissioning fund, the assets of each separate fund are treated as distributed on the date of disqualification (see paragraph (c)(3) of this section).

(2) Limitation on contributions. Except as otherwise provided in paragraph (b)(2)(ii) of § 1.468A-8 (relating to a special transitional rule), a nuclear decommissioning fund is not permitted to accept any contributions in cash or property other than cash payments with respect to which a deduction is allowed under section 468A(a) and paragraph (a) of § 1.468A-2. Thus, for example, unless the exception contained in paragraph (b)(2)(ii) of § 1.468A-8 applies, securities may not be contributed to a nuclear decommissioning fund even if the taxpayer or a fund established by the taxpayer previously held such securities for the purpose of providing funds for the decommissioning of a nuclear power plant.

(3) Limitation on use of fund—(i) In general. The assets of a nuclear decommissioning fund are to be used exclusively—

(A) To satisfy, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(B) To pay administrative costs and other incidental expenses of the nuclear decommissioning fund; and

(C) To the extent that the assets of the nuclear decommissioning fund are not currently required for the purposes described in paragraph (a)(3)(i) (A) or (B) of this section, to invest directly in—

(1) Public debt securities of the United States;

(2) Obligations of a State or local government that are not in default as to principal or interest; or

(3) Time or demand deposits in a bank (as defined in section 581) or an insured credit union (within the meaning of section 101(6) of the Federal Credit Union Act, 12 U.S.C. 1752(7) (1982)), located in the United States.

(ii) Terms defined. The following terms are defined for purposes of paragraph (a)(3)(i) of this section:

(A) The term "administrative costs and other incidental expenses of a nuclear decommissioning fund" means all ordinary and necessary expenses incurred in connection with the operation of the nuclear decommissioning fund. Such term includes the tax imposed by section 468A(e)(2) and paragraph (a) of § 1.468A-4, any State or local tax imposed on the income or the assets of the fund, legal expenses, accounting expenses, actuarial expenses and trustee expenses. Such term does not include decommissioning costs. Such term also does not include the excise tax imposed on the trustee or other disqualified person under section 4951 or the reimbursement of any expenses incurred in connection with the assertion of such tax unless such expenses are considered reasonable and necessary under section 4951(d)(2)(C) and it is determined that the trustee or other disqualified person is not liable for the excise tax.

(B) The term "public debt securities of the United States" means obligations that are taken into consideration for purposes of the public debt limit.

(C) The term "obligations of a State or local government" means obligations of a State or local governmental unit the interest on which is exempt from tax under section 103(a).

(D) The term "time or demand deposits" includes checking accounts, savings accounts, certificates of deposit or other time or demand deposits. The term does not include common or collective trust funds, such as a common trust fund as defined in section 584.

(b) Prohibitions against self-dealing—(1) In general. Except as otherwise provided in this paragraph (b), the excise taxes imposed by section 4951 shall apply to each act of self-dealing between a disqualified person and a nuclear decommissioning fund.

(2) Self-dealing defined. For purposes of this paragraph (b), the term "self-dealing" means any act described in section 4951(d), except—

(i) A payment by a nuclear decommissioning fund for the purpose of satisfying, in whole or in part, the liability of the electing taxpayer for decommissioning costs of the nuclear power plant to which the nuclear decommissioning fund relates;

(ii) A withdrawal of an excess contribution by the electing taxpayer pursuant to the rules of paragraph (c)(2) of this section;

(iii) A withdrawal by the electing taxpayer of amounts that have been treated as distributed under paragraph (c)(3) of this section;

(iv) A payment of amounts remaining in a nuclear decommissioning fund to the electing taxpayer after the termination of such fund (as determined under paragraph (d) of this section);

(v) Any act described in section 4951(d)(2) (B) or (C); or

(vi) A payment by a nuclear decommissioning fund for the performance of trust functions and certain general banking services by a bank or trust company which is a disqualified person, where the banking services are reasonable and necessary to carry out the purposes of the fund, if the compensation paid to the bank or trust company, taking into account the fair interest rate for the use of the funds by the bank or trust company, for such services is not excessive. The general banking services allowed by this paragraph (b)(2)(vi) are—

(A) Checking accounts, as long as the bank does not charge interest on any overwithdrawals,

(B) Savings accounts, as long as the fund may withdraw its funds on no more than 30 days' notice without subjecting itself to a loss of interest on its money for the time during which the money was on deposit, and

(C) Safekeeping activities. (See example 3 of § 53.4941(d)-3(c)(2).)

(3) Disqualified person defined. For purposes of this paragraph (b), the term "disqualified person" includes each person described in section 4951(e)(4) and paragraph (d) of § 53.4951-1.

(c) Disqualification of nuclear decommissioning fund—(1) In general. Except as otherwise provided in paragraph (c)(2) of this section, if at any time during a taxable year of a nuclear decommissioning fund—

(i) The nuclear decommissioning fund does not satisfy the requirements of paragraph (a) of this section, or

(ii) The nuclear decommissioning fund and a disqualified person engage in an act of self-dealing (as defined in paragraph (b)(2) of this section), the Internal Revenue Service may, in its discretion, disqualify all or any portion of the fund as of the date that the fund does not satisfy the requirements of paragraph (a) of this section or the date on which the act of self-dealing occurs, whichever is applicable, or as of any subsequent date ("date of disqualification"). The Internal Revenue Service shall notify the electing taxpayer of the disqualification of a nuclear decommissioning fund and the date of disqualification by registered or certified mail to the last known address of the electing taxpayer (the "notice of disqualification").

(2) Exception to disqualification—(i) In general. A nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section by reason of an excess contribution or the withdrawal of such excess contribution by an electing taxpayer if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year to which the excess contribution relates. In the case of an excess contribution that is the result of a payment made pursuant to paragraph (j)(1) of § 1.468A-3, a nuclear decommissioning fund will not be disqualified under paragraph (c)(1) of this section if the amount of the excess contribution is withdrawn by the electing taxpayer on or before the later of—

(A) The date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year to which the excess contribution relates; or

(B) The date that is 30 days after the date that the taxpayer receives the ruling amount for such taxable year.

(ii) Excess contribution defined. For purposes of this section, an excess contribution is the amount by which cash payments made (or deemed made) to a nuclear decommissioning fund during any taxable year exceed the payment limitation contained in section 468A(b) and paragraph (b) of § 1.468A-2.

(iii) Taxation of income attributable to an excess contribution. The income of a nuclear decommissioning fund attributable to an excess contribution is required to be included in the gross income of the nuclear decommissioning fund under paragraph (b) of § 1.468A-4.

(3) Effect of disqualification. If all or any portion of a nuclear decommissioning fund is disqualified under paragraph (c)(1) of this section, the portion of the nuclear decommissioning fund that is disqualified is treated as distributed to the electing taxpayer on the date of disqualification. Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (see paragraph (c)(2) of § 1.468A-4). In addition, the electing taxpayer must include in gross income for the taxable year that includes the date of disqualification an amount equal to the product of—

(i) The fair market value of the assets of the fund determined as of the date of disqualification, reduced by—

(A) The amount of any excess contribution that was not withdrawn before the date of disqualifica-

tion if no deduction was allowed with respect to such excess contribution;

(B) The amount of any deemed distribution that was not actually distributed before the date of disqualification (as determined under paragraph (d)(2)(iii) of § 1.468A-2) if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(C) The amount of any tax that—

(1) Is imposed on the income of the fund;

(2) Is attributable to income taken into account before the date of disqualification or as a result of the disqualification; and

(3) Has not been paid as of the date of disqualification; and

(ii) The fraction of the nuclear decommissioning fund that was disqualified under paragraph (c)(1) of this section.

Contributions made to a disqualified fund after the date of disqualification are not deductible under section 468A(a) and paragraph (a) of § 1.468A-2, or, if the fund is disqualified only in part, are deductible only to the extent provided in the notice of disqualification. In addition, if any assets of the fund that are deemed distributed under this paragraph (c)(3) are held by the fund after the date of disqualification (or if additional assets are acquired with nondeductible contributions made to the fund after the date of disqualification), the income earned by such assets after the date of disqualification must be included in the gross income of the electing taxpayer (see section 671) to the extent that such income is otherwise includible under chapter 1 of the Internal Revenue Code. An electing taxpayer can establish a nuclear decommissioning fund to replace a fund that has been disqualified in its entirety only if the Internal Revenue Service specifically consents to the establishment of a replacement fund in connection with the issuance of an initial schedule of ruling amounts for such replacement fund.

(d) Termination of nuclear decommissioning fund upon substantial completion of decommissioning—(1) In general. Upon substantial completion of the decommissioning of a nuclear power plant to which a nuclear decommissioning fund relates, such nuclear decommissioning fund shall be considered terminated and treated as having distributed all of its assets on the date the termination occurs. Such a distribution shall be treated for purposes of section 1001 as a disposition of property held by the nuclear decommissioning fund (see paragraph (c)(2) of § 1.468A-4). In addition, the electing taxpayer shall include in gross income for the taxable year in which the termination occurs an amount equal to the fair market value of the assets of the fund determined as of the date of termination, reduced by—

(i) The amount of any deemed distribution that was not actually distributed before the date of termination if the amount of the deemed distribution was included in the gross income of the electing taxpayer for the taxable year in which the deemed distribution occurred; and

(ii) The amount of any tax that—

(A) Is imposed on the income of the fund;

(B) Is attributable to income taken into account before the date the termination occurs or as a result of the termination; and

(C) Has not been paid as of the date the termination occurs.

Contributions made to a nuclear decommissioning fund after the termination date are not deductible under section 468A(a) and paragraph (a) of § 1.468A-2. In addition, if any assets are held by the fund after the termination date, the income earned by such assets after the termination date must be included in the gross income of the electing taxpayer (see section 671) to the extent that such income is otherwise includible under chapter 1 of the Internal Revenue Code. Finally, an electing taxpayer using an accrual method of accounting is allowed a deduction for nuclear decommissioning costs that are incurred during any taxable year (see paragraph (e) of § 1.468A-2) even if such costs are incurred after substantial completion of decommissioning (e.g., expenses incurred to monitor or safeguard the plant site).

(2) Substantial completion of decommissioning defined. (i) Except as otherwise provided in paragraph (d)(2)(ii) of this section, the substantial completion of the decommissioning of a nuclear power plant occurs on the date that the maximum acceptable radioactivity levels mandated by the Nuclear Regulatory Commission with respect to a decommissioned nuclear power plant are satisfied (the "substantial completion date").

(ii) If a significant portion of the total estimated decommissioning costs with respect to a nuclear power plant are not incurred on or before the substantial completion date, an electing taxpayer may request, and the Internal Revenue Service shall issue, a ruling that designates the date on

which substantial completion of decommissioning occurs. The date designated in the ruling shall not be later than the last day of the third taxable year after the taxable year that includes the substantial completion date. The request for a ruling under this paragraph (d)(2)(ii) must be filed during the taxable year that includes the substantial completion date and must comply with the procedural rules in effect at the time of the request.
[T.D. 8184, 53 FR 6815, March 3, 1988]

§ 1.468A-6 Disposition of an interest in a nuclear power plant. [Reserved]

§ 1.468A-7 Manner of and time for making election.

(a) **In general.** An eligible taxpayer is allowed a deduction for the taxable year in which the taxpayer makes a cash payment (or is deemed to make a cash payment) to a nuclear decommissioning fund only if the taxpayer elects the application of section 468A. A separate election is required for each nuclear decommissioning fund and for each taxable year with respect to which payments are to be deducted under section 468A. In the case of an affiliated group of corporations that join in the filing of a consolidated return for a taxable year, the common parent must make a separate election on behalf of each member whose payments to a nuclear decommissioning fund during such taxable year are to be deducted under section 468A. The election under section 468A for any taxable year is irrevocable and must be made by attaching a statement ("Election Statement") and a copy of the schedule of ruling amounts provided pursuant to the rules of § 1.468A-3 to the taxpayer's Federal income tax return (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the consolidated return) for such taxable year. Except as otherwise provided in paragraph (b)(3) of § 1.468A-8, the return to which the Election Statement and a copy of the schedule of ruling amounts is attached must be filed on or before the time prescribed by law (including extensions) for filing the return for the taxable year with respect to which payments are to be deducted under section 468A.

(b) **Required information.** The Election Statement must include the following information:

(1) The legend "Election Under Section 468A" typed or legibly printed at the top of the first page.

(2) The electing taxpayer's name, address and taxpayer identification number (or, in the case of an affiliated group of corporations that join in the filing of a consolidated return, the name, address and taxpayer identification number of each electing taxpayer).

(3) The taxable year for which the election is made.

(4) For each nuclear decommissioning fund for which an election is made—

(i) The name and location of the nuclear power plant to which the fund relates;

(ii) The name and employer identification number of the nuclear decommissioning fund;

(iii) The total amount of actual cash payments made to the nuclear decommissioning fund during the taxable year that were not treated as deemed cash payments under paragraph (c)(1) of § 1.468A-2 for a prior taxable year;

(iv) The total amount of cash payments deemed made to the nuclear decommissioning fund under paragraph (c)(1) of § 1.468A-2 for the taxable year; and

(v) The cost of service amount for the taxable year (see paragraph (b)(2) of § 1.468A-2).
[T.D. 8184, 53 FR 6818, March 3, 1988]

§ 1.468A-8 Effective date and transitional rules.

(a) **Effective date—(1) In general.** Section 468A and §§ 1.468A-1 through 1.468A-5, 1.468A-7 and 1.468A-8 are effective on July 18, 1984, and apply with respect to taxable years ending on or after such date.

(2) **Cut-off method applicable to electing taxpayers.** Any amount of nuclear decommissioning costs taken into account before July 18, 1984, for a taxable year beginning before such date, is not allowable as a deduction after July 17, 1984, under section 468A(c)(2) and paragraph (e) of § 1.468A-2.

(b) **Transitional rules—(1) Time for filing request for schedule of ruling amounts.** The Internal Revenue Service shall provide a ruling amount for any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, if—

(i) Paragraph (g) of § 1.468A-3 is satisfied for the taxable year; and

(ii) The taxpayer files a request for a schedule of ruling amounts that includes a proposed ruling amount for the taxable year on or before June 1, 1988.

(2) Manner of and time for making contributions to a nuclear decommissioning fund. (i) The amount of any contribution (including a contribution of property allowed under paragraph (b)(2)(ii) of this section) to a nuclear decommissioning fund that relates to a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, shall be deemed made during such taxable year if—

(A) The taxpayer makes such contribution on or before the 30th day after the date the taxpayer receives a ruling amount applicable to such taxable year; and

(B) The taxpayer irrevocably designates the amount of such contribution as relating to such taxable year on the Election Statement attached to its Federal income tax return (or amended return) for such taxable year.

(ii) (A) An electing taxpayer may contribute property to a nuclear decommissioning fund if the property—

(*1*) Is described in paragraph (a)(3)(i)(C) of § 1.468-5;

(*2*) Was acquired after July 18, 1984, and before March 3, 1988; and

(*3*) Is contributed for any taxable year ending after July 18, 1984, and beginning before March 3, 1988.

(B) If a taxpayer contributes property to a nuclear decommissioning fund under this paragraph (b)(2)(ii)—

(*1*) The amount of the contribution (and the basis of the property to the nuclear decommissioning fund) shall equal the fair market value of the property on the date the property is contributed to the nuclear decommissioning fund;

(*2*) The contribution of the property to the nuclear decommissioning fund shall be considered a sale or exchange of the property by the taxpayer for purposes of section 1001; and

(*3*) For purposes of section 1001, the amount realized by the taxpayer shall be the fair market value of the property on the date the property was contributed to the nuclear decommissioning fund.

(iii) A fund established by a taxpayer for the purpose of paying the decommissioning costs of a nuclear power plant is not treated as a nuclear decommissioning fund before the earlier of—

(A) The date the taxpayer receives an initial schedule of ruling amounts with respect to the fund, or

(B) The first day of the first taxable year of the taxpayer that begins on or after January 1, 1987, even if the taxpayer elects the application of section 468A for a taxable year that begins before such date. Any income earned before such date by the assets of a fund that satisfies the requirements of § 1.468A-5 must be included in the gross income of the taxpayer treated under section 671 as the owner of such assets.

(iv) If a fund is first treated as a nuclear decommissioning fund on the date described in paragraph (b)(2)(iii) of this section—

(A) The assets held in the fund on such date shall be treated for purposes of this paragraph (b)(2) as assets contributed to the nuclear decommissioning fund on such date; and

(B) The withdrawal of any such assets on or before the date prescribed by law (including extensions) for filing the return of the nuclear decommissioning fund for the taxable year that includes such date shall be treated in the same manner as the withdrawal of an excess contribution (see paragraph (c)(2) of § 1.468A-5).

(3) Manner of and time for making election. A taxpayer may elect the application of section 468A for a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, by attaching the Election Statement and a copy of the schedule of ruling amounts to—

(i) A return that is filed on or before the time prescribed by law (including extensions) for filing to return for such taxable year; or

(ii) An amended return for such taxable year that is filed on or before the 90th day after the date that the taxpayer receives a ruling amount for such table year.

(4) Determination of cost of service limitation. (i) For purposes of section 468A(b)(1) and paragraph (b)(2)(ii) of § 1.468A-2, decommissioning costs included in cost of service for any taxable year beginning before January 1, 1987, shall include decommissioning costs that can be accurately determined from information contained in the regulated books of account or other written records of the taxpayer.

(ii) For purposes of section 468A(b)(1) and paragraph (b)(2) of § 1.468A-2, the cost of service amount applicable to a nuclear decommissioning fund for the taxable year that includes July 18,

1984, is the amount determined under paragraph (b)(2) of § 1.468A-2 multiplied by a fraction, the numerator of which is the amount of nuclear decommissioning costs that is directly or indirectly charged to customers in such taxable year and that is included in the taxable income of the taxpayer for such taxable year and the denominator of which is the amount of nuclear decommissioning costs that is directly or indirectly charged to customers in such taxable year and that would have been included in the gross income of the taxpayer if such costs were taken into account by the taxpayer in the same manner as amounts charged for electric energy (see § 1.88-1). Under the preceding sentence, an amount of decommissioning costs is included in the taxable income of a taxpayer for the taxable year that includes July 18, 1984, if the amount is included in gross income for such taxable year and no deduction (other than a deduction allowed under section 468A(a) and paragraph (a) of § 1.468A-2) is claimed with respect to such amount for such taxable year.

(5) Assumptions and determinations to be used in determining ruling amounts. (i) To the extent consistent with the principles and provisions of § 1.468A-3, a ruling amount for any taxable year beginning before January 1, 1987, shall be based on the reasonable assumptions and determinations used by the applicable public utility commission(s) in establishing or approving the amount of decommissioning costs included in cost of service for ratemaking purposes for such taxable year.

(ii) If the applicable public utility commission(s) did not disclose the after-tax rate of return used in establishing or approving the amount of decommissioning costs included in cost of service for any period during a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, the after-tax rate of return during such period is equal to 54 percent of the overpayment rate in effect under section 6621 during such period.

(iii) If the applicable public utility commission(s) did not disclose the other assumptions and determinations used in establishing or approving the amount of decommissioning costs included in cost of service for any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, ruling amount for each such taxable year shall be determined by taking into account—

(A) The amount of decommissioning costs included in cost of service for such taxable year;

(B) The qualifying percentage (as determined under paragraph (d)(4) of § 1.468A-3 and paragraph (b)(7) of this section); and

(C) The amount of decommissioning costs included in cost of service for any earlier taxable year.

(6) Exception to level funding limitation. Notwithstanding paragraph (b) of § 1.468A-3, the Internal Revenue Service may, in its discretion, provide a schedule of ruling amounts specifying a ruling amount for a taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, that is greater than the ruling amount specified in such schedule for a later taxable year.

(7) Determination of qualifying percentage. (i) (A) The qualifying percentage shall be determined under this paragraph (b)(7)(i) if a nuclear power plant began commercial operations on or before July 10, 1986, and a taxpayer—

(*1*) Files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988; and

(*2*) Elects the application of this paragraph (b)(7)(i) in its request for a schedule of ruling amounts.

(B) If the qualifying percentage is determined under this paragraph (b)(7)(i), the estimated period for which the nuclear decommissioning fund is to be in effect for purposes of paragraph (d)(4)(ii) of § 1.468A-3 begins on the later of—

(*1*) The first day of the taxable year that includes the date that the nuclear power plant began commercial operations; or

(*2*) The first day of the taxable year that includes July 18, 1984.

(ii) (A) The qualifying percentage shall be determined under this paragraph (b)(7)(ii) if a nuclear power plant began commercial operations before July 18, 1984, and a taxpayer—

(*1*) Files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988; and

(*2*) Elects the application of this paragraph (b)(7)(ii) in its request for a schedule of ruling amounts.

(B) If the qualifying percentage is determined under this paragraph (b)(7)(ii), the estimated period for which the nuclear decommissioning fund is to be in effect for purposes of paragraph (d)(4)(ii) of § 1.468A-3 and the estimated useful life of the nuclear power plant for purposes of paragraph

(d)(4)(iii) of § 1.468A-3 shall end on the earlier of—

(*1*) The last day of the taxable year in which it is estimated that decommissioning will begin; or

(*2*) The last day of the taxable year that includes the expiration date of the Nuclear Regulatory Commission operating license as in effect on July 18, 1984, without regard to any extensions or amendments thereto.

(iii) In the case of a nuclear power plant that began commercial operations before July 18, 1984, and whose estimated useful life for ratemaking purposes was adjusted by a public utility commission before July 18, 1984, a taxpayer may elect in its request for a schedule of ruling amounts to compute the qualifying percentage in accordance with the following rules:

(A) If the taxpayer files a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988, the qualifying percentage equals the percentage of original depreciation costs (determined without regard to capitalized decommissioning costs) with respect to the nuclear power plant that remains to be recovered for ratemaking purposes as of the first day of the taxable year that includes July 18, 1984.

(B) If a taxpayer does not file a request for a schedule of ruling amounts for the nuclear decommissioning fund maintained with respect to such nuclear power plant on or before June 1, 1988, the qualifying percentage equals the percentage of original depreciation costs (determined without regard to capitalized decommissioning costs) with respect to the nuclear power plant that remains to be recovered for ratemaking purposes as of the first day of the first taxable year for which a deductible payment is made to the nuclear decommissioning fund that relates to such nuclear power plant.

(C) For purposes of this paragraph (b)(7)(iii), original depreciation costs with respect to a nuclear power plant include only those costs that were taken into account in determining the amount of depreciation with respect to such plant in the first ratemaking proceeding in which such depreciation was treated as a cost of service.

(8) Limitation on payments to a nuclear decommissioning fund—(i) The limitation on payments to a nuclear decommissioning fund (see section 468A(b) and paragraph (b) of § 1.468A-2) for a taxable year that ends on or after July 18, 1984, and begin before January 1, 1987, shall be determined under paragraph (b)(8)(ii) of this section if—

(A) The electing taxpayer receives a ruling amount applicable to such taxable year after the deemed payment deadline date for such taxable year; and

(B) The requirements of paragraph (b)(8)(iii) of this section are satisfied.

(ii) If the limitation on payments to a nuclear decommissioning fund for a taxable year is determined under this paragraph (b)(8)(ii), the maximum amount of payments made (or deemed made) to the nuclear decommissioning fund during such taxable year shall not exceed the sum of—

(A) The amount determined under section 468A(b) and paragraph (b) of § 1.468A-2 (i.e., the lesser of the cost of service amount or the ruling amount) after application of the transitional rules contained in paragraph (b)(4), (5), (6) and (7) of this section; and

(B) The amount of after-tax earnings that would have accumulated to the date of actual payment to the nuclear decommissioning fund if the amount described in paragraph (b)(8)(ii)(A) of this section had been contributed to the nuclear decommissioning fund on the deemed payment deadline date for such taxable year.

In determining the after-tax earnings that would have accumulated to the date of payment, an electing taxpayer must use the after-tax rate of return of the nuclear decommissioning fund that was used in determining the initial schedule of ruling amounts.

(iii) In order to compute the payment limitation under paragraph (b)(8)(ii) of this section for any taxable year, an electing taxpayer must—

(A) Indicate on the Election Statement for the taxable year that the amount of the deductible payment is greater than the amount determined under section 468A(b) and paragraph (b) of § 1.468A-2 because paragraph (b)(8) of § 1.468A-8 applies;

(B) Not have claimed a deduction for the taxable year under section 468A(a) or paragraph (a) of § 1.468A-2 on any return that is filed before the date that a ruling amount is received for the taxable year;

(C) Not have taken a deduction under section 468A (a) or paragraph (a) of § 1.468A-2 into account in determining the amount properly estimated as tax for the taxable year under section

6081 (b) (relating to the automatic extension for filing corporate income tax returns); and

(D) Not take the deduction allowed with respect to such payment into account in determining the amount of any overpayment of tax (within the meaning of section 6611) or underpayment of tax (within the meaning of section 6601) for the period ending on the date of such payment (see paragraph (b)(9) of this section).

(iv) The following example illustrates the application of the principles of paragraph (b)(8) of this section:

Example. X corporation is a calendar year, accrual method taxpayer engaged in the sale of electric energy generated by a nuclear power plant owned by X. On September 15, 1987, X receives a schedule of ruling amounts from the Internal Revenue Service that includes a ruling amount of $1,000,000 for the 1986 taxable year. For purposes of this example, assume that the cost of service amount applicable to the nuclear decommissioning fund for the 1986 taxable year is also $1,000,000 and that the after-tax rate of return of the nuclear decommissioning fund that was used in determining the schedule of ruling amounts is 10 percent compounded semi-annually. On September 15, 1987, X makes a contribution of $1,050,000 to a nuclear decommissioning fund established by X. Under paragraph (b)(8)(ii) of this section, this contribution does not exceed the limitation on payments for the 1986 taxable year and the entire amount of the contribution is deductible for such year. The additional $50,000 deductible payment that is allowed under this paragraph (b)(8) reflects the foregone earnings of the fund for the six-month period beginning on the deemed payment deadline date for the 1986 taxable year (March 15, 1987) and ending on the date of the contribution (September 15, 1987).

(9) Denial of interest on overpayment. If a deduction is allowed by reason of paragraph (b)(2) of this section for the amount of any payment made after the 15th day of the third calendar month after the close of the taxable year to which such payment relates, such deduction shall not be taken into account in determining the amount of any overpayment of tax (within the meaning of section 6611) or underpayment of tax (within the meaning of section 6601) for the period ending on the date of such payment.

(10) Determination of addition to tax for failure to pay estimated tax. In the case of any taxable year that ends on or after July 18, 1984, and begins before January 1, 1987, the tax shown on the return for such taxable year for purposes of section 6655(b) shall equal the tax that would be shown on the return if a deduction were allowed for the lesser of—

(i) The amount of the payment made to the nuclear decommissioning fund for such taxable year; or

(ii) The amount determined under section 468A(b) and paragraph (b) of § 1.468A-2 (i.e., the lesser of the cost of service amount or the ruling amount) after application of the transitional rules contained in paragraph (b)(4), (5), (6) and (7) of this section but without regard to the transitional rule contained in paragraph (b)(8) of this section.

[T.D. 8184, 53 FR 6818, March 3, 1988; T.D. 8184, 53 FR 9726, March 24, 1988]

§ 1.469–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 469.

(vi) Rental of property incidental to a nonrental activity of the taxpayer.

(A) In general.

(B) Property held for investment.

(C) Property used in a trade or business.

(D) Property held for sale to customers.

(E) Lodging rented for convenience of employer.

(F) Unadjusted basis.

(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

(viii) Examples.

(4) Special rule for oil and gas working interests.

(i) In general.

(ii) Exception for deductions attributable to a period during which liability is limited.

(A) In general.

(B) Coordination with rules governing the identification of disallowed passive activity deductions.

(C) Meaning of certain terms.

(1) Allocable deductions.

(2) Disqualified deductions.

(3) Net loss.

(4) Ratable portion.

(iii) Examples.

(iv) Definitions of "working interest."

(v) Entities that limit liability.

(A) General rule.

(B) Other limitations disregarded.

(C) Examples.

(vi) Cross reference to special rule for income from certain oil or gas properties.

(5) Rental of dwelling unit.

(6) Activity of trading personal property.

(i) In general.

(ii) Personal property.

(iii) Example.

(f) Treatment of disallowed passive activity losses and credits.

(1) Scope of this paragraph.

(2) Identification of disallowed passive activity deductions.

(i) Allocation of disallowed passive activity loss among activities.

(A) General rule.

(B) Loss from an activity.

(C) Significant participation passive activities.

(D) Examples.

(ii) Allocation within loss activities.

(A) In general.

(B) Excluded deductions.

(iii) Separately identified deductions.

(3) Identification of disallowed credits from passive activities.

(i) General rule.

(ii) Coordination rule.

(iii) Separately identified credits.

(4) Carryover of disallowed deductions and credits.

(g) Application of these rules to C corporations.

(1) In general.

(2) Definitions.

(3) Participation of corporations.

(i) Material participation.

(ii) Significant participation.

(iii) Participation of individual.

(4) Modified computation of passive activity loss in the case of closely held corporations.

(i) In general.

(ii) Net active income.

(iii) Examples.

(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability.

(i) In general.

(ii) Net active income tax liability.

(h) Special rules for affiliated group filing consolidated return.

(1) In general.

(2) Definitions.

(3) Disallowance of consolidated group's passive activity loss or credit.

(4) Status and material participation of members.

(i) Determination by reference to status and participation of group.

(ii) Determination of status and material participation of consolidated group.

(5) Modification of rules for identifying disallowed passive activity deductions and credits.

(i) Identification of disallowed deductions.

(ii) Ratable portion of disallowed passive activity loss.

(iii) Identification of disallowed credits.

(6) Transactions between members of a consolidated group.

(i) Scope.

(ii) Recharacterization of gain or loss from intercompany transactions other than deferred intercompany transactions.

(A) In general.

(B) Recharacterization of gain or loss as portfolio items.

(iii) Deferred intercompany transactions.

(A) In general.

(B) Deferred intercompany transactions involving property subject to depreciation, amortization, or depletion.

(C) Restoration of deferred gain or loss or dispositions.

(D) Certain recharacterized items treated as portfolio items.

(E) Property involved in deferred intercompany transaction.

(iv) Definitions.

(A) Deferred intercompany transaction.

(B) Directly related.

(C) Intercompany transaction.

(D) Purchasing member.

(E) Selling member.

(7) Disposition of stock of a member of an affiliated group.

(8) Dispositions of property used in multiple activities.

(i) [Reserved]

(j) Spouses filing joint return.

(1) In general.

(2) Exceptions to treatment as one taxpayer.

(i) Identification of disallowed deductions and credits.

(ii) Treatment of deductions disallowed under sections 704(d), 1366(d) and 465.

(iii) Treatment of losses from working interests.

(3) Joint return no longer filed.

(4) Participation of spouses.

(k) Former passive activities and changes in status of corporations. [Reserved]

§ 1.469-2T Passive activity loss (temporary).

(a) Scope of this section.

(b) Definition of passive activity loss.

(1) In general.

(2) Cross references.

(c) Passive activity gross income.

(1) In general.

(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity.

(i) In general.

(A) Treatment of gain.

(B) Dispositions of partnership interests and S corporation stock.

(C) Interest in property.

(D) Examples.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition.

(iii) Disposition of substantially appreciated property formerly used in nonpassive activity.

(A) In general.

(B) Date of disposition.

(C) Substantially appreciated property.

(D) Coordination with paragraph (c)(2)(ii) of this section.

(E) Coordination with section 163(d).

(F) Example.

(3) Items of portfolio income specifically excluded.

(i) In general.

(ii) Gross income derived in the ordinary course of a trade or business.

(iii) Special rules.

(A) Income from property held for investment by dealer.

(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property.

(1) In general.

(2) Substantial services or costs.

(i) In general.

(ii) Exception.

(iii) Expenditures taken into account.

(3) Passthrough entities.

(4) Cross reference.

(C) Mineral production payments.

(iv) Examples.

(4) Items of personal service income specifically excluded.

(i) In general.

(ii) Example.

(5) Income from section 481 adjustment.

(i) In general.

(ii) Positive section 481 adjustments.

(iii) Ratable portion.

(6) Gross income from certain oil or gas properties.

(i) In general.

(ii) Net income from the property.

(iii) Property.

(iv) Examples.

(7) Other items specifically excluded.

(d) Passive activity deductions.

(1) In general.

(2) Exceptions.

(3) Interest expense.

(4) Clearly and directly allocable expenses.

(5) Treatment of loss from disposition.

(i) In general.

(ii) Disposition of Property used in more than one activity in 12-month period preceding disposition.

(iii) Other applicable rules.

(A) Interest in property.

(B) Dispositions of partnership interests and S Corporation stock.

(6) Coordination with other limitations on deduction that apply before section 469.

(i) In general.

(ii) Proration of deductions disallowed under basis limitations.

(A) Deductions disallowed under section 704(d).

(B) Deductions disallowed under section 1366(d).

(iii) Proration of deductions disallowed under at-risk limitation.

(iv) Coordination of basis and at-risk limitations.

(v) Separately identified items of deduction and loss.

(7) Deductions from section 481 adjustment.

(i) In general.

(ii) Negative section 481 adjustment.

(iii) Ratable portion.

(8) Taxable year in which item arises.

(e) Special rules for partners and S corporation shareholders.

(1) In general.

(2) Payments under section 707(a), 707(c), and 736(b).

(i) Section 707(a).

(ii) Section 707(c).

(A) In general.

(B) Exception.

(iii) Section 736 (b).

(3) Sale or exchange of interest in passthrough entity.

(i) Application of this paragraph (e) (3).

(ii) General rule.

(A) Allocation among activities.

(B) Ratable portion.

(1) Dispositions on which gain is recognized.

(2) Dispositions on which loss is recognized.

(C) Default rule.

(D) Special rules.

(1) Applicable valuation date.

(i) In general.

(ii) Exception.

(2) Basis adjustments.

(3) Tiered passthrough entities.

(E) Meaning of certain terms.

(iii) Treatment of gain allocated to certain passive activities as not from a passive activity.

(iv) Dispositions occurring in taxable years beginning before February 19, 1988.

(A) In general.

(B) Exceptions.

(v) Treatment of portfolio assets.

(vi) Definitions.

(vii) Examples.

(f) Recharacterization of passive income in certain situations.

(1) In general.

(2) Special rule for significant participation.

(i) In general.

(ii) Significant participation passive activity.

(iii) Example.

(3) Rental of nondepreciable property.

(4) Net interest income from passive equity-financed lending activity.

(i) In general.

(ii) Equity-financed lending activity.

(A) In general.

(B) Certain liabilities not taken into account.

(iii) Equity-financed interest income.

(iv) Net interest income.

(v) Interest-bearing assets.

(vi) Liabilities incurred in the activity.

(vii) Average outstanding balance.

(viii) Example.

(5) Net income from certain property rented incidental to development activity.

(i) In general.

(ii) Commencement of use.

(iii) Services performed for the purpose of enhancing the value of property.

(iv) Example.

(6) Property rented to a nonpassive activity.

(7) Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property.

(i) In general.

(ii) Royalty income from property.

(iii) Exceptions.

(iv) Capital expenditures.

(v) Example.

(8) Limitation on recharacterized income.

(9) Meaning of certain terms.

(10) Coordination with section 163 (d).

(11) Effective date.

§ 1.469-3T Passive activity credit (temporary).

(a) Computation of passive activity credit.

(b) Credits subject to section 469.

(1) In general.

(2) Treatment of credits attributable to qualified progress expenditures.

(3) Special rule for partners and S corporation shareholders.

(4) Exception for pre-1987 credits.

(c) Taxable year to which credit is attributable.

(d) Regular tax liability allocable to passive activities.

(1) In general.

(2) Regular tax liability.

(e) Coordination with section 39.

(f) Examples.

§ 1.469-4T Definition of activity (temporary). [Reserved]

§ 1.469-5T Material participation (temporary).

(a) In general.

(b) Facts and circumstances.

(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b).

(i) Participation satisfying standards not contained in section 469.

(ii) Certain management activities.

(iii) Participation less than 100 hours.

(c) Significant participation activity.

(1) In general.

(2) Significant participation.

(d) Personal service activity.

(e) Treatment of limited partners.

(1) General rule.

(2) Exceptions.

(3) Limited Partnership interest.

(i) In general.

(ii) Limited Partner holding general partner interest.

(f) Participation.

(1) In general.

(2) Exceptions.

(i) Certain work not customarily done by owners.

(ii) Participation as an investor.

(A) In general.

(B) Work done in individual's capacity as an investor.

(3) Participation of spouse.

(4) Methods of proof.

(g) Material participation of trusts and estates. [Reserved]

(h) Miscellaneous rules.

(1) Participation of corporations.

(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers.

(i) [Reserved]

(j) Material participation for taxable years beginning before January 1, 1987.

(k) Examples.

§ 1.469-6T Treatment of losses upon certain dispositions (temporary). [Reserved]

§ 1.469-7T Treatment of self-charged items of income and expense (temporary). [Reserved]

§ 1.469-8T Application of section 469 to trusts, estates, and their beneficiaries (temporary). [Reserved]

§ 1.469-9T Treatment of income, deductions, and credits from certain rental real estate activities (temporary). [Reserved]

§ 1.469-10T Application of section 469 to publicly traded partnerships (temporary). [Reserved]

§ 1.469-11T Effective date and transition rules (temporary).

(a) Effective date.

(1) In general.

(2) Application of certain income recharacterization rules.

(i) In general.

(ii) Property rented to a nonpassive activity.

(3) Qualified low-income housing projects.

(4) Effect of events occurring in years prior to 1987.

(5) Examples.

(b) Transitional rule for pre-enactment loss and pre-enactment credit.

(1) In general.

(2) Applicable percentage.

(3) Pre-enactment loss.

(4) Pre-enactment credit.

(5) Examples.

(c) Definitions of pre-enactment interest.

(1) General rule.

(2) Qualified interest.

(i) In general.

(ii) Stock in a C corporation.

(3) Pre-enactment activity.

(i) In general.

(ii) Character before 1987 irrelevant.

(4) Examples.

(5) Effect of changes in a taxpayer's interest in a pre-enactment activity.

(i) In general.

(ii) Partnership terminations under section 708(b)(1)(B).

(iii) Examples.

(6) Special rule for beneficiaries of trusts or estates.

(i) In general.

(ii) Interests distributed to beneficiaries.

(7) Written binding contract.

(i) In general.

(ii) Special rule for contract of partnership or S corporation.

(iii) Application of rule to partnership agreements.

[T.D. 8175, 53 FR 5698, Feb. 25, 1988]

§ 1.469–1T General rules (temporary).

(a) Passive activity loss and credit disallowed—(1) In general. Except as otherwise provided in paragraph (a)(2) of this section—

(i) The passive activity loss for the taxable year shall not be allowed as a deduction; and

(ii) The passive activity credit for the taxable year shall not be allowed.

(2) Exceptions. Paragraph (a)(1) of this section shall not apply to the passive activity loss or the passive activity credit for the taxable year to the extent provided in—

(i) Section 469(i) and the rules to be contained in § 1.469-9T (relating to losses and credits attributable to certain rental real estate activities); and

(ii) Section 1.469-11T (relating to losses and credits attributable to certain pre-enactment interests in activities).

(b) Taxpayers to whom these rules apply. The rules of section 469 and the regulations thereunder generally apply to—

(1) Individuals;

(2) Trusts (other than trusts (or portions of trusts) described in section 671);

(3) Estates;

(4) Personal service corporations (within the meaning of paragraph (g)(2)(i) of this section); and

(5) Closely held corporations (within the meaning of paragraph (g)(2)(ii) of this section).

(c) Cross references—(1) Definition of "passive activity." Rules relating to the definition of the term "passive activity" are contained in paragraph (e) of this section.

(2) Passive activity loss. Rules relating to the computation of the passive activity loss for the taxable year are contained in § 1.469-2T.

(3) Passive activity credit. Rules relating to the computation of the passive activity credit for the taxable year are contained in § 1.469-3T.

(4) Effect of rules for other purposes. Rules relating to the effect of section 469 and the regulations thereunder for other purposes under the Code are contained in paragraph (d) of this section.

(5) Special rule for oil and gas working interests. Rules relating to the treatment of losses and credits from certain interests in oil and gas wells are contained in paragraph (e)(4) of this section

(6) Treatment of disallowed losses and credits. Paragraph (f) of this section contains rules relating to—

(i) The treatment of deductions from passive activities in taxable years in which the passive activity loss is disallowed in whole or in part under paragraph (a)(1)(i) of this section; and

(ii) The treatment of credits from passive activities in taxable years in which the passive activity credit is disallowed in whole or in part under paragraph (a)(1)(ii) of this section.

(7) Corporation subject to section 469. Rules relating to the application of section 469 and regulations thereunder to C corporations are contained in paragraph (g) of this section.

(8) Consolidated groups. Rules relating to the application of section 469 and the regulations thereunder to affiliated groups of corporations filing a consolidated return for the taxable year are contained in paragraph (h) of this section.

(9) Joint returns. Rules relating to the application of section 469 and the regulations thereunder to spouses filing a joint return for the taxable year are contained in paragraph (j) of this section.

(10) Material participation. Rules defining the term "material participation" are contained in § 1.469-5T.

(11) Effective date and transition rules. Rules relating to the effective date of section 469 and the regulations thereunder and transition rules applicable to pre-enactment interests in activities are contained in § 1.469-11T.

(12) Future regulations. (i) Rules relating to former passive activities and changes in corporate status will be contained in paragraph (k) of this section.

(ii) Rules relating to the definition of "activity" will be contained in § 1.469-4T.

(iii) Rules relating to the treatment of deductions from activities that are disposed of in certain transactions will be contained in § 1.469-6T.

(iv) Rules relating to the treatment of self-charged items of income and expense will be contained in § 1.469-7T.

(v) Rules relating to the application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries will be contained in § 1.469-8T.

(vi) Rules relating to the treatment of income, deductions, and credits from certain rental real estate activities of individuals and certain estates will be contained in § 1.469-9T.

(vii) Rules relating to the application of section 469 to publicly traded partnerships will be contained in § 1.469-10T.

(d) Effect of section 469 and the regulations thereunder for other purposes—(1) Treatment of items of passive activity income and gain. Neither the provisions of section 469 (a) (1) and paragraph (a)(1) of this section nor the characterization of items of income or deduction as passive activity gross income (within the meaning of § 1.469-2T (c)) or passive activity deductions (within the meaning of § 1.469-2T (d)) affects the treatment of any item of income or gain under any provision of the Internal Revenue Code other than section 469. The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1991, an individual's only income and loss from passive activities are a $10,000 capital gain from passive activity X and a $12,000 ordinary loss from passive activity Y. The taxpayer also has a $10,000 capital loss that is not derived from a passive activity.

(ii) Under § 1.469-2T (b), the taxpayer has a $2,000 passive activity loss for the taxable year. The only effect of section 469 and the regulations thereunder is to disallow a deduction for the taxpayer's $2,000 passive activity loss for the taxable year. Thus, the taxpayer's capital loss for the taxable year is allowed because the $10,000 capital gain from passive activity X is taken into account under section 1211 (b) in computing the taxpayer's allowable capital loss for the year.

(2) Coordination with section 1211. A passive activity deduction that is not disallowed for the taxable year under section 469 and the regulations thereunder may nonetheless be disallowed for the taxable year under section 1211. The following example illustrates the application of this paragraph (d)(2):

Example. In 1987, an individual derives $10,000 of ordinary income from passive activity X, no gains from the sale or exchange of capital assets or assets used in a trade or business, $12,000 of capital loss from passive activity Y, and no income, gain, deductions, or losses from any other passive activity. The capital loss from activity Y is a passive activity deduction (within the meaning of § 1.469-2T(d)). Under section 469 and the regulations thereunder, the taxpayer is allowed $10,000 of the $12,000 passive activity deduction and has a $2,000 passive activity loss for the taxable year. Since the $10,000 passive activity deduction allowed under section 469 is a capital loss, such deduction is allowable for the taxable year only to the extent provided under section 1211. Therefore, the taxpayer is allowed $3,000 of the $10,000 capital loss under section 1211 and has a $7,000 capital loss carryover (within the meaning of section 1212 (b)) to the succeeding taxable year.

(3) Treatment of passive activity losses. Except as otherwise provided by regulations, a deduction that is disallowed for a taxable year under section 469 and the regulations thereunder is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code. The following example illustrates the application of this paragraph (d)(3):

Example. An individual has a $5,000 passive activity loss for a taxable year, all of which is disallowed under paragraph (a)(1) of this section. All of the disallowed loss is allocated under paragraph (f) of this section to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. In addition, under this paragraph (d)(3), such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.

(e) Definition of "passive activity"—(1) In general. Except as otherwise provided in this paragraph (e), an activity is a passive activity of the taxpayer for a taxable year if and only if the activity—

(i) Is a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer does not materially participate for such taxable year; or

(ii) Is a rental activity (within the meaning of paragraph (e) (3) of this section), without regard to whether or to what extent the taxpayer participates in such activity.

(2) Trade or business activity—(i) In general. An activity is a trade or business activity for a taxable year if for such year—

(A) (1) The activity involves the conduct of a trade or business (within the meaning of section 162);

(2) Research or experimental expenditures paid or incurred with respect to the activity are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)); or

(3) The activity is described in paragraph (e)(2)(ii) of this section; and

(B) The activity is not a rental activity or an activity involving the rental of property described in paragraph (e)(3) (vi)(B) of this section.

(ii) Certain activities not involving the conduct of a trade or business treated as trade or business activities. [Reserved]

(3) Rental activity—(1) In general. Except as otherwise provided in this paragraph (e)(3), an activity is a rental activity for a taxable year if—

(A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and

(B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

(ii) Exceptions. For purposes of this paragraph (e)(3), an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year—

(A) The average period of customer use for such property is seven days or less;

(B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

(C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);

(D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;

(E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

(F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

(iii) Average period of customer use. For purposes of this paragraph (e)(3), the average period of customer use for property held in connection

with an activity is determined for a taxable year by dividing—

(A) The aggregate number of days in all periods of customer use for such property ending during the taxable year; by

(B) The number of such periods of customer use.

For this purpose, each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether such right to use the property is pursuant to a single agreement or to renewals thereof) is treated as a separate period of customer use.

(iv) Significant personal services—(A) In general. For purposes of paragraph (e)(3)(ii)(B) of this section, personal services include only services performed by individuals, and do not include excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section). In determining whether personal services provided in connection with making property available for use by customers are significant, all of the relevant facts and circumstances shall be taken into account. Relevant facts and circumstances include the frequency with which such services are provided, the type and amount of labor required to perform such services, and the value of such services relative to the amount charged for the use of the property.

(B) Excluded services. For purposes of paragraph (e)(3)(iv)(A) of this section, the term "excluded services" means, with respect to any property made available for use by customers—

(1) Services necessary to permit the lawful use of the property;

(2) Services performed in connection with the construction of improvements to the property, or in connection with the performance of repairs that extend the property's useful life for a period substantially longer than the average period for which such property is used by customers; and

(3) Services, provided in connection with the use of any improved real property, that are similar to those commonly provided in connection with long-term rentals of high-grade commercial or residential real property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security at entrances or perimeters).

(v) Extraordinary personal services. For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

(vi) Rental of property incidental to a nonrental activity of the taxpayer—(A) In general. For purposes of paragraph (e)(3)(ii)(D) of this section, the rental of property shall be treated as incidental to a nonrental activity of the taxpayer only to the extent provided in this paragraph (e)(3)(vi).

(B) Property held for investment. The rental of property during a taxable year shall be treated as incidental to an activity of holding such property for investment if and only if—

(1) The principal purpose for holding the property during such taxable year is to realize gain from the appreciation of the property (without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development); and

(2) The gross rental income from the property for such taxable year is less than two percent of the lesser of—

(i) The unadjusted basis of such property; and

(ii) The fair market value of such property.

(C) Property used in a trade or business. The rental of property during a taxable year shall be treated as incidental to a trade or business activity (within the meaning of paragraph (e)(2) of this section) if and only if—

(1) The taxpayer owns an interest in such trade or business activity during the taxable year;

(2) The property was predominantly used in such trade or business activity during the taxable year or during at least two of the five taxable years that immediately precede the taxable year; and

(3) The gross rental income from such property for the taxable year is less than two percent of the lesser of—

(i) The unadjusted basis of such property; and

(ii) The fair market value of such property.

(D) Property held for sale to customers. The rental of property during the taxable year in which the property is sold or exchanged (in a transaction in which gain or loss is recognized) shall be treated as incidental to an activity of dealing in such property if at the time of the sale or exchange the property is held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business of the taxpayer (within the meaning of section 1221(1)).

(E) Lodging rented for convenience of employer. The provision of lodging to an employee or to an employee's spouse or dependents shall be treated as incidental to the activity (or activities) of the taxpayer in which the employee performs services if such lodging is furnished for the taxpayer's convenience (within the meaning of section 119).

(F) Unadjusted basis. For purposes of this paragraph (e)(3)(vi), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis.

(vii) Property made available for use in a nonrental activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest. If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity. Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a payment described in section 707(c) is not income from a rental activity under any circumstances (see § 1.469-2T (e)(2)). The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

(viii) Examples. The following examples illustrate the application of this paragraph (e)(3):

Example (1). The taxpayer is engaged in an activity of leasing photocopying equipment. The average period of customer use for the equipment exceeds 30 days. Pursuant to the lease agreements, skilled technicians employed by the taxpayer maintain the equipment and service malfunctioning equipment for no additional charge. Service calls occur frequently (three times per week on average) and require substantial labor. The value of the maintenance and repair services (measured by the cost to the taxpayer of employees performing these services) exceeds 50 percent of the amount charged for the use of the equipment. Under these facts, services performed by individuals are provided in connection with the use of the photocopying equipment, but the customers' use of the photocopying equipment is not incidental to their receipt of the services. Therefore, extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are not provided in connection with making the photocopying equipment available for use by customers, and the activity is a rental activity.

Example (2). The facts are the same as in example (1), except that the average period of customer use for the photocopying equipment exceeds seven days but does not exceed 30 days. Under these facts, significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided in connection with making the photocopying equipment available for use by customers and, under paragraph (e)(3)(ii)(B) of this section, the activity is not a rental activity.

Example (3). The taxpayer is engaged in an activity of transporting goods for customers. In conducting the activity, the taxpayer provides tractor-trailers to transport goods for customers pursuant to arrangements under which the tractor-trailers are selected by the taxpayer, may be replaced at the sole option of the taxpayer, and are operated and maintained by drivers and mechanics employed by the taxpayer. The average period of customer use for the tractor-trailers exceeds 30 days. Under these facts, the use of tractor-trailers by the taxpayer's customers is incidental to their receipt of personal services provided by the taxpayer. Accordingly, the services performed in the activity are extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) and, under paragraph (e)(3)(ii)(C) of this section, the activity is not a rental activity.

Example (4). The taxpayer is engaged in an activity of owning and operating a residential apartment hotel. For the taxable year, the average period of customer use for apartments exceeds seven days but does not exceed 30 days. In addition to cleaning public entrances, exists, stairways, and lobbies, and collecting and removing trash, the taxpayer provides a daily maid and linen service at no additional charge. All of the services other than maid and linen service are excluded services (within the meaning of paragraph (e)(3)(iv)(B) of this section), because such services are similar to those commonly provided in connection with long-term rentals of high-grade residential real property. The value of the maid and linen services (measured by the cost to the taxpayer of employees performing such services) is less than 10 percent of the amount charged to tenants for occupancy of apartments. Under these facts, neither significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) nor extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided in connection with making apartments available for use by customers. Accordingly, the activity is a rental activity.

Example (5). The taxpayer owns 1,000 acres of unimproved land with a fair market value of $350,000 and an unadjusted basis of $210,000. The taxpayer holds the land for the principal purpose of realizing gain from appreciation. In order to defray the cost of carrying the land, the taxpayer leases the land to a rancher, who uses the land to graze cattle and pays rent of $4,000 per year. Thus, the gross rental income from the land is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02×$210,000=$4,200). Accordingly, under paragraph (e)(3)(ii)(D) of this section, the rental of the land is not a rental activity because the

rental is treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

Example (6). (i) A calendar year taxpayer owns an interest in a farming activity which is a trade or business activity (within the meaning of paragraph (e)(2) of this section) and owns farmland which was used in the farming activity in 1985 and 1986. The fair market value of the farmland is $350,000 and its unadjusted basis is $210,000. In 1987, 1988, and 1989, the taxpayer continues to own an interest in the farming activity but does not use the land in the activity. In 1987, the taxpayer leases the land for $4,000 to a rancher, who uses the land to graze cattle. In 1988, the taxpayer leases the land for $10,000 to a film production company, which uses the land to film scenes for a movie. In 1989, the taxpayer again leases the land for $4,000 to the rancher.

(ii) For 1987 and 1989, the taxpayer owns an interest in a trade or business activity, and the farmland which the taxpayer leases to the rancher was used in such activity for two out of the five immediately preceding taxable years. In addition, the gross rental income from the land ($4,000) is less than two percent of the lesser of the fair market value and the unadjusted basis of the land (.02x$210,000=$4,200). Accordingly, the taxpayer's rental of the land is treated under paragraph (e)(3)(vi)(C) of this section as incidental to the taxpayer's farming activity, and is not a rental activity.

(iii) Because the taxpayer's gross rental income from the land for 1988 ($10,000) is not less than two percent of the lesser of the fair market value and the unadjusted basis of the land, the requirement of paragraph (e)(3)(vi)(C)(3) of this section is not met. Therefore, the taxpayer's rental of the land in 1988 is not treated as incidental to the taxpayer's farming activity and is a rental activity.

Example (7). (i) In 1988, the taxpayer acquires vacant land for the purpose of constructing a shopping mall. Before commencing construction, the taxpayer leases the land under a one-year lease to an automobile dealer, who uses the land to park cars held in its inventory. The taxpayer commences construction of the shopping mall in 1989.

(ii) The taxpayer acquired the land for the principal purpose of constructing the shopping mall, not for the principal purpose or realizing gain from the appreciation of the property. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(B) of this section as incidental to an activity of holding the property for investment.

(iii) The land has not been used in any taxable year in any trade or business of the taxpayer. Therefore, the rental of the property in 1988 is not treated under paragraph (e)(3)(vi)(C) of this section as incidental to a trade or business activity.

(iv) Since the rental of the land in 1988 is not treated under paragraph (e)(3)(vi) of this section as incidental to a nonrental activity of the taxpayer, the rental of the land in 1988 is a rental activity. See § 1.469-2T(f)(3) for a special rule relating to the treatment of gross income from the rental of nondepreciable property.

Example (8). The taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "crop-share lease." Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced (or 50 percent of the proceeds from marketing the crops). For purposes of paragraph (e)(3)(vii) of this section, the taxpayer is treated as providing the farmland for use in a farming activity conducted by a joint venture in the taxpayer's capacity as an owner of an interest in the joint venture. Accordingly, under paragraph (e)(3)(ii)(F) of this section, the taxpayer is not engaged in a rental activity, without regard to whether the taxpayer performs any services in the farming activity.

Example (9). The taxpayer owns a taxicab which the taxpayer operates during the day and leases to another driver for use at night under a one-year lease. Under the terms of the lease, the other driver is charged a fixed rental for use of the taxicab. Assume that, under the rules to be contained in § 1.469-4T, the taxpayer is engaged in two separate activities, an activity of operating the taxicab and an activity of making the taxicab available for use by the other driver. Under these facts, the period for which the other driver uses the taxicab exceeds 30 days, and the taxpayer does not provide extraordinary personal services in connection with making the taxicab available to the other driver. Accordingly, the lease of the taxicab is a rental activity.

Example (10). The taxpayer operates a golf course. Some customers of the golf course pay green fees upon each use of the golf course, while other customers purchase weekly, monthly, or annual passes. The golf course is open to all customers from sunrise to sunset every day of the year except certain holidays and days on which the taxpayer determines that the course is to wet for play. The taxpayer thus makes the golf course available during prescribed hours for nonexclusive use by various customers. Accordingly, under paragraph (e)(3)(ii)(E) of this section, the taxpayer is not engaged in a rental activity, without regard to the average period of customer use for the golf course.

(4) Special rule for oil and gas working interests—(i) In general. Except as otherwise provided in paragraph (e)(4)(ii) of this section, an interest in an oil or gas well drilled or operated pursuant to a working interest (within the meaning of paragraph (e)(4)(iv) of this section) of a taxpayer is not an interest in a passive activity for the taxpayer's taxable year (without regard to whether the taxpayer materially participates in such activity) if at any time during such taxable year the taxpayer holds such working interest either—

(A) Directly; or

(B) Through an entity that does not limit the liability of the taxpayer with respect to the drilling or operation of such well pursuant to such working interest.

(ii) Exception for deductions attributable to a period during which liability is limited—(A) In general. If paragraph (e)(4)(i) of this section applies for a taxable year to the taxpayer's interest in an oil or gas well that would, but for the application of paragraph (e)(4)(i) of this section, by an interest in a passive activity for the taxable year, and the taxpayer has a net loss (within the meaning of paragraph (e)(4)(ii)(C)(3) of this section) from the well for the taxable year—

(1) The taxpayer's disqualified deductions (within the meaning of paragraph (e)(4)(ii)(C)(2) of this section) from such oil or gas well for such year shall be treated as passive activity deductions for

such year (within the meaning of § 1.469-2T(d)); and

(2) A ratable portion (within the meaning of paragraph (e)(4)(ii)(C)(4) of this section) of the taxpayer's gross income from such oil or gas well for such year shall be treated as passive activity gross income for such year (within the meaning of § 1.469-2T(c)).

(B) Coordination with rules governing the identification of disallowed passive activity deductions. If gross income and deductions from an activity for a taxable year are treated as passive activity gross income and passive activity deductions under paragraph (e)(4)(ii)(A) of this section, such activity shall be treated as a passive activity for such year for purposes of applying paragraph (f) (2) and (4) of this section.

(C) Meaning of certain terms. For purposes of this paragraph (e)(4)(ii), the following terms shall have the meanings set forth below:

(1) Allocable deductions. The deductions allocable to a taxable year are any deductions that arise in such year (within the meaning of § 1.469-2T (d)(8)) and any deductions that are treated as deductions for such year under paragraph (f)(4) of this section.

(2) Disqualified deductions. The taxpayer's "disqualified deductions" from an oil or gas well for a taxable year are the taxpayer's deductions—

(i) That are attributable to such well and allocable to the taxable year; and

(ii) With respect to which economic performance (within the meaning of section 461(h), without regard to section 461 (h)(3) or (i)(2)) occurs at a time during which the taxpayer's only interest in the working interest is held through an entity that limits the taxpayer's liability with respect to the drilling or operation of such well.

(3) Net loss. The "net loss" of a taxpayer from an oil or gas well for a taxable year equals the amount by which the taxpayer's deductions that are attributable to such oil or gas well and allocable to such year exceeds the gross income of the taxpayer from such well for such year.

(4) Ratable portion. The "ratable portion" of the taxpayer's gross income from an oil or gas well for a taxable year equals the total amount of such gross income multiplied by the fraction obtained by dividing—

(i) The disqualified deductions from such oil or gas well for the taxable year; by

(ii) The total amount of the deductions that are attributable to such oil or gas well and allocable to the taxable year.

(iii) Examples. The following examples illustrate the application of paragraphs (e)(4) (i) and (ii) of this section:

Example (1). (i) A, a calendar year individual, acquires on January 1, 1987, a general partnership interest in P, a calendar year partnership that holds a working interest in an oil or gas property. Pursuant to the partnership agreement, A is entitled to convert the general partnership interest into a limited partnership interest at any time. On December 1, 1987, pursuant to a contract with D, an independent drilling contractor, P commences drilling a single well pursuant to the working interest. Under the drilling contract, P pays D for the drilling only as the work is performed. All drilling costs are deducted by P in the year in which they are paid. At the end of 1987, A converts the general partnership interest into a limited partnership interest, effective immediately. The drilling of the well is completed on February 28, 1988. A's interest in the well would but for this paragraph (e)(4) be an interest in a passive activity.

(ii) Throughout 1987, A holds the working interest through an entity that does not limit A's liability with respect to the drilling of the well pursuant to the working interest. In 1988, however, A holds the working interest through an entity that limits A's liability with respect to the drilling and operation of the well throughout such year. Accordingly, under paragraph (e)(4)(i) of this section, A's interest in P's well is not an interest in a passive activity for 1987 but is an interest in a passive activity for 1988. Moreover, since economic performance occurs in 1987 with respect to all items of deduction for drilling costs that are allocable to 1987, A has no disqualified deductions for 1987.

Example (2). The facts are the same as in example (1), except that all costs of drilling under the contract with D (including costs of drilling performed after 1987) are paid before the end of 1987 and A has a net loss for 1987. In addition, A has $15,000 of total deductions that are attributable to the well and allocable to 1987, but economic performance (as that term is used in paragraph (e)(4)(ii)(C)(2)(ii) of this section) does not occur with respect to $5,000 of those deductions until 1988. Under paragraph (e)(4)(ii) of this section, the $5,000 of deductions with respect to which economic performance occurs in 1988 are disqualified deductions and are treated as passive activity deductions for 1987. In addition, one-third ($5,000/$15,000) of A's gross income from the well for 1987 is treated as passive activity gross income.

(iv) Definition of "working interest." For purposes of section 469 and the regulations thereunder, the term "working interest" means an operating mineral interest (within the meaning of section 614(d) and the regulations thereunder).

(v) Entities that limit liability—(A) General rule. For purposes of paragraph (e)(4)(i)(B) of this section, an entity limits the liability of the taxpayer with respect to the drilling or operation of a well pursuant to a working interest held through such entity if the taxpayer's interest in the entity is in the form of—

(1) A limited partnership interest in a partnership in which the taxpayer is not a general partner;

(2) Stock in a corporation; or

(3) An interest in any entity (other than a limited partnership or corporation) that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions).

(B) Other limitations disregarded. For purposes of this paragraph (e)(4), protection against loss through any of the following is not taken into account in determining whether a taxpayer holds a working interest through an entity that limits the taxpayer's liability:

(1) An indemnification agreement;

(2) A stop loss arrangement;

(3) Insurance;

(4) Any similar arrangement; or

(5) Any combination of the foregoing.

(C) Examples. The following examples illustrate the application of this paragraph (e)(4)(v):

Example (1). A owns a 20 percent interest as a general partner in the capital and profits of P, a partnership which owns oil or gas working interests. The other partners of P agree to indemnify A against liability in excess of A's capital contribution for any of P's costs and expenses with respect to P's working interests. As a general partner, however, A is jointly and severally liable for all of P's liabilities and, under paragraph (e)(4)(v)(B)(1) of this section, the indemnification agreement is not taken into account in determining whether A holds the working interests through an entity that limits A's liability. Accordingly, the partnership does not limit A's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (2). B owns a 10 percent interest in X, an entity (other than a limited partnership or corporation) created under applicable State law to hold working interests in oil or gas properties. Under applicable State law, B is liable without limitation for 10 percent of X's costs and expenses with respect to X's working interests but is not liable for the remaining 90 percent of such costs and expenses. Since B's liability for the obligations of X is not limited to a determinable fixed amount (within the meaning of paragraph (e)(4)(v)(A)(3) of this section), the entity does not limit B's liability with respect to the drilling or operation of wells pursuant to the working interests.

Example (3). C is both a general partner and a limited partner in a partnership that owns a working interest in oil or gas property. Because C owns an interest as a general partner in each well drilled pursuant to the working interest, C's entire interest in each well drilled pursuant to the working interest is treated under paragraph(e)(4)(i) of this section as an interest in an activity that is not a passive activity (without regard to whether C materially participates in such activity).

(vi) Cross reference to special rule for income from certain oil or gas properties. A special rule relating to the treatment of income from certain interests in oil or gas properties is contained in § 1.469-2T(c)(6).

(5) Rental of dwelling unit. An activity involving the rental of a dwelling unit that is used as a residence by the taxpayer during the taxable year (within the meaning of section 280A(c)(5)) is not a passive activity of the taxpayer for such year.

(6) Activity of trading personal property—(i) In general. An activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether such activity is a trade or business activity (within the meaning of paragraph (e)(2) of this section)).

(ii) Personal property. For purposes of this paragraph (e)(6), the term "personal property" means personal property (within the meaning of section 1092(d), without regard to paragraph (3) thereof).

(iii) Example. The following example illustrates the application of this paragraph (e)(6):

Example. A partnership is a trader of stocks, bonds, and other securities (within the meaning of section 1236(c)). The capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests, and funds borrowed by the partnership. The partnership derives gross income from the activity in the form of interest, dividends, and capital gains. Under these facts, the partnership is treated as conducting an activity of trading personal property for the account of its partners. Accordingly, under this paragraph (e)(6), the activity is not a passive activity.

(f) Treatment of disallowed passive activity losses and credits—(1) Scope of this paragraph. The rules in this paragraph (f)—

(i) Identify the passive activity deductions that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity loss is disallowed under paragraph (a)(1)(i) of this section;

(ii) Identify the credits from passive activities that are disallowed for any taxable year in which all or a portion of the taxpayer's passive activity credit is disallowed under paragraph (a)(1)(i) of this section; and

(iii) Provide for the carryover of disallowed deductions and credits.

(2) Identification of disallowed passive activity deductions—(i) Allocation of disallowed passive activity loss among activities—(A) General rule. If all or any portion of the taxpayer's passive activity

loss is disallowed for the taxable year under paragraph (a)(1)(i) of this section, a ratable portion of the loss (if any) from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a loss from an activity is computed by multiplying the passive activity loss that is disallowed for the taxable year by the fraction obtained by dividing—

(1) The loss from the activity for the taxable year; by

(2) The sum of the losses for the taxable year from all activities having losses for such year.

(B) Loss from an activity. For purposes of this paragraph (f)(2)(i), the term "loss from an activity" means—

(1) The amount by which the passive activity deductions from the activity for the taxable year (within the meaning of § 1.469-2T(d)) exceed the passive activity gross income from the activity for the taxable year (within the meaning of § 1.469-2T(c)); reduced by

(2) Any part of such amount that is allowed under section 469(i) and the rules to be contained in § 1.469-9T (relating to the $25,000 allowance for certain rental real estate activities).

(C) Significant participation passive activities. If the taxpayer's passive activity gross income from significant participation passive activities (within the meaning of § 1.469-2T(f) (2)(ii)) for the taxable year (determined without regard to § 1.469-2T(f)(2) through (4)) exceeds the taxpayer's passive activity deductions from such activities for the taxable year, such activities shall be treated, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, as a single activity that does not have a loss for such taxable year.

(D) Examples. The following examples illustrate the application of this paragraph (f)(2)(i):

Example (1). An individual holds interests in three passive activities, A, B, and C. The gross income and deductions from these activities for the taxable year are as follows:

	A	B	C	Total
Gross income	$ 7,000	$ 4,000	$12,000	$23,000
Deductions	(16,000)	(20,000)	(8,000)	(44,000)
Net income (loss)	($ 9,000)	($16,000)	$ 4,000	($21,000)

The taxpayer's $21,000 passive activity loss for the taxable year is disallowed under paragraph (a)(1)(i) of this section. Therefore, a ratable portion of the losses from activities A and B is disallowed. The disallowed portion of each loss is determined as follows:

A: $21,000 X $9,000/$25,000 .... $ 7,560

B: $21,000 X $16,000/$25,000 .... $13,440

Total $21,000

Example (2). An individual holds interests in four passive activities, A, B, C, and D. The results of operations of these activities for the taxable year are as follows:

	A	B	C	D	Total
Gross income	15,000	5,000	10,000	10,000	40,000
Deductions	(5,000)	(10,000)	(20,000)	(8,000)	(43,000)
Net income (loss)	10,000	(5,000)	(10,000)	2,000	(3,000)

Activities A and B are significant participation passive activities (within the meaning of § 1.469-2T(f)(2)(ii)). The gross income from these activities for the taxable year ($20,000) exceeds the passive activity deductions from those activities for the taxable year ($15,000) by $5,000 and, under § 1.469-2T(f)(2), $5,000 of gross income from those activities is treated as not from a passive activity. Therefore, solely for purposes of applying this paragraph (f)(2)(i) for the taxable year, activities A and B are treated as a single activity that does not have a loss for the taxable year. Under § 1.469-2T(b), the taxpayer's passive activity loss for the taxable year is $8,000 ($43,000 of passive activity deductions minus $35,000 of passive activity gross income). The results of treating activities A and B as a single activity that does not have a loss for the taxable year is that none of the $8,000 passive activity loss is allocated under this paragraph (f)(2)(i) to activity B for the taxable year, even though the taxpayer incurred a loss in that activity for the taxable year.

(ii) **Allocation within loss activities**—(A) In general. If all or any portion of a taxpayer's loss from an activity is disallowed under paragraph (f)(2)(i) of this section for the taxable year, a ratable portion of each passive activity deduction (other than an excluded deduction (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity is disallowed. For purposes of the preceding sentence, the ratable portion of a passive activity deduction of a taxpayer is the amount of the disallowed portion of the taxpayer's loss from the activity (within the meaning of paragraph (f)(2)(i)(B) of this section) for the taxable year multiplied by the fraction obtained by dividing—

(1) The amount of such deduction; by

(2) The sum of all passive activity deductions (other than excluded deductions (within the meaning of paragraph (f)(2)(ii)(B) of this section)) of the taxpayer from such activity from the taxable year.

(B) Excluded deductions. The term "excluded deduction" means any passive activity deduction of a taxpayer that is taken into account in computing the taxpayer's net income from an item of property for a taxable year in which an amount of the taxpayer's gross income from such item of

property is treated as not from a passive activity under § 1.469-2T(c)(6) or § 1.469-2T(f) (5), (6), or (7).

(iii) Separately identified deductions. In identifying the deductions from an activity that are disallowed under this paragraph (f)(2), the taxpayer need not account separately for a deduction unless such deduction may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such deduction not taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Deductions that must be accounted for separately include (but are not limited to) deductions that—

(A) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity; or

(C) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions).

(3) Identification of disallowed credits from passive activities—(i) General rule. If all or any portion of the taxpayer's passive activity credit is disallowed for the taxable year under paragraph (a)(1)(ii) of this section, a ratable portion of each credit from each passive activity of the taxpayer is disallowed. For purposes of the preceding sentence, the ratable portion of a credit of a taxpayer is computed by multiplying the portion of the taxpayer's passive activity credit that is disallowed for the taxable year by the fraction obtained by dividing—

(A) The amount of the credit; by

(B) The sum of all of the taxpayer's credits from passive activities for the taxable year.

(ii) Coordination rule. For purposes of paragraph (f)(3)(i) of this section, the credits from a passive activity do not include any credit or portion of a credit that—

(A) Is allowed for the taxable year under section 469(i) and the rules to be contained in § 1.469-9T (relating to the $25,000 allowance for certain rental real estate activities); or

(B) Increases the basis of property during the taxable year under section 469(j)(9) and the rules to be contained in § 1.469-6T (relating to the election to increase the basis of certain property by disallowed credits).

(iii) Separately identified credits. In identifying the credits from an activity that are disallowed under this paragraph (f)(3), the taxpayer need not account separately for any credit unless such credit may, if separately taken into account, result in an income tax liability for any taxable year different from that which would result were such credit not taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Credits that must be accounted for separately include (but are not limited to)—

(A) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) that arise in a taxable year in which the taxpayer actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(B) Credits (other than the low-income housing and rehabilitation investment credits) from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) that arise in a taxable year in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(C) Low-income housing and rehabilitation investment credits from a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T); and

(D) Any credit that is subject to the limitations of sections 26(a), 28(d)(2), 29(b)(5), or 38(c) in a manner that differs from the manner in which any other credit is subject to such limitations.

(4) Carryover of disallowed deductions and credits. Any deduction or credit from an activity of the taxpayer that is disallowed for a taxable year under paragraph (f)(2) or (3) of this section, respectively, shall be treated for purposes of section 469 and the regulations thereunder as a deduction or credit, as the case may be, from such activity

for the taxpayer's immediately succeeding taxable year. The following example illustrates the application of this paragraph (f)(4):

Example. The facts are the same as in example (1) in paragraph (f)(2)(i)(D) of this section. The $7,560 of loss from activity A and the $13,440 of loss from activity B that are disallowed for the taxable year under paragraph (f)(2) of this section are allocated among the passive activity deductions from those activities for such year under paragraph (f)(2)(ii) of this section and are treated under this paragraph (f)(4) as deductions from activities A and B, respectively, for the succeeding taxable year.

(g) **Application of these rules to C corporations—(1) In general.** Except as otherwise provided in the rules to be contained in paragraph (k) of this section, section 469 and the regulations thereunder do not apply to any corporation that is not a personal service corporation or a closely held corporation for the taxable year. See paragraphs (g)(4) and (5) of this section for special rules for computing the passive activity loss and passive activity credit, respectively, of a closely held corporation.

(2) **Definitions.** For purposes of section 469 and the regulations thereunder—

(i) The term "personal service corporation" means a C corporation that is a personal service corporation for the taxable year (within the meaning of § 1.441-4T(d)); and

(ii) The term "closely held corporation" means a C corporation that meets the stock ownership requirements of section 542(a)(2) (taking into account the modifications in section 465(a)(3)) for the taxable year and is not a personal service corporation for such year.

(3) **Participation of corporations—(i) Material participation.** For purposes of section 469 and the regulations thereunder, a corporation described in paragraph (g)(2) of this section shall be treated as materially participating in an activity for a taxable year if and only if—

(A) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as materially participating in such activity for the taxable year, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation; or

(B) In the case of a closely held corporation (within the meaning of paragraph (g)(2)(ii) of this section), the requirements of section 465(c)(7)(C) (without regard to clause (iv) thereof and taking into account section 465(c)(7)(D)) are met with respect to such activity.

(ii) **Significant participation.** For purposes of § 1.469-2T(f)(2), an activity of a corporation described in paragraph (g)(2) of this section shall be treated as a significant participation passive activity for a taxable year if and only if—

(A) The corporation is not treated as materially participating in such activity for the taxable year; and

(B) One or more individuals, each of whom is treated under paragraph (g)(3)(iii) of this section as significantly participating in such activity, directly or indirectly hold (in the aggregate) more than 50 percent (by value) of the outstanding stock of such corporation.

(iii) **Participation of individual.** Whether an individual is treated for purposes of this paragraph (g)(3) as materially participating or significantly participating in an activity of a corporation shall be determined under the rules of § 1.469-5T, except that in applying such rules—

(A) All activities of the corporation shall be treated as activities in which the individual holds an interest in determining whether the individual participates (within the meaning of § 1.469-5T(f)) in an activity of the corporation; and

(B) The individual's participation in all activities other than activities of the corporation shall be disregarded in determining whether the individual's participation in an activity of the corporation is treated as material participation under § 1.469-5T(a)(4) (relating to material participation in significant participation activities).

(4) **Modified computation of passive activity loss in the case of closely held corporations.—(i) In general.** A closely held corporation's passive activity loss for the taxable year is the amount, if any, by which the corporation's passive activity deductions for the taxable year (within the meaning of § 1.469-2T(d)) exceed the sum of—

(A) The corporation's passive activity gross income for the taxable year (within the meaning of § 1.469-2T(c)); and

(B) The corporation's net active income for the taxable year.

(ii) **Net active income.** For purposes of this paragraph (g)(4), a corporation's net active income for the taxable year is such corporation's taxable income for the taxable year, determined without regard to the following items for the year:

(A) Passive activity gross income;

(B) Passive activity deductions;

(C) Portfolio income (within the meaning of § 1.469-2T(c)(3)(i)), including any gross income that is treated as portfolio income under any other provision of the regulations (see, e.g., § 1.469-2T(c)(2)(iii)(E) (relating to gain from the disposition of substantially appreciated property formerly held for investment) and § 1.469-2T(f)(10) (relating to certain recharacterized passive activity gross income);

(D) Gross income that is treated under § 1.469-2T(c)(6) (relating to gross income from certain oil or gas properties) as not from a passive activity;

(E) Gross income and deductions from any trade or business activity (within the meaning of paragraph (e)(2) of this section) that is described in paragraph (e)(6) of this section (relating to certain activities of trading personal property) but only if the corporation did not materially participate in such activity for the taxable year;

(F) Deductions described in § 1.469-2T(d)(2)(i), (ii), and (iv) (relating to certain deductions attributable to portfolio income); and

(G) Interest expense allocated under § 1.163-8T to a portfolio expenditure (within the meaning of § 1.163-8T(b)(6)).

(iii) **Examples.** The following examples illustrate the application of this paragraph (g)(4):

Example (1). (i) For 1987, X, a closely held corporation, is engaged in two activities, a trade or business activity in which X materially participates for 1987 and a rental activity. X also holds portfolio investments. For 1987, X has the following gross income and deductions:

Gross income:	
Rents	$60,000
Gross income from business	100,000
Portfolio income	35,000
Total	$195,000
Deductions:	
Rental deductions	($100,000)
Business deductions	(80,000)
Interest expense allocable to portfolio expenditures under § 1.163–8T	(10,000)
Deductions (other than interest expense) clearly and directly allocable to portfolio income	(5,000)
Total	($195,000)

(ii) The corporation's net active income for 1987 is $20,000, computed as follows:

Gross income		$195,000	
Amounts not taken into account in computing net active income:			
Rents (see paragraph (g)(4)(ii)(A) of this section)	$60,000		
Portfolio income (see paragraph (g)(4)(ii)(C) of this section)	$35,000		
	$95,000	($95,000)	
Gross income taken into account in computing net active income		$100,000	$100,000
Deductions		($195,000)	
Amounts not taken into account in computing net active income:			
Rental deductions (see paragraph (g)(4)(ii)(B) of this section)	($100,000)		
Interest expense allocated to portfolio expenditures (see paragraph (g)(4)(ii)(G) of this section)	($10,000)		
Other deductions clearly and directly allocable to portfolio income (see paragraph (g)(4)(ii)(F) of this section)	(5,000)		
	($115,000)	$115,000	
Deductions taken into account in computing net active income		($80,000)	($80,000)
Net active income			$20,000

(iii) Under paragraph(g)(4)(i) of this section, X's passive activity loss for 1987 is $20,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($20,000). Under paragraph (f)(4) of this section, the $20,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. If computed without regard to the net active income for the taxable year, X's passive activity loss would be $40,000 ($100,000 of rental deductions minus $60,000 of rental income). Thus, the effect of the rule in paragraph (g)(4)(i) of this section is to reduce the corporation's passive activity loss for the taxable year by the amount of the corporation's net active income for such year.

(iv) Under these facts, X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($195,000)	
Passive activity loss	$20,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Example (2). (i) The facts are the same as in example (1), except that, in 1988, X has a loss from the trade or business activity, and a net operating loss ("NOL") of $15,000 that is carried back under section 172(b) to 1987. Since NOL carry-

backs are taken into account in computing net active income, X's net active income for 1987 must be recomputed as follows:

Net active income before NOL carryback	$20,000
NOL carryback	($15,000)
Net active income	$5,000

(ii) Under these facts, X's disallowed passive activity loss for 1987 is $35,000, the amount by which the passive activity deductions for the taxable year ($100,000) exceed the sum of (a) the passive activity gross income for the taxable year ($60,000) and (b) the net active income for the taxable year ($5,000).

(iii) Under paragraph (f)(4) of this section, the $35,000 of deductions from X's rental activity that are disallowed for 1987 are treated as deductions from the rental activity for 1988. X's taxable income for 1987 is $20,000, computed as follows:

Gross income		$195,000
Deductions:		
Total deductions	($210,000)	
Passive activity loss	$35,000	
Allowable deductions	($175,000)	($175,000)
Taxable income		$20,000

Thus, taking the NOL carryback into account in computing net active income for 1987 does not affect X's taxable income for 1987, but increases the deductions treated under paragraph (f)(4) as deductions from X's rental activity for 1988 and decreases X's NOL carryover to years other than 1987.

(5) Allowance of passive activity credit of closely held corporations to extent of net active income tax liability—(i) In general. Solely for purposes of determining the amount disallowed under paragraph (a)(1)(ii) of this section, a closely held corporation's passive activity credit for the taxable year shall be reduced by such corporation's net active income tax liability for such year.

(ii) Net active income tax liability. For purposes of paragraph (g)(5)(i) of this section, a corporation's net active income tax liability for a taxable year is the amount (if any) by which—

(A) The corporation's regular tax liability (within the meaning of section 26(b)) for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the corporation's passive activity gross income for such year over the corporation's passive activity deductions for such year; exceeds

(B) The sum of—

(*1*) The corporation's regular tax liability for the taxable year, determined by reducing the corporation's taxable income for such year by an amount equal to the excess (if any) of the sum of the corporation's net active income (within the meaning of paragraph (g)(4)(ii) of this section) and passive activity gross income for such year over the corporation's passive activity deductions for such year; and

(*2*) The corporation's credits (other than credits from passive activities) that are allowable for the taxable year (without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469).

(h) Special rules for affiliated group filing consolidated return—(1) In general. For purposes of computing the consolidated taxable income and tax liability of an affiliated group of corporations filing a consolidated return for the taxable year, and the separate taxable income (within the meaning of § 1.1502-12) of each member of such group, section 469 and the regulations thereunder shall be applied in the manner provided in this paragraph (h).

(2) Definitions. For purposes of this paragraph (h)—

(i) The terms "group," "member," "subsidiary," and "consolidated return year" shall have the meanings set forth in § 1.1502-1;

(ii) The term "consolidated group" means a group filing a consolidated return for the taxable year; and

(iii) The term "consolidated taxable income" shall have the meaning set forth in § 1.1502-11.

(3) Disallowance of consolidated group's passive activity loss or credit. A consolidated group's passive activity loss or passive activity credit for the taxable year shall be disallowed to the extent provided in paragraph (a) of this section. For purposes of the preceding sentence, a consolidated group's passive activity loss and passive activity credit shall be determined by taking into account the following items of each member of such group:

(i) Passive activity gross income;

(ii) Passive activity deductions;

(iii) Net active income (in the case of a consolidated group treated as a closely held corporation under paragraph (h)(4)(ii) of this section); and

(iv) Credits from passive activities.

(4) Status and material participation of members—(i) Determination by reference to status and participation of group. For purposes of section 469 and the regulations thereunder—

(A) Each member of a consolidated group shall be treated as a closely held corporation or personal service corporation, respectively, for the taxable year, if and only if the consolidated group is treated (under the rules of paragraph (h)(4)(ii) of

this section) as a closely held corporation or personal service corporation for such year; and

(B) The determination of whether a trade or business activity (within the meaning of paragraph (e)(2) of this section) conducted by one or more members of a consolidated group is a passive activity of such members shall be made by reference to the consolidated group's participation in such activity.

(ii) Determination of status and material participation of consolidated group. For purposes of determining under paragraph (g)(2) of this section whether a consolidated group is treated as a closely held corporation or a personal service corporation, and determining under paragraph (g)(3) of this section whether the consolidated group materially participates in any activity conducted by one or more members of such group—

(A) The members of such consolidated group shall be treated as one corporation;

(B) Only the outstanding stock of the common parent shall be treated as outstanding stock of such corporation;

(C) An employee of any member of such group shall be treated as an employee of such corporation; and

(D) An activity is treated as the principal activity of such corporation if and only if it is the principal activity (within the meaning of § 1.44-4T(f)) of the consolidated group.

(5) Modification of rules for identifying disallowed passive activity deductions and credits—(i) Identification of disallowed deductions. In applying paragraphs (f) (2) and (4) of this section to a consolidated group for purposes of identifying the passive activity deductions of such consolidated group and of each member of such consolidated group that are disallowed for the taxable year and treated as deductions from activities for the succeeding taxable year, the following rules shall apply:

(A) A ratable portion (within the meaning of paragraph (h)(5)(ii) of this section) of the passive activity loss of the consolidated group that is disallowed for the taxable year shall be allocated to each member of the group;

(B) Paragraph (f)(2) of this section shall then be applied to each member of the group as if—

(1) Such member were a separate taxpayer; and

(2) The amount allocated to such member under paragraph (h)(5)(i)(A) of this section were the amount of such member's passive activity loss that is disallowed for the taxable year; and

(C) Paragraph (f)(4) of this section shall be applied to each member of the group as if it were a separate taxpayer.

(ii) Ratable portion of disallowed passive activity loss. For purposes of paragraph (h)(5)(i)(A) of this section, a member's ratable portion of the disallowed passive activity loss of the consolidated group is the amount of such disallowed loss multiplied by the fraction obtained by dividing—

(A) The amount of the passive activity loss of such member of the consolidated group that would be disallowed for the taxable year if the items of gross income and deduction of such member were the only items of the group for such year; by

(B) The sum of the amounts described in paragraph (h)(5)(ii)(A) of this section for all members of the group.

(iii) Identification of disallowed credits. In applying paragraph (f)(3) of this section to a consolidated group for purposes of identifying the credits from passive activities of members of such consolidated group that are disallowed for the taxable year, the consolidated group shall be treated as one taxpayer. Thus, a ratable portion of each of the group's credits from passive activities is disallowed.

(6) Transactions between members of a consolidated group—(i) Scope. This paragraph (h)(6) provides rules regarding the treatment, for purposes of section 469 and the regulations thereunder, of items of income and deduction attributable to intercompany transactions. See paragraph (h)(6)(iv) of this section for the definition of "intercompany transaction" and certain other terms used in this paragraph (h)(6).

(ii) Recharacterization of gain or loss from intercompany transactions other than deferred intercompany transactions—(A) In general. If the selling member in an intercompany transaction (other than a deferred intercompany transaction) recognizes an item of gain or loss described in § 1.1502-13(b) that is directly related to an item of deduction of the purchasing member, and both the gain or loss and the directly related item of deduction are taken into account in computing consolidated taxable income for the same taxable year, the items of income or deduction that are taken into account by the selling member in computing such gain or loss shall be taken into account in computing consolidated taxable income

for such taxable year as items of income or deduction of the selling member from the activity to which the directly related deduction of the purchasing member is attributable.

(B) Recharacterization of gain or loss as portfolio items. Any item of income or deduction of a selling member that is recharacterized under this paragraph (h)(6)(ii) shall be treated as an item of income or deduction described in § 1.469-2T(c)(3)(i) (relating to portfolio income) or § 1.469-2T(d)(2)(i) (relating to expenses clearly and directly allocable to portfolio income), as the case may be, if and only if the directly related item of deduction is a deduction described in § 1.469-2T (d)(2)(i) or a deduction for interest expense that is allocated under § 1.163-8T to a portfolio expenditure (within the meaning of § 1.163-8T (b)(6)).

(iii) **Deferred intercompany transactions**—(A) In general. For purposes of section 469 and the regulations thereunder, the treatment of deferred gain or loss on a deferred intercompany transaction between members of a group shall be determined in accordance with this paragraph (h)(6)(iii).

(B) Deferred intercompany transactions involving property subject to depreciation, amortization, or depletion. If, for any consolidated return year, the selling member in a deferred intercompany transaction is required to take into account deferred gain or loss under § 1.1502-13(d) as a result of depreciation, amortization, or depletion of a member of the group, then for purposes of section 469 and the regulations thereunder such deferred gain or loss shall be taken into account for such year as gain or loss of the selling member from the activity (or activities) to which such depreciation, amortization, or depletion deductions are attributable.

(C) Restoration of deferred gain or loss on dispositions. If, for any consolidated return year, the selling member in a deferred intercompany transaction (other than a deferred intercompany transaction described in § 1.1502-13(e)(1)) is required to take deferred gain or loss into account under § 1.1502-13(e)(2) or (f), then for purposes of section 469 and the regulations thereunder—

(1) Such deferred gain or loss shall be treated as gain or loss of the selling member from a disposition of the property involved in such deferred intercompany transaction at the time of (i) the event that requires such gain or loss to be taken into account or (ii) in the case of a transaction described in § 1.1502-13(e)(2), the disposition of such property outside the consolidated group; and

(2) Such deferred gain or loss shall, except as otherwise provided in § 1.1502-2T (c)(2) or (d)(5), be taken into account for such year as gain or loss of the selling member from the activity (or activities) of the affiliated group in which the property involved in such deferred intercompany transaction is used immediately preceding the time specified in paragraph (h)(6)(iii)(C)(1) of this section.

See paragraph (h)(8) of this section, relating to dispositions by a member of substantially appreciated property formerly used in a nonpassive activity.

(D) Certain recharacterized items treated as portfolio items. Any deferred gain or loss or a selling member that is recharacterized under this paragraph (h)(6)(iii) shall be treated as an item of income or deduction described in § 1.469-2T(c)(3)(i) (relating to portfolio income) or § 1.469-2T(d)(2)(i) (relating to expenses clearly and directly allocable to portfolio income), as the case may be, if and only if the property involved in the transaction is property that produces portfolio income (within the meaning of § 1.469-2T(c)(3)((i)).

(E) Property involved in deferred intercompany transaction. For purposes of this paragraph (h)(6)(iii), the property involved in a deferred intercompany transaction is the property sold or exchanged in such transaction or the property with respect to which expenditures incurred in such transaction are capitalized.

(iv) **Definitions.** For purposes of this paragraph (h)(6), the terms set forth below shall have the following meanings:

(A) Deferred intercompany transaction. The term "deferred intercompany transaction" shall have the meaning set forth in § 1.1502-13(a)(2).

(B) Directly related. An item of gross income and an item of deduction are "directly related" if and to the extent that the same amount paid or accrued generates both the income and the deduction, without regard to whether the income and the deduction are taken into account by the taxpayer in the same taxable year.

(C) Intercompany transaction. The term "intercompany transaction" shall have the meaning set forth in § 1.1502-13(a)(1).

(D) Purchasing member. The term "purchasing member" shall have the meaning set forth in § 1.1502-13(a).

(E) Selling member. The term "selling member" shall have the meaning set forth in § 1.502-13(a).

(7) Disposition of stock of a member of an affiliated group. Any gain recognized by a member on the disposition of stock of a subsidiary (including income resulting from the recognition of an excess loss account under § 1.1502-19 (a)) shall be treated as portfolio income (within the meaning of § 1.469-2T (c)(3)(i)).

(8) Dispositions of property used in multiple activities. The determination of whether § 1.469-2T(c)(2)(ii) or (iii) or (d)(5)(ii) applies to a disposition (including a deemed disposition described in paragraph (h)(6)(iii)(C)(1) of this section) of property by a member of a consolidated group shall be made by treating such member as having held the property for the entire period that the group has owned such property and as having used the property in all of the activities in which the group has used such property

(i) [Reserved]

(j) Spouses filing joint return—(1) In general. Except as otherwise provided in the regulations under section 469, spouses filing a joint return for a taxable year shall be treated for such year as one taxpayer for purposes of section 469 and the regulations thereunder. Thus, for example, spouses filing a joint return are treated as one taxpayer for purposes of—

(i) Section 1.469-2T (relating generally to the computation of such taxpayer's passive activity loss); and

(ii) Paragraph (f) of this section (relating to the allocation of such taxpayer's disallowed passive activity loss and passive activity credit among activities and the identification of disallowed passive activity deductions and credits from passive activities).

(2) Exceptions to treatment as one taxpayer—(i) Identification of disallowed deductions and credits. For purposes of paragraphs (f)(2)(iii) and (3) (iii) of this section, spouses filing a joint return for the taxable year must account separately for the deductions and credits attributable to the interests of each spouse in any activity.

(ii) Treatment of deductions disallowed under sections 704(d), 1366(d), and 465. Notwithstanding any other provision of this section or § 1.469-2T, this paragraph (j) shall not affect the application of section 704(d), section 1366(d), or section 465 to taxpayers filing a joint return for the taxable year.

(iii) Treatment of losses from working interests. Paragraph (e)(4) of this section (relating to losses and credits from certain interests in oil and gas wells) shall be applied by treating a husband and wife (whether or not filing a joint return) as separate taxpayers.

(3) Joint return no longer filed. If an individual—

(A) Does not file a joint return for the taxable years; and

(B) Filed a joint return for the immediately preceding taxable year;

then the passive activity deductions and credits allocable to such individual's activities for the taxable year under paragraph (f)(4) of this section shall be determined by taking into account the items of deduction and credit attributable to such individual's interests in passive activities for the immediately preceding taxable year. See paragraph (j)(2)(i) of this section.

(4) Participation of spouses. Rules treating an individual's participation in an activity as participation of such individual's spouse in such activity (without regard to whether the spouses file a joint return) are contained in § 1.469-5T(f)(3).

(k) Former passive activities and changes in status of corporations. [Reserved]

[T.D. 8175, 53 FR 5700, Feb. 25, 1988]

§ 1.469–2T Passive activity loss (temporary).

(a) Scope of this section. This section contains rules for determining the amount of the taxpayer's passive activity loss for the taxable year for purposes of section 469 and the regulations thereunder. The rules contained in this section—

(1) Provide general guidance for identifying items of income and deduction that are taken into account in determining the amount of the passive activity loss for the taxable year;

(2) Specify particular items of income and deduction that are not taken into account in determining the amount of the passive activity loss for the taxable year; and

(3) Specify the manner in which provisions of the Internal Revenue Code and the regulations, other than section 469 and the regulations thereunder, are applied for purposes of determining the extent to which items of deduction are taken into account for a taxable year in computing the amount of the passive activity loss for such year.

(b) Definition of passive activity loss—(1) In general. In the case of a taxpayer other than a closely held corporation (within the meaning of § 1.469-1T(g)(2)(ii)), the passive activity loss for the taxable year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year.

(2) Cross references. See paragraph (c) of this section for the definition of "passive activity gross income," paragraph (d) of this section for the definition of "passive activity deduction," and § 1.469-1T(g)(4) for the computation of the passive activity loss of a closely held corporation.

(c) Passive activity gross income—(1) In general. Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

(2) Treatment of gain from disposition of an interest in an activity or an interest in property used in an activity—(i) In general—(A) Treatment of gain. Except as otherwise provided in the regulations under section 469, any gain recognized upon the sale, exchange or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation is treated in the following manner:

(1) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;

(2) If the activity is a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

(3) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

(B) Dispositions of partnership interests and S corporation stock. A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (c)(2). See paragraph (e)(3) of this section for rules treating the gain recognized upon the disposition of a partnership interest or S corporation stock as gain from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(C) Interest in property. For purposes of applying this paragraph (c)(2) to a disposition of property—

(1) Any material portion of the property that was used, at any time before the disposition, in any activity at a time when the remainder of the property was not used in such activity shall be treated as a separate interest in property; and

(2) The amount realized from the disposition and the adjusted basis of the property must be allocated among the separate interests in a reasonable manner.

(D) Examples. The following examples illustrate the application of this paragraph (c)(2)(i):

Example (1). A owns an interest in a trade or business activity in which A has never materially participated. In 1987, A sells equipment that was used exclusively in the activity and realizes a gain on the sale. Under paragraph (c)(2)(i)(A)(2) of this section, the gain is passive activity gross income.

Example (2). B owns an interest in a trade or business activity in which B materially participates for 1987. In 1987, B sells a building used in the activity in an installment sale and realizes a gain on the sale. B does not materially participate in the activity for 1988 or any subsequent year. Under paragraph (c)(2)(i)(A)(3) of this section, none of B's gain from the sale (including gain taken into account after 1987) is passive activity gross income.

Example (3). C enters into a contract to acquire property used by the seller in a rental activity. Before acquiring the property pursuant to the contract, C sells all rights under the contract and realizes a gain on the sale. Since C's rights under the contract are not property used in a rental activity, the gain is not income from a rental activity. The result would be the same if C owned an option to acquire the property and sold the option.

Example (4). D sells a ten-floor office building. D owned the building for three years preceding the sale and at all times during that period used seven floors of the building in a trade or business activity and three floors in a rental activity. The fair market value per square foot is substantially the same throughout the building, and D did not maintain a separate adjusted basis for any part of the building. Under paragraph (c)(2)(i)(C)(1) of this section, the seven floors used in the trade or business activity and the three floors used in the rental activity are treated as separate interests in property. Under paragraph (c)(2)(i)(C)(2) of this section, the amount realized and the adjusted basis of the building must be allocated between the separate interests in a reasonable manner. Under these facts, an allocation based on the square footage of the parts of the building used in each activity would be reasonable.

Example (5). The facts are the same as in example (4), except that two of the seven floors used in the trade or business activity were used in the rental activity until five months before the sale. Under paragraph (c)(2)(i)(C)(1) of this section, the five floors used exclusively in the trade or business activity and the two floors used first in the rental activity and then in the trade or business activity are treated as separate interests in property. See paragraph (c)(2)(ii) of this section for rules for allocating amount realized and adjusted basis upon a disposition of an interest in property used in more than one activity during the 12-month period ending on the date of the disposition.

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition. In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities on a basis that reasonably reflects the use of such interest in property during such 12-month period. For purposes of this paragraph (c)(2)(ii), an allocation of the amount realized and adjusted basis solely to the activity in which an interest in property is predominantly used during the 12-month period ending on the date of the disposition reasonably reflects the use of such interest in property if the fair market value of such interest does not exceed the lesser of—

(A) $10,000; and

(B) 10 percent of the sum of the fair market value of such interest and the fair market value of all other property used in such activity immediately before the disposition.

The following examples illustrate the application of this paragraph (c)(2)(ii):

Example (1). The facts are the same as in example (5) of paragraph (c)(2)(i)(D) of this section. Under paragraph (c)(2)(i)(C)(2) of this section, D allocates the amount realized and adjusted basis of the building 30 percent to the three floors used exclusively in the rental activity, 50 percent to the five floors used exclusively in the trade or business activity, and 20 percent to the two floors used first in the rental activity and then in the trade or business activity. Under this paragraph (c)(2)(ii), the amount realized and adjusted basis allocated to the two floors that were used in both activities during the 12-month period ending on the date of the disposition must also be allocated between such activities. Under these facts, an allocation of 7/12 of such amounts to the rental activity and 5/12 of such amounts to the trade or business activity would reasonably reflect the use of the two floors during the 12-month period ending on the date of the disposition.

Example (2). B is a limited partner in a partnership that sells a tractor-trailer. During the 12-month period ending on the date of the sale, the tractor-trailer was used in several activities, and the partnership allocates the amount realized from the disposition and the adjusted basis of the tractor-trailer among the activities based on the number of days during the 12-month period that the partnership used the tractor-trailer in each activity. Under these facts, the partnership's allocation reasonably reflects the use of the tractor-trailer during the 12-month period ending on the date of the sale.

Example (3). C sells a personal computer for $8,000. During the 12-month period ending on the date of the sale, 70 percent of C's use of the computer was in a passive activity. Immediately before the sale, the fair market value of all property used in the passive activity (including the personal computer) was $200,000. Under these facts, the computer was predominately used in the passive activity during the 12-month period ending on the date of the sale, and the value of the computer, as measured by its sale price ($8,000), does not exceed the lesser of (a) $10,000, and (b) 10 percent of the value of all property used in the activity immediately before the sale ($20,000). C allocates the amount realized and the adjusted basis solely to the passive activity. Under this paragraph (c)(2)(ii), C's allocation reasonably reflects the use of the computer during the 12-month period ending on the date of the sale.

(iii) Disposition of substantially appreciated property formerly used in nonpassive activity—(A) In general. If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless such interest in property was used in a passive activity for either—

(1) 20 percent of the period during which the taxpayer held such interest in property; or

(2) The entire 24-month period ending on the date of the disposition.

(B) Date of disposition. For purposes of this paragraph (c)(2)(iii), a disposition of an interest in property shall be deemed to occur on the date that such interest in property becomes subject to an oral or written agreement that either requires the owner or gives the owner an option to transfer such interest in property for consideration that is fixed or otherwise determinable on such date.

(C) Substantially appreciated property. For purposes of this paragraph (c)(2)(iii), an interest in property is substantially appreciated if the fair market value of such interest in property exceeds 120 percent of the adjusted basis of such interest.

(D) Coordination with paragraph (c)(2)(ii) of this section. If paragraph (c)(2)(ii) of this section applies to the disposition of an interest in property, this paragraph (c)(2)(iii) shall apply only to that portion of the gain from the disposition of such interest in property that is characterized as gain from a passive activity after the application of paragraph (c)(2)(ii) of this section.

(E) Coordination with section 163(d). Gain that is treated as not from a passive activity under this paragraph (c)(2)(iii) shall be treated as income described in section 469(e)(1)(A) and paragraph (c)(3)(i) of this section if and only if such gain is from the disposition of an interest in property that was held for investment for more than 50 percent of the period during which the taxpayer held such interest in property in activities other than passive activities.

(F) Example. The following example illustrates the application of this paragraph (c)(2)(iii):

Example. A acquires a building on January 1, 1987, and uses the building in a trade or business activity in which A material-

ly participates until March 31, 1997. On April 1, 1998, A leases the building to B. On December 31, 1999, A sells the building. Assuming A's lease of the building to B constitutes a rental activity (within the meaning of § 1.469-1T(e)(3)), the building is used in a passive activity for 21 months (April 1, 1998, through December 31, 1999). Thus, the building was not used in a passive activity for the entire 24-month period ending on the date of the sale. In addition, the 21-month period during which the building was used in a passive activity is less than 20 percent of A's holding period for the property (13 years). Therefore, the gain from the sale is treated under this paragraph (c)(2)(iii) as not from a passive activity.

(3) Items of portfolio income specifically excluded—(i) In general. Passive activity gross income does not include portfolio income. For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—

(A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));

(B) Dividends on S corporation stock (within the meaning of section 1368(c)(2);

(C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and

(D) The disposition of property held for investment (within the meaning of section 163 (d)).

(ii) Gross income derived in the ordinary course of a trade or business. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—

(A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;

(B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;

(C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amount included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

(iii) Special rules—(A) Income from property held for investment by dealer. For purposes of paragraph (c)(3)(i) of this section, a dealer's income or gain from an item of property is not derived by the dealer in the ordinary course of a trade or business of dealing in such property if the dealer held the property for investment at any time before such income or gain is recognized.

(B) Royalties derived in the ordinary course of the trade or business of licensing intangible property—(1) In general. Royalties received by any person with respect to a license or other transfer of any rights in intangible property shall be considered to be derived in the ordinary course of the trade or business of licensing such property only if such person—

(i) Created such property; or

(ii) Performed substantial services or incurred substantial costs with respect to the development or marketing of such property.

(2) Substantial services or costs—(i) In general. Except as provided in paragraph (c)(3)(iii)(B)(2)(ii) of this section, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the devel-

opment or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.

(ii) Exception. A person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if—

(a) The expenditures reasonably incurred by such person in such taxable year with respect to the development or marketing of the property exceed 50 percent of the gross royalties from licensing such property that are includible in such person's gross income for the taxable year; or

(b) The expenditures reasonably incurred by such person in such taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25 percent of the aggregate capital expenditures (without any adjustment of amortization) made by such person with respect to the property in all such taxable years.

(iii) Expenditures taken into account. For purposes of paragraph (c)(3)(iii)(B)(2)(ii) of this section, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed.

(3) Passthrough entities. For purposes of this paragraph (c)(3)(iii)(B), in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a trade or business shall be made by applying the rules of this paragraph (c)(3)(iii)(B) to such entity and not to any holder of an interest in such entity.

(4) Cross reference. For special rules applicable to certain gross income from a trade or business of licensing intangible property, see paragraph (f)(7) of this section.

(C) Mineral production payments. For purposes of section 469 and the regulations thereunder—

(1) If a mineral production payment is treated as a loan under section 636, the portion of any payment in discharge of the production payment that is the equivalent of interest shall be treated as interest; and

(2) If a mineral production payment is not treated as a loan under section 636, payments in discharge of the production payment shall be treated as royalties.

(iv) **Examples**. The following examples illustrate the application of this paragraph (c)(3):

Example (1). A, an individual engaged in the trade or business of farming, disposes of farmland in an installment sale. A is not engaged in a trade or business of selling farmland. Therefore, A's interest income from the installment note is not gross income derived in the ordinary course of a trade or business.

Example (2). P, a partnership, operates a rental apartment building for low-income tenants in City Y. Under Y's laws relating to the operation of low-income housing, P is required to maintain a reserve fund to pay for the maintenance and repair of the building. P invests the reserve fund in short-term interest-bearing deposits. Because P's interest income from the investment of the reserve fund is not interest income described in paragraph (c)(3)(ii) of this section, such income is not treated as derived in the ordinary course of a trade or business. Accordingly, P's interest income from the deposits is portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

Example (3). (i) B is a partner in a partnership that is engaged in an activity involving the conduct of a trade or business of dealing in securities. On February 1, the partnership acquires certain securities for investment (within the meaning of section 163(d)). On February 2, before recognizing any income with respect to the securities, the partnership determines that it would be advisable to hold the securities primarily for sale to customers and subsequently sells them to customers in the ordinary course of its business.

(ii) Under paragraph (c)(3)(iii)(A) of this section, income or gain from any security (including any security acquired pursuant to an investment of working capital) held by a dealer for investment at any time before such income or gain is recognized is not treated for purposes of paragraph (c)(3)(i) of this section as derived by the dealer in the ordinary course of its trade or business of dealing in securities. Accordingly, B's distributive share of the partnership's interest, dividends, or gains from the securities acquired by the partnership for investment on February 1 is portfolio income of B, notwithstanding that such securities were held by the partnership, subsequent to February 1, primarily for sale to customers in the ordinary course of the partnership's trade or business of dealing in securities.

Example (4). C is a partner in a partnership that is engaged in an activity of trading or dealing in royalty interests in mineral properties. The partnership derives royalty income from royalty interests held in the activity. If the activity is a trade or business activity, C's distributive share of the partnership's royalty income from such royalty interests is treated under paragraph (c)(3)(ii)(D) of this section as derived in the ordinary course of the partnership's trade or business.

Example (5). (i) D, a calendar year individual, is a partner in a calendar year partnership that is engaged in an activity of developing and marketing a design for a system that reduces air pollution in office buildings. D has a 10 percent distributive share of all items of partnership income, gain, loss, deduction, and credit. In 1987, the partnership acquired the rights to the design for $100,000. In 1987, 1988, and 1989, the partnership incurs expenditures with respect to the development and marketing of the design, and derives gross royalties from licensing the design, in the amounts set forth in the table below. The expenditures incurred in 1987 and 1988 are currently deductible expenses. The expenditures incurred in 1989 are capitalized and may be deducted only in subsequent taxable years.

Year	Gross royalties	Expenditures	Cumulative capital expenditures
1987	$20,000	$8,000	$100,000
1988	20,000	12,000	100,000
1989	60,000	15,000	115,000
1990	120,000	0	115,000

(ii) Under paragraph (c)(3)(iii)(B)(3) of this section, the determination of whether royalties from intangible property are derived in the ordinary course of a trade or business of a partnership is made by applying the rules of paragraph (c)(3)(iii)(B) of this section to the partnership rather than the partners. The expenditures reasonably incurred by the partnership in 1987 with respect to the development or marketing of the design ($8,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). In addition, the sum of such expenditures incurred in 1987 and all prior taxable years ($8,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such taxable years with respect to the design ($100,000). Accordingly, for 1987, the partnership is not treated under paragraph (c)(3)(iii)(B)(2)(ii) of this section as performing substantial services or incurring substantial costs with respect to the development or marketing of the design. Therefore, unless all of the facts and circumstances indicate that the partnership performed substantial services or incurred substantial costs with respect to the development or marketing of the design, D's distributive share of the partnership's royalty income for 1987 is portfolio income.

(iii) As of the end of 1988, the sum of the expenditures reasonably incurred by the partnership during such taxable year and all prior taxable years with respect to the development or marketing of the design ($20,000) does not exceed 25 percent of the aggregate capital expenditures made by the partnership in all such years with respect to the design ($100,000). However, the amount of such expenditures incurred by the partnership in 1988 ($12,000) exceeds 50 percent of the partnership's gross royalties for such year from licensing the design ($20,000). Accordingly, for 1988, under paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income for 1988 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(iv) The expenditures reasonably incurred by the partnership in 1989 with respect to the development or marketing of the design ($15,000) do not exceed 50 percent of the partnership's gross royalties for such year from licensing the design ($60,000). However, the sum of such expenditures incurred by the partnership in 1989 and all prior taxable years ($35,000) exceeds 25 percent of the partnership's aggregate capital expenditures made in all such years with respect to the design ($115,000). Accordingly, for 1989, under paragraph (c)(3)(iii)(B)(2)(ii)(b) of this section, the partnership is treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design, and D's distributive share of the partnership's royalty income in 1989 is considered for purposes of paragraph (c)(3)(i) of this section to be derived in the ordinary course of a trade or business and therefore is not portfolio income.

(v) The result for 1990 is the same as for 1989, notwithstanding that the partnership incurs no expenditures in 1990 with respect to the development or marketing of the design.

Example (6). The facts are the same as in example (5), except that, for 1987, D's distributive share of the partnership's development and marketing costs is 15 percent, while D's distributive share of the partnership's gross royalties is 10 percent. Although D's distributive share of the expenditures reasonably incurred by the partnership during 1987 with respect to the development and marketing of the design ($1,200) is more than 50 percent of D's distributive share of the partnership's gross royalties from licensing the design ($2,000), D is not treated as performing substantial services or incurring substantial costs with respect to the development or marketing of the design for 1987 under paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. This is because, under paragraph (c)(3)(iii)(B)(3) of this section, the determination of whether the royalties are derived in the ordinary course of a trade or business is made by applying paragraph (c)(3)(iii)(B) of this section to the partnership, and not to D.

(4) Items of personal service income specifically excluded—(i) In general. Passive activity gross income does not include compensation paid to or on behalf of an individual for personal services performed or to be performed by such individual at any time. For purposes of this paragraph (c)(4), compensation for personal services includes only—

(A) Earned income (within the meaning of section 911(d)(2)(A)), including gross income from a payment described in paragraph (e)(2) of this section that represents compensation for the performance of services by a partner;

(B) Amounts includible in gross income under section 83;

(C) Amounts includible in gross income under sections 402 and 403;

(D) Amounts (other than amounts described in paragraph (c)(4)(i)(C) of this section) paid pursuant to retirement, pension, and other arrangements for deferred compensation for services;

(E) Social security benefits (within the meaning of section 86(d)) includible in gross income under section 86; and

(F) Other income identified by the Commissioner as income derived by the taxpayer from personal services;

provided, however, that no portion of a partner's distributive share of partnership income (within the meaning of section 704(b)) or a shareholder's pro rata share of income from an S corporation (within the meaning of section 1377(a)) shall be treated as compensation for personal services.

(ii) Example. The following example illustrates the application of this paragraph (c)(4):

Example. C owns 50 percent of the stock of X, an S corporation. X owns rental real estate, which it manages. X pays C a salary for services performed by C on behalf of X in

connection with the management of X's rental properties. Under this paragraph (c)(4), although C's pro rata share of X's gross rental income is passive activity gross income (even if the salary paid to C is less than the fair market value of C's services), the salary paid to C does not constitute passive activity gross income.

(5) Income from section 481 adjustment—(i) In general. If a change in accounting method results in a positive section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (c)(5)(iii) of this section) of the amount taken into account for a taxable year as a net positive section 481 adjustment by reason of such change shall be treated as gross income from the activity for such taxable year, and such gross income shall be treated as passive activity gross income if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)).

(ii) Positive section 481 adjustments. For purposes of applying this paragraph (c)(5)—

(A) The term "net positive section 481 adjustment" means the increase (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term "positive section 481 adjustment with respect to an activity" means the increase (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) Ratable portion. The ratable portion of the amount taken into account as a net positive section 481 adjustment for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The positive section 481 adjustment with respect to the activity; by

(B) The sum of the positive section 481 adjustments with respect to all of the activities of the taxpayer.

(6) Gross income from certain oil or gas properties—(i) In general. Notwithstanding any other provision of the regulations under section 469, passive activity gross income for any taxable year does not include an amount of the taxpayer's gross income for such year from—

(A) An oil or gas property, if any loss from a working interest in such property for any prior taxable year beginning after December 31, 1986, was treated by the taxpayer, solely by reason of § 1.469-1T(e)(4) (relating to a special rule for losses from oil and gas working interests), and not by reason of the taxpayer's material participation in the activity, as a loss that is not from a passive activity; or

(B) Any property the basis of which is determined in whole or in part by reference to the basis of property described in paragraph(c)(6)(i)(A) of this section;

equal to the taxpayer's net income from such property for the taxable year. The preceding sentence applies without regard to whether the taxpayer's interest in the property is held through an entity that limits the taxpayer's liability (within the meaning of § 1.469-1T(e)(4)(v)).

(ii) Net income from the property. For purposes of this paragraph (c)(6), the taxpayer's net income for the taxable year from any property described in paragraph (c)(6)(i) of this section is the amount, if any, by which the taxpayer's gross income from such property exceeds the taxpayer's deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469-1T(f)(4)) that are reasonable allocable to such property.

(iii) Property. For purposes of paragraph (c)(6)(i)(A) of this section, the term "property" does not have the meaning given such term by section 614(a) or the regulations thereunder, but means any property the value of which is directly enhanced by any drilling, logging, seismic testing, or other activities any part of the costs of which were borne by the taxpayer as a result of holding the working interest described in such paragraph (c)(6)(i)(A).

(iv) Examples. The following examples illustrate the application of this (c)(6):

Example (1). A is a general partner in partnership P and a limited partner in partnership R. P and R own oil and gas working interests in two separate tracts of land acquired from two separate landowners. In 1987, P drills a well on its tract, and A's distributive share of P's losses from drilling the well are treated under § 1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, P develops information indicating that the reservoir in which the well was drilled underlies R's tract as well as P's. Under these facts, P's and R's tracts are treated as one property for purposes of this paragraph (c)(6), even if A's interests in the mineral deposits in the tracts are treated as separate properties under section 614(a). Accordingly, in 1988 and subsequent years, A's distributive share of both P's and R's income and expenses from their respective tracts is taken into account in computing A's net income from the property for purposes of this paragraph (c)(6).

Example (2). B is a general partner in partnership S. S owns an oil and gas working interest in a single tract of land. In

1987, S drills a well, and B's distributive share of S's losses from drilling the well is treated under § 1.469-1T(e)(4) as not from a passive activity. In the course of drilling the well, S discovers two oil-bearing formations, one underlying the other. On December 1, 1987, S completes the well in the underlying formation. On January 1, 1988, B converts B's entire general partnership interest in S into a limited partnership interest. In 1988, S completes in, and commences production from, the shallow formation. Under these facts, the two mineral deposits in S's tract are treated as one property for purposes of this paragraph (c)(6), even if they are treated as separate properties under section, 614 (a). Accordingly, B's distributive share of S's income and expenses from both the underlying formation and from recompletion in and production from the shallow formation is taken into account in computing B's net income from the property for purposes of this paragraph (c)(6).

Example (3). C is a general partner in partnership T and a limited partner in partnership U. T and U both own oil and gas working interests in tracts of land in County X. In 1987, T drills a well, and C's distributive share of T's losses from drilling the well is treated under § 1.469-1T(e)(4) as not from a passive activity. In the course of selecting the drilling site and drilling the well, T develops information indicating a significant probability that substantial oil and gas reserves underlie most portions of County X. As a result, the value of all oil and gas properties in County X is enhanced. The information developed by T does not, however, indicate that the reservoir in which T's well is drilled underlies U's tract. Under these facts, T's and U's tracts are not treated as one property for purposes of this paragraph (c)(6), because the value of U's tract is not directly enhanced by T's activities.

(7) Other items specifically excluded. Notwithstanding any other provision of the regulations under section 469, passive activity gross income does not include the following:

(i) Gross income of an individual from intangible property, such as a patent, copyright, or literary, musical, or artistic composition, if the taxpayer's personal efforts significantly contributed to the creation of such property;

(ii) Gross income from a qualified low-income housing project (within the meaning of section 502 of the Tax Reform Act of 1986) for any taxable year in the relief period (within the meaning of section 502(b) of such Act;

(iii) Gross income attributable to a refund of any state, local, or foreign income, war profits, or excess profits tax;

(iv) Gross income of an individual from a covenant by such individual not to compete; and

(v) Gross income that is treated as not from a passive activity under any provision of the regulations under section 469, including but not limited to § 1.469-1T(h)(6) (relating to income from intercompany transactions of members of an affiliated group of corporations filing a consolidated return) and paragraph (f) of this section (relating to recharacterized passive income).

(d) Passive activity deductions—(1) In general. Except as otherwise provided in section 469 and the regulations thereunder, a deduction is a passive activity deduction for a taxable year if and only if such deduction—

(i) Arises (within the meaning of paragraph (d)(8) of this section) in connection with the conduct of an activity that is a passive activity for the taxable year; or

(ii) Is treated as a deduction from an activity under § 1.469-1T(f)(4) for the taxable year.

The following example illustrates the application of this paragraph (d)(1):

Example. (i) In 1987, A, a calendar year individual, acquires a partnership interest in R, a calendar year partnership. R's only activity is a trade or business activity in which A materially participates for 1987. R incurs a loss in 1987. A's distributive share of R's 1987 loss is $1,000. However, A's basis in the partnership interest at the end of 1987 (without regard to A's distributive share of partnership loss) is $600; accordingly, section 704(d) disallows any deduction in 1987 for $400 of A's distributive share of R's loss. The remainder of A's distributive share of R's loss would be allowed as a deduction for 1987 if taxable income for all taxable years were determined without regard to sections 469 and 1211. See paragraph (d)(8) of this section.

(ii) A does not materially participate in R's activity for 1988. In 1988, R again incurs a loss, and A's distributive share of the loss is again $1,000. At the end of 1988, A's basis in the partnership interest (without regard to A's distributive share of partnership loss) is $2,000; accordingly, in 1988 section 704(d) does not limit A's deduction for either A's $1,000 distributive share of R's 1988 loss or the $400 loss carried over from 1987 under the second sentence of section 704(d). These losses would be allowed as a deduction for 1988 if taxable income for all taxable years were determined without regard to sections 469 and 1211. See paragraph (d)(8) of this section.

(iii) Under these facts, only $400 of A's distributive share of R's deductions from the activity are disallowed under section 704(d) in 1987. A's remaining deductions from the activity are treated as deductions that arise in connection with the activity for 1987 under paragraph (d)(8) of this section. Because A materially participates in the activity for 1987, the activity is not a passive activity (within the meaning of § 1.469-1T(e)(1)) of A for such year. Accordingly, the deductions that are not disallowed in 1987 are not passive activity deductions.

(iv) A does not materially participate in R's activity for 1988. Accordingly, the activity is a passive activity of A for such year. No portion of A's distributive share of R's deductions from the activity is disallowed under section 704(d) in 1988. Accordingly, A's distributive share of R's deductions for 1988 and the $400 of deductions carried over from 1987 are both treated under paragraph (d)(8) of this section as deductions that arise in 1988. Since the activity is a passive activity for 1988, such deductions are passive activity deductions.

(2) Exceptions. Passive activity deductions do not include—

(i) A deduction for an item of expense (other than interest) that is clearly and directly allocable (within the meaning of paragraph (d)(4) of this

section) to portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(ii) A deduction allowed under section 243, 244, or 245 with respect to any dividend that is not included in passive activity gross income;

(iii) Interest expense (other than interest expense described in paragraph (d)(3) of this section);

(iv) A deduction for a loss from the disposition of property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(v) A deduction that, under section 469(g) and § 1.469-6T (relating to the allowance of passive activity losses upon certain dispositions of interests in passive activities), is treated as a deduction that is not a passive activity deduction;

(vi) A deduction for any state, local, or foreign income, war profits, or excess profits tax;

(vii) A miscellaneous itemized deduction (within the meaning of section 67(b)) that is subject to disallowance in whole or in part under section 67(a) (without regard to whether any amount of such deduction is disallowed under section 67);

(viii) A deduction allowed under section 170 for a charitable contribution;

(ix) An item of loss or deduction that is carried to the taxable year under section 172(a), section 1212(a)(1)(B) (in the case of corporations), or section 1212(b) (in the case of taxpayers other than corporations); and

(x) An item of loss or deduction that would have been allowed for a taxable year beginning before January 1, 1987, but for section 704(d), 1366, or 465.

(3) Interest expense. Except as otherwise provided in the regulations under section 469, interest expense is taken into account as a passive activity deduction if and only if such interest expense—

(i) Is allocated under § 1.163-8T to a passive activity expenditure (within the meaning of § 1.163-8T(b)(4)); and

(ii) Is not—

(A) Qualified residence interest (within the meaning of § 1.163-10T); or

(B) Capitalized pursuant to a capitalization provision (within the meaning of § 1.163-8T(m)(7)(i)).

(4) Clearly and directly allocable expenses. For purposes of section 469 and the regulations thereunder, an expense (other than interest expense) is clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section) if and only if such expense is incurred as a result of, or incident to, an activity in which such gross income is derived or in connection with property from which such gross income is derived. For example, general and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular activity or particular property are not clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section).

(5) Treatment of loss from disposition—(i) In general. Except as otherwise provided in the regulations under section 469—

(A) Any loss recognized in any year upon the sale, exchange, or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition or of an interest in an activity held through a partnership or S corporation and any deduction allowed on account of the abandonment or worthlessness of such an interest is treated as a deduction from such activity; and

(B) Any such deduction is a passive activity deduction if and only if the activity is a passive activity of the taxpayer for the taxable year of the disposition (or other event giving rise to the deduction).

(ii) Disposition of property used in more than one activity in 12-month period preceding disposition. In the case of a disposition of an interest in property that is used in more than one activity during the 12-month period ending on the date of the disposition, the amount realized from the disposition and the adjusted basis of such interest must be allocated among such activities in the manner described in paragraph (c)(2)(ii) of this section.

(iii) Other applicable rules—(A) Interest in property. For purposes of this paragraph (d)(5), a taxpayer's interests in property used in an activity and the amounts allocated to such interests shall be determined under paragraph (c)(2)(i)(C) of this section.

(B) Dispositions of partnership interests and S corporation stock. A partnership interest or S corporation stock is not property used in an activity for purposes of this paragraph (d)(5). See paragraph (e)(3) of this section for rules treating

the loss recognized upon the disposition of a partnership interest or S corporation stock as loss from the disposition of interests in the activities in which the partnership or S corporation has an interest.

(6) Coordination with other limitations on deductions that apply before section 469—(i) In general. An item of deduction from a passive activity that is disallowed for a taxable year under section 704(d), 1366(d), or 465 is not a passive activity deduction for the taxable year. Paragraphs (d)(6) (ii) and (iii) of this section provide rules for determining the extent to which items of deduction from a passive activity are disallowed for a taxable year under sections 704(d), 1366(d), and 465.

(ii) Proration of deductions disallowed under basis limitations—(A) Deductions disallowed under section 704(d). If any amount of a partner's distributive share of a partnership's loss for the taxable year is disallowed under section 704(d), a ratable portion of the partner's distributive share of each item of deduction or loss of the partnership is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(1) The amount of the partner's distributive share of partnership loss that is disallowed for the taxable year; by

(2) The sum of the partner's distributive shares of all items of deduction and loss of the partnership for the taxable year.

(B) Deductions disallowed under section 1366(d). If any amount of an S corporation shareholder's pro rata share of an S corporation's loss for the taxable year is disallowed under section 1366(d), a ratable portion of the taxpayer's pro rata share of each item of deduction or loss of the S corporation is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(1) The amount of the shareholder's pro rata share of S corporation loss that is disallowed for the taxable year; by

(2) The sum of the shareholder's pro rata shares of all items of deduction and loss of the corporation for the taxable year.

(iii) Proration of deductions disallowed under at-risk limitation. If any amount of the taxpayer's loss from an activity (within the meaning of section 465(c)) is disallowed under section 465 for the taxable year, a ratable portion of each item of deduction or loss from the activity is disallowed for the taxable year. For purposes of the preceding sentence, the ratable portion of an item of deduction or loss is the amount of such item multiplied by the fraction obtained by dividing—

(1) The amount of the loss from the activity that is disallowed for the taxable year; by

(2) The sum of all deductions from the activity for the taxable year.

(iv) Coordination of basis and at-risk limitations. The portion of any item of deduction or loss that is disallowed for the taxable year under section 704(d) or 1366(d) is not taken into account for the taxable year in determining the loss from an activity (within the meaning of section 465(c)) for purposes of applying section 465.

(v) Separately identified items of deduction and loss. In identifying the items of deduction and loss from an activity that are not disallowed under sections 704(d), 1366(d), and 465 (and that therefore may be treated as passive activity deductions), the taxpayer need not account separately for any item of deduction or loss unless such item may, if separately taken into account, result in an income tax liability different from that which would result were such item of deduction or loss taken into account separately. For related rules applicable to partnerships and S corporations, see § 1.702-1(a)(8)(ii) and section 1366(a)(1)(A), respectively. Items of deduction or loss that must be accounted for separately include (but are not limited to) items of deduction or loss that—

(A) Are attributable to separate activities (within the meaning of the rules to be contained in § 1.469-4T);

(B) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer activity participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(C) Arise in a rental real estate activity (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in taxable years in which the taxpayer does not actively participate (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in such activity;

(D) Arose in a taxable year beginning before 1987 and were not allowed for such taxable year under section 704(d), 1366(d), or 465(a)(2);

(E) Are taken into account under section 1211 (relating to the limitation on capital losses) or section 1231 (relating to property used in a trade or business and involuntary conversions); or

(F) Are attributable to pre-enactment interests in activities (within the meaning of § 1.469-11T(c)).

(7) Deductions from section 481 adjustment—(i) In general. If a change in accounting method results in a negative section 481 adjustment with respect to an activity, a ratable portion (within the meaning of paragraph (d)(7)(iii) of this section) of the amount taken into account for a taxable year as a net negative section 481 adjustment by reason of such change shall be treated as a deduction from the activity for such taxable year, and such deduction shall be treated as a passive activity deduction if and only if such activity is a passive activity for the year of the change (within the meaning of section 481(a)). See the rules to be contained in § 1.469-1T(k) for the treatment of passive activity deductions from an activity in taxable years in which the activity is a former passive activity.

(ii) Negative section 481 adjustments. For purposes of applying this paragraph (d)(7)—

(A) The term "net negative section 481 adjustment" means the decrease (if any) in taxable income taken into account under section 481(a) to prevent amounts from being duplicated or omitted by reason of a change in accounting method; and

(B) The term "negative section 481 adjustment with respect to an activity" means the decrease (if any) in taxable income that would be taken into account under section 481(a) to prevent only the duplication or omission of amounts from such activity by reason of the change in accounting method.

(iii) Ratable portion. The ratable portion of the amount taken into account as a net negative section 481 adjustments for a taxable year by reason of a change in accounting method is determined with respect to an activity by multiplying such amount by the fraction obtained by dividing—

(A) The negative section 481 adjustment with respect to the activity; by

(B) The sum of the negative section 481 adjustments with respect to all of the activities of the taxpayer.

(8) Taxable year in which item arises. For purposes of this paragraph (d), an item of deduction arises in the taxable year in which such item would be allowable as a deduction under the taxpayer's method of accounting if taxable income for all taxable years were determined without regard to sections 469 and 1211.

(e) Special rules for partners and S corporation shareholders—(1) In general. For purposes of section 469 and the regulations thereunder, the character (as an item of passive activity gross income or passive activity deduction) of each item of gross income and deduction allocated to a taxpayer from a partnership or S corporation (a "passthrough entity") shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in the activity (or activities) that generated such item. Such participation is determined for the taxable year of the passthrough entity (and not the taxable year of the taxpayer). The following example illustrates the application of this paragraph (e)(1):

Example. A, a calendar year individual, is a partner in a partnership that has a taxable year ending January 31. During its taxable year ending on January 31, 1988, the partnership engages in a single trade or business activity. For the period from February 1, 1987, through January 31, 1988, A does not materially participate in this activity. In A's calendar year 1988 return, A's distributive share of the partnership's gross income and deductions from the activity must be treated as passive activity gross income and passive activity deductions, without regard to A's participation in the activity from February 1, 1988, through December 31, 1988. See also § 1.469-11T(a)(4) (relating to the effective date of, and transition rules under, section 469 and the regulations thereunder).

(2) Payments under sections 707(a), 707(c), and 736(b). Items of gross income and deduction attributable to a transaction described in section 707(a), 707(c), or 736(b) shall be characterized for purposes of section 469 and the regulations thereunder in accordance with the following rules:

(i) Section 707(a). Any item of gross income or deduction attributable to a transaction that is treated under section 707(a) as a transaction between a partnership and a partner acting in a capacity other than as a member of such partnership shall be characterized for purposes of section 469 and the regulations thereunder in a manner that is consistent with the treatment of such transaction under section 707(a).

(ii) Section 707(c)—(A) In general. Except as provided in paragraph(e)(2)(ii)(B) of this section, any payment to a partner for services or the use of capital that is described in section 707(c) (including any payment described in section 736(a)(2)

(relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner)) shall be characterized as the payment of compensation for services or as the payment of interest, respectively, and not as a distributive share of partnership income.

(B) Exception. (1) If section 736(a)(2) applies to a payment made in liquidation of a retiring or deceased partner's interest, any income that—

(i) Is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or a deceased partner's successor in interest as a result of such payment; and

(ii) Is attributable to the portion (if any) of such payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of an activity of the partnership; shall be treated as passive activity gross income if and only if the activity was a passive activity of such retiring or deceased partner (or such other person) for the taxable year of such retiring or deceased partner (or such other person) in which the liquidation of such partner's interest commenced.

(2) If section 736(a)(2) applies to a payment made in liquidation of a retiring or deceased partner's interest, the portion (if any) of such payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of an activity of the partnership is determined, for purposes of this paragraph (e)(2)(ii)(B), by multiplying the amount of such payment by the fraction obtained by dividing—

(i) The amount to be paid under section 736(a)(2) in liquidation of such partner's interest in the unrealized receivables and goodwill of such activity of the partnership; by

(ii) The sum of all payments to be made under section 736(a)(2) in liquidation of such partner's interest.

(iii) Section 736(b). If any gain or loss is taken into account by a retiring partner (or any other person that owns (directly or indirectly) an interest in such partner if such partner is a passthrough entity) or a deceased partner's successor in interest as a result of a payment to which section 736(b) (relating to payments made in exchange for a retiring or deceased partner's interest in partnership property) applies, such gain or loss shall be treated as passive activity gross income or a passive activity deduction only to the extent that such gain or loss would have been passive activity gross income or a passive activity deduction of such retiring or deceased partner (or such other person) if it had been recognized at the time the liquidation of such partner's interest commenced.

(3) Sale or exchange of interest in passthrough entity—(i) Application of this paragraph (e)(3). In the case of the sale, exchange, or other disposition (a "disposition") of an interest in a passthrough entity, the amount of the seller's gain or loss from each activity in which such entity has an interest is determined, for purposes of section 469 and the regulations thereunder, under this paragraph (e)(3). In the case of any such disposition, except as otherwise provided in paragraph (e)(3)(iii) or (iv) of this section, paragraph (e)(3)(ii) of this section shall apply. See paragraphs (c)(2) and (d)(5) of this section for rules for determining the character of gain or loss, respectively, recognized upon a disposition of an interest in an activity held through a passthrough entity.

(ii) General rule—(A) Allocation among activities. Except as otherwise provided in this paragraph (e)(3)(ii) or in paragraph (e)(3) (iii) or (iv) of this section, if a holder of an interest in a passthrough entity disposes of such interest, a ratable portion (within the meaning of paragraph (e)(3)(ii)(B) of this section) of any gain or loss from such disposition shall be treated as gain or loss from the disposition of an interest in each trade or business, rental, or investment activity in which such passthrough entity owns an interest on the applicable valuation date.

(B) Ratable portion—(1) Dispositions on which gain is recognized. The ratable portion of any gain from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such gain by the fraction obtained by dividing—

(i) The amount of net gain (within the meaning of paragraph (e)(3)(ii)(E)(3) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net gain that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each appreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(1) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair mar-

ket value of each such activity on the applicable valuation date.

(2) Dispositions on which loss is recognized. The ratable portion of any loss from the disposition of an interest in a passthrough entity that is allocable to an activity described in paragraph (e)(3)(ii)(A) of this section is determined by multiplying the amount of such loss by the fraction obtained by dividing—

(i) The amount of net loss (within the meaning of paragraph (e)(3)(ii)(E)(4) of this section) that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date; by

(ii) The sum of the amounts of net loss that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in each depreciated activity (within the meaning of paragraph (e)(3)(ii)(E)(2) of this section) described in paragraph (e)(3)(ii)(A) of this section for the fair market value of each such activity on the applicable valuation date.

(C) Default rule. If the gain or loss recognized upon the disposition of an interest in a passthrough entity cannot be allocated under paragraph (e)(3)(ii)(A) of this section, such gain or loss shall be allocated among the activities described in paragraph (e)(3)(ii)(A) of this section in proportion to the respective fair market values of the passthrough entity's interests in such activities at the applicable valuation date, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity.

(D) Special rules. For purposes of this paragraph (e)(3)(ii), the following rules shall apply:

(1) Applicable valuation date—(i) In general. Except as otherwise provided in paragraph (e)(3)(ii)(D)(1)(ii) of this section, the applicable valuation date with respect to any disposition of an interest in a passthrough entity is whichever one of the following dates is selected by the passthrough entity:

(a) The beginning of the taxable year of the passthrough entity in which such disposition occurs; or

(b) The date on which such disposition occurs.

(ii) Exception. If, after the beginning of a passthrough entity's taxable year in which a holder's disposition of an interest in such passthrough entity occurs and before the time of such disposition—

(a) The passthrough entity disposes of more than 10 percent of its interest (by value as of the beginning of such taxable year) in any activity;

(b) More than 10 percent of the property (by value as of the beginning of such taxable year) used in any activity of the passthrough entity is disposed of; or

(c) The holder of such interest contributes to the passthrough entity substantially appreciated property or substantially depreciated property with a total fair market value or adjusted basis, respectively, which exceeds 10 percent of the total fair market value of the holder's interest in the passthrough entity as of the beginning of such taxable year;

then the applicable valuation date shall be the date immediately preceding the date on which such disposition occurs.

(2) Basis adjustments. Any adjustment to the basis of partnership property under section 743(b) made with respect to the holder of an interest in a partnership shall be taken into account in computing the net gain or net loss that would have been allocated to the holder with respect to such interest if the partnership had sold its entire interest in an activity.

(3) Tiered passthrough entities. In the case of a disposition of an interest in a passthrough entity (the "subsidiary passthrough entity") by a holder that is also a passthrough entity, any gain or loss from such disposition that is taken into account by any person that owns (directly or indirectly) an interest in such holder shall be allocated among the activities of the subsidiary passthrough entity by applying the rules of this paragraph (e)(3)(ii) to the person taking such gain or loss into account as if such person has been the holder of an interest in such subsidiary passthrough entity and had recognized such gain or loss as a result of a disposition of such interest.

(E) Meaning of certain terms. For purposes of this paragraph (e)(3)(ii)—

(1) An activity is an appreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net gain would have been allocated to the holder with respect to such interest if the passthrough entity has sold its entire interest in such activity for its fair market value on the applicable valuation date;

(2) An activity is a depreciated activity with respect to a holder that has disposed of an interest in a passthrough entity if a net loss would have been allocated to the holder with respect to such interest if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date;

(3) The term "net gain" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the gains from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the losses (if any) from such sale;

(4) The term "net loss" means, with respect to the sale of a passthrough entity's entire interest in an activity, the amount by which the losses from the sale of all of the property used by (or representing the interest of) the passthrough entity in such activity exceed the gains (if any) from such sale.

(iii) Treatment of gain allocated to certain passive activities as not from a passive activity. If, in the case of a disposition of an interest in a passthrough entity—

(A) An amount of gain recognized on account of such disposition by the holder of such interest (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) is allocated to a passive activity of such holder (or such other person) under paragraph (e)(3)(ii) of this section;

(B) An amount of gain that would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section (relating to substantially appreciated property formerly used in a nonpassive activity) would have been allocated to such holder (or such other person) with respect to such interest if all of the property used in such passive activity had been sold immediately prior to the disposition for its fair market value on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(1) of this section; and

(C) The amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section exceeds 10 percent of the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(A) of this section;

then the gain of the holder (or such other person) that is described in paragraph (e)(3)(iii)(A) of this section shall be treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of the gain of the holder (or such other person) described in paragraph (e)(3)(iii)(B) of this section. For purposes of applying the preceding sentence to the disposition of an interest in a partnership, the amount of gain that would have been allocated to the holder (or such other person) if all of the property used in an activity had been sold shall be determined by taking into account any adjustment to the basis of partnership property made with respect to such holder (or such other person) under section 743(b).

(iv) Dispositions occurring in taxable years beginning before February 19, 1988—(A) In general. Except as otherwise provided in this paragraph (e)(3)(iv), if the holder of an interest in a passthrough entity sells, exchanges, or otherwise disposes of all or part of such interest during a taxable year of such entity beginning prior to February 19, 1988, any gain or loss recognized from such disposition shall be allocated among the activities of the passthrough entity under any reasonable method selected by the passthrough entity, and the gain or loss allocated to each activity of the passthrough entity shall be treated as gain or loss from the disposition of an interest in such activity. For purposes of the preceding sentence, a reasonable method shall include the method prescribed by paragraph (e)(3)(ii) of this section. In addition, a method that allocates gain or loss among the passthrough entity's activities on the basis of the fair market value, cost, or adjusted basis of the property used in such activities shall generally be considered a reasonable method for purposes of this paragraph (e)(3)(iv).

(B) Exceptions. This paragraph (e)(3)(iv) shall not apply to any disposition of an interest in a passthrough entity occurring after February 19, 1988, if after such date, but before the holder's disposition of such interest, the holder (or any other person that owns (directly or indirectly) an interest in such holder if such holder is a passthrough entity) contributes to the passthrough entity substantially appreciated portfolio assets or any other substantially appreciated property that was used in any trade or business activity (within the meaning of § 1.469-1T(e)) of the holder (or such other person) during—

(1) The taxable year of such person in which such contribution occurs; or

(2) The immediately preceding taxable year of such person;

but only if such person materially participated (within the meaning of § 1.469-5T) in the activity for such year.

(v) **Treatment of portfolio assets.** For purposes of the paragraph (e)(3), all portfolio assets owned by a passthrough entity shall be treated as held in a single investment activity.

(vi) **Definitions.** For purposes of this paragraph (e)(3)—

(A) The term "portfolio asset" means any property of a type that produces portfolio income (within the meaning of paragraph (c)(3)(i) of this section);

(B) The term "substantially appreciated property" means property with a fair market value that exceeds 120 percent of its adjusted basis; and

(C) The term "substantially depreciated property" means property with an adjusted basis that exceeds 120 percent of its fair market value.

(vii) **Examples.** The following examples illustrate the application of this paragraph (e)(3):

Example (1). (i) A owns a one-half interest in P, a calendar year partnership. In 1993, A sells 50 percent of such interest for $50,000. A's adjusted basis for the interest sold is $30,000. Thus, A recognizes $20,000 of gain from the sale. P is engaged in three trade or business activities, X, Y, and Z, and owns marketable securities that are portfolio assets. For 1993, A materially participates in activity Z, but does not participate in activities X and Y. Paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if, immediately before A's sale, P had disposed of all of the property used in its trade or business activities. During the portion of 1993 preceding A's sale, P did not sell any of the property used in its activities, and A did not contribute any property to P.

(ii) Under paragraph (e)(3)(ii) of this section, a ratable portion of A's $20,000 gain is allocated to each appreciated activity in which P owned an interest on the applicable valuation date (within the meaning of paragraph (e)(3)(ii)(D)(*1*) of this section). For this purpose, paragraph (e)(3)(v) of this section treats the marketable securities owned by P as a single investment activity.

(iii) P selects the beginning of 1993 as the applicable valuation date pursuant to paragraph (e)(3)(ii)(D)(*1*)(i) of this section. P is not required to use the date of A's sale as the applicable valuation date under paragraph (e)(3)(ii)(D)(*1*)(ii) of this section because during the portion of 1993 preceding A's sale, P did not sell any of its property and A did not contribute any property to P. At the beginning of 1993, the fair market value and adjusted basis of the property used in P's activities are as follows:

	Adjusted basis	Fair market value
X	$68,000	$48,000
Y	30,000	62,000
Z	20,000	80,000
Marketable securities	2,000	10,000
Total	120,000	200,000

(iv) Under paragraph (e)(3)(ii)(B) of this section, the portion of A's $20,000 gain that is allocated to an appreciated activity of P (i.e., activities Y and Z and the marketable securities) is the amount of such gain multiplied by the fraction obtained by dividing (a) the net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in such activity at the beginning of 1993 by (b) the sum of the amounts of net gain that would have been allocated to A with respect to the interest sold by A if P had sold its entire interest in each appreciated activity at the beginning of 1993.

(v) If P had sold its entire interest in activities Y and Z and the marketable securities at the beginning of 1993, A would have been allocated the following amounts of net gain with respect to the interest in P that A sold in 1993:

Activity	Net gain
Y	$8,000
Z	15,000
Marketable securities	2,000
Total	25,000

(vi) Accordingly, under paragraph (e)(3)(ii) of this section, $6,400 of A's $20,000 gain ($20,000 × $8,000/$25,000) is allocated to activity Y, $12,000 of A's $20,000 gain ($20,000 × $15,000/$25,000) is allocated to activity Z, and $1,600 of A's $20,000 gain ($20,000 × $2,000/$25,000) is allocated to the marketable securities. The gain allocated to activity Y is passive activity gross income. None of that gain is treated as gain that is not from a passive activity under paragraph (e)(3)(iii) of this section because paragraph (c)(2)(iii) of this section would not have applied to any of the gain that A would have been allocated if P had sold all of the property used in activity Y immediately prior to A's sale.

Example (2). (i) B and C, calendar year individuals, are equal partners in calendar year partnership R, which they formed on January 1, 2005, with contributions of property and money. The only item of property (other than money) contributed by B was a building that B had used for 12 years preceding the contribution in an activity that was not a passive activity during such period. At the time of its contribution, the building had an adjusted basis of $40,000 and a fair market value of $66,000. R is engaged in a single activity: the sale of equipment to customers in the ordinary course of the business of dealing in such property. R uses the building contributed by B in the dealership activity. B did not materially participate in the dealership activity during 2005. On July 1, 2005, D purchases one-half of B's interest in R for $37,500 in cash. At the time of the sale, the balance sheet of R, which uses the accrual method of accounting, is as follows:

	Adjusted basis per books	Fair market value
Assets		
Cash	$30,000	$30,000
Accounts receivable:		
Dealership	20,000	18,000
Inventory:		
Dealership	52,000	66,000
Building	40,000	66,000
Total	142,000	180,000
Liabilities and Capital		
Liabilities	$30,000	$30,000

	Adjusted basis per books	Fair market value
Capital:		
B	47,000	75,000
C	65,000	75,000
Total	142,000	180,000

Thus, B's gain from the sale is $14,000 ($45,000 amount realized from the sale (consisting of $37,500 of cash and $7,500 of liabilities assumed by the purchaser) minus B's $31,000 adjusted basis for the interest sold (one-half of B's total adjusted basis of $62,000)).

(ii) Under paragraph (e)(3)(ii) of this section, all $14,000 of B's gain from the sale is allocated to R's dealership activity, which is a passive activity of B for 2005. If, however, R had sold its interest in the building immediately prior to B's sale for its fair market value on the applicable valuation date (the valuation date selected by R is irrelevant since the building had a fair market value of $66,000 at the beginning of 2005 and at the time of the sale), B would have been allocated $13,000 of gain under section 704(c) with respect to the interest in R that B sold to D. This gain would have been treated as gain that is not from a passive activity under paragraph (c)(2)(iii) of this section and would have exceeded 10 percent of the total amount of B's gain that is allocated to the dealership activity under paragraph (e)(3)(ii) of this section. Accordingly, under paragraph (e)(3)(iii) of this section, B's gain from the sale ($14,000) is treated as gain that is not from a passive activity to the extent that such gain does not exceed the amount of gain subject to paragraph (c)(2)(iii) of this section that B would have been allocated with respect to the interest sold to D if R had sold all of the property used in the dealership activity immediately prior to B's sale ($13,000). Thus, $13,000 of B's gain from the sale is treated as gain that is not from a passive activity.

(f) Recharacterization of passive income in certain situations—(1) In general. This paragraph (f) sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder). For definitions of certain terms used in this paragraph (f), see paragraph (f)(9) of this section.

(2) Special rule for significant participation—(i) In general. An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from all such activities for such year. For purposes of this paragraph (f)(2), the ratable portion of the net passive income from an activity is determined by multiplying the amount of such income by the fraction obtained by dividing—

(A) The amount of the excess described in the preceding sentence; by

(B) The amount of the excess described in the preceding sentence taking into account only significant participation passive activities from which the taxpayer has net passive income for the taxable year.

(ii) Significant participation passive activity. For purposes of this paragraph (f)(2), the term "significant participation passive activity" means any trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the taxpayer significantly participates (within the meaning of § 1.469-5T(c)(2)) for the taxable year but in which the taxpayer does not materially participate (within the meaning of § 1.469-5T) for such year.

(iii) Example. The following example illustrates the application of this paragraph (f)(2):

Example. (i) A owns interests in three trade or business activities, X, Y, and Z. A does not materially participate in any of these activities for the taxable year, but participates in activity X for 110 hours, in activity Y for 160 hours, and in activity Z for 125 hours. A owns no interest in any other trade or business activity in which A does not materially participate for the taxable year but in which A participates for more than 100 hours during the taxable year. A's net passive income (or loss) for the taxable year from activities X, Y, and Z is as follows:

	X	Y	Z
Passive activity gross income	$600	$700	$900
Passive activity deductions	(200)	(1,000)	(300)
Net passive income	400	(300)	600

(ii) Under paragraph (f)(2)(ii) of this section, activities X, Y, and Z are A's only significant participation passive activities for the taxable year. A's passive activity gross income from significant participation passive activities ($2,200) exceeds A's passive activity deductions from significant participation passive activities ($1,500) by $700 for such year. Therefore, under paragraph (f)(2)(i) of this section, a ratable portion of A's gross income from activities X and Z (A's significant participation passive activities with net passive income for the taxable year) is treated as gross income that is not from a passive activity. The ratable portion is determined by dividing (a) the amount by which A's passive activity gross income from significant participation passive activities exceeds A's passive activity deductions from significant participation passive activities for the taxable year ($700) by (b) such excess taking into account only A's significant participation passive activities having net passive income for the taxable year ($1,000). Accordingly, $280 of gross income from activity X ($400 x 700/1000) and $420 of gross income from activity Z ($600 x 700/1000) is treated as gross income that is not from a passive activity.

(3) Rental of nondepreciable property. If less than 30 percent of the unadjusted basis of the

property used or held for use by customers in a rental activity (within the meaning of § 1.469-1T(e)(3)) during the taxable year is subject to the allowance for depreciation under section 167, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. For purposes of this paragraph (f)(3), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis. The following example illustrates the application of this paragraph (f)(3):

Example. C is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements ($100,000) equals 25 percent of the unadjusted basis of all property ($400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity.

(4) Net interest income from passive equity-financed lending activity—(i) In general. An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity equal to the lesser of—

(A) The taxpayer's equity-financed interest income from the activity for such year; and

(B) The taxpayer's net passive income from the activity for such year

shall be treated as not from a passive activity.

(ii) Equity-financed lending activity—(A) In general. For purposes of this paragraph (f)(4), an activity is an equity-financed lending activity for a taxable year if—

(*1*) The activity involves a trade or business of lending money; and

(*2*) The average outstanding balance of the liabilities incurred in the activity for the taxable year does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity for such year.

(B) Certain liabilities not taken into account. For purposes of paragraph (f)(4)(ii)(A)(*2*) of this section, liabilities incurred principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(*2*) of this section shall not be taken into account in computing such percentage.

(iii) Equity-financed interest income. For purposes of this paragraph (f)(4), the taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing—

(A) The excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity; by

(B) The average outstanding balance for such year of the interest-bearing assets held in the activity.

(iv) Net interest income. For purposes of this paragraph (f)(4), the net interest income from an activity for a taxable year is—

(A) The gross interest income from the activity for such year; reduced by

(B) Expenses from the activity (other than interest on liabilities described in paragraph (f)(4)(vi) of this section) for such year that are reasonably allocable to such gross interest income.

(v) Interest-bearing assets. For purposes of this paragraph (f)(4), the interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers.

(vi) Liabilities incurred in the activity. For purposes of this paragraph (f)(4), liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. In the case of an activity conducted by an entity in which the taxpayer owns a interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower.

(vii) Average outstanding balance. For purposes of this paragraph (f)(4), the average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer.

(viii) Example. The following example illustrates the application of this paragraph (f)(4):

Example: (i) A, a calendar year individual, acquires on January 1, 1988, a limited partnership interest in P, a calendar year partnership. Under the partnership agreement, A has a one percent share of each item of income, gain, loss, deduction, and credit of P. A acquires the partnership interest for $90,000, using $50,000 of unborrowed funds and $40,000 of proceeds of

a loan bearing interest at an annual rate of 10 percent. A pays $4,000 of interest on the loan in 1988.

(ii) P's sole activity is a trade or business of lending money. A does not materially participate in the activity for 1988. During 1988, the average outstanding balance of P's interest-bearing assets (including loans to customers, temporary deposits with other lending institutions, and government and corporate securities) is $20 million. P incurs numerous interest-bearing liabilities in connection with its lending activity, including liabilities for deposits taken from customers, unsecured short-term and long-term loans from other lending institutions, and a mortgage loan secured by the building, owned by P, in which P conducts its business. For 1988, the average outstanding balance of all of these liabilities (other than the mortgage loan) is $11 million. None of these liabilities was incurred by P principally for the purpose of increasing the percentage described in paragraph (f)(4)(ii)(A)(2) of this section.

(iii) The interest income derived by P for 1988 from its interest-bearing assets is $2.2 million. The interest expense paid by P for 1988 with respect to the liabilities incurred in connection with its lending activity (other than the mortgage loan) is $990,000. P's other expenses for 1988 that are reasonably allocable to P's gross interest income (including expenses for advertising, loan processing and servicing, and insurance, and depreciation on P's building) total $250,000. P's interest expense for 1988 on the mortgage loan secured by the building used in P's lending activity is $50,000. All of the interest expense paid or incurred by P for 1988 is allocated under § 1.63-8T to expenditures in connection with P's lending activity.

(iv) Under paragraph (f)(4)(ii) of this section, P's activity is an equity-financed lending activity for 1988, since, for 1988, the activity involves a trade or business of lending money and the average outstanding balance of the liabilities incurred in the activity ($11 million) does not exceed 80 percent of the average outstanding balance of the interest-bearing assets held in the activity ($20 million). Accordingly, under paragraph (f)(4)(i) of this section, an amount of A's gross income from the activity equal to the lesser of (a) A's equity-financed interest income from the activity for 1988, or (b) A's net passive income from the activity for 1988, is treated as income that is not from a passive activity.

(v) Under paragraph (f)(4)(iii) of this section, A's equity-financed interest income from the activity for 1988 is determined by multiplying A's net interest income from the activity for 1988 by the fraction obtained by dividing $9 million (the excess of the average interest-bearing assets for 1988 over the average interest-bearing liabilities for 1988) by $20 million (the average interest-bearing assets for 1988). Under paragraph (f)(4)(iv) of this section, A's net interest income from the activity for 1988 is $19,000 (A's distributive share of $2.2 million of gross interest income less A's distributive share of $300,000 of expenses described in paragraph (f)(4)(iv)(B) of this section, including interest expense on the mortgage loan). A's distributive share of P's other interest expense ($990,000) is not taken into account in computing A's net interest income for 1988. Accordingly, A's equity-financed interest income from the activity for 1988 is $8,550 ($19,000 x $9 million/$20 million).

(vi) Under paragraph (f)(9)(i) of this section, A's net passive income from the activity for 1988 is determined by taking into account A's distributive share of P's gross income and deductions from the activity for 1988, as well as any interest expense incurred by A individually that is taken into account under § 1.163-8T in determining A's income or loss from the activity for 1988. Assuming that for 1988 all $4,000 of interest expense on the loan that A used to finance the acquisition of A's interest in P is allocated under § 1.163-8T to expenditures of A in connection with the lending activity for 1988, A's net passive income from the activity for 1988 is $5,100, computed as set forth in the following table:

Gross income:	
Interest income	$22,000
Deductions:	
Distributive share of P's expenses from the activity	(12,900)
Interest expense on A's acquisition debt	(4,000)
Net passive income	5,100

(vii) A's net passive income from the activity for 1988 ($5,100) is less than A's equity-financed income from the activity for 1988 ($8,550). Accordingly, under this paragraph (f)(4), $5,100 of A's gross income from the activity for 1988 is treated as not from a passive activity.

(5) Net income from certain property rented incidental to development activity—(i) In general. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property used in a rental activity for such year equal to the net rental activity income for the year from such item of property shall be treated as not from a passive activity if—

(A) Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

(B) The use of the item of property in an activity involving the rental of such property commenced less than 24 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

(C) The taxpayer materially participated (within the meaning of § 1.469-5T, but without regard to paragraph (e) thereof) or significantly participated (within the meaning of § 1.469-5T(c)(2)) for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

(ii) Commencement of use. For purposes of paragraph (f)(5)(i)(B) of this section, the use cf an item of property in an activity involving the rental of such property commences when substantially all of the property is first held out for rent and is in a state of readiness for rental.

(iii) Services performed for the purpose of enhancing the value of property. For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to—

(A) Construction;

(B) Renovation; and

(C) Lease-up (but only if, as of the time the taxpayer commences using the property in the activity described in paragraph (f)(5)(i)(B), a substantial portion of the property is not leased).

(iv) Example. The following example illustrates the application of this paragraph (f)(5):

Example. (i) A, a calendar year individual, is a partner in calendar year partnership P, which is engaged in an activity of developing commercial real estate. In 1988, P acquires an interest in undeveloped land, and arranges for the financing and construction of an office building on the land. Beginning on March 1, 1990, substantially all of the building is held out for rent and is in a state of readiness for rental.

(ii) P holds the building for rent for the remainder of 1990 and all of 1991 and 1992, and sells the building on January 15, 1993, pursuant to a contract entered into on January 15, 1992. P did not hold the building for sale to customers in the ordinary course of P's trade or business (see § 1.469-1T (e)(3)(vi)(D)). A's distributive share of P's taxable losses from the rental of the building is $50,000, $30,000, and $30,000, respectively, for 1990, 1991, and 1992. All of A's losses from the rental of the building are disallowed under § 1.469-1T (a)(1)(i). A's distributive share of the gain recognized by P on the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) For purposes of paragraph (f)(5)(i)(C), in 1988, 1989, and 1990, P's real estate development activity involves the performance of services for the purpose of enhancing the value of the building. In 1993, the building is sold, and the date on which the use of the building in the rental activity commenced (March 1, 1990) was less then 24 months before the date on which a binding contract for such sale was entered into (January 15, 1992). Accordingly, if A materially participated in P's real estate development activity in 1988, 1989, or 1990 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income for 1993 from the building equal to A's net rental activity income for 1993 from such building ($150,000—$110,000 of previously disallowed deductions = $40,000) is treated under this paragraph (f)(5) as gross income that is not from a passive activity.

(6) Property rented to a nonpassive activity. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property used in a rental activity for such year equal to the net rental activity income for the year from such item of property shall be treated as not from a passive activity if such property—

(i) Is rented for use in a trade or business activity (within the meaning of § 1.469-1T (e)(2)) in which the taxpayer materially participates (within the meaning of § 1.469-5T, but without regard to paragraph (e) thereof) for the taxable year; and

(ii) Is not described in paragraph (f)(5) of this section.

(7) Special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property—**(i) In general.** If a taxpayer acquires an interest in an entity described in paragraph (c)(3)(iii)(B)(3) of this section (the "development entity") after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as not from a passive activity.

(ii) Royalty income from property. For purposes of this paragraph (f)(7)—

(A) A taxpayer's gross royalty income for a taxable year from an item of property is the taxpayer's share of passive activity gross income for such year (determined without regard to paragraphs (f)(2) through (7) of this section) from the licensing or transfer of any right in such property; and

(B) A taxpayer's net royalty income for a taxable year from an item of property is the excess, if any, of—

(1) The taxpayer's gross royalty income for the taxable year from such item of property; over

(2) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469-1T (f)(4)) that are reasonably allocable to such item of property.

(iii) Exceptions. Paragraph (f)(7)(i) of this section shall not apply to a taxpayer's gross royalty income for a taxable year from the licensing of an item of intangible property if—

(A) The expenditures reasonably incurred by the development entity for the taxable year of the entity ending with or within the taxpayer's taxable year with respect to the development or marketing of such property satisfy paragraph (c)(3)(iii)(B)(2)(ii) (a) of this section; or

(B) The taxpayer's share of the expenditures reasonably incurred by the development entity with respect to the development or marketing of such property for all taxable years of the entity beginning with the taxable year of the entity in which the taxpayer acquired the interest in the entity and ending with the taxable year of the entity ending with or within the taxpayer's current taxable year exceeds 25 percent of the fair market value of the taxpayer's interest in such property at

the time the taxpayer acquired the interest in the entity.

(iv) Capital expenditures. For purposes of paragraph (f)(7)(iii)(B) of this section, a capital expenditure shall be taken into account for the taxable year of the entity in which such expenditure is chargeable to capital account, and the taxpayer's share of such expenditure shall be determined as though such expenditure were allowed as a deduction for such year.

(v) Example. The following example illustrates the application of this paragraph (f)(7):

Example. (i) The facts are the same as in example (5) in paragraph (c)(3)(iv) of this section, except that, in 1988, D's 10 percent partnership interest is sold to F for $13,000, all of which is attributable to the design licensed by the partnership.

(ii) For 1988, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design satisfy paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. Accordingly, under paragraph (f)(7)(iii)(A) of this section, paragraph (f)(7)(i) of this section does not apply to F's distributive share of the partnership's gross income from licensing the design.

(iii) For 1989, the expenditures reasonably incurred by the partnership with respect to the development or marketing of the design do not satisfy paragraph (c)(3)(iii)(B)(2)(ii)(a) of this section. Moreover, F's distributive share of such expenditures reasonably incurred by the partnership for 1988 and 1989 ($27,000 x .10 = $2,700) does not exceed 25 percent of the fair market value of F's interest in the design at the time F acquired the partnership interest ($13,000). Accordingly, neither of the exceptions provided in paragraph (f)(7)(iii) of this section applies for 1989 and, under paragraph (f)(7)(i) of this section, an amount of F's gross royalty income from the design equal to F's net royalty income from the design is treated as not from a passive activity.

(8) Limitation on recharacterized income. The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under subparagraphs (f) (2) through (4) of this paragraph (f) shall not exceed the greatest amount of gross income treated as not from a passive activity under any one of such subparagraphs.

(9) Meaning of certain terms. For purposes of this paragraph (f), the terms set forth below shall have the following meanings:

(i) The net passive income from an activity for a taxable year is the amount by which the taxpayer's passive activity gross income from the activity for the taxable year (determined without regard to paragraphs (f) (2) through (4) of this section) exceeds the taxpayer's passive activity deductions from the activity for such year;

(ii) The net passive loss from an activity for a taxable year is the amount by which the taxpayer's passive activity deductions from the activity for the taxable year exceeds the taxpayer's passive activity gross income from the activity for such year (determined without regard to paragraphs (f) (2) through (4) of this section).

(iii) The gross rental activity income for a taxable year from an item of property used in a rental activity for such year is any passive activity gross income for such year (determined without regard to paragraphs (f) (2) through (6) of this section) from the rental or disposition of such item of property; and

(iv) The net rental activity income from an item of property for a taxable year is the excess, if any, of—

(A) The gross rental activity income from such item of property for the taxable year; over

(B) Any passive activity deductions for such taxable year (including any deduction treated as a deduction for such year under § 1.469-1T(f)(4)) that are reasonably allocable to the use of such item of property in the rental activity.

(10) Coordination with section 163(d). Gross income that is treated as not from a passive activity under paragraph (f) (3), (4), or (7) of this section shall be treated as income described in section 469 (e)(1)(A) and paragraph (c)(3)(i) of this section except in determining whether—

(i) Any property is treated for purposes of section 469(e)(1)(A)(ii)(I) and paragraph (c)(3)(i)(C) of this section as property that produces income of a type described in paragraph (c)(3)(i)(A) of this section;

(ii) An expense (other than interest expense) is treated for purposes of section 469(e)(1)(A)(i)(II) and paragraph (d)(4) of this section as clearly and directly allocable to portfolio income (within the meaning of paragraph (c)(3)(i) of this section); and

(iii) Interest expense is allocated under § 1.163-8T to an investment expenditure (within the meaning of § 1.163-8T(b)(3)) or to a passive activity expenditure (within the meaning of § 1.163-8T(b)(4)).

(11) Effective date. For the effective date of the rules in this paragraph (f), see § 1.469-11T (relating to effective date and transition rules).

[T.D. 8175, 53 FR 5711, Feb. 25, 1988; 53 FR 15494, April 29, 1988]

§ 1.469–3T Passive activity credit (temporary).

(a) Computation of passive activity credit. The taxpayer's passive activity credit for the taxable year is the amount (if any) by which—

(1) The sum of all of the taxpayer's credits that are subject to section 469 for such year; exceeds

(2) The taxpayer's regular tax liability allocable to all passive activities for such year.

(b) Credits subject to section 469—(1) In general. Except as otherwise provided in this paragraph (b), a credit is subject to section 469 for a taxable year if and only if—

(i) Such credit—

(A) Is attributable to such taxable year and arises in connection with the conduct of an activity that is a passive activity for such taxable year; and

(B) Is described in—

(*1*) Section 38(b) (1) through (5) (relating to general business credits);

(*2*) Section 27(b) (relating to corporations described in section 936);

(*3*) Section 28 (relating to clinical testing of certain drugs); or

(*4*) Section 29 (relating to fuel from nonconventional sources); or

(ii) Such credit is allocable to an activity for such taxable year under § 1.469-1T(f)(4).

(2) Treatment of credits attributable to qualified progress expenditures. Any credit attributable to an increase in qualified investment under section 46(d)(1)(A) (relating to qualified progress expenditures) with respect to progress expenditure property (as defined in section 46(d)(2)) is subject to section 469 for a taxable year if—

(i) Such credit is attributable to such taxable year;

(ii) Such credit is described in paragraph (b)(1)(i)(B) of this section; and

(iii) It is reasonable to believe that such progress expenditure property will be used in a passive activity of the taxpayer when it is placed in service.

(3) Special rule for partners and S corporation shareholders. The character of a credit of a taxpayer arising in connection with an activity conducted by a partnership or S corporation (as a credit subject to section 469) shall be determined, in any case in which participation is relevant, by reference to the participation of the taxpayer in such activity. Such participation is determined for the taxable year of the partnership or S corporation (and not the taxable year of the taxpayer). See § 1.469-2T(e)(1).

(4) Exception for pre-1987 credits. A credit is not subject to section 469 if it is attributable to a taxable year of the taxpayer beginning prior to January 1, 1987.

(c) Taxable year to which credit is attributable. A credit is attributable to the taxable year in which such credit would be (or would have been) allowed if the credits regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469.

(d) Regular tax liability allocable to passive activities—(1) In general. For purposes of paragraph (a)(2) of this section, the taxpayer's regular tax liability allocable to all passive activities for the taxable year is the excess (if any) of—

(i) The taxpayer's regular tax liability for such taxable year; over

(ii) The amount of such regular tax liability determined by reducing the taxpayer's taxable income for such year by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions for such year.

(2) Regular tax liability. For purposes of this section, the term "regular tax liability" has the meaning given such term in section 26(b).

(e) Coordination with section 39. For purposes of section 39 (relating to the carryback and carryforward of unused business credits), any credit described in section 38(b) (1) through (5) is treated as a current year business credit for the first taxable year in which such credit is subject to section 469 and is not disallowed by section 469 and the regulations thereunder.

(f) Examples. The following examples illustrate the application of this section:

Example (1). (i) A, a calendar year individual, is a general partner in calendar year partnership P. P purchases a building in 1987 and, in 1987, 1988, and 1989, incurs rehabilitation costs with respect to the building. The building is placed in service in the rental activity in 1989. P's rehabilitation costs are qualified rehabilitation expenditures (within the meaning of section 48(g)(2)) and are taken into account in determining the amount of the investment credit for rehabilitation expenditures. P's qualified rehabilitation expenditures are not qualified progress expenditures (within the meaning of section 46(d)).

(ii) Because, under section 46(c)(1), the credit is allowable for the taxable year in which the rehabilitated property is placed in service, the credit allowable for P's qualified rehabilitation expenditures arises in connection with the activity in which the property is placed in service. In addition, the credit is attributable to 1989, the year in which the property is placed in service, because it would be allowed for such year if A's credits allowed for all taxable years were determined without regard to the limitations contained in sections 26(a), 28(d)(2), 29(b)(5), 38(c), and 469. Accordingly, under paragraph (b)(1) of this section, A's distributive share of the credit is subject to section 469 for 1989 because the credit arises in connection with a rental activity for such year.

Example (2). The facts are the same as in example (1), except that the rehabilitation costs are incurred in anticipation of placing the building in service in a rental activity, the qualified rehabilitation expenditures in 1987 and 1988 are qualified progress expenditures ("QPEs") (within the meaning of section 46(d)(3)), the improvements resulting from the expenditures are progress expenditure property (within the meaning of paragraph (d)(2) of this section), and it is reasonable to expect that such property will be transition property (within the meaning of section 49(e)) when the property is placed in service. Therefore, under section 46(d)(1)(A), the qualified investment for 1987 and 1988 is increased by an amount equal to the aggregate of the applicable percentage of the qualified rehabilitation expenditures incurred in such years. The credits that are based on these expenditures are attributable (under paragraph (c) of this section) to 1987 and 1988, respectively. It is reasonable to believe in 1987 and 1988 that the progress expenditure property will be used in a rental activity when it is placed in service. Accordingly, under paragraph (b)(2) of this section, A's distributive share of the credit for 1987 and 1988 is subject to section 469. Under paragraph (b)(1) of this section (as in example (1)), A's distributive share of the credit for 1989 is also subject to section 469.

Example (3). (i) B, a single individual, acquires an interest in a partnership that, in 1988, rehabilitates a building and places it in service in a trade or business activity in which B does not materially participate. For 1988, B has the following items of gross income, deduction, and credit:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	23,950	
Passive activity deductions	18,000	(41,950)
Taxable income		88,050
Credits:		
Rehabilitation credit from the passive activity		8,000

(ii) For 1988, the amount by which B's passive activity gross income exceeds B's passive activity deductions (B's net passive income) is $2,000. Under paragraph (d) of this section, B's regular tax liability allocable to passive activities for 1988 is determined as follows:

(A)	Taxable income	$88,050	
(B)	Regular tax liability		$24,578.50
(C)	Taxable income minus net passive income	86,050	
(D)	Regular tax liability for taxable income of $86,050.00		23,918.50
(E)	Regular tax liability allocable to passive activities ((B) minus (D))		$660.00

(iii) Under paragraph (a) of this section, B's passive activity credit for 1988 is the amount by which B's credits that are subject to section 469 for 1988 ($8,000) exceed B's regular tax liability allocable to passive activities for 1988 ($660.00). Accordingly, B's passive activity credit for 1988 is $7,340.

Example (4). (i) The facts are the same as in example (3) except that, in 1988, B also has additional deductions of $100,000 from a trade or business activity in which B materially participates for 1988. Thus, B has a taxable loss for 1988 of $11,950, determined as follows:

Gross income:		
Income other than passive activity gross income	$110,000	
Passive activity gross income	20,000	$130,000
Deductions:		
Deductions other than passive activity deductions	123,950	
Passive activity deductions	18,000	(141,950)
Taxable income		(11,950)

(ii) Under section 26(b) and paragraph (d)(2) of this section, the regular tax liability for a taxable year cannot exceed the tax imposed by chapter 1 of subtitle A of the Internal Revenue Code for the taxable year. Therefore, under paragraph (d)(1) of this section, B's regular tax liability allocable to passive activities for 1988 is zero. Although B's net operating loss for the taxable year is reduced by B's net passive income, and B's regular tax liability for other taxable years may increase as a result of the reduction, such an increase does not change B's regular tax liability allocable to passive activities for 1988. Accordingly, B's passive activity credit for 1988 is $8,000.

[T.D. 8175, 53 FR 5724, Feb. 25, 1988; 53 FR 15494, April 29, 1988]

§ 1.469–4T Definition of activity (temporary). [Reserved]

§ 1.469–5T Material participation (temporary).

(a) In general. Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including

individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

(b) Facts and circumstances—(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b) —(i) Participation satisfying standards not contained in section 469. Except as provided in section 469(h)(3) and paragraph (h)(2) of this section (relating to certain retired individuals and surviving spouses in the case of farming activities), the fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision (including sections 1402 and 2032A and the regulations thereunder) other than section 469 and the regulations thereunder shall not be taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the regulations thereunder.

(ii) Certain management activities. An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year—

(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and

(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

(iii) Participation less than 100 hours. If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.

(c) Significant participation activity —(1) In general. For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity—

(i) Is a trade or business activity (within the meaning of § 1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) Significant participation. An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(d) Personal service activity. An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in—

(A) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or

(B) Any other trade or business in which capital is not a material income-producing factor.

(e) Treatment of limited partners—(1) General rule. Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to—

(i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) **Exceptions.** Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the individual would be treated as materially participating for the taxable year under paragraph (a)(1), (5), or (6) of this section if the individual were not a limited partner for such taxable year.

(3) **Limited partnership interest—(i) In general.** Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

(ii) **Limited partner holding general partner interest.** A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

(f) **Participation—(1) In general.** Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does such work) in connection with an activity in which the individual owns (directly or indirectly, other than through a C corporation) an interest at the time the work is done shall be treated for purposes of this section as participation of such individual in the activity.

(2) **Exceptions—(i) Certain work not customarily done by owners.** Work done in connection with an activity shall not be treated as participation in the activity for purposes of this section if—

(A) Such work is not of a type that is customarily done by an owner of such an activity; and

(B) One of the principal purposes for the performance of such work is to avoid the disallowance, under section 469 and the regulations thereunder, of any loss or credit from such activity.

(ii) **Participation as an investor—(A) In general.** Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

(B) Work done in individual's capacity as an investor. For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes—

(1) Studying and reviewing financial statements or reports on operations of the activity;

(2) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and

(3) Monitoring the finances or operations of the activity in a non-managerial capacity.

(3) **Participation of spouse.** In the case of any person who is a married individual (within the meaning of section 7703) for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year.

(4) **Methods of proof.** The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

(g) **Material participation of trusts and estates.** [Reserved]

(h) Miscellaneous rules—(1) Participation of corporations. For rules relating to the participation in an activity of a personal service corporation (within the meaning of § 1.468-1T(g)(2)(i)) or a closely held corporation (within the meaning of § 1.469-1T(g)(2)(ii)), see § 1.469-1T(g)(3).

(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers. An individual shall be treated as materially participating for a taxable year in any trade or business activity of farming in paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity had the individual died during such taxable year.

(i) [Reserved]

(j) Material participation for taxable years beginning before January 1, 1987. In any case in which it is necessary to determine whether an individual materially participated in any activity for a taxable year beginning before January 1, 1987 (other than a taxable year of a partnership, S corporation, estate, or trust ending after December 31, 1986), such determination shall be made without regard to paragraphs (a) (2) through (7) of this section.

(k) Examples. The following examples illustrate the application of this section:

Example (1). A, a calendar year individual, owns all of the stock of X, a C corporation. X is the general partner, and A is the limited partner, in P, a calendar year partnership. P has a single activity, a restaurant, which is a trade or business activity (within the meaning of § 1.469-1T(e)(2)). During the taxable year, A works for an average of 30 hours per week in connection with P's restaurant activity. Under paragraphs (a)(1) and (e)(2) of this section, A is treated as materially participating in the activity for the taxable year because A participates in the restaurant activity during such year for more than 500 hours. In addition, under § 1.469-1T(g)(3)(i), A's participation will cause X to be treated as materially participating in the restaurant activity.

Example (2). The facts are the same as in example (1), except that the partnership agreement provides that P's restaurant activity is to be managed by X, and A's work in the activity is performed pursuant to an employment contract between A and X. Under paragraph (f)(1) of this section, work done by A in connection with the activity in any capacity is treated as participation in the activity by A. Accordingly, the conclusion is the same as in example (1). The conclusion would be the same if A owned no stock in X at any time, although in that case A's participation would not be taken into account in determining whether X materially participates in the restaurant activity.

Example (3). B, an individual, is employed fulltime as a carpenter. B also owns an interest in a partnership which is engaged in a van conversion activity, which is a trade or business activity (within the meaning of § 1.469-1T(e)(2)). B and C, the other partner, are the only participants in the activity for the taxable year. The activity is conducted entirely on Saturdays. Each Saturday throughout the taxable year, B and C work for eight hours in the activity. Although B does not participate in the activity for more than 500 hours during the taxable year, under paragraph (a)(3) of this section, B is treated for such year as materially participating in the activity because B participates in the activity for more than 100 hours during the taxable year, and B's participation in the activity for such year is not less than the participation of any other person in the activity for such year.

Example (4). C, an individual, is employed full-time as an accountant. C also owns interests in a restaurant and a shoe store. The restaurant and shoe store are trade or business activities (within the meaning of § 1.469-1T(e)(2)) that are treated as separate activities under the rules to be contained in § 1.469-4T. Each activity has several full-time employees. During the taxable year, C works in the restaurant activity for 400 hours and in the shoe store activity for 150 hours. Under paragraph (c) of this section, both the restaurant and shoe store activities are significant participation activities of C for the taxable year. Accordingly, since C's aggregate participation in the restaurant and shoe store activities during the taxable year exceeds 500 hours, C is treated under paragraph (a)(4) of this section as materially participating in both activities.

Example (5). In 1990, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of § 1.469-1T(e)(2)). For every taxable year from 1990 through 1994, D is treated as materially participating (without regard to paragraph (a)(5) of this section) in the activity. D retires from the activity at the beginning of 1995, and would not be treated as materially participating in the activity for 1995 and subsequent taxable years if material participation for such years were determined without regard to paragraph (a)(5) of this section. Under paragraph (a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1995 through 1999 because D materially participated in the activity (determined without regard to paragraph (a)(5) of this section) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under paragraph (a)(5) of this section as materially participating in the activity for taxable years after 1999 because of such years D has not materially participated in the activity (determined without regard to paragraph (a)(5) of this section) for five of the ten immediately preceding taxable years.

Example (6). The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own as interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (7). (i) E, a married individual filing a separate return for the taxable year, is employed full-time as an attorney. E also owns an interest in a professional football team that is a trade or business activity (within the meaning of § 1.469-1T(e)(2)). E does no work in connection with this activity. E anticipates that, for the taxable year, E's deductions from the activity will exceed E's gross income from the activity and that, if E does not materially participate in the activity for the taxable year, part or all of F's passive activity loss for the taxable year will be disallowed under § 1.469-1T(a)(1)(i). Accordingly, E pays E's spouse to work as an office receptionist in connection with the activity for an average of 15 hours per week during the taxable year.

(ii) Under paragraph (f)(3) of this section any participation in the activity by E's spouse is treated as participation in the activity by E. However, under paragraph (f)(2)(i) of this section, the work done by E's spouse is not treated as participation in the activity because work as an office receptionist is not

work of a type customarily done by an owner of a football team, and one of E's principal purposes for paying E's spouse to do this work is to avoid the disallowance under § 1.469-1T(a)(1)(i) of E's passive activity loss. Accordingly, E is not treated as participating in the activity for the taxable year.

Example (8). (i) F, an individual, owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter setting forth certain proposed actions and decisions with respect to the cattle-feeding operation. Such actions and decisions include, for example, what kind of feed to purchase, how much to purchase, and when to purchase it, how often to feed cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasize that taking or not taking a particular action or decision is solely within the discretion of F and other partners, and ask F to indicate a decision with respect to each proposed action by answering certain questions. The general partner receives a fee that constitutes earned income (within the meaning of section 911 (d)(2)(A)) for managing the cattle-feeding operation. F is not treated as materially participating in the cattle-feeding operation under paragraph (a) (1) through (6) of this section.

(ii) F's only participation in the cattle-feeding operation is to make certain managerial decisions. Under paragraph (b)(2)(ii) of this section, such management services are not taken into account in determining whether the taxpayer is treated as materially participating in the activity for a taxable year under paragraph (a)(7) of this section, if any other person performs services in connection with the management of the activity and receives compensation described in section 911(d)(2)(A) for such services. Therefore, F is not treated as materially participating for the taxable year in the cattle-feeding operation.

[T.D. 8175, 53 FR 5725, Feb. 25, 1988; 53 FR 15494, April 29, 1988]

§ 1.469–6T Treatment of losses upon certain dispositions (temporary). [Reserved]

§ 1.469–7T Treatment of self-charged items of income and expense (temporary). [Reserved]

§ 1.469–8T Application of section 469 and the regulations thereunder to trusts, estates, and their beneficiaries (temporary). [Reserved]

§ 1.469–9T Treatment of income, deductions, and credits from certain rental real estate activities (temporary). [Reserved]

§ 1.469–10T Application of section 469 to publicly traded partnerships (temporary). [Reserved]

§ 1.469–11T Effective date and transition rules (temporary).

(a) Effective date—(1) In general. Except as provided in paragraph (a)(2) of this section, section 469 and the regulations thereunder apply for taxable years beginning after December 31, 1986.

(2) Application of certain income recharacterization rules—(i) In general. No amount of gross income shall be treated under § 1.469-2T(f)(3) through (7) as income that is not from a passive activity for any taxable year of the taxpayer beginning before January 1, 1988.

(ii) Property rented to a nonpassive activity. In applying § 1.469-2T(f)(6) to a taxpayer's rental of an item of property, the taxpayer's net rental activity income (within the meaning of § 1.469-2T(f)(9)(iv)) from such property for any taxable year beginning after December 31, 1987, shall not include the portion of such income (if any) that is attributable to the rental of such item of property pursuant to a written binding contract entered into before February 19, 1988.

(3) Qualified low-income housing projects. For a transitional rule concerning the application of section 469 to losses from qualified low-income housing projects, see section 502 of the Tax Reform Act of 1986.

(4) Effect of events occurring in years prior to 1987. The treatment for a taxable year beginning after December 31, 1986, of any item of income, gain, loss, deduction, or credit as an item of passive activity gross income, passive activity deduction, or credit from a passive activity, shall be determined as if section 469 and the regulations thereunder had been in effect for taxable years beginning before January 1, 1987, but without regard to any passive activity loss or passive activity credit that would have been disallowed for any taxable year beginning before January 1, 1987, if section 469 and the regulations thereunder had been in effect for such year. For example, in determining whether a taxpayer materially participates in an activity under § 1.469-5T(a)(5) (relating to taxpayers who have materially participated in an activity for five of the ten immediately preceding taxable years) for any taxable year beginning after December 31, 1986, the taxpayer's participation in the activity for all prior taxable years (including taxable years beginning before 1987) is taken into account. See § 1.469-5T(j) (relating to the determination of material participation for taxable years beginning before January 1, 1987).

(5) Examples. The following examples illustrate the application of this paragraph (a):

Example (1). A, a calendar year individual, is a partner in a partnership with a taxable year ending on January 31. During its taxable year ending January 31, 1987, the partnership was engaged in a single activity involving the conduct of a trade or business. In applying section 469 and the regulations thereunder to A for calendar year 1987, A's distributive share of partnership items for the partnership's taxable year ending January 31, 1987, is taken into account. Therefore, under § 1.469-2T(e)(1) and paragraph (a)(4) of this section, A's participation in the activity throughout the partnership's taxable year beginning February 1, 1986, and ending January 31, 1987, is taken into account for purposes of determining the character under section 469 of the items of gross income, deduction, and credit allocated to A for the partnership's taxable year ending January 31, 1987.

Example (2). B, a calendar year individual, is a beneficiary of a trust described in section 651 that has a taxable year ending January 31. The trust conducts a rental activity (within the meaning of § 1.469-1T(e)(3)). Because the trust's taxable year ending January 31, 1987, began before January 1, 1987, section 469 and the regulations thereunder do not apply to the trust for such year. Section 469 and the regulations thereunder do apply, however, to B for B's calendar year 1987. Therefore, income of the trust from the rental activity for the trust's taxable year ending January 31, 1987, that is included in B's gross income for 1987 is taken into account in applying section 469 to B for 1987.

(b) Transitional rule for pre-enactment loss and pre-enactment credit—(1) In general. For taxable years beginning after December 31, 1986, and before January 1, 1991, § 1.469-1T(a)(1) shall not apply to—

(i) An amount of the passive activity loss equal to the applicable percentage of the pre-enactment loss; and

(ii) An amount of the passive activity credit equal to the applicable percentage of the pre-enactment credit.

(2) Applicable percentage. For purposes of this paragraph (b), the applicable percentage of the pre-enactment loss or the pre-enactment credit for a taxable year shall be determined in accordance with the following table:

In the case of a taxable year beginning in:	The applicable percentage is:
1987	65
1988	40
1989	20
1990	10

(3) Pre-enactment loss. The pre-enactment loss for any taxable year is the lesser of—

(i) The amount of the passive activity loss that would be disallowed for the taxable year under § 1.469-1T(a)(1)(i) if this section were disregarded; and

(ii) The amount of the passive activity loss that would be disallowed for the taxable year under § 1.469-1T(a)(1)(i) if this section were disregarded and the following items were not taken into account:

(A) Any deduction treated as a deduction from an activity for the taxable year under § 1.469-1T(f)(4); and

(B) Any item from an interest (other than a pre-enactment interest) in any passive activity.

(4) Pre-enactment credit. The pre-enactment credit for any taxable year is the lesser of—

(i) The amount of the passive activity credit that would be disallowed for the taxable year under § 1.469-1T(a)(1)(ii) if this section were disregarded; and

(ii) The amount of the passive activity credit that would be disallowed for the taxable year under § 1.469-1T(a)(1)(ii) if this section were disregarded and the following items were not taken into account:

(A) Any deduction or credit treated as a deduction or credit from an activity for the taxable year under § 1.469-1T(f)(4); and

(B) Any item from an interest (other than a pre-enactment interest) in a passive activity.

(5) Examples. The following examples illustrate the application of this paragraph (b):

Example (1). A, an individual, owns interest in two passive activities, X and Y. A's interest in activity X is a pre-enactment interest (within the meaning of paragraph (c) of this section), while A's interest in activity Y is not a pre-enactment interest. For 1987 A has a $10,000 loss from activity X and $9,000 of income from activity Y. The amount determined under paragraph (b)(3)(i) of this section is $1,000. The amount determined under paragraph (b)(3)(ii) of this section is $10,000. Therefore, A's pre-enactment loss for 1987 is $1,000. Accordingly, § 1.469-1T(a)(1)(i) does not apply to $650 ($1,000 × .65) of A's $1,000 passive activity loss for 1987.

Example (2). (i) B, an individual, owns an interest in one passive activity, and B's interest in the activity is a pre-enactment interest (within the meaning of paragraph (c) of this section). For 1987 and 1988, B has the following passive activity gross income and passive activity deductions from the activity:

	1987	1988
Gross income	$20,000	$20,000
Deductions	($50,000)	($40,000)

(ii) Under § 1.469-2T(b), B's passive activity loss for 1987 is $30,000 ($50,000 of passive activity deductions minus $20,000 of passive activity gross income). Under paragraph (b)(3) of this section, B's pre-enactment loss for 1987 is $30,000. Ac-

cordingly, under paragraphs (b) (1) and (2) of this section, § 1.469-1T(a)(1)(i) does not apply to $19,500 ($30,000 × .65) of B's $30,000 passive activity loss for 1987. Under § 1.469-1T(a)(1)(i), $10,500 of B's loss for 1987 ($30,000 × .35) is disallowed. Under § 1.469-1T(f) (2) and (4), the disallowed loss is allocated among deductions from the activity, and the disallowed deductions are treated as deductions from the activity for 1988.

(iii) For 1988, B's pre-enactment loss is computed as shown in the following table:

	(b)(3)(i)	(b)(3)(ii)
Gross income	$20,000	$20,000
Current deductions	(40,000)	(40,000)
§ 1.469–1T(f)(4)	(10,500)	0
Net loss	($30,500)	($20,000)

Therefore, B's pre-enactment loss for 1988 is $20,000.

(iv) Under paragraph (b)(2) of this section, the applicable percentage for 1988 is 40 percent. Therefore, under paragraph (b)(1) of this section § 1.469-1T(a)(1)(i) does not apply to $8,000 ($20,000 × .40) of B's $30,500 passive activity loss for 1988.

Example (3). (i) C, an individual, owns interests in three passive activities, R, S, and T. C's interest in each activity is a pre-enactment interest. For 1987 and 1988, C's gross income, deductions, and net income (loss) from each of the three activities are as follows:

	R	S	T
1987:			
Gross income	$8,000	$5,000	$2,000
Deductions	(9,000)	(7,000)	(1,400)
Net income (loss)	($1,000)	($2,000)	$600
1988:			
Gross income	$7,000	$6,000	$2,000
Deductions	(8,000)	(4,500)	(3,000)
Net income (loss)	($1,000)	$1,500	($1,000)

(ii) Under § 1.469-2T(b), C's passive activity loss for 1987 is $2,400 ($17,400 of passive activity deductions less $15,000 of passive activity gross income). Under paragraph (b)(3) of this section, C's pre-enactment loss for 1987 is $2,400. Accordingly, under paragraph (b)(1) and (2) of this section, § 1.469-1T (a)(1)(i) does not apply to $1,560 ($2,400 × .65) of C's passive activity loss for 1987. Under § 1.469-1T (a)(1)(i), $840 of C's passive activity loss for 1987 ($2,400 x .35) is disallowed.

(iii) Under § 1.469-1T (f)(2)(i), since a portion of C's passive activity loss for 1987 is disallowed, a ratable portion of the loss from each of C's activities that has a loss for 1987 (activity R and activity S) is disallowed for 1987. Accordingly, $280 of the 1987 loss from activity R ($840 × $1,000/$3,000) and $560 of the 1987 loss from activity S ($840 × $2,000/$3,000) is disallowed for 1987. Under § 1.469-1T (f)(2) and (4), corresponding portions of the deductions from each activity are disallowed for 1987 and treated as deductions from activities R and S, respectively, for 1988. The deductions that are disallowed for 1987 and treated as deductions for 1988 are taken into account under paragraph (b)(3)(i) but not paragraph (b)(3)(ii) of this section. Thus, the amounts determined under paragraphs (b)(3)(i) and (b)(3)(ii) of this section for 1988 are as follows:

Activity	(b)(3)(i)	(b)(3)(ii)
R	($1,280)	($1,000)
S	940	1,500
T	(1,000)	(1,000)
Total	($1,340)	($500)

Therefore, C's pre-enactment loss for 1988 is $500.

(iv) Under paragraph (b)(2) of this section, the applicable percentage for 1988 is 40 percent. Therefore, under paragraph (b)(1) of this section, § 1.469-1T (a)(1)(i) does not apply to $200 ($500 × .40) of C's $1,340 passive activity loss for 1988.

Example (4). (i) D, an individual, has interests in three passive activities, X, Y, and Z. Activities X and Y are rental real estate activities (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) in which D actively participates (within the meaning of section 469(i) and the rules to be contained in § 1.469-9T) for the taxable year. D's interest in activity X is a pre-enactment interest, and D's interest in activity Y is not a pre-enactment interest. Activity Z is not a rental real estate activity, and D's interest in activity Z is not a pre-enactment interest. The amount of income (loss) from each activity for the taxable year is as follows:

Activity	Income (loss)
X (pre-enactment rental)	($40,000)
Y (other rental)	$30,000
Z (other non-rental)	($20,000)

(ii) The amount determined under paragraph (b)(3)(ii) of this section is computed by applying section 469 to D as if D's only interests in passive activities were D's pre-enactment interests in such activities. If D's only interests in passive activities were D's pre-enactment interests in such activities, the amount to which § 1.469-1T (a)(1)(i) would not apply, by reason of section 469(i) and the rules to be contained in § 1.469-9T, would be $25,000. Taking into account all of D's interests in passive activities, the amount to which § 1.469-1T (a)(1)(i) would not apply, by reason of section 469(i) and the rules to be contained in § 1.469-9T, is $10,000. Accordingly, the amounts determined under paragraph (b)(3)(i) and (b)(3)(ii) of this section for the taxable year are as follows:

Activity	(b)(3)(i)	(b)(3)(ii)
X	($40,000)	($40,000)
Y	$30,000	
Z	($20,000)	
Subtotal	($30,000)	($40,000)
§ 469(i) allowance	$10,000	$25,000
Total	($20,000)	($15,000)

Therefore, D's pre-enactment loss for the taxable year is $15,000.

Example (5). E, an individual, has for the taxable year the following items of income, deduction, and credit from passive activities:

	Pre-enactment interests	Other interests	Total
Income (deductions)	$100	($100)	0

	R	S	T
Credits	28	28	$56

For the taxable year, E is subject to tax at a marginal rate of 28 percent. Under § 1.469-3T (d), E's regular tax liability allocable to passive activities for the taxable year is zero. If, however, the only interests in passive activities taken into account were the pre-enactment interests (i.e., if the $100 loss were disregarded), E's regular tax liability allocable to passive activities for the taxable year would be $28. Thus, the amounts determined under paragraphs (b)(4)(i) and (b)(4)(ii) of this section are as follows:

(b)(4)(i)	(b)(4)(ii)
$56	0

Therefore, E's pre-enactment credit for the taxable year is zero, and § 1.469-1T (a)(1)(ii) applies to E's $56 passive activity credit for the taxable year.

(c) Definition of pre-enactment interest—(1) General rule. Except as otherwise provided in this paragraph (c), the term "pre-enactment interest" means a qualified interest in a pre-enactment activity.

(2) Qualified interest—(i) In general. For purposes of this paragraph (c), a qualified interest in an activity is any interest in an activity that was—

(A) Held by the taxpayer on October 22, 1986, and at all times thereafter (but only if the activity existed on October 22, 1986); or

(B) Acquired by the taxpayer after October 22, 1986, directly or indirectly, pursuant to one or more written binding contracts to which the taxpayer was a party on October 22, 1986, and held by the taxpayer at all times after such acquisition.

See paragraph (c)(7) of this section for rules for determining whether a taxpayer was a party on October 22, 1986, to a written binding contract.

(ii) Stock in a C corporation. For purposes of this paragraph (c)(2), stock in a C corporation is not treated as an interest in any activity of the corporation. The following example illustrates the application of this paragraph (c)(2)(ii):

Example. On October 22, 1986, the taxpayer owned all of the stock of a C corporation that conducted a single activity. On December 31, 1986, the corporation liquidated and distributed to the taxpayer the assets used in the activity. Under this paragraph (c)(2)(ii), the taxpayer does not have a qualified interest in the corporation's activity as a result of the liquidation. The result would be the same if, on December 31, 1986, instead of liquidating, the corporation elected under section 1362(a) to be an S corporation.

(3) Pre-enactment activity—(i) In general. For purposes of this paragraph (c), an activity is a pre-enactment activity if—

(A) The activity was being conducted by any person on October 22, 1986; or

(B) At least 50 percent (by value) of the property used in the activity during the taxable year was—

(1) In existence or under construction on August 16, 1986; or

(2) Acquired or constructed by any person pursuant to a written binding contract (without regard to whether the taxpayer or any person related to the taxpayer was a party to such contract) in effect on August 16, 1986.

(ii) Character before 1987 irrelevant. For purposes of this paragraph (c), an activity may be treated as a pre-enactment activity without regard to whether such activity would have been a passive activity of the taxpayer for any taxable year beginning before January 1, 1987, had section 469 and the regulations thereunder been in effect for such year.

(4) Examples. The following examples illustrate the application of paragraphs (c) (1), (2), and (3) of this section:

Example (1). On October 22, 1986, the taxpayer owned an interest in property used as a personal residence. After October 22, 1986, the taxpayer ceased to use the property as a personal residence and began to use it in a rental activity. The rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section) because the property used in the rental activity was in existence on August 16, 1986. The taxpayer did not hold any interest in the rental activity on October 22, 1986, however, because the activity did not exist on that date. In addition, the taxpayer did not acquire an interest in the activity after October 22, 1986, pursuant to a written binding contract to which the taxpayer was a party on such date. Accordingly, the taxpayer's interest in the rental activity is not a qualified interest (within the meaning of paragraph (c)(2) of this section), and the taxpayer does not have a pre-enactment interest in the rental activity.

Example (2). The taxpayer owns an interest in a partnership, which owns property used in a rental activity. The taxpayer acquired the partnership interest pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. The partnership acquired its interest in the rental property pursuant to written binding contracts to which the partnership was a party on October 22, 1986. Construction of the property used in the rental activity commenced prior to August 16, 1986. Under paragraph (c)(7)(ii) of this section, the taxpayer is treated as a party to the contracts to which the partnership was a party on October 22, 1986. Therefore, the taxpayer's interest in the partnership's rental activity is a qualified interest (within the meaning of paragraph (c)(2) of this section) because the taxpayer is treated as acquiring an interest in the partnership's rental activity pursuant to written binding contracts to which the taxpayer was party on October 22, 1986. Since the property used in the rental activity was under construction on August 16, 1986, the partnership's rental activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Accordingly, the taxpayer's

interest in the partnership's rental activity is a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that the partnership acquired the property after October 22, 1986, pursuant to a contract entered into after October 22, 1986. The taxpayer's interest in the partnership's rental activity is not a pre-enactment interest because such interest was not acquired pursuant to written binding contracts to which the taxpayer was a party on October 22, 1986.

Example (4). The taxpayer owned a pre-enactment interest in an activity on October 22, 1986. After that date, the taxpayer died, and the decedent's interest in the activity passed to the decedent's estate. Since a decedent and the decedent's estate are not the same taxpayer, the estate must independently satisfy the requirements for a pre-enactment interest regardless of the fact that the decedent had a pre-enactment interest in the activity. Since the activity was being conducted by the decedent on October 22, 1986, the activity is a pre-enactment activity (within the meaning of paragraph (c)(3) of this section). Since, however, the estate did not hold any interest in the activity on October 22, 1986, the estate does not have a qualified interest in the activity (within the meaning of paragraph (c)(2) of this section). Accordingly, the estate does not have a pre-enactment interest in the activity.

(5) Effect of changes in a taxpayer's interest in a pre-enactment activity—(i) In general. If the taxpayer's share for a taxable year of an item of income, gain, loss, deduction, or credit from a pre-enactment activity was increased or decreased at any time after October 22, 1986, and prior to the end of such taxable year (other than pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986), the share of such item that is attributable to the taxpayer's pre-enactment interest in such activity shall be determined by taking into account—

(A) The taxpayer's share for such taxable year of such item as of October 22, 1986; reduced by

(B) The greatest amount at any time subsequent to October 22, 1986, by which the sum of all the decreases in the taxpayer's share for such year of such item (other than decreases pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986) exceeds the sum of all the increases in the taxpayer's share for such year of such item (other than increases pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986).

For purposes of this paragraph (c)(5)(i), the taxpayer's share of an item as of October 22, 1986, is determined by taking into account any written binding contract to which the taxpayer was a party on October 22, 1986.

(ii) Partnership terminations under section 708(b)(1)(B). A taxpayer's share for a taxable year of an item of income, gain, loss, deduction, or credit from a pre-enactment activity conducted by a partnership shall not be treated as having increased or decreased at any time after October 22, 1986, solely because the partnership is treated as terminating at any time after such date under section 708(b)(1)(B).

(iii) Examples. The following examples illustrate the application of this paragraph (c)(5):

Example (1). On October 22, 1986, an individual owned a 10 percent interest in a pre-enactment activity. After October 22, 1986, the taxpayer acquires an additional five percent interest in the activity pursuant to a contract entered into after October 22, 1986. Under this paragraph (c)(5), only the 10 percent interest in the activity the taxpayer owned on October 22, 1986, is a pre-enactment interest.

Example (2). On October 22, 1986, individuals A and B each owned a rental activity. After October 22, 1986, A and B contribute their rental activities to a partnership in exchange for which each receives a 50 percent interest in all items of income, gain, loss, deduction, and credit of the partnership. Under paragraph (c)(5)(i) of this section, A's 50 percent interest in each partnership item attributable to the rental activity contributed by A is attributable to a pre-enactment interest. None of A's interest in the partnership items attributable to the rental activity contributed by B is attributable to a pre-enactment interest.

Example (3). The facts are the same as in example (2), except that under the partnership agreement the items of income, gain, loss, deduction, and credit attributable to the rental activity A contributed to the partnership are allocated 80 percent to A and 20 percent to B. Under paragraph (c)(5)(i) of this section, A's 80 percent interest in each partnership item attributable to the rental activity contributed by A is attributable to a pre-enactment interest.

Example (4). The facts are the same as in example (3) except that on January 1, 1988, the partnership liquidates, distributing to A the rental activity contributed by A to the partnership. Under paragraph (c)(5)(i) of this section, only 80 percent of A's interest in the rental activity distributed to A is a pre-enactment interest.

Example (5). On October 22, 1986, an individual is the general partner in a limited partnership. Under the partnership agreement in effect on that date, the taxpayer is allocated one percent of each item of partnership income, gain, loss, deduction, and credit for 1987 and 10 percent of each such item for 1988. Since the increase was provided for in a written binding contract to which the taxpayer was a party on October 22, 1986, the increase in the taxpayer's share of each item of partnership income, gain, loss, deduction, and credit is taken into account, under paragraph (c)(5)(i) of this section, as income, gain, loss, deduction, and credit from a pre-enactment interest.

Example (6). The facts are the same as in example (5) except that the partnership agreement is amended on November 30, 1986. The amendment decreases the taxpayer's share of partnership depreciation for 1987 from 10 percent to five percent, but does not affect the partner's share of partnership depreciation for any other year. Since the taxpayer's share of partnership depreciation for 1988 is not decreased by the amendment, the result, for 1988, is the same as in example (5). For 1987, however, only five percent of the partnership depreciation is attributable to the taxpayer's pre-enactment interest even if, after November 30, 1986, another amendment to the partnership agreement restores the taxpayer's 10 percent share of partnership depreciation for 1987.

Example (7). (i) A and B, calendar year individuals, own all the stock of X, a calendar year S corporation. On October 22,

1986, A and B each own 50 shares of X stock. On July 1, 1987, X issues an additional 100 shares of stock to B (but does not issue any additional stock to A). On December 1, 1987, A purchases 70 shares of X stock from B. Thus, A and B have the following shares of items of income, gain, loss, deduction, and credit from activities of X:

Period	A's share	B's share
10/22/86–6/30/87	50%	50%
7/1/87–11/30/87	25%	75%
12/1/87–	60%	40%

(ii) Under paragraph (c)(5)(i) of this section, A and B each have a 50 percent share of each item of X as of October 22, 1986. Since there are no increases or decreases in their shares before June 30, 1987, their 50 percent shares of items of X assigned to the period from January 1, 1987, through June 30, 1987, are attributable to their pre-enactment interests.

(iii) As a result of the decrease in A's share on June 30, 1987, only a 25 percent share of the items of X assigned to the period from July 1, 1987, through November 30, 1987, is attributable to A's pre-enactment interest. In addition, notwithstanding the increase in B's share, only a 50 percent share of such items (B's share as of October 22, 1986) is attributable to B's pre-enactment interest.

(iv) As a result of the decrease in B's share on November 30, 1987, only a 40 percent share of the items of X assigned to the period from December 1, 1987, through December 31, 1987, is attributable to B's pre-enactment interest. In addition, notwithstanding the increase in A's share, only a 25 percent share of such items (A's share as of October 22, 1986, reduced by the amount of the decrease in A's share on June 30, 1987) is attributable to A's pre-enactment interest.

(6) Special rule for beneficiaries of trusts or estates—(i) In general. If a beneficial interest in a trust or estate was held by a taxpayer on October 22, 1986, and at all times thereafter, any income, directly allocable deductions, and credits taken into account by the taxpayer with respect to such interest shall be treated as income, deductions, and credits, respectively, from a pre-enactment interest of the beneficiary if and only if such income, deductions, and credits are from a pre-enactment interest of the trust or estate. For purposes of the preceding sentence, "directly allocable deductions" means—

(A) Depreciation allowable to the beneficiary under section 167(h);

(B) Depletion allowable to the beneficiary under section 611(b)(3); and

(C) Amortization apportioned to the beneficiary under section 642(f).

The following example illustrates the application of this paragraph (c)(6)(i):

Example. The taxpayer is a beneficiary of a trust that conducts a rental activity. The trust's interest in the activity is a pre-enactment interest of the trust. On October 22, 1986, under the trust agreement the trustee had discretion to allocate any amount of the depreciation deductions from the rental activity to the beneficiary. Under this paragraph (c)(6)(i), any depreciation deductions from the rental activity that are allocated to the beneficiary will be treated as deductions attributable to a pre-enactment interest of the beneficiary.

(ii) Interests distributed to beneficiaries. A beneficiary of a trust or estate to whom the trust or estate distributes an interest in an activity shall be treated as having a pre-enactment interest in the activity by reason of such distribution if and only if such interest was a pre-enactment interest of the trust or estate, and the beneficiary held a beneficial interest in the trust or estate on October 22, 1986, and at all times thereafter.

(7) Written binding contract—(i) In general. A contract shall be treated as a written binding contract of a person for purposes of this section if and only if the contract is enforceable against such person under the applicable State law and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). For purposes of the preceding sentence, a contractual provision that limits damages to an amount equal to five percent or more of the total contract price is not treated as limiting damages. In general, a contract is binding upon a person even if it is subject to a condition, as long as the condition is not within the control of such person. A contract is not binding on any date with respect to a person if the contract became enforceable against such person only by reason of an assignment occurring after such date. The following example illustrates the application of this paragraph (c)(7)(i):

Example. As of October 22, 1986, the taxpayer had signed a subscription agreement to acquire an interest in a partnership. The taxpayer's obligation to purchase an interest in the partnership was contingent on other persons signing subscription agreements by a particular date after October 22, 1986, to acquire a minimum number of the total interests offered for sale. If the taxpayer acquires an interest in the partnership, such interest will be treated as acquired pursuant to a written binding contract to which the taxpayer was a party on October 22, 1986. Although the taxpayer's obligation to acquire an interest in the partnership was subject to a contingency, the contingency was not within the taxpayer's control.

(ii) Special rule for contract of partnership or S corporation. For purposes of this section, a person shall be treated as a party to a contract on October 22, 1986, if on such date such person is a partner in a partnership or a shareholder in an S corporation (or is bound by a written contract to acquire an interest in such partnership or stock in such corporation) which itself is a party to such contract (or is treated under this paragraph (c)(7)(ii) as a party to such contract) on such date.

(iii) Application of rule to partnership agreements. A provision of a partnership agreement

shall be treated as a binding contract with respect to a partner if the requirements of this paragraph (c)(7) are otherwise satisfied and such partner does not have the power to amend any provision of the partnership agreement without the consent of other partners.

[T.D. 8175, 53 FR 5728, Feb. 25, 1988]

Inventories

§ 1.471–1 Need for inventories.

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 1.472–1.)

[T.D. 6500, 25 FR 11724, Nov. 26, 1960]

§ 1.471–2 Valuation of inventories.

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with §§ 1.471–1 through 1.471–11.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see § 1.471–5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

(d) In respect of normal goods, whichever method is adopted must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business except as to those goods inventoried under the last-in, first-out method authorized by section 472 or to animals inventoried under the elective unit, livestock-price-method authorized by § 1.471–6. See paragraph (d) of § 1.446–1 for rules permitting the use of different methods of accounting if the taxpayer has more than one trade or business. Where the taxpayer is engaged in more than one trade or business the Commissioner may require that the method of valuing inventories with respect to goods in one trade or business also be used with respect to similar goods in other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essen-

tial to a clear reflection of income. Taxpayers were given an option to adopt the basis of either (1) cost or (2) cost or market, whichever is lower, for their 1920 inventories. The basis properly adopted for that year or any subsequent year is controlling, and a change can now be made only after permission is secured from the Commissioner. Application for permission to change the basis of valuing inventories shall be made in writing and filed with the Commissioner as provided in paragraph (e) of § 1.446-1. Goods taken in the inventory which have been so intermingled that they cannot be identified with specific invoices will be deemed to be the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired. But see section 472 as to last-in, first-out inventories. Where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year), the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

(e) Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting records of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the district director, and the taxpayer must satisfy the district director of the correctness of the prices adopted.

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

(6) Segregating indirect production costs into fixed and variable production cost classifications (as defined in § 1.471-11(b)(3)(ii)) and allocating only the variable costs to the cost of goods produced while treating fixed costs as period costs which are currently deductible. This method is commonly referred to as the "direct cost" method.

(7) Treating all or substantially all indirect production costs (whether classified as fixed or variable) as period costs which are currently deductible. This method is generally referred to as the "prime cost" method.

[T.D. 6500, 25 FR 11724, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973]

§ 1.471-3 Inventories at cost.

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, and (3) indirect production costs incident to and necessary for the production of the particular article, including in such indirect production costs an appropriate portion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit. See § 1.263A-1T for more specific rules regarding the treatment of production costs.

(d) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry.

Among such cases are: (1) Farmers and raisers of livestock (see § 1.471–6); (2) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see § 1.471–7); and (3) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 1.471–8). Notwithstanding the other rules of this section, cost shall not include an amount which is of a type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960, as amended by T.D. 7285, 38 FR 26185, Sept. 19, 1973; T.D. 7345, 40 FR 7439, Feb. 20, 1975; T.D. 8131, 52 FR 10084, March 30, 1987]

§ 1.471–4 Inventories at cost or market, whichever is lower.

(a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (*i.e.*, those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

(b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960]

§ 1.471–5 Inventories by dealers in securities.

A dealer in securities who in his books of account regularly inventories unsold securities on hand either—

(a) At cost,

(b) At cost or market, whichever is lower, or

(c) At market value,

may make his return upon the basis upon which his accounts are kept, provided that a description of the method employed is included in or attached to the return, that all the securities are inventoried by the same method, and that such method is adhered to in subsequent years, unless another method is authorized by the Commissioner pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1. A dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded, for the purposes of this section, as regularly inventorying his securities at cost. For the purposes of this section, a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person, the securities inventoried as provided in this section may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this section. See

§ 1.263A–1T for rules regarding the treatment of costs with respect to property acquired for resale.

[T.D. 6500, 25 FR 11725, Nov. 26, 1960; T.D. 8131, 52 FR 10084, March 30, 1987]

§ 1.471–6 Inventories of livestock raisers and other farmers.

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446–1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446–1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner. See § 1.263A–1T for rules regarding the computation of costs for purposes of the unit livestock-price method.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446–1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the taxpayer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock

inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960; T.D. 8131, 52 FR 10084, March 30, 1987]

§ 1.471–7 Inventories of miners and manufacturers.

A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product, which in the aggregate will absorb the total cost of production, may, with the consent of the Commissioner, use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds, sizes, or grades of product. See section 472 as to last-in, first-out inventories.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960]

§ 1.471–8 Inventories of retail merchants.

(a) Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that method, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner as provided in paragraph (e) of § 1.446–1. Under the retail method the total of the retail selling prices of the goods on hand at the end of the year in each department or of each class of goods is reduced to approximate cost by deducting therefrom an amount which bears the same ratio to such total as—

(1) The total of the retail selling prices of the goods included in the opening inventory plus the retail selling prices of the goods purchased during the year, with proper adjustment to such selling prices for all mark-ups and mark-downs, less

(2) The cost of the goods included in the opening inventory plus the cost of the goods purchased during the year, bears to (1).

The result should represent as accurately as may be the amounts added to the cost price of the goods to cover selling and other expenses of doing business and for the margin of profit. See § 1.263A–1T for rules regarding the computation of costs with respect to property acquired for resale.

(b) For further adjustments to be made in the case of a retail merchant using the last-in, first-out inventory method authorized by section 472, see paragraph (k) of § 1.472–1.

(c) A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods.

(d) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories in accordance with the retail method, except that, to obtain a basis of approximate cost or market, whichever is lower, has consistently and uniformly followed the practice of adjusting the retail selling prices of the goods included in the opening inventory and purchased during the taxable year for mark-ups but not for mark-downs, may continue such practice subject to the conditions prescribed in this section. The adjustments must be bona fide and consistent and uniform. Where mark-downs are not included in the adjustments, mark-ups made to cancel or correct mark-downs shall not be included; and the mark-ups included must be reduced by the mark-downs made to cancel or correct such mark-ups.

(e) In no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the taxable year.

(f) A taxpayer (other than one using the last-in, first-out inventory method) who previously has

determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, paragraph (e) of § 1.446–1. A taxpayer filing a first return of income may adopt such practice subject to approval by the district director upon examination of the return.

(g) A taxpayer using the last-in, first-out inventory method in conjunction with retail computations must adjust retail selling prices for markdowns as well as mark-ups, in order that there may be reflected the approximate cost of the goods on hand at the end of the taxable year regardless of market values.

[T.D. 6500, 25 FR 11726, Nov. 26, 1960; T.D. 8131, 52 FR 10084, March 30, 1987]

§ 1.471–9 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 11727, Nov. 26, 1960]

§ 1.471–10 Applicability of long-term contract methods.

See § 1.451-3 for rules providing for the application of the long-term contract methods to certain manufacturing contracts.

[T.D. 7397, 41 FR 2642, Jan. 19, 1976; T.D. 8067, 51 FR 393, Jan. 6, 1986]

§ 1.471–11 Inventories of manufacturers.

(a) Use of full absorption method of inventory costing. In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the "full absorption" method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer's method of identifying goods in inventory. Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs. For purposes of this section, the term "financial reports" means financial reports (including consolidated financial statements) to shareholders, partners, beneficiaries or other proprietors and for credit purposes. See § 1.263A–1T relating to the treatment of production costs with respect to taxable years beginning after December 31, 1986.

(b) Production costs—(1) In general. Costs are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes. Production costs include direct production costs and fixed and variable indirect production costs.

(2) Direct production costs. (i) Costs classified as "direct production costs" are generally those costs which are incident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material or direct labor. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See § 1.471–3 for the elements of direct material costs. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. For the treatment of rework labor, scrap, spoilage costs, and any other costs not specifically described as direct production costs see § 1.471–11(c)(2).

(ii) Under the full absorption method, a taxpayer must take into account all items of direct production cost in his inventoriable costs. Nevertheless, a taxpayer will not be treated as using an incorrect method of inventory costing if he treats any direct production costs as indirect production costs, provided such costs are allocated to the taxpayer's ending inventory to the extent provided by paragraph (d) of this section. Thus, for example, a taxpayer may treat direct labor costs as part of indirect production costs (for example, by use of the conversion cost method), provided all such costs are allocated to ending inventory to the extent provided by paragraph (d) of this section.

(3) Indirect production costs—(i) In general. The term "indirect production costs" includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined in subparagraph (2) of this paragraph). Indirect production costs may be classified as to kind or type in accordance with acceptable accounting principles so as to enable convenient identification with various production or manufacturing activities or functions and to facilitate reasonable groupings of such costs for purposes of determining unit product costs.

(ii) Fixed and variable classifications. For purposes of this section, fixed indirect production costs are generally those costs which do not vary significantly with changes in the amount of goods produced at any given level of production capacity. These fixed costs may include, among other costs, rent and property taxes on buildings and machinery incident to and necessary for manufacturing operations or processes. On the other hand, variable indirect production costs are generally those costs which do vary significantly with changes in the amount of goods produced at any given level of production capacity. These variable costs may include, among other costs, indirect materials, factory janitorial supplies, and utilities. Where a particular cost contains both fixed and variable elements, these elements should be segregated into fixed and variable classifications to the extent necessary under the taxpayer's method of allocation, such as for the application of the practical capacity concept (as described in paragraph (d)(4) of this section).

(c) Certain indirect and production costs—(1) General rule. Except as provided in paragraph (c)(3) of this section and in paragraph (d)(6)(v) of § 1.451-3, in order to determine whether indirect production costs referred to in paragraph (b) of this section must be included in a taxpayer's computation of the amount of inventoriable costs, three categories of costs have been provided in subparagraph (2) of this paragraph. Costs described in subparagraph (2)(i) of this paragraph must be included in the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(ii) of this paragraph need not enter into the taxpayer's computation of the amount of inventoriable costs, regardless of their treatment by the taxpayer in his financial reports. Costs described in subparagraph (2)(iii) of this paragraph must be included in or excluded from the taxpayer's computation of the amount inventoriable costs in accordance with the treatment of such costs by the taxpayer in his financial reports and generally accepted accounting principles. For the treatment of indirect production costs described in subparagraph (2) of this paragraph in the case of a taxpayer who is not using comparable methods of accounting for such costs for tax and financial reporting see paragraph (c)(3) of this section. For contracts entered into after December 31, 1982, notwithstanding this section, taxpayers who use an inventory method of accounting for extended period long-term contracts (as defined in paragraph (b)(3) of § 1.451-3) for tax purposes may be required to use the cost allocation rules provided in paragraph (d)(6) of § 1.451-3 rather than the cost allocation rules provided in this section. See paragraph (d)(6)(v) of § 1.451-3. After a taxpayer has determined which costs must be treated as indirect production costs includible in the computation of the amount of inventoriable costs, such costs must be allocated to a taxpayer's ending inventory in a manner prescribed by paragraph (d) of this section.

(2) Includibility of certain indirect production costs—(i) Indirect production costs included in inventoriable costs. Indirect production costs which must enter into the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(a) Repair expenses,

(b) Maintenance,

(c) Utilities, such as heat, power and light,

(d) Rent,

(e) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan,

(f) Indirect materials and supplies,

(g) Tools and equipment not capitalized, and

(h) Costs of quality control and inspection,

to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes.

(ii) Costs not included in inventoriable costs. Costs which are not required to be included for tax purposes in the computation of the amount of

inventoriable costs (regardless of their treatment by a taxpayer in his financial reports) include:

(a) Marketing expenses,

(b) Advertising expenses,

(c) Selling expenses,

(d) Other distribution expenses,

(e) Interest,

(f) Research and experimental expenses including engineering and product development expenses,

(g) Losses under section 165 and the regulations thereunder,

(h) Percentage depletion in excess of cost depletion,

(i) Depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(j) Income taxes attributable to income received on the sale of inventory,

(k) Pension contributions to the extent that they represent past services cost,

(*l*) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(m) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities taken as a whole rather than to production or manufacturing operations or processes.

Notwithstanding the preceding sentence, if a taxpayer consistently includes in his computation of the amount of inventoriable costs any of the costs described in the preceding sentence, a change in such method of inclusion shall be considered a change in method of accounting within the meaning of sections 446, 481, and paragraph (e)(4) of this section.

(iii) Indirect production costs includible in inventoriable costs depending upon treatment in taxpayer's financial reports. In the case of costs listed in this subdivision, the inclusion or exclusion of such costs from the amount of inventoriable costs for purposes of a taxpayer's financial reports shall determine whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes, but only if such treatment is not inconsistent with generally accepted accounting principles. In the case of costs which are not included in subdivision (i) or (ii) of this subparagraph, nor listed in this subdivision, whether such costs must be included in or excluded from the computation of inventoriable costs for tax purposes depends upon the extent to which such costs are similar to costs included in subdivision (i) or (ii), and if such costs are dissimilar to costs in subdivision (i) or (ii), such costs shall be treated as included in or excludable from the amount of inventoriable costs in accordance with this subdivision. The costs listed in this subdivision are:

(a) Taxes. Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes) attributable to assets incident to and necessary for production or manufacturing operations or processes. Thus, for example, the cost of State and local property taxes imposed on a factory or other production facility and any State and local taxes imposed on inventory must be included in or excluded from the computation of the amount of inventoriable costs for tax purposes depending upon their treatment by a taxpayer in his financial reports.

(b) Depreciation and depletion. Depreciation reported in financial reports and cost depletion on assets incident to and necessary for production or manufacturing operations or processes. In computing cost depletion under this section, the adjusted basis of such assets shall be reduced by cost depletion and not by percentage depletion taken thereon.

(c) Employee benefits. Pension and profit-sharing contributions representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor incident to and necessary for production or manufacturing operations or processes. These other benefits include workmen's compensation expenses, payments under a wage continuation plan described in section 105(d), amounts of a type which would be includible in the gross income of employees under non-qualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code.

(d) Costs attributable to strikes, rework labor, scrap and spoilage. Costs attributable to rework labor, scrap and spoilage which are incident to and necessary for production or manufacturing opera-

tions or processes and costs attributable to strikes incident to production or manufacturing operation or processes.

(e) Factory administrative expenses. Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes.

(f) Officers' salaries. Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes.

(g) Insurance costs. Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment. A change in the taxpayer's treatment in his financial reports of costs described in this subdivision which results in a change in treatment of such costs for tax purposes shall constitute a change in method of accounting within the meaning of sections 446 and 481 to which paragraph (e) applies.

(3) Exception. Except as provided in paragraph (d)(6) of § 1.451-3, in the case of a taxpayer whose method of accounting for production costs in his financial reports is not comparable to his method of accounting for such costs for tax purposes (such as a taxpayer using the prime cost method for purposes of financial reports), the following rules apply:

(i) Indirect production costs included in inventoriable costs. Indirect production costs which must enter into the computation of the amount of inventoriable costs (to the extent, and only to the extent, such costs are incident to and necessary for production or manufacturing operations or processes) include:

(a) Repair expenses,

(b) Maintenance,

(c) Utilities, such as heat, power and light,

(d) Rent,

(e) Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and contributions to a supplemental unemployment benefit plan,

(f) Indirect materials and supplies,

(g) Tools and equipment not capitalized,

(h) Costs of quality control and inspection,

(i) Taxes otherwise allowable as a deduction under section 164 (other than State and local and foreign income taxes),

(j) Depreciation and amortization reported for financial purposes and cost depletion,

(k) Administrative costs of production (but not including any cost of selling or any return on capital) incident to and necessary for production or manufacturing operations or processes,

(*l*) Salaries paid to officers attributable to services performed incident to and necessary for production or manufacturing operations or processes, and

(m) Insurance costs incident to and necessary for production or manufacturing operations or processes such as insurance on production machinery and equipment.

(ii) Costs not included in inventoriable costs. Costs which are not required to be included in the computation of the amount of inventoriable costs include:

(a) Marketing expenses,

(b) Advertising expenses,

(c) Selling expenses,

(d) Other distribution expenses,

(e) Interest,

(f) Research and experimental expenses including engineering and product development expenses,

(g) Losses under section 165 and the regulations thereunder,

(h) Percentage depletion in excess of cost depletion,

(i) Depreciation reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports,

(j) Income taxes attributable to income received on the sale of inventory,

(k) Pension and profit-sharing contributions representing either past service costs or representing current service costs otherwise allowable as a deduction under section 404, and other employee benefits incurred on behalf of labor. These other benefits include workmen's compensation expenses, payments under a wage continuation plan

described in section 105(d), amounts of a type which would be includible in the gross income of employees under nonqualified pension, profit-sharing and stock bonus plans, premiums on life and health insurance and miscellaneous benefits provided for employees such as safety, medical treatment, cafeteria, recreational facilities, membership dues, etc., which are otherwise allowable as deductions under chapter 1 of the Code,

(*l*) Cost attributable to strikes, rework labor, scrap and spoilage,

(m) General and administrative expenses incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes, and

(n) Salaries paid to officers attributable to the performance of services which are incident to and necessary for the taxpayer's activities as a whole rather than to production or manufacturing operations or processes.

(d) Allocation methods—(1) In general. Indirect production costs required to be included in the computation of the amount of inventoriable costs pursuant to paragraphs (b) and (c) of this paragraph must be allocated to goods in a taxpayer's ending inventory (determined in accordance with the taxpayer's method of identification) by the use of a method of allocation which fairly apportions such costs among the various items produced. Acceptable methods for allocating indirect production costs to the cost of goods in the ending inventory include the manufacturing burden rate method and the standard cost method. In addition, the practical capacity concept can be used in conjunction with either the manufacturing burden rate or standard cost method.

(2) Manufacturing burden rate method—(i) In general. Manufacturing burden rates may be developed in accordance with acceptable accounting principles and applied in a reasonable manner. In developing a manufacturing burden rate, the factors described in paragraph (d)(2)(ii) of this section may be taken into account. Furthermore, if the taxpayer chooses, he may allocate different indirect production costs on the basis of different manufacturing burden rates. Thus, for example, the taxpayer may use one burden rate for allocating rent and another burden rate for allocating utilities. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. Any change in a manufacturing burden rate which is merely a periodic adjustment to reflect current operating conditions, such as increases in automation or changes in operation, does not constitute a change in method of accounting under section 446. However, a change in the concept upon which such rates are developed does constitute a change in method of accounting requiring the consent of the Commissioner. The taxpayer shall maintain adequate records and working papers to support all manufacturing burden rate calculations.

(ii) Development of manufacturing burden rate. The following factors, among others, may be taken into account in developing manufacturing burden rates:

(a) The selection of an appropriate level of activity and period of time upon which to base the calculation of rates which will reflect operating conditions for purposes of the unit costs being determined;

(b) The selection of an appropriate statistical base such as direct labor hours, direct labor dollars, or machine hours, or a combination thereof, upon which to apply the overhead rate to determine production costs; and

(c) The appropriate budgeting, classification and analysis of expenses (for example, the analysis of fixed and variable costs).

(iii) Operation of the manufacturing burden rate method. (a) The purpose of the manufacturing burden rate method used in conjunction with the full absorption method of inventory costing is to allocate an appropriate amount of indirect production costs to a taxpayer's goods in ending inventory by the use of predetermined rates intended to approximate the actual amount of indirect production costs incurred. Accordingly, the proper use of the manufacturing burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of indirect production costs allocated to the goods in ending inventory and the total amount of indirect production costs actually incurred and required to be allocated to such goods (*i.e.*, the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such adjustment need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial

reports. The taxpayer must treat both positive and negative adjustments consistently.

(b) Notwithstanding subdivision (a), the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(3) Standard cost method—(i) In general. A taxpayer may use the so-called "standard cost" method of allocating inventoriable costs to the goods in ending inventory, provided he treats variances in accordance with the procedures prescribed in paragraph (d)(3)(ii) of this section. The method used by the taxpayer in allocating such costs in his financial reports shall be given great weight in determining whether the taxpayer's method employed for tax purposes fairly allocates indirect production costs to the ending inventory. For purposes of this subparagraph, a "net positive overhead variance" shall mean the excess of total standard (or estimated) indirect production costs over total actual indirect production costs and a "net negative overhead variance" shall mean the excess of total actual indirect production costs over total standard (or estimated) indirect production costs.

(ii) Treatment of variances. (a) The proper use of the standard cost method pursuant to this subparagraph requires that a taxpayer must reallocate to the goods in ending inventory a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct production cost variances. The taxpayer must apportion such variances among his various items in ending inventory. However, if such variances are not significant in amount in relation to the taxpayer's total actual indirect production costs for the year then such variances need not be allocated to the taxpayer's goods in ending inventory unless such allocation is made in the taxpayer's financial reports. The taxpayer must treat both positive and negative variances consistently.

(b) Notwithstanding subdivision (a), the practical capacity concept may be used to determine the total amount of fixed indirect production costs which must be allocated to goods in ending inventory. See subparagraph (4) of this paragraph.

(4) Practical capacity concept—(i) In general. Under the practical capacity concept, the percentage of practical capacity represented by actual production (not greater than 100 percent), as calculated under subdivision (ii) of this subparagraph, is used to determine the total amount of fixed indirect production costs which must be included in the taxpayer's computation of the amount of inventoriable costs. The portion of such costs to be included in the taxpayer's computation of the amount of inventoriable costs is then combined with variable indirect production costs and both are allocated to the goods in ending inventory in accordance with this paragraph. See the example in subdivision (ii)(d) of this subparagraph. The difference (if any) between the amount of all fixed indirect production costs and the fixed indirect production costs which are included in the computation of the amount of inventoriable costs under the practical capacity concept is allowable as a deduction for the taxable year in which such difference occurs.

(ii) Calculation of practical capacity—(a) In general. Practical capacity and theoretical capacity (as described in (c) of this subdivision) may be computed in terms of tons, pounds, yards, labor hours, machine hours, or any other unit of production appropriate to the cost accounting system used by a particular taxpayer. The determination of practical capacity and theoretical capacity should be modified from time to time to reflect a change in underlying facts and conditions such as increased output due to automation or other changes in plant operation. Such a change does not constitute a change in method of accounting under sections 446 and 481.

(b) Based upon taxpayer's experience. In selecting an appropriate level of production activity upon which to base the calculation of practical capacity, the taxpayer shall establish the production operating conditions expected during the period for which the costs are being determined, assuming that the utilization of production facilities during operations will be approximately at capacity. This level of production activity is frequently described as practical capacity for the period and is ordinarily based upon the historical experience of the taxpayer. For example, a taxpayer operating on a 5-day, 8-hour basis may have a "normal" production of 100,000 units a year based upon three years of experience.

(c) Based upon theoretical capacity. Practical capacity may also be established by the use of "theoretical" capacity, adjusted for allowances for estimated inability to achieve maximum production, such as machine breakdown, idle time, and other normal work stoppages. Theoretical capacity is the level of production the manufacturer could reach if all machines and departments were operated continuously at peak efficiency.

(d) Example. The provisions of (c) of this subdivision may be illustrated by the following example:

Corporation X operates a stamping plant with a theoretical capacity of 50 units per hour. The plant actually operates 1960 hours per year based on an 8-hour day, 5 day week basis and 15 shutdown days for vacations and holidays. A reasonable allowance for down time (the time allowed for ordinary and necessary repairs and maintenance) is 5 percent of practical capacity before reduction for down time. Assuming no loss of production during starting up, closing down, or employee work breaks, under these facts and circumstances X may properly make a practical capacity computation as follows:

Practical capacity without allowance for down time based on theoretical capacity per hour is (1960 × 50)	98,000
Reduction for down time (98,000 × 5 percent)	4,900
Practical capacity	93,100

The 93,100 unit level of activity (*i.e.*, practical capacity) would, therefore, constitute an appropriate base for calculating the amount of fixed indirect production costs to be included in the computation of the amount of inventoriable costs for the period under review. On this basis if only 76,000 units were produced for the period, the effect would be that approximately 81.6 percent (76,000, the actual number of units produced, divided by 93,100, the maximum number of units producible at practical capacity) of the fixed indirect production costs would be included in the computation of the amount of inventoriable costs during the year. The portion of the fixed indirect production costs not so included in the computation of the amount of inventoriable costs would be deductible in the year in which paid or incurred. Assume further that 7,600 units were on hand at the end of the taxable year and the 7,600 units were in the same proportion to the total units produced. Thus, 10 percent (7,600 units in inventory at the end of the taxable year, divided by 76,000, the actual number of units produced) of the fixed indirect production costs included in the computation of the amount of inventoriable costs (the above-mentioned 81.6 percent) and 10 percent of the variable indirect production costs would be included in the cost of the goods in the ending inventory, in accordance with a method of allocation provided by this paragraph.

(e) Transition to full absorption method of inventory costing—(1) In general—(i) Mandatory requirement. A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, must change to that method. Any change to the full absorption method must be made by the taxpayer with respect to all trades or businesses of the taxpayer to which this section applies. A taxpayer not using the full absorption method of inventory costing, as prescribed by paragraph (a) of this section, who makes the special election provided in subdivision (ii) of this subparagraph during the transition period described in subdivision (ii) of this subparagraph need not change to the full absorption method of inventory costing for taxable years prior to the year for which such election is made. In determining whether the taxpayer is changing to a more or less inclusive method of inventory costing, all positive and negative adjustments for all items and all trades or businesses of the taxpayer shall be aggregated. If the net adjustment is positive, paragraph (e)(3) shall apply, and if the net adjustment is negative, paragraph (e)(4) shall apply to the change. The rules otherwise prescribed in sections 446 and 481 and the regulations thereunder shall apply to any taxpayer who fails to make the special election in subdivision (ii) of this subparagraph. The transition rules of this paragraph are available only to those taxpayers who change their method of inventory costing.

(ii) Special election during two-year-transition period. If a taxpayer elects to change to the full absorption method of inventory costing during the transition period provided herein, he may elect on Form 3115 to change to such full absorption method of inventory costing and, in so doing, employ the transition procedures and adopt any of the transition methods prescribed in subparagraph (3) of this paragraph. Such election shall be made during the first 180 days of any taxable year beginning on or after September 19, 1973 and before September 19, 1975 (*i.e.*, the "transition period") and the change in inventory costing method shall be made for the taxable year in which the election is made. Notwithstanding the preceding sentence if the taxpayer's prior returns have been examined by the Service prior to Sept. 19, 1973, and there is a pending issue involving the taxpayer's method of inventory costing, the taxpayer may request the application of this regulation by agreeing and filing a letter to that effect with the district director, within 90 days after September 19, 1973 to change to the full absorption method for the first taxable year of the taxpayer beginning after Sept. 19, 1973 and subsequently filing Form 3115 within the first 180 days of such taxable year of change.

(iii) Change initiated by the Commissioner. A taxpayer who properly makes an election under subdivision (ii) of this subparagraph shall be considered to have made a change in method of accounting not initiated by the taxpayer, notwithstanding the provisions of § 1.481–1(c)(5). Thus, any of the taxpayer's "pre-1954 inventory balances" with respect to such inventory shall not be taken into account as an adjustment under section 481. For purposes of this paragraph, a "pre-1954 inventory balance" is the net amount of the adjustments which would have been required if the taxpayer had made such change in his method of accounting with respect to his inventory in his first taxable year which began after December 31, 1953,

and ended after August 16, 1954. See section 481(a)(2) and § 1.481–3.

(2) **Procedural rules for change.** If a taxpayer makes an election pursuant to subparagraph (1)(ii) of this paragraph, the Commissioner's consent will be evidenced by a letter of consent to the taxpayer, setting forth the values of inventory, as provided by the taxpayer, determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)(B) of this paragraph (the cut-off method), the amount of the adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded to any such adjustments. Such full absorption values shall be subject to verification on examination by the district director. The taxpayer shall preserve at his principal place of business all records, data, and other evidence relating to the full absorption values of inventory.

(3) **Transition methods.** In the case of a taxpayer who properly makes an election under subparagraph (1)(ii) of this paragraph during the transition period—

(i) **10-year adjustment period.** Such taxpayer may elect to take any adjustment required by section 481 with respect to any inventory being revalued under the full absorption method into account ratably over a period designated by the taxpayer at the time of such election, not to exceed the lesser of 10 taxable years commencing with the year of transition or the number of years the taxpayer has been on the inventory method from which he is changing. If the taxpayer dies or ceases to exist in a transaction other than one to which section 381(a) of the Code applies or if the taxpayer's inventory (determined under the full absorption method) on the last day of any taxable year is reduced (by other than a strike or involuntary conversion) by more than an amount equal to 33⅓ percent of the taxpayer's inventory (determined under the full absorption method) as of the beginning of the year of change, the entire amount of the section 481 adjustment not previously taken into account in computing income shall be taken into account in computing income for the taxable year in which such taxpayer so ceases to exist or such taxpayer's inventory is so reduced.

(ii) **Additional rules for LIFO taxpayers.** A taxpayer who uses the LIFO method of inventory identification may either—

(a) Employ the special transition rules described in subdivision (i) of this subparagraph. Accordingly, all LIFO layers must be revalued under the full absorption method and the section 481 adjustment must be computed for all items in all layers in inventory, but no pre-1954 inventory balances shall be taken into account as adjustments under section 481; or

(b)(1) Employ a cut-off method whereby the full absorption method is only applied in costing layers of inventory acquired during all taxable years beginning with the year for which an election is made under subparagraph (e)(1)(ii).

(2) In the case of a taxpayer using dollar value LIFO, employ a cut-off method whereby the taxpayer must use, for the year of change, the full absorption method in computing the base year cost and current cost of a dollar value inventory pool for the beginning of such year. The taxpayer shall not be required to recompute his LIFO inventories based on the full absorption method for a taxable year beginning prior to the year of change to the full absorption method. The base cost and layers of increment previously computed shall be retained and treated as if such base cost and layers of increment had been computed under the method authorized by this section. The taxpayer shall use the year of change as the base year in applying the double extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(4) **Transition to full absorption method of inventory costing from a method more inclusive of indirect production costs—(i) Taxpayer has not previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph.** If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has not previously changed to his present method by use of the special transition rules provided by subparagraphs (1), (2) and (3) of this paragraph, he may elect on Form 3115 to change to the full absorption method of inventory costing and, in so doing, take into account any resulting section 481 adjustment generally over 10 taxable years commencing with the year of transition. The Commissioner's consent to such election will be evidenced by a letter of consent to the taxpayer setting forth the values of inventory, as provided by the taxpayer determined under the full absorption method of inventory costing, except to the extent that no determination of such values is necessary under subparagraph (3)(ii)(b) of this paragraph, the amount of the

adjustments (if any) required to be taken into account by section 481, and the treatment to be accorded such adjustments, subject to terms and conditions specified by the Commissioner to prevent distortions of income. Such election must be made within the transition period described in subparagraph (1)(ii) of this paragraph. A change pursuant to this subparagraph shall be a change initiated by the taxpayer as provided by § 1.481–1(c)(5). Thus, any of the taxpayers "pre-1954 inventory balances" will be taken into account as an adjustment under section 481.

(ii) Taxpayer has previously changed to his present method pursuant to subparagraph (1), (2), and (3) of this paragraph or would satisfy all the requirements of subdivision (i) of this subparagraph but fails to elect within the transition period. If a taxpayer wishes to change to the full absorption method of inventory costing (as prescribed by paragraph (a) of this section) from a method of inventory costing which is more inclusive of indirect production costs and he has previously changed to his present method pursuant to subparagraphs (1), (2), and (3) of this paragraph or he would satisfy the requirements of subdivision (i) of this subparagraph but he fails to elect within the transition period, he must secure the consent of the Commissioner prior to making such change.

[T.D. 7285, 38 FR 26185, Sept. 19, 1973; T.D. 8067, 51 FR 393, Jan. 6, 1986; T.D. 8131, 52 FR 10084, March 30, 1987]

§ 1.472–1 Last-in, first-out inventories.

(a) Any taxpayer permitted or required to take inventories pursuant to the provisions of section 471, and pursuant to the provisions of §§ 1.471–1 to 1.471–9, inclusive, may elect with respect to those goods specified in his application and properly subject to inventory to compute his opening and closing inventories in accordance with the method provided by section 472, this section, and § 1.472–2. Under this last-in, first-out (LIFO) inventory method, the taxpayer is permitted to treat those goods remaining on hand at the close of the taxable year as being:

(1) Those included in the opening inventory of the taxable year, in the order of acquisition and to the extent thereof, and

(2) Those acquired during the taxable year.

The LIFO inventory method is not dependent upon the character of the business in which the taxpayer is engaged, or upon the identity or want of identity through commingling of any of the goods on hand, and may be adopted by the taxpayer as of the close of any taxable year.

(b) If the LIFO inventory method is used by a taxpayer who regularly and consistently, in a manner similar to hedging on a futures market, matches purchases with sales, then firm purchases and sales contracts (*i.e.*, those not legally subject to cancellation by either party) entered into at fixed prices on or before the date of the inventory may be included in purchases or sales, as the case may be, for the purpose of determining the cost of goods sold and the resulting profit or loss, provided that this practice is regularly and consistently adhered to by the taxpayer and provided that, in the opinion of the Commissioner, income is clearly reflected thereby.

(c) A manufacturer or processor who has adopted the LIFO inventory method as to a class of goods may elect to have such method apply to the raw materials only (including those included in goods in process and in finished goods) expressed in terms of appropriate units. If such method is adopted, the adjustments are confined to costs of the raw material in the inventory and the cost of the raw material in goods in process and in finished goods produced by such manufacturer or processor and reflected in the inventory. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Assume that the opening inventory had 10 units of raw material, 10 units of goods in process, and 10 units of finished goods, and that the raw material cost was 6 cents a unit, the processing cost 2 cents a unit, and overhead cost 1 cent a unit. For the purposes of this example, it is assumed that the entire amount of goods in process was 50 percent processed.

OPENING INVENTORY

	Raw material	Goods in process	Finished goods
Raw material	$0.60	$0.60	$0.60
Processing cost	....	.10	.20
Overhead	....	.05	.10

In the closing inventory there are 20 units of raw material, 6 units of goods in process, and 8 units of finished goods and the costs were: Raw material 10 cents, processing cost 4 cents, and overhead 1 cent.

CLOSING INVENTORY

[Based on cost and prior to adjustment]

	Raw material	Goods in process	Finished goods
Raw material	$2.00	$0.60	$0.80
Processing costs	....	.12	.32
Overhead	....	.03	.08
Total	2.00	.75	1.20

There were 30 units of raw material in the opening inventory and 34 units in the closing inventory. The adjustment to the closing inventory would be as follows:

CLOSING INVENTORY AS ADJUSTED

	Raw material	Goods in process	Finished goods
Raw material:			
20 at 6 cents	$1.20	....	....
6 at 6 cents	....	$0.36	....
4 at 6 cents	....	....	$0.24
4 at 10 cents [1]	....	....	.40
Processing costs	....	.12	.32
Overhead	....	.03	.08
Total	1.20	.51	1.04

[1] This excess is subject to determination of price under section 472(b)(1) and § 1.472–2. If the excess falls in goods in process, the same adjustment is applicable.

The only adjustment to the closing inventory is the cost of the raw material; the processing costs and overhead cost are not changed.

Example (2). Assume that the opening inventory had 5 units of raw material, 10 units of goods in process, and 20 units of finished goods, with the same prices as in example (1), and that the closing inventory had 20 units of raw material, 20 units of goods in process, and 10 units of finished goods, with raw material costs as in the closing inventory in example (1). The adjusted closing inventory would be as follows in so far as the raw material is concerned:

Raw material, 20 at 6 cents	$1.20
Goods in process:	
15 at 6 cents........................	.90
5 at 10 cents [1]........................	.50
Finished goods:	
None at 6 cents	0.00
10 at 10 cents [1].......................	1.00

[1] This excess is subject to determination of price under section 472(b)(1) and § 1.472–2.

The 20 units of raw material in the raw state plus 15 units of raw material in goods in process make up the 35 units of raw material that were contained in the opening inventory.

(d) For the purposes of this section, raw material in the opening inventory must be compared with similar raw material in the closing inventory. There may be several types of raw materials, depending upon the character, quality, or price, and each type of raw material in the opening inventory must be compared with a similar type in the closing inventory.

(e) In the cotton textile industry there may be different raw materials depending upon marked differences in length of staple, in color or grade of the cotton. But where different staple lengths or grades of cotton are being used at different times in the same mill to produce the same class of goods, such differences would not necessarily require the classification into different raw materials.

(f) As to the pork packing industry a live hog is considered as being composed of various raw materials, different cuts of a hog varying markedly in price and use. Generally a hog is processed into approximately 10 primal cuts and several miscellaneous articles. However, due to similarity in price and use, these may be grouped into fewer classifications, each group being classed as one raw material.

(g) When the finished product contains two or more different raw materials as in the case of cotton and rayon mixtures, each raw material is treated separately and adjustments made accordingly.

(h) Upon written notice addressed to the Commissioner of Internal Revenue, Attention T:R, Washington, D.C. 20224 by the taxpayer, a taxpayer who has heretofore adopted the LIFO inventory method in respect of any goods may adopt the method authorized in this section and limit the election to the raw material including raw materials entering into goods in process and in finished goods. If this method is adopted as to any specific goods, it must be used exclusively for such goods for any prior taxable year (not closed by agreement) to which the prior election applies and for all subsequent taxable years, unless permission to change is granted by the Commissioner.

(i) The election may also be limited to that phase in the manufacturing process where a product is produced that is recognized generally as a salable product as, for example, in the textile industry where one phase of the process is the production of yarn. Since yarn is generally recognized as a salable product, the election may be limited to that portion of the process when yarn is produced. In the case of copper and brass processors, the election may be limited to the production of bars, plates, sheets, etc., although these may be further processed into other products.

(j) The election may also apply to any one raw material, when two or more raw materials enter into the composition of the finished product; for example, in the case of cotton and rayon yarn, the taxpayer may elect to inventory the cotton only. However, a taxpayer who has previously made an election to use the LIFO inventory method may not later elect to exclude any raw materials that were covered by such previous election.

(k) If a taxpayer using the retail method of pricing inventories, authorized by § 1.471–8, elects to use in connection therewith the LIFO inventory method authorized by section 472 and this section, the apparent cost of the goods on hand at the end

of the year, determined pursuant to § 1.471–8, shall be adjusted to the extent of price changes therein taking place after the close of the preceding taxable year. The amount of any apparent inventory increase or decrease to be eliminated in this adjustment shall be determined by reference to acceptable price indexes established to the satisfaction of the Commissioner. Price indexes prepared by the United States Bureau of Labor Statistics which are applicable to the goods in question will be considered acceptable to the Commissioner. Price indexes which are based upon inadequate records, or which are not subject to complete and detailed audit within the Internal Revenue Service, will not be approved.

(*l*) If a taxpayer uses consistently the so-called "dollar-value" method of pricing inventories, or any other method of computation established to the satisfaction of the Commissioner as reasonably adaptable to the purpose and intent of section 472 and this section, and if such taxpayer elects under section 472 to use the LIFO inventory method authorized by such section, the taxpayer's opening and closing inventories shall be determined under section 472 by the use of the appropriate adaptation. See § 1.472–8 for rules relating to the use of the dollar-value method.

[T.D. 6500, 25 FR 11727, Nov. 26, 1960, as amended by T.D. 6539, 26 FR 518, Jan. 20, 1961]

§ 1.472–2 Requirements incident to adoption and use of LIFO inventory method.

Except as otherwise provided in § 1.472–1 with respect to raw material computations, with respect to retail inventory computations, and with respect to other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 472, and in § 1.472–8 with respect to the "dollar-value" method, the adoption and use of the LIFO inventory method is subject to the following requirements:

(a) The taxpayer shall file an application to use such method specifying with particularity the goods to which it is to be applied.

(b) The inventory shall be taken at cost regardless of market value.

(c) Goods of the specified type included in the opening inventory of the taxable year for which the method is first used shall be considered as having been acquired at the same time and at a unit cost equal to the actual cost of the aggregate divided by the number of units on hand. The actual cost of the aggregate shall be determined pursuant to the inventory method employed by the taxpayer under the regulations applicable to the prior taxable year with the exception that restoration shall be made with respect to any writedown to market values resulting from the pricing of former inventories.

(d) Goods of the specified type on hand as of the close of the taxable year in excess of what were on hand as of the beginning of the taxable year shall be included in the closing inventory, regardless of identification with specific invoices and regardless of specific cost accounting records, at costs determined pursuant to the provisions of subparagraph (1) or (2) of this paragraph, dependent upon the character of the transactions in which the taxpayer is engaged:

(1)(i) In the case of a taxpayer engaged in the purchase and sale of merchandise, such as a retail grocer or druggist, or engaged in the initial production of merchandise and its sale without processing, such as a miner selling his ore output without smelting or refining, such costs shall be determined—

(*a*) By reference to the actual cost of the goods most recently purchased or produced;

(*b*) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(*c*) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced, the goods reflected in such inventory increase being considered for the purposes of section 472 as having been acquired all at the same time; or

(*d*) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(ii) Whichever of the several methods of valuing the inventory increase is adopted by the taxpayer and approved by the Commissioner shall be consistently adhered to in all subsequent taxable years so long as the LIFO inventory method is used by the taxpayer.

(iii) The application of subdivisions (i) and (ii) of this subparagraph may be illustrated by the following examples:

Example (1). Suppose that the taxpayer adopts the LIFO inventory method for the taxable year 1957 with an opening

inventory of 10 units at 10 cents per unit, that it makes 1957 purchases of 10 units as follows:

January	1 at	$0.11 =	$0.11
April	2 at	.12 =	.24
July	3 at	.13 =	.39
October	4 at	.14 =	.56
Totals	10		1.30

and that it has a 1957 closing inventory of 15 units. This closing inventory, depending upon the taxpayer's method of valuing inventory increases, will be computed as follows:

(a) Most recent purchases—

	10 at	$0.10	$1.00
October	4 at	.14	.56
July	1 at	.13	.13
Totals	15		1.69

(b) In order of acquisitions—

	10 at	$0.10	$1.00
January	1 at	.11	.11
April	2 at	.12	.24
July	2 at	.13	.26
Totals	15		1.61

or

(c) At an annual average—

	10 at	$0.10	$1.00
(130/10)	5 at	.13	.65
Totals	15		1.65

Example (2). Suppose that the taxpayer's closing inventory for 1958, the year following that involved in example (1) of this subdivision, reflects an inventory decrease for the year, and not an increase; suppose that there is, accordingly, a 1958 closing inventory of 13 units. Inasmuch as the decreased closing inventory will be determined wholly by reference to the 15 units reflected in the opening inventory for the year, and will be taken "in the order of acquisition" pursuant to section 472(b)(1), and inasmuch as the character of the taxpayer's opening inventory for 1958 will be dependent upon its method of valuing its 5-unit inventory increase for 1957, the closing inventory for 1958 will be computed as follows:

(a) In case the increase for 1957 was taken by reference to the most recent purchases—

From 1956	10 at	$0.10	$1.00
July 1957	1 at	.13	.13
October 1957	2 at	.14	.28
Totals	13		1.41

or

(b) In case the increase for 1957 was taken in the order of acquisition—

From 1956	10 at	$0.10	$1.00
January 1957	1 at	.11	.11
April 1957	2 at	.12	.24
Totals	13		1.35

or

(c) In case the increase for 1957 was taken on the basis of an average—

From 1956	10 at	$0.10	$1.00
From 1957	3 at	.13	.39
Totals	13		1.39

(2) In the case of a taxpayer engaged in manufacturing, fabricating, processing, or otherwise producing merchandise, such costs shall be determined:

(i) In the case of raw materials purchased or initially produced by the taxpayer, in the manner elected by the taxpayer under subparagraph (1) of this paragraph to the same extent as if the taxpayer were engaged in purchase and sale transactions; and

(ii) In the case of goods in process, regardless of the stage to which the manufacture, fabricating, or processing may have advanced, and in the case of finished goods, pursuant to any proper method which, in the opinion of the Commissioner, clearly reflects income.

(e) **LIFO conformity requirement—(1) In general.** The taxpayer must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss for the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, or other proprietors, or to beneficiaries, has not used any inventory method other than that referred to in § 1.472–1 or at variance with the requirement referred to in § 1.472–2(c). See paragraph (e)(2) of this section for rules relating to the meaning of the term "taxable year" as used in this paragraph. The following are not considered at variance with the requirement of this paragraph:

(i) The taxpayer's use of an inventory method other than LIFO for purposes of ascertaining information reported as a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for a taxable year in credit statements or financial reports (including preliminary and unaudited financial reports). See paragraph (e)(3) of this section for rules relating to the reporting of supplemental and explanatory information ascertained by the use of an inventory method other than LIFO.

(ii) The taxpayer's use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventory of goods on hand for purposes of reporting the value of such inventories as assets. See paragraph (e)(4) of this section for rules relating to such disclosures.

(iii) The taxpayer's use of an inventory method other than LIFO for purposes of ascertaining information reported in internal management reports. See paragraph (e)(5) of this section for rules relating to such reports.

(iv) The taxpayer's use of an inventory method other than LIFO for purposes of issuing reports or credit statements covering a period of operations that is less than the whole of a taxable year for which the LIFO method is used for Federal income tax purposes. See paragraph (e)(6) of this section for rules relating to series of interim reports.

(v) The taxpayer's use of the lower of LIFO cost or market method to value LIFO inventories for purposes of financial reports and credit statements. However, except as provided in paragraph (e)(7) of this section, a taxpayer may not use market value in lieu of cost to value inventories for purposes of financial reports or credit statements.

(vi) The taxpayer's use of a costing method or accounting method to ascertain income, profit, or loss for credit purposes or for purposes of financial reports if such costing method or accounting method is neither inconsistent with the inventory method referred to in § 1.472–1 nor at variance with the requirement referred to in § 1.472–2(c), regardless of whether such costing method or accounting method is used by the taxpayer for Federal income tax purposes. See paragraph (e)(8) of this section for examples of such costing methods and accounting methods.

(vii) For credit purposes or for purposes of financial reports, the taxpayer's treatment of inventories, after such inventories have been acquired in a transaction to which section 351 applies from a transferor that used the LIFO method with respect to such inventories, as if such inventories had the same acquisition dates and costs as in the hands of the transferor.

(viii) For credit purposes or for purposes of financial reports relating to a taxable year, the taxpayer's determination of income, profit, or loss for the taxable year by valuing inventories in accordance with the procedures described in section 472(b)(1) and (3), notwithstanding that such valuation differs from the valuation of inventories for Federal income tax purposes because the taxpayer either—

(A) Adopted such procedures for credit or financial reporting purposes beginning with an accounting period other than the taxable year for which the LIFO method was first used by the taxpayer for Federal income tax purposes, or

(B) With respect to such inventories treated as a business combination for credit or financial reporting purposes in a manner different from the treatment of the business combination for Federal income tax purposes.

(2) One-year periods other than a taxable year. The rules of this paragraph relating to the determination of income, profit, or loss for a taxable year and credit statements or financial reports that cover a taxable year also apply to the determination of income, profit, or loss for a one-year period other than a taxable year and credit statements or financial reports that cover a one-year period other than a taxable year, but only if the one-year period both begins and ends in a taxable year or years for which the taxpayer uses the LIFO method for Federal income tax purposes. For example, the requirements of paragraph (e)(1) of this section apply to a taxpayer's determination of income for purposes of a credit statement that covers a 52-week fiscal year beginning and ending in a taxable year for which the taxpayer uses the LIFO method for Federal income tax purposes. Similarly, in the case of a calendar year taxpayer, the requirements of paragraph (e)(1) of this section apply to the taxpayer's determination of income for purposes of a credit statement that covers the period October 1, 1981, through September 30, 1982, if the taxpayer uses the LIFO method for Federal income tax purposes in taxable years 1981 and 1982. However, the Commissioner will waive any violation of the requirements of this paragraph in the case of a credit statement or financial report that covers a one-year period other than a taxable year if the report was issued before January 22, 1981.

(3) Supplemental and explanatory information—(i) Face of the income statement. Information reported on the face of a taxpayer's financial income statement for a taxable year is not considered a supplement to or explanation of the taxpayer's primary presentation of the taxpayer's income, profit, or loss for the taxable year in credit statements or financial reports. For purposes of paragraph (e)(3) of this section, the face of an income statement does not include notes to the income statement presented on the same page as the income statement, but only if all notes to the financial income statement are presented together.

(ii) Notes to the income statement. Information reported in notes to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation

of income, profit, or loss for the period covered by the income statement if all notes to the financial income statement are presented together and if they accompany the income statement in a single report. If notes to an income statement are issued in a report that does not include the income statement, the question of whether the information reported therein is supplemental or explanatory is determined under the rules in paragraph (e)(3)(iv) of this section.

(iii) Appendices and supplements to the income statement. Information reported in an appendix or supplement to a taxpayer's financial income statement is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by the income statement if the appendix or supplement accompanies the income statement in a single report and the information reported in the appendix or supplement is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement. If an appendix or supplement to an income statement is issued in a report that does not include the income statement, the question of whether the information reported therein is supplemental or explanatory is determined under the rules in paragraph (e)(3)(iv) of this section. For purposes of paragraph (e)(3)(iii) of this section, an appendix or supplement to an income statement includes written statements, schedules, and reports that are labelled supplements or appendices to the income statement. However, sections of an annual report such as those labelled "President's Letter", "Management's Analysis", "Statement of Changes in Financial Position", "Summary of Key Figures", and similar sections are reports described in paragraph (e)(3)(iv) of this section and are not considered "supplements or appendices to an income statement" within the meaning of paragraph (e)(3)(iii) of this section, regardless of whether such sections are also labelled as supplements or appendices. For purposes of paragraph (e)(3)(iii) of this section, information is considered to be clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement if the information either—

(A) Is reported in an appendix or supplement that contains a general statement identifying all such supplemental or explanatory information;

(B) Is identified specifically as supplemental or explanatory by a statement immediately preceding or following the disclosure of the information;

(C) Is disclosed in the context of making a comparison to corresponding information disclosed both on the face of the taxpayer's income statement and in the supplement or appendix; or

(D) Is a disclosure of the effect on an item reported on the face of the taxpayer's income statement of having used the LIFO method.

For example, a restatement of cost of goods sold based on an inventory method other than LIFO is considered to be clearly identified as supplemental or explanatory information if the supplement or appendix containing the restatement contains a general statement that all information based on such inventory method is reported in the appendix or supplement as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement.

(iv) Other reports; in general. The rules of paragraph (e)(3)(iv), (v), and (vi) of this section apply to the following types of reports: news releases; letters to shareholders, partners, or other proprietors or beneficiaries; oral statements at press conferences, shareholders' meetings or securities analysts' meetings; sections of an annual report such as those labelled "President's Letter", "Management's Analysis", "Statement of Changes in Financial Position", "Summary of Key Figures", and similar sections; and reports other than a taxpayer's income statement or accompanying notes, appendices, or supplements. Information disclosed in such a report is considered a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss for the period covered by an income statement if the supplemental or explanatory information is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of income, profit, or loss as reported on the face of the taxpayer's income statement and the specific item of information being explained or supplemented, such as the cost of goods sold, net income, or earnings per share ascertained using the LIFO method, is also reported in the other report.

(v) Other reports; disclosure of non-LIFO income. For purposes of paragraph (e)(3)(iv) of this section, supplemental or explanatory information is considered to have been clearly identified as such if it would be considered to have been clearly identified as such under the rules of paragraph (e)(3)(iii) of this section, relating to information

reported in supplements or appendices to an income statement. For example, if at a securities analysts' meeting the following question is asked, "What would the reported earnings per share for the year have been if the FIFO method had been used to value inventories?", it would be permissible to respond "Reported earnings per share for the year were $6.00. If the company had used the FIFO method to value inventories this year and had computed earnings based upon the following assumptions, earnings per share would have been $8.20. FIFO earnings are based on the following assumptions:

"(A) The use of the same effective tax rate as used in computing LIFO earnings, and

"(B) All other conditions and assumptions remain the same, including—

"(1) The use of the LIFO method for Federal income tax purposes and

"(2) The investment of the tax savings resulting from such use of the LIFO method, the income from which is included in both LIFO and FIFO 'earnings.' "

(vi) Other reports; disclosure of effect on income. For purposes of paragraph (e)(3)(iv) of this section, if the only supplement to or explanation of a specific item is the effect on the item of having used LIFO instead of a method other than LIFO to value inventories, it is not necessary to also report the specific item. For example, if at a shareholders' meeting the question is asked, "What was the effect on reported earnings per share of not having used FIFO to value inventories?", it would be permissible to respond "If earnings would have been computed on the basis of the following assumptions, the use of LIFO instead of FIFO to value inventories would have decreased reported earnings per share by $2.20. FIFO earnings are based on the following assumptions:

"(A) The use of the same effective tax rate as used in computing LIFO earnings, and

"(B) All other conditions and assumptions remain the same, including—

"(1) The use of the LIFO method for Federal income tax purposes and

"(2) The investment of the tax savings resulting from such use of the LIFO method, the income from which is included in both LIFO and FIFO earnings."

(4) Inventory asset value disclosures. Under paragraph (e)(1)(ii) of this section, the use of an inventory method other than LIFO to ascertain the value of the taxpayer's inventories for purposes of reporting the value of the inventories as assets is not considered the ascertainment of income, profit, or loss and therefore is not considered at variance with the requirement of paragraph (e)(1) of this section. Therefore, a taxpayer may disclose the value of inventories on a balance sheet using a method other than LIFO to identify the inventories, and such a disclosure will not be considered at variance with the requirement of paragraph (e)(1) of this section. However, the disclosure of income, profit, or loss for a taxable year on a balance sheet issued to creditors, shareholders, partners, other proprietors, or beneficiaries is considered at variance with the requirement of paragraph (e)(1) of this section if such income information is ascertained using an inventory method other than LIFO and such income information is for a taxable year for which the LIFO method is used for Federal income tax purposes. Therefore, a balance sheet that discloses the net worth of a taxpayer, determined as if income had been ascertained using an inventory method other than LIFO, may be at variance with the requirement of paragraph (e)(1) of this section if the disclosure of net worth is made in a manner that also discloses income, profit, or loss for a taxable year.

However, a disclosure of income, profit, or loss using an inventory method other than LIFO is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made in the form of either a footnote to the balance sheet or a parenthetical disclosure on the face of the balance sheet. In addition, an income disclosure is not considered at variance with the requirement of paragraph (e)(1) of this section if the disclosure is made on the face of a supplemental balance sheet labelled as a supplement to the taxpayer's primary presentation of financial position, but only if, consistent with the rules of paragraph (e)(3) of this section, such a disclosure is clearly identified as a supplement to or explanation of the taxpayer's primary presentation of financial income as reported on the face of the taxpayer's income statement.

(5) Internal management reports. [Reserved]

(6) Series of interim reports. For purposes of paragraph (e)(1)(iv) of this section, a series of credit statements or financial reports is considered a single statement or report covering a period of operations if the statements or reports in the series are prepared using a single inventory method and

can be combined to disclose the income, profit, or loss for the period. However, the Commissioner will waive any violation of the requirement of this paragraph in the case of a series of interim reports issued before February 6, 1978, that cover a taxable year, or a series of interim reports issued before January 22, 1981 that cover a one-year period other than a taxable year.

(7) **Market value.** The Commissioner will waive any violation of the requirement of this paragraph in the case of a taxpayer's use of market value in lieu of cost for a credit statement or financial report issued before January 22, 1981. However, the special rule of this (7) applies only to a taxpayer's use of market value in lieu of cost and does not apply to the use of a method of valuation such as market value in lieu of cost but not more than FIFO cost.

(8) **Use of different methods.** The following are examples of costing methods and accounting methods that are neither inconsistent with the inventory method referred to in § 1.472–1 nor at variance with the requirement of § 1.472–2(c) and which, under paragraph (e)(1)(vi) of this section, may be used to ascertain income, profit, or loss for credit purposes or for purposes of financial reports regardless of whether such method is also used by the taxpayer for Federal income tax purposes:

(i) Any method relating to the determination of which costs are includible in the computation of the cost of inventory under the full absorption inventory method.

(ii) Any method of establishing pools for inventory under the dollar-value LIFO inventory method.

(iii) Any method of determining the LIFO value of a dollar-value inventory pool, such as the double-extension method, the index method, and the link chain method.

(iv) Any method of determining or selecting a price index to be used with the index or link chain method of valuing inventory pools under the dollar-value LIFO inventory method.

(v) Any method permitted under § 1.472–8 for determining the current-year cost of closing inventory for purposes of using the dollar-value LIFO inventory method.

(vi) Any method permitted under § 1.472–2(d) for determining the cost of goods in excess of goods on hand at the beginning of the year for purposes of using a LIFO method other than the dollar-value LIFO method.

(vii) Any method relating to the classification of an item as inventory or a capital asset.

(viii) The use of an accounting period other than the period used for Federal income tax purposes.

(ix) The use of cost estimates.

(x) The use of actual cost of cut timber or the cost determined under section 631(a).

(xi) The use of inventory costs unreduced by any adjustment required by the application of section 108 and section 1017, relating to discharge of indebtedness.

(xii) The determination of the time when sales or purchases are accrued.

(xiii) The use of a method to allocate basis in the case of a business combination other than the method used for Federal income tax purposes.

(xiv) The treatment of transfers of inventory between affiliated corporations in a manner different from that required by § 1.1502–13.

(9) **Reconciliation of LIFO inventory values.** A taxpayer may be required to reconcile differences between the value of inventories maintained for credit or financial reporting purposes and for Federal income tax purposes in order to show that the taxpayer has satisfied the requirements of this paragraph.

(f) Goods of the specified type on hand as of the close of the taxable year preceding the taxable year for which this inventory method is first used shall be included in the taxpayer's closing inventory for such preceding taxable year at cost determined in the manner prescribed in paragraph (c) of this section.

(g) The LIFO inventory method, once adopted by the taxpayer with the approval of the Commissioner, shall be adhered to in all subsequent taxable years unless—

(1) A change to a different method is approved by the Commissioner; or

(2) The Commissioner determines that the taxpayer, in ascertaining income, profit, or loss for the whole of any taxable year subsequent to his adoption of the LIFO inventory method, for credit purposes or for the purpose of reports to shareholders, partners, or other proprietors, or to beneficiaries, has used any inventory method at variance with that referred to in § 1.472–1 and requires of the taxpayer a change to a different

method for such subsequent taxable year or any taxable year thereafter.

(h) The records and accounts employed by the taxpayer in keeping his books shall be maintained in conformity with the inventory method referred to in § 1.472–1; and such supplemental and detailed inventory records shall be maintained as will enable the district director readily to verify the taxpayer's inventory computations as well as his compliance with the requirements of section 472 and §§ 1.472–1 through 1.472–7.

(i) Where the taxpayer is engaged in more than one trade or business, the Commissioner may require that if the LIFO method of valuing inventories is used with respect to goods in one trade or business the same method shall also be used with respect to similar goods in the other trades or businesses if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

[T.D. 6500, 25 FR 11728, Nov. 26, 1960, as amended by T.D. 6539, 26 FR 518, Jan. 20, 1961; T.D. 7756, 46 FR 6920, Jan. 22, 1981; T.D. 7756, 46 FR 15685, March 9, 1981]

§ 1.472–3 Time and manner of making election.

(a) The LIFO inventory method may be adopted and used only if the taxpayer files with his income tax return for the taxable year as of the close of which the method is first to be used a statement of his election to use such inventory method. The statement shall be made on Form 970 pursuant to the instructions printed with respect thereto and to the requirements of this section, or in such other manner as may be acceptable to the Commissioner. Such statement shall be accompanied by an analysis of all inventories of the taxpayer as of the beginning and as of the end of the taxable year for which the LIFO inventory method is proposed first to be used, and also as of the beginning of the prior taxable year. In the case of a manufacturer, this analysis shall show in detail the manner in which costs are computed with respect to raw materials, goods in process, and finished goods, segregating the products (whether in process or finished goods) into natural groups on the basis of either (1) similarity in factory processes through which they pass, or (2) similarity of raw materials used, or (3) similarity in style, shape, or use of finished products. Each group of products shall be clearly described.

(b) The taxpayer shall submit for the consideration of the Commissioner in connection with the taxpayer's adoption or use of the LIFO inventory method such other detailed information with respect to his business or accounting system as may be at any time requested by the Commissioner.

(c) As a condition to the taxpayer's use of the LIFO inventory method, the Commissioner may require that the method be used with respect to goods other than those specified in the taxpayer's statement of election if, in the opinion of the Commissioner, the use of such method with respect to such other goods is essential to a clear reflection of income.

(d) Whether or not the taxpayer's application for the adoption and use of the LIFO inventory method should be approved, and whether or not such method, once adopted, may be continued, and the propriety of all computations incidental to the use of such method, will be determined by the Commissioner in connection with the examination of the taxpayer's income tax returns.

[T.D. 6500, 25 FR 11729, Nov. 26, 1960, as amended by T.D. 7295, 38 FR 34203, Dec. 12, 1973]

§ 1.472–4 Adjustments to be made by taxpayer.

A taxpayer may not change to the LIFO method of taking inventories unless, at the time he files his application for the adoption of such method, he agrees to such adjustments incident to the change to or from such method, or incident to the use of such method, in the inventories of prior taxable years or otherwise, as the district director upon the examination of the taxpayer's returns may deem necessary in order that the true income of the taxpayer will be clearly reflected for the years involved.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–5 Revocation of election.

An election made to adopt and use the LIFO inventory method is irrevocable, and the method once adopted shall be used in all subsequent taxable years, unless the use of another method is required by the Commissioner, or authorized by him pursuant to a written application therefor filed as provided in paragraph (e) of § 1.446–1.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–6 Change from LIFO inventory method.

If the taxpayer is granted permission by the Commissioner to discontinue the use of LIFO method of taking inventories, and thereafter to use some other method, or if the taxpayer is required

by the Commissioner to discontinue the use of the LIFO method by reason of the taxpayer's failure to conform to the requirements detailed in § 1.472–2, the inventory of the specified goods for the first taxable year affected by the change and for each taxable year thereafter shall be taken—

(a) In conformity with the method used by the taxpayer under section 471 in inventorying goods not included in his LIFO inventory computations; or

(b) If the LIFO inventory method was used by the taxpayer with respect to all of his goods subject to inventory, then in conformity with the inventory method used by the taxpayer prior to his adoption of the LIFO inventory method; or

(c) If the taxpayer had not used inventories prior to his adoption of the LIFO inventory method and had no goods currently subject to inventory by a method other than the LIFO inventory method, then in conformity with such inventory method as may be selected by the taxpayer and approved by the Commissioner as resulting in a clear reflection of income; or

(d) In any event, in conformity with any inventory method to which the taxpayer may change pursuant to application approved by the Commissioner.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–7 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

[T.D. 6500, 25 FR 11730, Nov. 26, 1960]

§ 1.472–8 Dollar-value method of pricing LIFO inventories.

(a) Election to use dollar-value method. Any taxpayer may elect to determine the cost of his LIFO inventories under the so-called "dollar-value" LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of this section. The dollar-value method of valuing LIFO inventories is a method of determining cost by using "base-year" cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement. Under such method the goods contained in the inventory are grouped into a pool or pools as described in paragraphs (b) and (c) of this section. The term "base-year cost" is the aggregate of the cost (determined as of the beginning of the taxable year for which the LIFO method is first adopted, *i.e.*, the base date) of all items in a pool. The taxable year for which the LIFO method is first adopted with respect to any item in the pool is the "base year" for that pool, except as provided in paragraph (g)(3) of this section. Liquidations and increments of items contained in the pool shall be reflected only in terms of a net liquidation or increment for the pool as a whole. Fluctuations may occur in quantities of various items within the pool, new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole. An increment in the LIFO inventory occurs when the end of the year inventory for any pool expressed in terms of base-year cost is in excess of the beginning of the year inventory for that pool expressed in terms of base-year cost. In determining the inventory value for a pool, the increment, if any, is adjusted for changing unit costs or values by reference to a percentage, relative to base-year-cost, determined for the pool as a whole. See paragraph (e) of this section. See also paragraph (f) of this section for rules relating to the change to the dollar-value LIFO method from another LIFO method.

(b) Principles for establishing pools of manufacturers and processors—(1) Natural business unit pools. A pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects to use the multiple pooling method provided in subparagraph (3) of this paragraph. Thus, if a business enterprise is composed of only one natural business unit, one pool shall be used for all of its inventories, including raw materials, goods in process, and finished goods. If, however, a business enterprise is actually composed of more than one natural business unit, more than one pool is required. Where similar types of goods are inventoried in two or more natural business units of the taxpayer, the Commissioner may apportion or allocate such goods among the various natural business units, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of such taxpayer. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, any pooling of the LIFO inventory of such purchased goods for the wholesaling or retailing operations shall be determined in accordance with the rules of paragraph (c) of this section.

(2) Definition of natural business unit. (i) Whether an enterprise is composed of more than

one natural business unit is a matter of fact to be determined from all the circumstances. The natural business divisions adopted by the taxpayer for internal management purposes, the existence of separate and distinct production facilities and processes, and the maintenance of separate profit and loss records with respect to separate operations are important considerations in determining what is a business unit, unless such divisions, facilities, or accounting records are set up merely because of differences in geographical location. In the case of a manufacturer or processor, a natural business unit ordinarily consists of the entire productive activity of the enterprise within one product line or within two or more related product lines including (to the extent engaged in by the enterprise) the obtaining of materials, the processing of materials, and the selling of manufactured or processed goods. Thus, in the case of a manufacturer or processor, the maintenance and operation of a raw material warehouse does not generally constitute, of itself, a natural business unit. If the taxpayer maintains and operates a supplier unit the production of which is both sold to others and transferred to a different unit of the taxpayer to be used as a component part of another product, the supplier unit will ordinarily constitute a separate and distinct natural business unit. Ordinarily, a processing plant would not in itself be considered a natural business unit if the production of the plant, although saleable at this stage, is not sold to others, but is transferred to another plant of the enterprise, not operated as a separate division, for further processing or incorporation into another product. On the other hand, if the production of a manufacturing or processing plant is transferred to a separate and distinct division of the taxpayer, which constitutes a natural business unit, the supplier unit itself will ordinarily be considered a natural business unit. However, the mere fact that a portion of the production of a manufacturing or processing plant may be sold to others at a certain stage of processing with the remainder of the production being further processed or incorporated into another product will not of itself be determinative that the activities devoted to the production of the portion sold constitute a separate business unit. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods shall not be considered a part of any manufacturing or processing unit.

(ii) The rules of this subparagraph may be illustrated by the following examples:

Example (1). A corporation manufactures, in one division, automatic clothes washers and driers of both commercial and domestic grade as well as electric ranges, mangles, and dishwashers. The corporation manufactures, in another division, radios and television sets. The manufacturing facilities and processes used in manufacturing the radios and television sets are distinct from those used in manufacturing the automatic clothes washers, etc. Under these circumstances, the enterprise would consist of two business units and two pools would be appropriate, one consisting of all of the LIFO inventories entering into the manufacture of clothes washers and driers, electric ranges, mangles, and dishwashers and the other consisting of all of the LIFO inventories entering into the production of radio and television sets.

Example (2). A taxpayer produces plastics in one of its plants. Substantial amounts of the production are sold as plastics. The remainder of the production is shipped to a second plant of the taxpayer for the production of plastic toys which are sold to customers. The taxpayer operates his plastics plant and toy plant as separate divisions. Because of the different product lines and the separate divisions the taxpayer has two natural business units.

Example (3). A taxpayer is engaged in the manufacture of paper. At one stage of processing, uncoated paper is produced. Substantial amounts of uncoated paper are sold at this stage of processing. The remainder of the uncoated paper is transferred to the taxpayer's finishing mill where coated paper is produced and sold. This taxpayer has only one natural business unit since coated and uncoated paper are within the same product line.

(3) **Multiple pools—(i) Principles for establishing multiple pools.** (a) A taxpayer may elect to establish multiple pools for inventory items which are not within a natural business unit as to which the taxpayer has adopted the natural business unit method of pooling as provided in subparagraph (1) of this paragraph. Each such pool shall ordinarily consist of a group of inventory items which are substantially similar. In determining whether such similarity exists, consideration shall be given to all the facts and circumstances. The formulation of detailed rules for selection of pools applicable to all taxpayers is not feasible. Important considerations to be taken into account include, for example, whether there is substantial similarity in the types of raw materials used or in the processing operations applied; whether the raw materials used are readily interchangeable; whether there is similarity in the use of the products; whether the groupings are consistently followed for purposes of internal accounting and management; and whether the groupings follow customary business practice in the taxpayer's industry. The selection of pools in each case must also take into consideration such factors as the nature of the inventory items subject to the dollar-value LIFO method and the significance of such items to the taxpayer's business operations. Where similar types of goods are inventoried in natural business units and multiple pools of the taxpayer, the Commissioner may apportion or allocate such goods

among the natural business units and the multiple pools, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of the taxpayer.

(b) Raw materials which are substantially similar shall be pooled together in accordance with the principles of this subparagraph. However, inventories of raw or unprocessed materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(c) Finished goods and goods-in-process in the inventory shall be placed into pools classified by major classes or types of goods. The same class or type of finished goods and goods-in-process shall ordinarily be included in the same pool. Where the material content of a class of finished goods and goods-in-process included in a pool has been changed, for example, to conform with current trends in an industry, a separate pool of finished goods and goods-in-process will not ordinarily be required unless the change in material content results in a substantial change in the finished goods.

(d) The requirement that pools be established by major types of materials or major classes of goods is not to be construed so as to preclude the establishment of a miscellaneous pool. Since a taxpayer may elect the dollar-value LIFO method with respect to all or any designated goods in his inventory, there may be a number of such inventory items covered in the election. A miscellaneous pool shall consist only of items which are relatively insignificant in dollar value by comparison with other inventory items in the particular trade or business and which are not properly includible as part of another pool.

(ii) Raw materials content pools. The dollar-value method of pricing LIFO inventories may be used in conjunction with the raw materials content method authorized in § 1.472–1. Raw materials (including the raw material content of finished goods and goods-in-process) which are substantially similar shall be pooled together in accordance with the principles of subdivision (i) of this subparagraph. However, inventories of materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(c) Principles for establishing pools for wholesalers, retailers, etc. Items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. An example of such customary business classification is the department in the department store. In such case, practices are relatively uniform throughout the trade, and departmental grouping is peculiarly adapted to the customs and needs of the business. However, in appropriate cases, the principles set forth in paragraphs (b)(1) and (2) of this section, relating to pooling by natural business units, may be used, with permission of the Commissioner, by wholesalers, retailers, jobbers, or distributors. Where a wholesaler or retailer is also engaged in the manufacturing or processing of goods, the pooling of the LIFO inventory for the manufacturing or processing operations shall be determined in accordance with the rules of paragraph (b) of this section.

(d) Determination of appropriateness of pools. Whether the number and the composition of the pools used by the taxpayer is appropriate, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by paragraph (e) of this section which is used in computing the LIFO value of the dollar-value pool. The pool or pools selected must be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446–1. However, see paragraph (h) of this section for authorization to change the method of pooling in certain specified cases.

(e) Methods of computation of the LIFO value of a dollar-value pool—(1) Methods authorized. A taxpayer may ordinarily use only the so-called "double-extension" method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items, in a dollar-value pool, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound

and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns. The use of any so-called "link-chain" method will be approved for taxable years beginning after December 31, 1960, only in those cases where the taxpayer can demonstrate to the satisfaction of the district director that the use of either an index method or the double-extension method would be impractical or unsuitable in view of the nature of the pool. A taxpayer using either an index or link-chain method shall attach to his income tax return for the first taxable year beginning after December 31, 1960, for which the index or link-chain method is used, a statement describing the particular link-chain method or the method used in computing the index. The statement shall be in sufficient detail to facilitate the determination as to whether the method used meets the standards set forth in this subparagraph. In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20224. The taxpayer shall submit such other information as may be requested with respect to such index or link-chain method. Adequate records must be maintained by the taxpayer to support the appropriateness, accuracy, and reliability of an index or link-chain method. A taxpayer may request the Commissioner to approve the appropriateness of an index or link-chain method for the first taxable year beginning after December 31, 1960, for which it is used. Such request must be submitted within 90 days after the beginning of the first taxable year beginning after December 31, 1960, in which the taxpayer desires to use the index or link-chain method, or on or before May 1, 1961, whichever is later. A taxpayer entitled to use the retail method of pricing LIFO inventories authorized by paragraph (k) of § 1.472–1 may use retail price indexes prepared by the United States Bureau of Labor Statistics. Any method of computing the LIFO value of a dollar-value pool must be used for the year of adoption and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a different method.

(2) Double-extension method. (i) Under the double-extension method the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions at the two costs are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second total gives the amount of such inventory in terms of current-year cost.

(ii) The total current-year cost of items making up a pool may be determined—

(a) By reference to the actual cost of the goods most recently purchased or produced;

(b) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(c) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or

(d) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(iii) Under the double-extension method a base-year unit cost must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base-year unit cost of the entering item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the entering item is a product or raw material not in existence on the base date, its cost may be reconstructed, that is, the taxpayer using reasonable means may determine what the cost of the item would have been had it been in existence in the base year. If the item was in existence on the base date but not stocked by the taxpayer, he may establish, by using available data or records, what the cost of the item would have been to the taxpayer had he stocked the item. If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner, such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base year, he may use the earliest cost which he does reconstruct or establish as the base-year unit cost.

(iv) To determine whether there is an increment or liquidation in a pool for a particular taxable

year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment. The LIFO value of each such increment is hereinafter referred to in this section as the "layer of increment" and must be separately accounted for and a record thereof maintained as a separate layer of the pool, and may not be combined with a layer of increment occurring in a different year. On the other hand, when the end of the year inventory of the pool is less than the beginning of the year inventory of the pool, a liquidation occurs in the pool for that year. Such liquidation is to be reflected by reducing the most recent layer of increment by the excess of the beginning of the year inventory over the end of the year inventory of the pool. However, if the amount of the liquidation exceeds the amount of the most recent layer of increment, the preceding layers of increment in reverse chronological order are to be successively reduced by the amount of such excess until all the excess is absorbed. The base-year inventory is to be reduced by liquidation only to the extent that the aggregate of all liquidation exceeds the aggregate of all layers of increment.

(v) The following examples illustrate inventories under the double-extension the computation of the LIFO value of method.

Example (1). (a) A taxpayer elects, beginning with the calendar year 1961, to compute his inventories by use of the LIFO inventory method under section 472 and further elects to use the dollar-value method in pricing such inventories as provided in paragraph (a) of this section. He creates Pool No. 1 for items A, B, and C. The composition of the inventory for Pool No. 1 at the base date, January 1, 1961, is as follows:

Items	Units	Unit cost	Total cost
A	1,000	$5	$5,000
B	2,000	4	8,000
C	500	2	1,000
Total base-year cost at Jan. 1, 1961	.....	.....	14,000

(b) The closing inventory of Pool No. 1 at December 31, 1961, contains 3,000 units of A, 1,000 units of B, and 500 units of C. The taxpayer computes the current-year cost of the items making up the pool by reference to the actual cost of goods most recently purchased. The most recent purchases of items A, B, and C are as follows:

Item	Purchase date	Quantity pur-chased	Unit cost
A	Dec. 15, 1961.....	3,500	$6.00
B	Dec. 10, 1961.....	2,000	5.00
C	Nov. 1, 1961	500	2.50

(c) The inventory of Pool No. 1 at December 31, 1961, shown at base-year and current-year cost is as follows:

		Dec. 31, 1961 inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1961, inventory at current-year cost	
Item	Quan-tity	Unit cost	Amount	Unit cost	Amount
A	3,000	$5.00	$15,000	$6.00	$18,000
B	1,000	4.00	4,000	5.00	5,000
C	500	2.00	1,000	2.50	1,250
Total	.....	.....	20,000	.....	24,250

(d) If the amount of the December 31, 1961, inventory at base-year cost were equal to, or less than, the base-year cost of $14,000 at January 1, 1961, such amount would be the closing LIFO inventory at December 31, 1961. However, since the base-year cost of the closing LIFO inventory at December 31, 1961, amounts to $20,000, and is in excess of the $14,000 base-year cost of the opening inventory for that year, there is a $6,000 increment in Pool No. 1 during the year. This increment must be valued at current-year cost, *i.e.*, the ratio of 24,250/20,000, or 121.25 percent. The LIFO value of the inventory at December 31, 1961, is $21,275, computed as follows:

Pool No. 1

	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
Jan. 1, 1961, base cost	14,000	100.00	$14,000
Dec. 31, 1961, increment	6,000	121.25	7,275
Total	20,000	....	21,275

Example (2). (a) Assume the taxpayer in example (1) during the year 1962 completely disposes of item C and purchases item D. Assume further that item D is properly includible in Pool No. 1 under the provisions of this section. The closing inventory on December 31, 1962, consists of quantities at current-year unit cost, as follows:

Items	Units	Current-year unit cost Dec. 31, 1962
A	2,000	$6.50
B	1,500	6.00
D	1,000	5.00

(b) The taxpayer establishes that the cost of item D, had he acquired it on January 1, 1961, would have been $2.00 per unit. Such cost shall be used as the base-year unit cost for item D, and the LIFO computations at December 31, 1962, are made as follows:

		Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1962, inventory at current-year cost	
Item	Quantity	Unit cost	Amount	Unit cost	Amount
A	2,000	$5.00	$10,000	$6.50	$13,000
B	1,500	4.00	6,000	6.00	9,000
D	1,000	2.00	2,000	5.00	5,000
Total	.....	.....	18,000	.....	27,000

(c) Since the closing inventory at base-year cost, $18,000, is less than the 1962 opening inventory at base-year cost, $20,000, a liquidation of $2,000 has occurred during 1962. This liquidation is to be reflected by reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 1962, is $18,850, and is summarized as follows:

Pool No 1

	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1962, inventory at LIFO value
Jan. 1, 1961, base cost	14,000	100.00	$14,000
Dec. 31, 1961, increment	4,000	121.25	4,850
Total	18,000	....	18,850

(3) Use of inventory price index computed with reference to consumer or producer price indexes—(i) In general. For purposes of paragraph (e)(1) of this section, for taxable years beginning after December 31, 1981, an inventory price index computed in the manner provided by paragraph (e)(3) will be accepted by the Commissioner as an appropriate method of computing an index, and the use of such inventory price index to compute the LIFO value of a dollar-value inventory pool will be accepted as accurate, reliable, and suitable. A taxpayer using the inventory price index computation method provided by paragraph (e)(3) must use such method in determining the value of all goods for which the taxpayer has elected to use the LIFO method. However, the inventory price index computation method provided by paragraph (e)(3) may not be used by a taxpayer eligible to use inventory price indexes prepared by the United States Bureau of Labor Statistics for the purpose of valuing the LIFO inventories of a specific industry. Thus, a taxpayer eligible to use the retail price indexes prepared by the Bureau of Labor Statistics and published in *Department Store Inventory Price Indexes* may not use the inventory price index computation method provided by paragraph (e)(3). An inventory price index computed as provided by paragraph (e)(3) is computed in the manner provided by paragraph (e)(3)(ii) with reference to consumer or producer price indexes selected in the manner provided by paragraph (e)(3)(iii). Special rules for establishing inventory pools to be valued by an inventory price index computed in the manner provided by paragraph (e)(3) are in paragraph (e)(3)(iv). Rules relating to the adoption of, or change to, the method of computing an inventory price index in the manner provided by paragraph (e)(3) are in paragraph (e)(3)(v) and (vi).

(ii) Computation of index. An inventory price index computed in the manner provided by this (ii) shall be a stated percentage of the percent change in the selected consumer or producer price index or indexes for a specific category or categories of goods. The stated percentage for a taxpayer in a taxable year in which it is an eligible small business, as defined by section 474(b) of the Code, shall be 100 percent of the percent change in the selected price indexes. The stated percentage for all other taxpayers shall be 80 percent of the percent change in the selected price indexes.

See paragraph (e)(3)(iii) of this section for rules relating to the selection of appropriate consumer or producer price indexes. Thus, if the selected consumer or producer price index for a specific category of goods increased 10 percent for the period December 1981 to December 1982, an inventory price index computed in the manner provided by this (ii) with reference to such consumer or producer price index will reflect an increase of either 10 percent for an eligible small business or 8 percent (80 percent of 10 percent) for all other taxpayers. If the selected consumer or producer price index for a specific category of goods increased 10 percent per year for the period December 1981 to December 1983, an inventory price index computed in the manner provided by this (ii) with reference to such consumer or producer price index will reflect an increase of either 21 percent for an eligible small business or 16.8 percent (80 percent of 21 percent) for all other taxpayers. If under paragraph (e)(3)(iii) it is necessary to select more than one specific consumer or producer price

index for an inventory pool, the stated percentage of the percent change in such indexes is the stated percentage of the weighted average percent change for such indexes. Such weighted average is computed with reference to the relative amounts of costs in the inventory pool for each index category of goods. The costs to be used in computing such weighted average must be the relative current-year costs in ending inventory.

(iii) **Selection of consumer or producer price indexes**—(A) In general. An inventory price index computed as provided by paragraph (e)(3) of this section is computed with reference to the consumer or producer price indexes for specific categories of inventory items in the *CPI Detailed Report* or *Producer Prices and Price Indexes* published by the United States Bureau of Labor Statistics.

(B) Selection of indexes by category of inventory items. The selection of consumer or producer price indexes for an inventory pool is accomplished via a two-step process. First, the inventory items in each pool should be classified according to the detailed listings in the appropriate tables of the *CPI Detailed Report* or in *Producer Prices and Price Indexes* and assigned an index category. Second, an appropriate consumer or producer price index must be determined for each index category to which inventory items have been assigned. The assignment of index categories to the taxpayer's inventory items is accomplished by a process of elimination as follows:

(1) Whenever a specific inventory item in the taxpayer's inventory comprises 10 percent or more of total inventory value, such an inventory item must be placed in its own, separate index category. The index category selected must be the most detailed index category which includes that specific inventory item. In addition, any other inventory item that is included in such most detailed index category must also be included in such index category.

(2) If there are inventory items still remaining in the pool that have not been included in an index category, the taxpayer, beginning with the most detailed index categories for such remaining inventory items, must investigate successively less detailed index category levels and select the first index category that contains remaining inventory items which in the aggregate comprise 10 percent or more of total inventory value. The index category so selected must be the separate index category for the included inventory items. This procedure must be repeated either until all inventory items in the pool have been included in an index category, or until the remaining inventory items in the aggregate comprise less than 10 percent of total inventory value, or until it has been determined that no appropriate index category exists for the aggregate of such remaining inventory items.

(3) If there are inventory items remaining in the pool that comprise less than 10 percent of total inventory value, the index category to be selected for these inventory items must be the most detailed index category that includes such inventory items. If it has been determined that no appropriate index category exists for such remaining inventory items, such remaining inventory items must be combined in a miscellaneous index category created by the taxpayer.

In no event shall an index category be selected that is less detailed than either the 11 general categories of consumer goods described in Tables 3 and 5 of the *CPI Detailed Report* (see paragraph (e)(3)(iv) of this section), or the 15 general categories of producer goods described in Table 6 of the *Producer Prices and Price Indexes.* The determination of the appropriate index for an index category is accomplished as follows:

(4) Whenever an index category has been selected pursuant to paragraph (e)(3)(iii)(B)(1) of this section the appropriate index must be the published index for that index category.

(5) Whenever an index category has been selected pursuant to paragraph (e)(3)(iii)(B)(2) or (3) of this section, the appropriate index must be a weighted average of the published indexes of the index category items actually present in the taxpayer's inventory, excluding any index category items that have been placed in any other separate index category, weighted according to the weights used by BLS. Thus, if a taxpayer's inventory contains every inventory item that comprises the selected index category and none of these inventory items have been placed in any other separate index category, the appropriate index must be the published index for that index category. In the case of a miscellaneous index category created by the taxpayer, the appropriate index must be a weighted average of the published indexes for the index category items, weighted according to the weights used by BLS.

The use of BLS weights is limited only to the determination of the appropriate index for an index category. In computing the index for a pool, the taxpayer will weigh the appropriate indexes for the separate index categories comprising the pool according to the taxpayer's actual inventory weights for such separate index categories.

Whether the selection of the consumer or producer price indexes to be used to compute an inventory price index is appropriate, and the propriety of all computations incidental to the use of such consumer or producer price indexes, will be determined in connection with the examination of the taxpayer's income tax return. The selection of a consumer or producer price index for a specific good to compute an inventory price index under paragraph (e)(3) is a method of accounting. A taxpayer desiring to change the selection of such a consumer or producer price index must secure the consent of the Commissioner as provided in § 1.446–1(e). In the case of such a change, any layers of inventory increments previously determined and the LIFO value of such increments shall be retained. Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the inventory pool, the year of such change shall be used as the base year in determining the LIFO value of the inventory pool for the year of change and later taxable years. The base year costs of layers of increments in the pool at the beginning of the year of change shall be restated in terms of new base year costs using the year of change as the new base year.

(C) Other selection requirements. Manufacturers, processors, wholesalers, jobbers, and distributors may select indexes from only *Producer Prices and Price Indexes.* Retailers may select indexes from either the *CPI Detailed Report* or *Producer Prices and Price Indexes,* but if equally appropriate indexes could be selected from either publication, a retailer using the retail inventory method must select the index from the *CPI Detailed Report* and a retailer not using the retail inventory method must select the index from *Producer Prices and Price Indexes.* If a retailer using the retail inventory method selects a price index from *Producer Prices and Price Indexes,* the selected index must be converted into a retail price index. If a retailer not using the retail inventory method selects an index from the *CPI Detailed Report,* the selected index must be converted into a cost price index. Manufacturers, processors, wholesalers, jobbers, and distributors, must convert selected indexes into cost price indexes. In the case of the *CPI Detailed Report,* indexes may be selected only from Table 3 (Consumer Price Index for All Urban Consumers: Food expenditure categories, U.S. city average) and Table 5 (Consumer Price Index for All Urban Consumers: Nonfood expenditure categories, U.S. city average). In the case of the *Producer Prices and Price Indexes,* indexes may be selected only from Table 6 (Producer prices and price indexes for commodity groupings and individual items), unless the taxpayer can demonstrate that the selection of an index from another *Producer Prices and Price Indexes* table would be more appropriate. In the case of a taxpayer using the retail inventory method, the selected index must be the index as of the last month of the taxpayer's taxable year. Taxpayers that do not use the retail inventory method must select indexes as of the month or months most appropriate to the taxpayer's method of determining the current-year cost of the inventory pool under paragraph (e)(2)(ii) of this section, or make a one-time binding election of an appropriate representative month during the taxable year. The election must be clearly set forth on Form 970 (see paragraph (e)(3)(v) of this section).

(iv) **Special rules for pools.** A retailer, wholesaler, jobber, or distributor computing an inventory price index in the manner provided by paragraph (e)(3) of this section may, at the option of the taxpayer, establish an inventory pool for any group of goods included within one of eleven general categories of consumer goods described in the *CPI Detailed Report.* The eleven categories are food and beverages, housing maintenance and repair commodities, fuels (other than gasoline), house furnishings and housekeeping supplies, apparel commodities, private transportation (including gasoline), medical care commodities, entertainment commodities, tobacco products, toilet goods and personal care appliances, and school books and supplies. Inventory pools that comprise less than 5 percent of inventory value may be combined to form a single miscellaneous inventory pool. If the resulting miscellaneous inventory pool itself comprises less than 5 percent of inventory value, such pool may be combined only with the largest inventory pool. See paragraphs (b), (c) and (d) of this section for additional rules relating to the establishment of pools. See also section 474 of the Code for rules relating to the use of a single pool by an eligible small business. Except as provided in paragraph (e)(3)(v) of this section, relating to the adoption or change of method of computing an inventory price index, the rules of paragraph (g)(1) and (2) of this section apply to a change in method of pooling.

(v) **Adoption or change of method.** The use of an inventory price index computed in the manner provided by paragraph (e)(3) of this section is considered a method of accounting. A taxpayer permitted to adopt or change to the dollar-value LIFO inventory method without first securing the consent of the Commissioner may also adopt the inventory price index computation method pre-

scribed by paragraph (e)(3) incident to such adoption or change without first securing the consent of the Commissioner. In all other cases, a taxpayer may adopt or change to the inventory price index computation method prescribed by paragraph (e)(3) only after first securing the consent of the Commissioner as provided in § 1.446–1(e). However, in the case of a taxpayer not using the inventory price index computation method prescribed by paragraph (e)(3), the taxpayer may adopt or change to such method for the taxpayer's first or second taxable year beginning after December 31, 1981, without requesting the Commissioner's consent to such adoption or change. In addition, in such a case the taxpayer is not required to request the Commissioner's consent to a change in method of pooling incident to such adoption or change if the taxpayer is changing to a method of pooling authorized by paragraph (e)(3)(iv). In this case the rules of § 1.472–8(g) will apply. The inventory price index computation method provided by paragraph (e)(3) may be adopted and used only if the taxpayer indicates on a Form 970, or in such other manner as may be acceptable to the Commissioner, a listing of each inventory pool, the type of goods included in each pool, and the consumer or producer price index or indexes selected for each inventory pool. In the case of a taxpayer permitted to adopt or change to the inventory price index computation method without requesting the Commissioner's consent, the Form 970 shall be attached to the taxpayer's income tax return for the taxable year of such adoption or change. In other cases, the Form 970 shall be attached to a Form 3115 filed in accordance with § 1.446–1(e). Taxpayers must maintain adequate books and records of the use and computation of the inventory price index method in order to satisfy the requirements of § 1.472–2(h). Notwithstanding the rules in paragraph (e)(1) of this section, a taxpayer adopting or changing to the use of an inventory price index computed in the manner provided by paragraph (e)(3) is not required to demonstrate that the use of the double-extension method is impractical.

(vi) Requirement incident to change. In the case of a taxpayer using a method other than an inventory price index computed as prescribed by paragraph (e)(3) of this section to determine the LIFO value of a dollar-value inventory pool, any layers of inventory increments previously determined by such method and the LIFO value of such layers shall be retained if the taxpayer changes to the use of a price index computed as prescribed by paragraph (e)(3). Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the pool, the year of such change shall be used as the base year in determining the LIFO value of the inventory pool for the year of change and later taxable years. The base year costs of layers of increments in the pool at the beginning of the year of change shall be restated in terms of new base year cost, using the year of change as the new base year. See paragraph (f)(2) of this section for rules relating to a change to the dollar-value method from another method of pricing LIFO inventories.

(f) Change to dollar-value method from another method of pricing LIFO inventories—(1) Consent required. Except as provided in § 1.472–3 in the case of a taxpayer electing to use a LIFO inventory method for the first time, or in the case of a taxpayer changing to the dollar-value method and continuing to use the same pools as were used under another LIFO method, a taxpayer using another LIFO method of pricing inventories may not change to the dollar-value method of pricing such inventories unless he first secures the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1.

(2) Method of converting inventory. Where the taxpayer changes from one method of pricing LIFO inventories to the dollar-value method, the ending LIFO inventory for the taxable year immediately preceding the year of change shall be converted to the dollar-value LIFO method. This is done to establish the base-year cost for subsequent calculations. Thus, if the taxpayer was previously valuing LIFO inventories on the specific goods method, these separate values shall be combined into appropriate pools. For this purpose, the base year for the pool shall be the earliest taxable year for which the LIFO inventory method had been adopted for any item in that pool. No change will be made in the overall LIFO value of the opening inventory for the year of change as a result of the conversion, and that inventory will merely be restated in the manner used under the dollar-value method. All layers of increment for such inventory must be retained, except that all layers of increment which occurred in the same taxable year must be combined. The following examples illustrate the provisions of this subparagraph:

Example (1). (i) Assume that the taxpayer has used another LIFO method for finished goods since 1954 and has complied with all the requirements prerequisite for a change to the dollar-value method. Items A, B, and C, which have previously been inventoried under the specific goods LIFO method, may properly be included in a single dollar-value LIFO pool. The LIFO inventory value of items A, B, and C at December 31, 1960, is $12,200, computed as follows:

Year	Base quantity and yearly increments	Unit cost	Dec. 31, 1960, inventory at LIFO value
Item A			
1954 (base year)	100	$1	$100
1955	200	2	400
1956	100	4	400
1960	100	6	600
Total	500	....	1,500
Item B			
1954 (base year)	300	6	1,800
1955	100	8	800
1960	50	10	500
Total	450	....	3,100
Item C			
1954 (base year)	1,000	4	4,000
1955	200	6	1,200
1956	300	8	2,400
Total	1,500	....	7,600
LIFO value of items A, B, and C at Dec. 31, 1960	....	....	12,200

There were no increments in the years 1957, 1958, or 1959.

(ii) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each layer of increment in Pool No. 1 is shown as follows:

Item	1954 base-year unit cost	Year 1954	Increments 1955	1956	1960
A					
Base-year cost	$1.00	$100	$200	$100	$100
LIFO value	......	100	400	400	600
B					
Base-year cost	6.00	1,800	600	......	300
LIFO value	......	1,800	800	......	500
C					
Base-year cost	4.00	4,000	800	1,200	......
LIFO value	......	4,000	1,200	2,400	......
Total—Base-year cost	5,900	1,600	1,300	400	
Total—LIFO value	5,900	2,400	2,800	1,100	
Ratio of total current-year cost to total base-year cost (percent)	......	100.00	150.00	215.38	275.00

(iii) On the basis of the foregoing computations, the LIFO inventory of Pool No. 1, at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
1954 base cost	$5,900	100.00	$5,900
1955 increment	1,600	150.00	2,400
1956 increment	$1,300	215.38	$2,800
1960 increment	400	275.00	1,100
Total	9,200	....	12,200

Example (2). Assume the same facts as in example (1) and assume further that the base-year cost of Pool No. 1 at December 31, 1961, is $8,350. Since the closing inventory for the taxable year 1961 at base-year cost is less than the opening inventory for that year at base-year cost, a liquidation has occurred during 1961. This liquidation absorbs all of the 1960 layer of increment and part of the 1956 layer of increment. The December 31, 1961, inventory is $10,131, computed as follows:

	Dec. 31, 1961, inventory at base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1961, inventory at LIFO value
1954 base cost	$5,900	100.00	$5,900
1955 increment	1,600	150.00	2,400
1956 increment	850	215.38	1,831
Total	8,350	....	10,131

(g) **Transitional rules—(1) Change in method of pooling.** Any method of pooling authorized by this section and used by the taxpayer in computing his LIFO inventories under the dollar-value method shall be treated as a method of accounting. Any method of pooling which is authorized by this section shall be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446–1. Where the taxpayer changes from one method of pooling to another method of pooling permitted by this section, the ending LIFO inventory for the taxable year preceding the year of change shall be restated under the new method of pooling.

(2) Manner of combining or separating dollar-value pools. (i) A taxpayer who has been using the dollar-value LIFO method and who is permitted or required to change his method of pooling, shall combine or separate the LIFO value of his inventory for the base year and each yearly layer of increment in order to conform to the new pool or pools. Each yearly layer of increment in the new pool or pools must be separately accounted for and a record thereof maintained, and any liquidation occurring in the new pool or pools subsequent to the formation thereof shall be treat-

ed in the same manner as if the new pool or pools had existed from the date the taxpayer first adopted the LIFO inventory method. The combination or separation of the LIFO value of his inventory for the base year and each yearly layer of increment shall be made in accordance with the appropriate method set forth in this subparagraph, unless the use of a different method is approved by the Commissioner.

(ii) Where the taxpayer is permitted or required to separate a pool into more than one pool, the separation shall be made in the following manner: First, each item in the former pool shall be placed in an appropriate new pool. Every item in each new pool is then extended at its base-year unit cost and the extensions are totaled. Each total is the amount of inventory for each new pool expressed in terms of base-year cost. Then a ratio of the total base-year cost of each new pool to the base-year cost of the former pool is computed. The resulting ratio is applied to the amount of inventory for the base year and each yearly layer of increment of the former pool to obtain an allocation to each new pool of the base-year inventory of the former pool and subsequent layers of increment thereof. The foregoing may be illustrated by the following example of a change for the taxable year 1961:

Example. (a) Assume that items A, B, C, and D are all grouped together in one pool prior to December 31, 1960. The LIFO inventory value at December 31, 1960, is computed as follows:

	Pool ABCD		
	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1956, base cost	$10,000	100	$10,000
Dec. 31, 1956, increment	1,000	110	1,100
Dec. 31, 1958, increment	5,000	120	6,000
Dec. 31, 1960, increment	4,000	125	5,000
Total	20,000	....	22,100

(b) The extension of the quantity of items A, B, C, and D at respective base-year unit costs is as follows:

Item	Quantity	Base-year unit cost	Amount
A	2,000	$2	$4,000
B	1,000	3	3,000
C	1,000	5	$5,000
D	4,000	2	8,000
Total			20,000

(c) Under the provisions of this section the taxpayer separates former Pool ABCD into two pools, Pool AB and Pool CD. The computation of the ratio of total base-year cost for each of the new pools to the base-year cost of the former pool is as follows:

Item	Total base-year cost	Ratio
Pool AB:		
A	$4,000	....
B	3,000	....
	7,000	7,000/20,000
Pool CD:		
C	5,000	....
D	8,000	....
	13,000	13,000/20,000
Total for Pool ABCD	20,000	....

(d) The ratio of the base-year cost of new Pools AB and CD to the base-year cost of former Pool ABCD is 7,000/20,000 and 13,000/20,000, respectively. The allocation of the January 1, 1956 base cost and subsequent yearly layers of increment of former Pool ABCD to new Pools AB and CD is as follows:

	Base-year cost to be allocated	Pool	
		AB	CD
Jan. 1, 1956, base cost	$10,000	$3,500	$6,500
Dec. 31, 1956, increment	1,000	350	650
Dec. 31, 1958, increment	5,000	1,750	3,250
Dec. 31, 1960, increment	4,000	1,400	2,600
Total	20,000	7,000	13,000

(e) The LIFO value of new Pools AB and CD at December 31, 1960, as allocated, is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool AB			
Jan. 1, 1956, base cost	$3,500	100	$3,500
Dec. 31, 1956, increment	350	110	385
Dec. 31, 1958, increment	1,750	20	2,100
Dec. 31, 1960, increment	1,400	125	1,750
Total	7,000	....	7,735
Pool CD			
Jan. 1, 1956, base cost	6,500	100	6,500

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Dec. 31, 1956, increment	$650	110	$715
Dec. 31, 1958, increment	3,250	120	3,900
Dec. 31, 1960, increment	2,600	125	3,250
Total	13,000	....	14,365

(iii) Where the taxpayer is permitted or required to combine two or more pools having the same base year, they shall be combined into one pool in the following manner: The LIFO value of the base-year inventory of each of the former pools is combined to obtain a LIFO value of the base-year inventory for the new pool. Then, any layers of increment in the various pools which occurred in the same taxable year are combined into one total layer of increment for that taxable year. However, layers of increment which occurred in different taxable years may not be combined. In combining the layers of increment a new ratio of current-year cost to base-year cost is computed for each of the combined layers of increment. The foregoing may be illustrated by the following example:

Example. (a) Assume the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
Jan. 1, 1956, base cost	$10,000	100	$10,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	1,000	120	1,200
Total	13,000	....	13,400
Pool No. 2			
Jan. 1, 1957, base cost	5,000	100	5,000
Dec. 31, 1960, increment	3,000	140	4,200
Total	8,000	....	9,200

(b) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1957	Increments: Dec. 31, 1957	Increments: Dec. 31, 1960
No. 1:			
Base-year cost	$10,000	$2,000	$1,000
LIFO value	10,000	2,200	1,200
No. 2:			
Base-year cost	5,000	....	3,000
LIFO value	5,000	....	4,200
Total, base-year cost	15,000	2,000	4,000
Total, LIFO value	15,000	2,200	5,400
Ratio of total current-year cost to total base-year cost (percent)	100	110	135

(c) On the basis of the foregoing computations, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1957, base cost	$15,000	100	$15,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	4,000	135	5,400
Total	21,000	....	22,600

(iv) In combining pools having different base years, the principles set forth in subdivision (iii) of this subparagraph are to be applied, except that all base years subsequent to the earliest base year shall be treated as increments, and the base-year costs for all pools having a base year subsequent to the earliest base year of any pool shall be redetermined in terms of the base cost for the earliest base year. The foregoing may be illustrated by the following example:

Example. (a) Assume that the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current rent-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
Jan. 1, 1956, base cost	$7,000	100	$7,000
Dec. 31, 1956, increment	1,000	105	1,050

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current rent-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Dec. 31, 1957, increment	$ 500	110	$ 550
Dec. 31, 1958, increment	500	110	550
Dec. 31, 1960, increment	1,000	120	1,200
Total	10,000	....	10,350
Pool No. 2			
Jan. 1, 1958, base cost	3,500	100	3,500
Dec. 31, 1958, increment	1,000	110	1,100
Dec. 31, 1959, increment	500	115	575
Total	5,000	....	5,175

(b) The next step is to redetermine the 1958 base-year cost for Pool No. 2 in terms of 1956 base-year cost. January 1, 1956 base-year unit cost must be reconstructed or established in accordance with paragraph (e)(2) of this section for each item in Pool No. 2. Such costs are assumed to be $9.00 for item A, $20.00 for item B, and $1.80 for item C. A ratio of the 1958 total base-year cost to the 1956 total base-year cost for Pool No. 2 is computed as follows:

Item	Quantity	Jan. 1, 1956, base-year unit cost	Jan. 1, 1956, base-year cost
A	250	$9.00	$2,250
B	75	20.00	1,500
C	500	1.80	900
Total			4,650
A	250	10.00	2,500
B	75	20.00	1,500
C	500	2.00	1,000
Total			5,000

(c) The ratio of the 1956 total base-year cost to the 1958 total base-year cost for Pool No. 2 is 4,650/5,000 or 93 percent. The January 1, 1958 base cost and each yearly layer of increment at 1958 base-year cost is multiplied by this ratio. Such computation is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1958, base-year cost	Ratio (percent)	Dec. 31, 1960, inventory restated at Jan. 1, 1956, base-year cost
Jan. 1, 1958, base cost	$3,500	93	$3,255
Dec. 31, 1958, increment	1,000	93	930
Dec. 31, 1959, increment	500	93	465
Total			4,650

(d) The computation of the ratio of the total current-year cost to the total base-year cost for the base year (1956) and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1956	Increments Dec. 31, 1956	Dec. 31, 1957	Dec. 31, 1958	Dec. 31, 1959	Dec. 31, 1960
No. 1:						
Base-year cost	$7,000	$1,000	$500	$500	....	$1,000
LIFO value	7,000	1,050	550	550	....	1,200
No. 2:						
Base-year cost as restated	....	....	3,255	930	$465	....
LIFO value	....	....	3,500	1,100	575	....
Total, base-year cost	7,000	1,000	3,755	1,430	465	1,000
Total, LIFO value	7,000	1,050	4,050	1,650	575	1,200
Ratio of total current-year cost to total base-year cost (percent)	100.00	105.00	107.86	115.38	133.66	120.00

(e) On the basis of the foregoing computation, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost (percent)	Dec. 31, 1960, inventory at LIFO value
Jan. 1, 1956, base cost	$7,000	100.00	$7,000
Dec. 31, 1956, increment	1,000	105.00	1,050
Dec. 31, 1957, increment	3,755	107.86	4,050
Dec. 31, 1958, increment	1,430	115.38	1,650
Dec. 31, 1959, increment	465	123.66	575
Dec. 31, 1960, increment	1,000	120.00	1,200
Total	14,650	....	15,525

(3) Change in methods of computation at the LIFO value of a dollar-value pool. For the first taxable year beginning after December 31, 1960, the taxpayer must use a method authorized by paragraph (e)(1) of this section in computing the base-year cost and current-year cost of a dollar-value inventory pool for the end of such year. If the taxpayer had previously used any methods other than one authorized by paragraph (e)(1) of this section, he shall not be required to recompute his LIFO inventories for taxable years beginning on or before December 31, 1960, under a method authorized by such paragraph. The base cost and layers of increment previously computed by such other method shall be retained and treated as if such base cost and layers of increment had been computed under a method authorized by paragraph (e)(1) of this section. The taxpayer shall use the year of change as the base year in applying the double-extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(h) Change without consent in method of pooling—(1) Authorization. Notwithstanding the provisions of paragraph (g) of this section, a taxpayer, for his first taxable year ending after April 15, 1961, may change from one method of pooling authorized by this section to any other method of pooling authorized by this section provided the requirements of subparagraph (2) of this paragraph are met. Also, for such year, if a taxpayer is currently using only a method of pooling authorized by this section, or a method of pooling which would be authorized by this section if additional items were included in the pool, and could change to the natural business unit method, except for the fact he has not inventoried all items entering into the inventory investment for such natural business unit on the LIFO method, he may change to the natural business unit method if he elects under the provisions of § 1.472-3 to extend the LIFO election to all items entering into the entire inventory investment for such natural business unit, provided the requirements of subparagraph (2) of this paragraph are met. The method of pooling adopted shall be used for the year of change and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commission as provided in paragraph (e) of § 1.446-1.

(2) Requirements. A statement shall be attached to the income tax return for the year of change referred to in subparagraph (1) of this paragraph setting forth, in summary form, the following information:

(i) A description of the new pool or pools,

(ii) The basis for selection of the new pool or pools,

(iii) A schedule showing the computation of the LIFO value of the former pool or pools, and,

(iv) A schedule showing the transition from the former pool or pools to the new pool or pools.

In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20024. The taxpayer shall submit such other information with respect to the change in method of pooling as may be requested.

[T.D. 6539, 26 FR 518, Jan. 20, 1961; T.D. 7814, 47 FR 11272, March 16, 1982]

Adjustments

§ 1.481-1 Adjustments in general.

(a)(1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and

paragraph (e) of § 1.446–1. In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The "year of the change" is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

(2) Unless the adjustments are attributable to a change in method of accounting initiated by the taxpayer, no part of the adjustments required by subparagraph (1) of this paragraph shall be based on amounts which were taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(b) The adjustments specified in section 481(a) and this section shall take into account inventories, accounts receivable, accounts payable, and any other item determined to be necessary in order to prevent amounts from being duplicated or omitted.

(c)(1) The term "adjustments", as used in section 481, has reference to the net amount of the adjustments required by section 481(a) and paragraph (b) of this section. In the case of a change in the over-all method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term "net amount of the adjustments" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting. With respect to the portion of the adjustments attributable to pre-1954 Code years, it is immaterial that the same items or class of items with respect to which adjustments would have to be made (for the first taxable year to which section 481 applies) do not exist at the time the actual change in method of accounting occurs. For purposes of section 481, only the net dollar balance is to be taken into account. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(2)(i) If the change in method of accounting is voluntary (that is, initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is to be taken into account in computing taxable income for the taxable year of the change, except as otherwise provided by section 481(b)(4) and (5). However, in such a case, if the portion of the adjustments which is attributable to taxable years subject to the Internal Revenue Code of 1954 increases taxable income by more than $3,000, the limitations on tax provided in section 481(b)(1) or (2) apply.

(ii) The portion of the adjustments arising from a voluntary change in method of accounting and attributable to taxable years not subject to the 1954 Code is determined in accordance with section 481(b)(4)(A) and paragraph (a) of § 1.481–4. If such portion increases taxable income by more than $3,000 for the first taxable year to which section 481 applies, such portion may be taken into account over the period prescribed in section 481(b)(4)(B). If the total increase in taxable income arising from the adjustments required by section 481(a) is more than $3,000 for the taxable year of the change, but the portion of such adjustments attributable by $3,000 or less for the first taxable year to which section 481 applies, then the limitations provided in section 481(b)(1) or (2) apply to the total adjustments. On the other hand, if the portion of such adjustments attributable to pre-1954 Code years under section 481(b)(4)(A) increases taxable income taxable year to which section 481 applies, and the portion attributable to 1954 Code years increases taxable income by $3,000 or less for the taxable year of the change, then the portion of the adjustments attributable to pre-1954 Code years may be taken into account over the period prescribed in section 481(b)(4)(B), and the portion of the adjustments attributable to 1954 Code years is to be taken into account in the taxable year of the change.

(3) If the change in method of accounting is not voluntary (that is, not initiated by the taxpayer), then only the adjustments required by section 481(a) which are attributable to taxable years subject to the Internal Revenue Code of 1954 are taken into account in computing taxable income for the taxable year of the change. If the amount of such adjustments increases taxable income by more than $3,000 for the taxable year of the change, the limitations on tax provided in section 481(b)(1) or (2) apply.

(4) If the adjustments required by section 481(a) as a result of a change in method of accounting decrease taxable income for the taxable year of the change, such decrease is taken into account for that year and the provisions of section 481(b) do

not apply. In the case of an involuntary change in method of accounting, no adjustments attributable to pre-1954 Code years are taken into account, whether or not such adjustments would decrease taxable income.

(5) A change in the method of accounting initiated by the taxpayer includes not only a change which he originates by securing the consent of the Commissioner, but also a change from one method of accounting to another made without the advance approval of the Commissioner. A change in the taxpayer's method of accounting required as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer. On the other hand, a taxpayer who, on his own initiative, changes his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to have made an involuntary change.

(6) Where the total adjustments required by section 481(a) include both—

(i) An amount attributable to 1954 Code years to which the limitations on tax provided by section 481(b)(1) or (2) apply, and

(ii) An amount attributable to pre-1954 Code years of which all or a pro rata portion thereof is to be taken into account under section 481(b)(4)(A) or (B),

two separate computations of tax must be made for the taxable year of the change. The tax for such year must first be computed under section 481(b)(1) or (2) in respect of the portion of the adjustments attributable to 1954 Code years, without regard to amounts taken into account under section 481(b)(4)(A) or (B). Then the tax for such year must be computed in respect of the portion of the adjustments attributable to pre-1954 Code years, taking into account the portion of the adjustments attributable to 1954 Code years. The total tax for the taxable year of the change will be the aggregate of the tax computed under section 481(b)(1) or (2) and the increase in tax attributable to taking into account the portion of the adjustments attributable to pre-1954 Code years under section 481(b)(4)(A) or (B).

(7) For rules relating to the limitations on tax provided by section 481(b)(1) and (2), see § 1.481–2. For rules relating to the adjustments attributable to taxable years beginning before January 1, 1954, or ending before August 17, 1954, see §§ 1.481–3 and 1.481–4.

(d) In determining the amount of any item of gain, loss, deduction, or credit which depends upon gross income, adjusted gross income, or taxable income for the taxable year of the change, the full amount of the adjustments required under section 481(a) shall be taken into account for such year if such adjustments increase taxable income by $3,000 or less, or decrease taxable income. However, if the amount of the adjustments increase taxable income by more than $3,000, the provisions of section 481(b) apply. Since section 481(b)(1) and (2) merely provide for limitations on the tax for the taxable year of the change, the entire amount of the adjustments which is subject to section 481(b)(1) and (2) is taken into account in such year. See § 1.481–2. Where section 481(b)(4) applies and the taxpayer does not elect to have the 10-year period begin with the first taxable year beginning after December 31, 1957, the pro rata portion of the adjustments attributable to pre-1954 Code years is also taken into account in the taxable year of the change. See § 1.481–4.

(e) The provisions of section 481 shall not apply in the case of a change from an accrual method to the installment method of accounting. In such case the rules provided in section 453 shall apply. However, section 481 does apply in the case of a change from the installment method of accounting to any other method.

[T.D. 6500, 25 FR 11731, Nov. 26, 1960]

§ 1.481–2 Limitation on tax.

(a) Three-year allocation. Section 481(b)(1) provides a limitation on the tax for the taxable year of the change attributable to the adjustments required under section 481(a) and § 1.481–1 (other than the amount of adjustments to which section 481(b)(4) or (5) applies). If such adjustments increase the taxpayer's taxable income for the taxable year of the change by more than $3,000, then the tax for such taxable year under chapter 1 of the Internal Revenue Code of 1954 attributable to the adjustments shall not exceed the lesser of (1) the tax attributable to taking such adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481–1, or (2) the aggregate of the increases in tax under chapter 1 (or under corresponding provisions of prior revenue laws) which would result if the adjustments were included ratably in the taxable year of the change and the two preceding taxable years. For the purpose of computing the limitation on tax under section 481(b)(1), the adjustments shall be allocated ratably to the taxable year of the change and the two preceding taxable years, whether or not the adjustments are

in fact attributable in whole or in part to such years. The limitation on the tax provided in this paragraph shall be applicable only if the taxpayer used the method of accounting from which the change was made in computing taxable income for the two taxable years preceding the taxable year of the change.

(b) Allocation under new method of accounting. Section 481(b)(2) provides a second alternative limitation on the tax for the taxable year of the change under chapter 1 attributable to the adjustments required under section 481(a) and § 1.481–1 which are not subject to section 481(b)(4) or (5) where such adjustments increase taxable income for the taxable year of the change by more than $3,000. If the taxpayer establishes from his books of account and other records what his taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of the change, and if the taxpayer in computing taxable income for such years used the method of accounting from which the change was made, then the tax attributable to the adjustments shall not exceed the smallest of the following amounts:

(1) The tax attributable to taking the adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481–1;

(2) The tax attributable to such adjustments computed under the 3-year allocation provided in section 481(b)(1), if applicable; or

(3) The net increase in the taxes under chapter 1 (or under corresponding provisions of prior revenue laws) which would result from allocating that portion of the adjustments to the one or more consecutive preceding taxable years to which properly allocable under the new method of accounting and from allocating the balance thereof to the taxable year of the change.

(c) Rules for computation of tax. (1) The first step in determining whether either of the limitations described in section 481(b)(1) or (2) applies is to compute the increase in tax for the taxable year of the change which is attributable to the increase in taxable income for such year resulting solely from the adjustments required under section 481(a) and § 1.481–1 which are not subject to section 481(b)(4) or (5). This increase in tax is the excess of the tax for the taxable year computed by taking into account such adjustments under section 481(a) over the tax computed for such year without taking the adjustments into account.

(2) The next step is to compute under section 481(b)(1) the tax attributable to the adjustments referred to in subparagraph (1) of this paragraph for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustments had been received or accrued in each of such taxable years. The increase in tax attributable to the adjustments for each such taxable year is the excess of the tax for such year computed with the allocation of one-third of the net adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year. For the purpose of computing the aggregate increase in taxes for such taxable years, there shall be taken into account the increase or decrease in tax for any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(1) but which is affected by a net operating loss under section 172 or by a capital loss carryback or carryover under section 1212, determined with reference to taxable years with respect to which adjustments under section 481(b)(1) are allocated.

(3) In the event that the taxpayer satisfies the conditions set forth in section 481(b)(2), the next step is to determine the amount of the net increase in tax attributable to the adjustments referred to in subparagraph (1) of this paragraph for:

(i) The taxable year of the change,

(ii) The consecutive taxable year or years immediately preceding the taxable year of the change for which the taxpayer can establish his taxable income under the new method of accounting, and

(iii) Any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(2), but which is affected by a net operating loss or by a capital loss carryback or carryover determined with reference to taxable years with respect to which such adjustments are allocated.

The net increase in tax for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph shall be computed as if the amount of the adjustments for the prior taxable years to which properly allocable in accordance with section 481(b)(2) had been received or accrued, or paid or incurred, as the case may be, in such prior years and the balance of the adjustments in the taxable year of the change. The amount of tax attributable to such adjustments for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph is the aggregate of the differences (increases and decreases) between the tax for

each such year computed by taking into account the allocable portion of the adjustments in computing taxable income and the tax computed without taking into account any portion of the adjustments in computing taxable income. Generally, where there is an increase in taxable income for a preceding consecutive taxable year established under the new method of accounting, computed without regard to adjustments attributable to any preceding taxable year, the amount of the adjustments to be allocated to each such year shall be an amount equal to such increase. However, where the amount of the adjustments to be allocated to a prior taxable year is less than the increase in taxable income for such year established under the new method of accounting, the amount of the increase in such taxable income for purposes of determining the increase in tax under section 481(b)(2) for such year shall be considered to be the amount so allocated. For example, if the amount of the adjustments required by section 481(a) for 1958 (the taxable year of the change) is $60,000, and the increase in taxable income is determined by the taxpayer to be $40,000, $5,000, and $35,000, computed under the new method of accounting, for the taxable years 1957, 1956, and 1955, respectively, then the amount of the adjustments to be allocated to 1955 will be the balance of the adjustments, or $15,000.

(4) The tax for the taxable year of the change (determined without regard to adjustments under section 481(b)(4) or (5)) shall be the tax for such year, computed without taking any of the adjustments referred to in subparagraph (1) of this paragraph into account, increased by the smallest of the following amounts:

(i) The amount of tax for the taxable year of the change attributable solely to taking into account the entire amount of the adjustments required by section 481(a) and § 1.481–1 which are not subject to section 481(b)(4) or (5);

(ii) The sum of the increases in tax liability for the taxable year of the change and the two immediately preceding taxable years which would have resulted solely from taking into account one-third of the amount of such adjustments required for each of such years as though such amounts had been properly attributable to such years (computed in accordance with subparagraph (2) of this paragraph); or

(iii) The net increase in tax attributable to allocating such adjustments under the new method of accounting (computed in accordance with subparagraph (3) of this paragraph).

(5)(i) In the case of a change in method of accounting by a partnership, the adjustments required by section 481 shall be made with respect to the taxable income of the partnership but the limitations on tax under section 481(b) shall apply to the individual partners. Each partner shall take into account his distributive share of the partnership items, as so adjusted, for the taxable year of the change. Section 481(b) applies to a partner whose taxable income is so increased by more than $3,000 as a result of such adjustments to the partnership taxable income. It is not necessary for the partner to have been a member of the partnership for the two taxable years immediately preceding the taxable year of the change of the partnership's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a partner may apply section 481(b)(2) even though he was not a member of the partnership for all the taxable years affected by the computation thereunder.

(ii) In the case of a change in method of accounting by an electing small business corporation under subchapter S, chapter 1 of the Code, the adjustments required by section 481 shall be made with respect to the taxable income of such electing corporation in the year of the change, but the limitations on tax under section 481(b) shall apply to the individual shareholders. Section 481(b) applies to a shareholder of an electing small business corporation whose taxable income is so increased by more than $3,000 as a result of such adjustments to such corporation's taxable income. It is not necessary for the shareholder to have been a member of the electing small business corporation, or for such corporation to have been an electing small business corporation, for the two taxable years immediately preceding the taxable year of the change of the corporation's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a shareholder may apply section 481(b)(2), even though he was not a shareholder, or the corporation was not an electing small business corporation, for all the taxable years affected by the computation thereunder.

(6) For the purpose of the successive computations of the limitations on tax under section 481(b)(1) or (2), if the treatment of any item under the provisions of the Internal Revenue Code of 1954 (or corresponding provisions of prior internal revenue laws) depends upon the amount of gross income, adjusted gross income, or taxable income (for example, medical expenses, charitable contributions, or credits against the tax), such item shall

be determined for the purpose of each such computation by taking into account the proper portion of the amount of any adjustments required to be taken into account under section 481 in each such computation.

(7) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning of section 1314(a)) for such year.

(8) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to tax on self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) **Examples.** The application of section 481(b)(1) and (2) may be illustrated by the following examples. Although the examples in this paragraph are based upon adjustments required in the case of a change in the over-all method of accounting, the principles illustrated would be equally applicable to adjustments required in the case of a change in method of accounting for a particular material item, provided the treatment of such adjustments is not specifically subject to some other provision of the Internal Revenue Code of 1954.

Example (1). An unmarried individual taxpayer using the cash receipts and disbursements method of accounting for the calendar year is required by the Commissioner to change to an accrual method effective with the year 1958. As of January 1, 1958, he had an opening inventory of $11,000. On December 31, 1958, he had a closing inventory of $12,500. Merchandise purchases during the year amounted to $22,500, and net sales were $32,000. Total deductible business expenses were $5,000. There were no receivables or payables at January 1, 1958. The computation of taxable income for 1958, assuming no other adjustments, using the new method of accounting follows:

Net sales		$32,000
Opening inventory	$11,000	
Purchases	22,500	
Total	33,500	
Less closing inventory	12,500	
Cost of goods sold		21,000
Gross profit		11,000
Business expenses		5,000
Business income		6,000
Personal exemption and itemized deductions		1,600
Taxable income		4,400

Under the cash receipts and disbursements method of accounting, only $9,000 of the $11,000 opening inventory had been included in the cost of goods sold and claimed as a deduction for the taxable years 1954 through 1957; the remaining $2,000 had been so accounted for in pre-1954 Code years. In order to prevent the same item from reducing taxable income twice, an adjustment of $9,000 must be made to the taxable income of 1958 under the provisions of section 481(a) and § 1.481–1. Since the change in method of accounting was not initiated by the taxpayer, the $2,000 of opening inventory which had been included in cost of goods sold in pre-1954 Code years is not taken into account. Taxable income for 1958 is accordingly increased by $9,000 under section 481(a) to $13,400. Assuming that the tax on $13,400 is $4,002 and that the tax on $4,400 (income without the adjustment) is $944, the increase in tax attributable to the adjustment, if taken into account for the taxable year of the change, would be the difference between the two, or $3,058. Since the adjustment required by section 481(a) and § 1.481–1 ($9,000) increases taxable income by more than $3,000, the increase in tax for the taxable year 1958 attributable to the adjustment of $9,000 (*i.e.*, $3,058) may be limited under the provisions of section 481(b)(1) or (2). See examples (2) and (3).

Example (2). Assume that the taxpayer in example (1) used the cash receipts and disbursements method of accounting in computing taxable income for the years 1956 and 1957 and that the taxable income for these years determined under such method was $4,000 and $6,000, respectively. The section 481(b)(1) limitation on tax with a pro rata three-year allocation of the $9,000 adjustment is computed as follows:

Taxable year	Taxable income before adjustment	Taxable income with adjustment	Assume total tax	Assumed tax before adjustment	Increase in tax attributable to adjustment
1956	$4,000	$7,000	$1,660	$840	$820
1957	6,000	9,000	2,300	1,360	940
1958	4,400	7,400	1,780	944	836
Total					2,596

Since this increase in tax of $2,596 is less than the increase in tax attributable to the inclusion of the entire adjustment in the income for the taxable year of the change ($3,058), the limitation provided by section 481(b)(1) applies, and the total tax for 1958, the taxable year of the change, if section 481(b)(2) does not apply, is determined as follows:

Tax without any portion of adjustment	$944
Increase in tax attributable to adjustment computed under section 481(b)(1)	2,596
Total tax for taxable year of the change	3,540

Example (3). (i) Assume the same facts as in example (1) and, in addition, assume that the taxpayer used the cash receipts and disbursements method of accounting in computing

taxable income for the years 1953 through 1957; that he established his taxable income under the new method for the taxable years 1953, 1954, and 1957, but did not have sufficient records to establish his taxable income under such method for the taxable years 1955 and 1956. The original taxable income and taxable income as redetermined are as follows:

Taxable year	Taxable income: Determined under cash receipts and disbursements method	Taxable income: Established under new method	Increase or (decrease) in taxable income
1953	$5,000	$7,000	$2,000
1954	6,000	7,000	1,000
1955	5,500	(1)	....
1956	4,000	(1)	....
1957	6,000	10,000	4,000

[1] Undetermined.

As in examples (1) and (2), the total adjustment under section 481(a) is $9,000. Of the $9,000 adjustment, $4,000 may be allocated to 1957, which is the only year consecutively preceding the taxable year of the change for which the taxpayer was able to establish his income under the new method. Since the income cannot be established under the new method for 1956 and 1955, no allocation may be made to 1954 or 1953, even though the taxpayer has established his income for those years under the new method of accounting. The balance of $5,000 ($9,000 minus $4,000) must be allocated to 1958.

(ii) The limitation provided by section 481(b)(2) is computed as follows: The tax for 1957, based on taxable income of $6,000, is assumed to be $1,360. Under the new method, based on taxable income of $10,000, the tax for 1957 is assumed to be $2,640, the increase attributable to $4,000 of the $9,000 section 481(a) adjustment being $1,280 ($2,640 minus $1,360). The tax for 1958, computed on the basis of taxable income of $4,400 (determined under the new method), is assumed to be $944. The tax computed for 1958 on taxable income of $9,400 ($4,400 plus the $5,000 adjustment allocated to 1958) is assumed to be $2,436, leaving a difference of $1,492 ($2,436 minus $944) attributable to the inclusion in 1958 of the portion of the total adjustment to be taken into account which could not be properly allocated to the taxable year or years consecutively preceding 1958.

(iii) The tax attributable to the adjustment is determined by selecting the smallest of the three following amounts:

Increase in tax attributable to adjustment computed under section 481(b)(2) ($1,280 + $1,492)	$2,772
Increase in tax attributable to adjustment computed under section 481(b)(1) (example (2))	2,596
Increase in tax if the entire adjustment is taken into account in the taxable year of the change (example (1))	3,058

The final tax for 1958 is then $3,540 computed as follows:

Tax before inclusion of any adjustment	$944
Increase in tax attributable to adjustments (smallest of $2,772, $2,596 or $3,058)	2,596
Total tax for 1958 (limited in accordance with section 481(b)(1))	3,540

Example (4). Assume that X Corporation has maintained its books of account and filed its income tax returns using the cash receipts and disbursements method of accounting for the years 1953 through 1957. The corporation secures permission to change to an accrual method of accounting for the calendar year 1958. The following tabulation presents the data with respect to the taxpayer's income for the years involved:

Year	Taxable income under the cash receipts and disbursements method: Before application of net operating loss carryback	Taxable income under the cash receipts and disbursements method: After application of net operating loss carryback	Taxable income established under accrual method	Increase or (decrease) attributable to change	Changes in taxable income due to changes in net loss carryback
1953	$2,000	0	(1)	....	$2,000
1954	4,000	$1,000	(1)	....	3,000
1955	(5,000)	....	$1,000	$6,000	....
1956	80,000	80,000	77,000	(3,000)	....
1957	90,000	90,000	96,000	6,000	....
1958	....	....	100,000	....	....

[1] Not established.

As indicated above, taxable income for 1953 and 1954, as determined under the cash receipts and disbursements method of accounting, was $2,000 and $4,000, respectively, and after application of the net operating loss carryback from 1955, the taxable income was reduced to zero in 1953 and to $1,000 in 1954. The taxpayer was unable to establish taxable income for these years under an accrual method of accounting; however, under section 481(b)(3)(A), increases or decreases in the tax for taxable years to which no adjustment is allocated must, nevertheless, be taken into account to the extent the tax for such years would be affected by a net operating loss determined with reference to taxable years to which adjustments are allocated. The total amount of the adjustments required under section 481(a) and attributable to the taxable years 1953 through 1957 in this example is assumed to be $10,000. The redetermination of taxable income established by the taxpayer for the taxable years 1955, 1956, and 1957 appears under the heading "Taxable income established under accrual method" in the above tabulation. The tabulation assumes that the taxpayer has been able to recompute the income for those years so as to establish

a net adjustment of $9,000, which leaves a balance of $1,000 unaccounted for. In accordance with the requirements of section 481(b)(2), the $1,000 amount is allocated to 1958, the taxable year of the change. The following computations are necessary in order to determine the tax attributable to the adjustments under section 481(a):

Increase in tax attributable to inclusion in 1958 of the entire $10,000 adjustment

Tax on income of 1958 increased by entire amount of adjustment ($100,000 + $10,000)	$51,700
Tax on income of 1958 without adjustment ($100,000)	$46,500
Increase in tax attributable to inclusion of entire adjustment in year of the change	5,200

Increase in tax attributed to adjustment computed under section 481(b)(1)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1958	$3,334	$46,500	$48,234	$1,734
1957	3,333	41,300	43,033	1,733
1956	3,333	36,100	37,833	1,733
Increase in tax attributable to adjustment computed under section 481(b)(1)				5,200
Increase in tax attributed to adjustment computed under section 481(b)(2)				
1953	[1] $2,000	0	[1] $600	$600
1954	[1] 3,000	$300	[1] 1,200	900
1955	6,000	0	300	300
1956	(3,000)	36,100	34,540	(1,560)
1957	96,000	41,300	44,420	3,120
1958	[2] 1,000	46,500	[2] 47,020	520
Increase in tax attributable to the adjustment computed under section 481(b)(2)				3,880

[1] Attributable to recomputations of net operating loss carrybacks determined with reference to net operating loss in 1955.

[2] Attributable to the inclusion of $1,000 in the year of the change which represents the portion of the $10,000 adjustment not allocated to taxable years prior to the year of the change for which taxable income is established under the new method.

Since the limitation under section 481(b)(2) ($3,880) on the amount of tax attributable to the adjustments is applicable, the final tax for the taxable year of the change is computed by adding such amount to the tax for that year computed without the inclusion of any amount attributable to the adjustments, that is, $46,500 plus $3,880, or $50,380.

[T.D. 6500, 25 FR 11732, Nov. 26, 1960, as amended by T.D. 6490, 25 FR 8374, Sept. 1, 1960; T.D. 7301, 39 FR 963, Jan. 4, 1974]

§ 1.481–3 Adjustments attributable to pre-1954 Code years where change was not initiated by taxpayer.

If the adjustments required by section 481(a) and § 1.481–1 are attributable to a change in method of accounting which was not initiated by the taxpayer, no portion of any adjustments which is attributable to pre-1954 Code years shall be taken into account in computing taxable income. For example, if the total adjustments in the case of a change in method of accounting which is not initiated by the taxpayer amount to $10,000, of which $4,000 is attributable to pre-1954 Code years, only $6,000 of the $10,000 total adjustments is required to be taken into account under section 481 in computing taxable income. The portion of the adjustments which is attributable to pre-1954 Code years is the net amount of the adjustments which would have been required if the taxpayer had changed his method of accounting in his first taxable year which began after December 31, 1953, and ended after August 16, 1954. See section 481(b)(4)(A).

[T.D. 6500, 25 FR 11735, Nov. 26, 1960]

§ 1.481–4 Adjustments attributable to pre-1954 Code years where change was initiated by taxpayer.

(a) Amount of adjustments to be taken into account. If the adjustments required by section 481(a) and § 1.481–1 are attributable to a change in method of accounting initiated by the taxpayer, the amount of such adjustments, to the extent such amount does not exceed the net amount which would have been required if the change had been made in the first taxable year beginning after December 31, 1953, and ending after August 16, 1954, shall be taken into account by the taxpayer in computing taxable income in the manner provided in section 481(b)(4)(B) and paragraph (b) of this section. The preceding sentence shall apply only if such amount would increase taxable income for such year by more than $3,000. For example, if the total adjustments amount to $19,000, and the portion of the adjustments attributable to pre-

1954 Code years is $10,000 and the balance of $9,000 is attributable to taxable years subject to the 1954 Code, the adjustments shall be taken into account as follows:

(1) The portion attributable to pre-1954 Code years ($10,000) shall be taken into account in the manner provided in section 481(b)(4)(B) and paragraph (b) of this section, and the limitations provided in section 481(b)(1) or (2) will apply to the balance of $9,000; or

(2) If the taxpayer elects under section 481(b)(6) to take the adjustments attributable to pre-1954 Code years into account under section 481(b)(1) or (2), the limitations provided in section 481(b)(1) or (2) will apply to the entire amount of the adjustments ($19,000).

The provisions of section 481(b)(4), section 481(b)(6), and paragraphs (b), (c), (d), and (e) of this section shall not apply with respect to changes in methods of accounting made in taxable years beginning after December 31, 1963.

(b) Years for which amounts are to be taken into account. **(1)** If the amount of the adjustments determined in accordance with section 481(b)(4)(A) and paragraph (a) of this section would increase the taxable income of the taxpayer for the first taxable year to which section 481 applies by more than $3,000, the amount of such adjustments shall, except as provided in paragraphs (c), (d), (f), and (g) of this section, be taken into account—

(i) One-tenth in each of the 10 taxable years beginning with the taxable year of the change, or

(ii) If the taxable year of the change was a taxable year beginning after December 31, 1953, and ending after August 16, 1954, but before January 1, 1958, and if the taxpayer makes the election under section 481(b)(4)(B) in the manner provided in subparagraph (4) of this paragraph, one-tenth in each of the 10 taxable years beginning with the first taxable year which begins after December 31, 1957.

(2)(i) The 10-year period which begins with the taxable year of the change shall be reduced by the number of years in respect of which assessment of the tax is prevented by operation of any law or rule of law. In the case of a taxpayer whose taxable year of the change ended before January 1, 1958, and who elects to use the period provided for in subparagraph (1)(ii) of this paragraph, the 10-year period which begins with the first taxable year beginning after December 31, 1957, shall be reduced by the number of years which corresponds to the number of taxable years, beginning with the taxable year of the change in respect of which assessment of the tax was prevented by the operation of any law or rule of law on September 2, 1958.

(ii) In the case of such a shortened period, the portion of the adjustments to be taken into account in any one taxable year within such shortened period shall be one-tenth of such adjustments, that is, the same pro rata portion which would have been taken into account in such taxable year if the 10-year period beginning with such first taxable year had not been shortened. If, for example, in a case where the 10-year period is properly used, assessment of a deficiency is prevented with respect to 1 of the 10 taxable years in which one-tenth of the adjustments would otherwise be required to be taken into account, then only nine-tenths of such adjustments is to be taken into account ratably in the other 9 taxable years. Thus, if the adjustments required under section 481(a) amount to $10,000 and assessment of a deficiency for the calendar year 1954 (the taxable year of the change) is prevented, only nine-tenths of the adjustments, or $9,000, is to be taken into account in 1955 and the eight following taxable years at the rate of $1,000 a year. Similarly, if the taxpayer elects to begin the 10-year period with the taxable year 1958, only nine-tenths, or $9,000, is to be taken into account in 1958 and the eight following taxable years at the rate of $1,000 a year.

(3) If assessment of a deficiency is prevented with respect to a taxable year for which a prorated part would otherwise be required to be taken into account under subparagraphs (1) and (2) of this paragraph, section 481(b)(4)(B) does not reopen that year for assessment purposes.

(4) The election provided in section 481(b)(4)(B) and subparagraph (1) of this paragraph shall be made—

(i) In cases where the taxpayer requests the Commissioner's permission to change his method of accounting, at the time such request is made or at such other time as the Commissioner, prior to granting the taxpayer permission to make the change, may afford the taxpayer an opportunity to make such election; or

(ii) In cases where the taxpayer changed his method of accounting without the advance approval of the Commissioner and has not made an election to return to his former method of accounting in accordance with § 1.481–6, at any time before May 21, 1959.

The election shall be in the form of a written statement to the effect that the taxpayer elects under section 481(b)(4)(B) to take the adjustments determined in accordance with section 481(b)(4)(A) into account in the 10-year period beginning with the first taxable year beginning after December 31, 1957, and that the taxpayer agrees to include one-tenth of such adjustments in taxable income for such years in the manner provided in subparagraph (2) of this paragraph. In the case of a partnership, the election shall be made by the individual partners. In the case of a taxpayer referred to in subdivision (i) of this subparagraph, the statement of election shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C. 20224. In the case of a taxpayer referred to in subdivision (ii) of this subparagraph, the statement of election shall be filed with the district director with whom he filed his income tax return for the taxable year of the change.

(c) Limitation on years in which adjustments can be taken into account. The amount of any adjustments determined in accordance with section 481(b)(4)(A) and paragraph (a) of this section, to the extent not taken into account in prior taxable years under section 481(b)(4)(B) and paragraph (b) of this section, shall be taken into account as follows:

(1) In the case of an individual taxpayer, such amount shall be taken into account in the taxable year in which he dies or ceases to engage in a trade or business;

(2) In the case of a partner, his distributive share of such amount shall be taken into account in his taxable year in which the partnership terminates or in which his entire interest in such partnership is transferred or liquidated; or

(3) In the case of a corporation, such amount shall be taken into account in the taxable year in which the corporation ceases to engage in a trade or business, unless the amount is required to be taken into account by the acquiring corporation under section 381(c)(21) and the regulations thereunder.

(d) Election under section 481(b)(6). **(1)** Under section 481(b)(6) a taxpayer may elect to take the adjustments determined in accordance with section 481(b)(4)(A) and paragraph (a) of this section into account in the manner provided in section 481(b)(1) or (2) and paragraphs (a) or (b) of § 1.481-2 in lieu of taking such adjustments into account under the 10-year allocation rule provided in section 481(b)(4)(B) and paragraph (b) of this section. If a taxpayer makes the election under section 481(b)(6), such taxpayer may not take any portion of the adjustments into account under the 10-year allocation rule provided in section 481(b)(4)(B). In such cases, the entire amount of the adjustments required by section 481(a) is to be taken into account in computing taxable income for the taxable year of the change, subject to the limitations on tax provided in section 481(b)(1) or (2). For example, if the adjustments resulting from a change in method of accounting which occurred in 1956 amount to $25,000, of which $10,000 is attributable to pre-1954 Code years, and the taxpayer elects under section 481(b)(6) to take such adjustments into account in the manner provided by section 481(b)(1) or (2), the limitations on tax provided in section 481(b)(1) or (2) shall apply to the entire $25,000 adjustments.

(2) The election under section 481(b)(6) may be made only if the taxpayer consents in writing to the assessment, within such period as may be agreed upon with the Commissioner or district director, of any deficiency for the taxable year of the change in the method of accounting which results from taking such adjustments into account in the manner so elected, even though at the time of filing such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law.

(3) The election provided in section 481(b)(6) shall be made within the time prescribed by law for filing the return (including extensions of time therefor) for the taxable year of the change, or within 90 days after the date on which the Commissioner grants permission to the taxpayer to change his method of accounting, or at any time before May 21, whichever is later. The statement shall be filed with the district director with whom the taxpayer files his income tax return for the taxable year of the change and shall be attached to the return for such year or, in the case of returns previously filed, the statement shall be attached to the necessary amended return or returns.

(e) Example. The application of the provisions of this section may be illustrated by the following examples:

Example (1). X Corporation has been filing its income tax returns and keeping its books on the cash receipts and disbursements method of accounting for the calendar year. It requests, and is granted, the permission of the Commissioner, effective with the calendar year 1960, to change to an accrual method of accounting. As of January 1, 1954, the taxpayer had an opening inventory of $20,000, accounts receivable of $22,000, and accounts payable of $14,000. As of January 1, 1960, its records reflect an opening inventory of $34,000, accounts receivable of $32,000, and accounts payable of $19,000. The

corporation has no other items which require adjustment under section 481(a). The adjustments required to be made by X Corporation in 1960 under section 481(a) amount to $47,000 ($34,000 plus $32,000 less $19,000). The amount of the adjustments which X Corporation would have been required to make if it had changed its method of accounting for the calendar year 1954 is $28,000 ($20,000 plus $22,000 less $14,000). Since such $28,000 of adjustments in respect of pre-1954 Code years would increase the taxable income for 1954 by more than $3,000, and since the adjustments are attributable to a change in method of accounting initiated by the taxpayer, such $28,000 of adjustments shall be taken into account under section 481(b)(4)(B) and paragraph (b) of § 1.481–4, unless X Corporation elects under section 481(b)(6) to have the limitations on tax provided by section 481(b)(1) or (2) apply to such adjustments. The remaining portion ($19,000) of the adjustments required by section 481(a) is to be taken into account in 1960, subject, however, to the tax limitation applicable under the 3-year allocation method of section 481(b)(1) or the new-accounting-method allocation under section 481(b)(2).

Example (2). If the facts in example (1) were the same except that as of January 1, 1960, the three adjustments are such that only $20,000 of adjustments is required to be taken into account under section 481(a) for 1960, then the entire amount of adjustments ($20,000) is to be taken into account in the manner provided by section 481(b)(4) or section 481(b)(6) since such amount does not exceed the $28,000 of adjustments that would have been required if the taxpayer had changed its method of accounting for the calendar year 1954.

(f) Special rule for pre-1954 adjustments in case of certain decedents. Section 481(b)(5) provides a special rule in respect of the tax attributable to pre-1954 adjustments in the case of a change from the cash receipts and disbursements method to an accrual method involving the use of inventories made on or after August 16, 1954, and before January 1, 1958, for a taxable year to which section 481 applies, by the executor or administrator of a decedent's estate in the first income tax return filed by such executor or administrator on behalf of the decedent. Such rule provides that—

(1) Such a change shall be given effect in determining taxable income (other than for the purpose of computing a net operating loss carryback to any prior taxable year of the decedent); and

(2) If the adjustments required by section 481(a) in respect of taxable years to which section 481 does not apply would increase taxable income of the decedent by more than $3,000, then the tax attributable to such adjustments shall not exceed an amount equal to the tax that would have been payable on the cash receipts and disbursements method for the years for which the executor or administrator filed income tax returns on behalf of the decedent, computed for each such year as though a ratable portion of the taxable income for such year had been received in each of 10 taxable years beginning and ending on the same dates as the taxable year for which the tax is being computed.

(g) Exception for certain agreements. (1) Section 29(d)(2) of the Technical Amendments Act of 1958 (72 Stat. 1629) provides as follows:

Sec. 29. Adjustments required by changes in method of accounting. * * *

(d) Effective date. * * *

(2) Exception for certain agreements. The amendments made by subsections (a), (b)(1), and (c) shall not apply if before the date of the enactment of this Act—

(A) The taxpayer applied for a change in the method of accounting in the manner provided by regulations prescribed by the Secretary of the Treasury or his delegate, and

(B) The taxpayer and the Secretary of the Treasury or his delegate agreed to the terms and conditions for making the change.

(2) The amendments made to section 481 by section 29 (other than paragraphs 2 through 5 of subsection (b)) of the Technical Amendments Act of 1958 shall not apply if, before September 2, 1958, the taxpayer applied for a change in method of accounting in the manner provided by any Federal income tax regulation and the taxpayer and the Commissioner agreed to the terms and conditions for making the change.

(3) A taxpayer who, in accordance with any provision of the Code or of any Federal income tax regulation permitting such action, elected to change his method of accounting with regard to one or more material items, such as research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), last-in, first-out inventories (section 472), and exploration expenditures (section 615), and who satisfied the requirements of the regulations dealing with such elections, shall be treated for purposes of section 29(d)(2) of the Technical Amendments Act of 1958 as a taxpayer who applied for and changed his method of accounting in the manner provided by regulations and who agreed to the terms and conditions for making the change.

[T.D. 6500, 25 FR 11735, Nov. 26, 1960]

§ 1.481–5 Adjustments taken into account with consent.

(a) In addition to the methods of allocation described in section 481(b), the adjustments required by section 481(a) may be taken into account in computing the tax under chapter 1 of the Code for such taxable years, in such manner and subject to such conditions as may be agreed upon between the Commissioner and the taxpayer. See section 481(c). Requests for approval of a method of allocation differing from those described in section 481(b) shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Wash-

ington, D.C. 20224, and shall set forth in detail the facts and circumstances upon which the taxpayer bases his request. Permission will be granted only if the taxpayer and the Commissioner agree to the terms and conditions under which the allocation is to be effected.

(b) The agreement shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each such year. The agreement shall be binding on the parties except upon a showing of fraud, malfeasance, or misrepresentation of a material fact.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.481–6 Election to return to former method of accounting.

(a) Section 29(e) of the Technical Amendments Act of 1958 (72 Stat. 1629) provides as follows:

Sec. 29. Adjustments required by changes in method of accounting. * * *

(e) Election to return to former method of accounting—(1) Election. Any taxpayer who for any taxable year beginning after December 31, 1953, and ending after August 16, 1954, and before the date of enactment of this Act, computed his taxable income under a method of accounting different from the method under which his taxable income for the preceding taxable year was computed, may elect to recompute his taxable income, beginning with the taxable year for which taxable income was computed under such different method of accounting, under the method of accounting under which taxable income was computed for such preceding taxable year. An election under this paragraph shall be made within 6 months after the date of the enactment of this Act, and shall be made in such manner as the Secretary of the Treasury or his delegate may provide. This paragraph shall not apply to any taxpayer—

(A) To whom subsection (d)(2) applies, or

(B) Who was required, before the date of the enactment of this Act, by the Secretary of the Treasury or his delegate to change his method of accounting.

(2) Statute of limitations. If assessment of any deficiency for any taxable year resulting from an election under paragraph (1) is prevented on the date on which such election is made, or at any time within one year after such date, by the operation of any law or rule of law, such assessment may, nevertheless, be made if made within one year after such date. An election by a taxpayer under paragraph (1) shall be considered as a consent to the assessment pursuant to this paragraph of any such deficiency. If refund or credit of any overpayment of income tax resulting from an election under paragraph (1) is prevented on the date on which such election is made, or at any time within one year after such date, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within one year after such date.

(b) Except as provided in paragraph (e) of this section, a taxpayer who for any taxable year beginning after December 31, 1953, and ending after August 16, 1954, but before September 2, 1958, computed his taxable income under a method of accounting different from the method used for the immediately preceding taxable year may elect to recompute his taxable income, beginning with the taxable year for which such method was first used, under the method used for such preceding taxable year.

(c) The election referred to in paragraph (b) of this section shall be made in the following manner:

(1) On or before March 2, 1959, the taxpayer shall file with the district director with whom he filed his income tax return for the taxable year of the change a statement to the effect that he elects to recompute his taxable income, beginning with the first taxable year for which he computed his taxable income under a method of accounting different from the preceding taxable year, under the method used for such preceding taxable year. The statement shall indicate the first taxable year for which taxable income was computed under a different method of accounting; and

(2) On or before June 1, 1959, the taxpayer shall file amended income tax returns for all taxable years affected by the election with a statement attached thereto showing the recomputation of taxable income for such taxable years under the method of accounting which he used in computing taxable income for the taxable year immediately preceding the taxable year of the change. The taxpayer shall also compute the amount of deficiency or overassessment in tax resulting from such recomputation of taxable income.

(d)(1) If assessment of a deficiency for any taxable year resulting from an election under this section is prevented on the date on which the election is made, or at any time within one year after such date, by the operation of any law or rule of law, such assessment may, nevertheless, be made within one year after such date. An election under this section shall be considered as a consent to the assessment of any such deficiency.

(2) If refund or credit of any overpayment of income tax resulting from an election under this section is prevented on the date on which such election is made, or at any time within one year after such date, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed if a claim for such refund or credit is filed within one year after such date.

(e) An election under this section may not be made by a taxpayer—

(1) To whom paragraph (g) of § 1.481–4, relating to exception for certain agreements, applies, or

(2) Who was required, before September 2, 1958, by the Commissioner or district director to change his method of accounting.

For purposes of subparagraph (2) of this paragraph, a taxpayer, who on his own initiative, changed his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to be a taxpayer who was required, for purposes of section 481, to change his method of accounting.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.482–1 Allocation of income and deductions among taxpayers.

(a) Definitions. When used in this section and in § 1.482–2—

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) Scope and purpose. (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) **Application.** Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(d) **Method of allocation.** (1) The method of allocating, apportioning, or distributing income, deductions, credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See § 1.482–2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U.S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the U.S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the U.S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U.S. income tax liability of such member for a later taxable year, or for the purposes of determining the U.S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

(i) The date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such adjustment,

(ii) Acceptance of a Form 870–AD (Offer of Waiver of Restriction on Assessment and Collection Deficiency in Tax and Acceptance of Overassessment),

(iii) Payment of the deficiency,

(iv) Stipulation in the Tax Court of the United States, or

(v) Final determination of tax liability by offer-in-compromise, closing agreement, or court action.

The principles of this subparagraph may be illustrated by the following examples in each of which it is assumed that X and Y are members of the same group of controlled entities and that they

regularly compute their incomes on the basis of a calendar year:

Example (1). Assume that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length rental charge for Y's use of X's tangible property in 1966; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. The primary adjustment is therefore considered to have been made in 1968. Assume further that both X and Y are United States corporations and that Y had net operating losses in 1963, 1964, 1965, 1966, and 1967. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability for any pending taxable year, an adjustment increasing Y's net operating loss for 1966 shall be deemed to have been made for the purposes of determining Y's U.S. income tax liability for 1968 or a later taxable year to which the increased operating loss may be carried. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (2). Assume that X and Y are United States corporations; that X is in the business of rendering engineering services; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length fee for the rendition of engineering services by X in 1966 relating to the construction of Y's factory; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Assume further that fees for such services would properly constitute a capital expenditure by Y, and that Y does not place the factory in service until 1969. Although a correlative adjustment (increase in basis) would not have an effect on Y's U.S. income tax liability for a pending taxable year, an adjustment increasing the basis of Y's assets for 1966 shall be deemed to have been made in 1968 for the purpose of computing allowable depreciation or gain or loss on disposition for 1969 and any future taxable year. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (3). Assume that X is a U.S. taxpayer and Y is a foreign taxpayer not engaged in a trade or business in the United States; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length interest charge on a loan made to Y; that X consents to an assessment reflecting such allocation by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Although a correlative adjustment would not have an effect on Y's U.S. income tax liability, an adjustment in Y's income for 1966 shall be deemed to have been made in 1968 for the purposes of determining the amount of Y's earnings and profits for 1966 and subsequent years, and of any other effect it may have on any person's U.S. income tax liability for any taxable year. The district director shall notify X in writing of the amount and nature of the allocation which is deemed to have been made to Y.

(3) In making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director shall consider the effect upon such members of an arrangement between them for reimbursement within a reasonable period before or after the taxable year if the taxpayer can establish that such an arrangement in fact existed during the taxable year under consideration. The district director shall also consider the effect of any other nonarm's length transaction between them in the taxable year which, if taken into account, would result in a set-off against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. For purposes of the preceding sentence, the term arm's length refers to the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances considering all the relevant facts and without regard to the rules found in § 1.482-2 by which certain charges are deemed to be equal to arm's length. For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the first member as a result of the other activities will be set-off against the allocation which would otherwise be made. If the effect of the set-off is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the United States tax liability of any member, allocations will be made to reflect the correct amount of each category of income or deductions. In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later. The principles of this subparagraph may be illustrated by the following examples, in each of which it is assumed that P and S are calendar year corporations and are both members of the same group of controlled entities:

Example (1). P performs services in 1966 for the benefit of S in connection with S's manufacture and sale of a product. S does not pay P for such services in 1966, but in consideration for such services, agrees in 1966 to pay P a percentage of the amount of sales of the product in 1966 through 1970. In 1966 it appeared this agreement would provide adequate considera-

tion for the services. No allocation will be made with respect to the services performed by P.

Example (2). P renders services to S in connection with the construction of S's factory. An arm's length charge for such services, determined under paragraph (b) of § 1.482–2, would be $100,000. During the same taxable year P makes available to S a machine to be used in such construction. P bills S $125,000 for the services, but does not bill for the use of the machine. No allocation will be made with respect to the excessive charge for services or the undercharge for the machine if P can establish that the excessive charge for services was equal to an arm's length charge for the use of the machine, and if the taxable income and income tax liabilities of P and S are not distorted.

Example (3). Assume the same facts as in example (2), except that, if P had reported $25,000 as rental income and $25,000 less service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in § 1.482–2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, if one member of a controlled group sells a product at less than an arm's length price to a second member of the group in one taxable year and the second member resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year. Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

(5) Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss. See, for example, "National Securities Corporation v. Commissioner of Internal Revenue", 137 F.2d 600 (3d Cir. 1943), cert. denied 320 U.S. 794 (1943).

(6) If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be treated as deferrable income or deductions, providing the taxpayer has, for the year to which the distributions, apportionments, or allocations relate, elected to use a method of accounting in which the reporting of deferrable income is deferred until the income ceases to be deferrable income. Under such method of accounting, referred to in this section as the deferred income method of accounting, any payments or reimbursements which were prevented or would have been prevented, and any deductions attributable directly or indirectly to such payments or reimbursements, shall be deferred until they cease to be deferrable under such method of accounting. If such method of accounting has not been elected with respect to the taxable year to which the allocations under section 482 relate, the taxpayer may elect such method with respect to such allocations (but not with respect to other deferrable income) at any time before the first occurring of the following events with respect to the allocations:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments reflecting such allocations or before July 16, 1968, whichever is later; or

(iii) Execution of a closing agreement or offer-in-compromise.

The principles of this subparagraph may be illustrated by the following example in which it is assumed that X, a domestic corporation, and Y, a foreign corporation, are members of the same group of controlled entities:

Example. X, which is in the business of rendering a certain type of service to unrelated parties, renders such services for the benefit of Y in 1965. The direct and indirect costs allocable to such services are $60,000, and an arm's length charge for such services is $100,000. Assume that the district director proposes to increase X's income by $100,000, but that the country in which Y is located would have blocked payment

in 1965 for such services. If, prior to the first occurring of the events described in subdivisions (i), (ii), or (iii) of this subparagraph, X elects to use the deferred income method of accounting with respect to such allocation, the $100,000 allocation and the $60,000 of costs are deferrable until such amounts cease to be deferrable under X's method of accounting.

[T.D. 6595, 27 FR 3598, April 14, 1962, as amended by T.D. 6952, 33 FR 5848, April 16, 1968]

§ 1.482–2 Determination of taxable income in specific situations.

(a) Loans or advances—(1) Interest on bona fide indebtedness—(i) In general. Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest (as defined in paragraph (a)(2) of this section) with respect to such loan or advance, the district directory may make appropriate allocations to reflect an arm's length rate of interest for the use of such loan or advance.

(ii) Application of paragraph (a) of this section—(A) Interest on bona fide indebtedness. Paragraph (a) of this section applies only to determine the appropriateness of the rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled entities, including—

(1) Loans or advances of money or other consideration (whether or not evidenced by a written instrument), and

(2) Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

(B) Alleged indebtedness. This paragraph (a) does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness, even if the stated rate of interest thereon would be within the safe haven rates prescribed in paragraph (a)(2)(iii) of this section. For example, paragraph (a) of this section does not apply to payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares. Similarly, this paragraph (a) does not apply to payments with respect to an alleged purchase-money debt instrument given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property. Payments made with respect to alleged indebtedness (including alleged stated interest thereon) shall be treated according to their substance. See § 1.482-2(a)(3)(i).

(iii) Period for which interest shall be charged—(A) General rule. This paragraph (a)(1)(iii) is effective for indebtedness arising after June 30, 1988. See 26 CFR 1.482-2(a)(3) (revised as of April 1, 1988) for indebtedness arising before July 1, 1988. Except as otherwise provided in paragraphs (a)(1)(iii)(B) through (E) of this section, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise.) Paragraphs (a)(2)(iii)(B) through (E) of this section provide certain alternative periods during which interest is not required to be charged on certain indebtedness. These exceptions apply only to indebtedness described in paragraph (a)(1)(ii)(A)(2) of this section (relating to indebtedness incurred in the ordinary course of business from sales, services, etc., between members of the group) and not evidenced by a written instrument requiring the payment of interest. Such amounts are hereinafter referred to as "intercompany trade receivables". The period for which interest is not required to be changed on intercompany trade receivables under this paragraph (a)(1)(iii) is called the "interest-free period". In general, an intercompany trade receivable arises at the time economic performance occurs (within the meaning of section 461(h) and the regulations thereunder) with respect to the underlying transaction between controlled entities. For purpose of this paragraph (a)(1)(iii), the term "United States" includes any possession of the United States, and the term "foreign country" excludes any possession of the United States.

(B) Exception for certain intercompany transactions in the ordinary course of business. Interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises.

(C) Exception for trade or business of debtor member located outside the United States. In the case of an intercompany trade receivable arising from a transaction in the ordinary course of a trade or business which is actively conducted outside the United States by the debtor member, interest is not required to be charged until the first day of the fourth calendar month following the month in which such intercompany trade receivable arises.

(D) Exception for regular trade practice of creditor member or others in creditor's industry. If the creditor member or unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated parties a longer period without charging interest than that described in paragraph (a)(1)(iii) (B) or (C) of this section (whichever is applicable) with respect to transactions which are similar to transactions that give rise to intercompany trade receivables, such longer interest-free period shall be allowed with respect a comparable amount of intercompany trade receivables.

(E) Exception for property purchased for resale in a foreign country—(1) General rule. If in the ordinary course of business one member of the group (the "related purchaser") purchases property from another member of the group (the "related seller") for resale to unrelated persons located in a particular foreign country, the related purchaser and the related seller may use as the interest-free period for the intercompany trade receivables arising during the related seller's taxable year from the purchase of such property within the same product group an interest-free period equal the sum of—

(i) The number of days in the related purchaser's average collection period (as determined under paragraph (a)(1)(iii)(E)(2) of this section) for sales of property within the same product group sold in the ordinary course of business to unrelated persons located in the same foreign country, plus

(ii) Ten (10) calendar days.

The interest-free period under this paragraph (a)(1)(iii)(E), however, shall in no event exceed 183 days. The related purchaser does not have to conduct business outside the United States in order to be eligible to use the interest-free period of this paragraph (a)(1)(iii)(E). The interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to intercompany trade receivables attributable to property which is manufactured, produced, or constructed (within the meaning of § 1.954-3(a)(4)) by the related purchaser. For purposes of this paragraph (a)(1)(iii)(E) a product group includes all products within the same three-digit Standard Industrial Classification (SIC) Code (as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President).

(2) Average collection period. An average collection period for purposes of this paragraph (a)(1)(iii)(E) is determined as follows:

(i) Step 1. Determine total sales (less returns and allowances) by the related purchaser in the product group to unrelated persons located in the same foreign country during the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(ii) Step 2. Determine the related purchaser's average month-end accounts receivable balance with respect to sales described in paragraph (a)(1)(iii)(E)(2)(i) for the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(iii) Step 3. Compute a receivables turnover rate by dividing the total sales amount described in paragraph (a)(1)(iii)(E)(2)(i) of this section by the average receivables balance described in paragraph (a)(1)(iii)(E)(2)(ii) of this section.

(iv) Step 4. Divide the receivables turnover rate determined under (a)(1)(iii)(E)(2)(iii) of this section into 365, and round the result to the nearest whole number to determine the number of days in the average collection period.

If the related purchaser makes sales in more than one foreign country, or sells property in more than one product group in any foreign country, separate computations of an average collection period, by product group within each country, are required. If the related purchaser resells fungible property in more than one foreign country and the intercompany trade receivables arising from the related party purchase of such fungible property cannot reasonably be identified with resales in particular foreign countries, then solely for the purpose of assigning an interest-free period to such intercompany trade receivables under this paragraph (a)(1)(iii)(E), an amount of each such intercompany trade receivable shall be treated as allocable to a particular foreign country in the same proportion that the related purchaser's sales of such fungible property in such foreign country during the period described in paragraph (a)(1)(iii)(E)(2)(i) of this section bears to the related purchaser's sales of all such fungible property in all such foreign countries during such period. An interest-free period under this paragraph (a)(1)(iii)(E) shall not apply to any intercompany trade receivables arising in a taxable year of the related seller if the related purchaser made no sales described in paragraph (a)(1)(iii)(E)(2)(i) of this section from which the appropriate interest-free period may be determined.

(3) Illustration. The interest-free period provided under paragraph (a)(1)(iii)(E) of this section may be illustrated by the following example:

Example—(i) Facts. X and Y use the calendar year as the taxable year and are members of the same group of controlled entities within the meaning of section 482. For Y's 1988 calendar taxable year X and Y intend to use the interest-free period determined under this paragraph (a)(1)(iii)(E) for intercompany trade receivables attributable to X's purchases of certain products from Y for resale by X in the ordinary course of business to unrelated persons in country Z. For its 1987 calendar taxable year all of X's sales in country Z were of products within a single product group based upon a three-digit SIC code, were not manufactured, produced, or constructed (within the meaning of § 1.954-3(a)(4)) by X, and were sold in the ordinary course of X's trade or business to unrelated persons located only in country Z. These sales and the month-end accounts receivable balances (for such sales and for such sales uncollected from prior months) are as follows:

Month (1987)	Sales	Accounts receivable
January	$500,000	$2,835,850
February	600,000	2,840,300
March	450,000	2,850,670
April	550,000	2,825,700
May	650,000	2,809,360
June	525,000	2,803,200
July	400,000	2,825,850
August	425,000	2,796,240
September	475,000	2,839,390
October	525,000	2,650,550
November	450,000	2,775,450
December	650,000	2,812,000
Totals	6,200,000	$33,665,160

(ii) Average collection period. X's total sales within the same product group to unrelated persons within country Z for the period are $6,200,000. The average receivables balance for the period is $2,805,430 ($33,665,160/12). The average collection period in whole days is determined as follows:

$$\text{Receivables turnover rate} = \frac{\$6{,}200{,}000}{\$2{,}805{,}430} = 2.21$$

$$\text{Average collection period} = \frac{365}{2.21} = \text{165.16 days,}$$

rounded to the nearest whole day = 165 days.

(iii) Interest-free period. Accordingly, for intercompany trade receivables incurred by X during Y's 1988 calendar taxable year attributable to the purchase of property from Y for resale to unrelated persons located in country Z and included in the product group, X may use an interest-free period of 175 days (165 days in the average collection period plus 10 days, but not in excess of a maximum of 183 days). All other intercompany trade receivables incurred by X are subject to the interest-free periods described in paragraphs (a)(1)(iii) (B), (C), or (D), whichever are applicable. If X makes sales in other foreign countries in addition to country Z or makes sales of property in more than one product group in any foreign country, separate computations of X's average collection period, by product group within each country, are required in order for X and Y to determine an interest-free period for such product groups in such foreign countries under this paragraph (a)(1)(iii)(E).

(iv) **Payment; book entries.** (A) Except as otherwise provided in this paragraph (a)(1)(iv), in determining the period of time for which an amount owed by one member of the group to another member is outstanding, payments or other credits to an account are considered to be applied against the earliest amount outstanding, that is, payments or credits are applied against amounts in a first-in, first-out (FIFO) order. Thus, tracing payments to individual intercompany trade receivables is generally not required in order to determine whether a particular intercompany trade receivable has been paid within the applicable interest-free period determined under paragraph (a)(1)(iii) of this section. The application of this paragraph (a)(1)(iv)(A) may be illustrated by the following example:

Example—(i) Facts. X and Y are members of a group of controlled entities within the meaning of section 482. Assume that the balance of intercompany trade receivables owed by X to Y on June 1 is $100, and that all of the $100 balance represents amounts incurred by X to Y during the month of May. During the month of June X incurs an additional $200 of intercompany trade receivables to Y. Assume that on July 15, $60 is properly credited against X's intercompany account to Y, and that $240 is properly credited against the intercompany account on August 31. Assume that under paragraph (a)(1)(iii)(B) of this section interest must be charged on X's intercompany trade receivables to Y beginning with the first day of the third calendar month following the month the intercompany trade receivables arise, and that no alternative interest-free period applies. Thus, the interest-free period for intercompany trade receivables incurred during the month of May ends on July 31, and the interest-free period for intercompany trade receivables incurred during the month of June ends on August 31.

(ii) Application of payments. Using a FIFO payment order, the aggregate payments of $300 are applied first to the opening June balance, and then to the additional amounts incurred during the month of June. With respect to X's June opening balance of $100, no interest is required to be accrued on $60 of such balance paid by X on July 15, because such portion was paid within its interest-free period. Interest for 31 days, from August 1 to August 31 inclusive, is required to be accrued on the $40 portion of the opening balance not paid until August 31. No interest is required to be accrued on the $200 of intercompany trade receivables X incurred to Y during June because the $240 credited on August 31, after eliminating the $40 of indebtedness remaining from periods before June, also eliminated the $20 incurred by X during June prior to the end of the interest-free period for that amount. The amount of interest incurred by X to Y on the $40 amount during August creates bona fide indebtedness between controlled entities and is subject to the provisions of paragraph (a)(1)(iii)(A) of this section without regard to any of the exceptions contained in paragraphs (a)(1)(iii) (B) through (E) of this section.

(B) Notwithstanding the first-in, first-out payment application rule described in paragraph (a)(1)(iv)(A) of this section, the taxpayer may

apply payments or credits against amounts owed in some other order on its books in accordance with an agreement or understanding of the related parties if the taxpayer can demonstrate that either it or others in its industry, as a regular trade practice, enter into such agreements or understandings in the case of similar balances with unrelated parties.

(2) **Arm's length interest rate—(i) In general.** For purposes of section 482 and paragraph (a) of this section, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

(ii) Funds obtained at situs of borrower. Notwithstanding the other provisions of paragraph (a)(2) of this section, if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

(iii) Safe haven interest rates for certain loans and advances made after May 8, 1986—(A) Applicability—(1) General rule. Except as otherwise provided in paragraph (a)(2) of this section, paragraph (a)(2)(iii)(B) of this section applies with respect to the rate of interest charged and to the amount of interest paid or accrued in any taxable year—

(i) Under a term loan or advance between members of a group of controlled entities where (except as provided in paragraph (a)(2)(iii)(A)(2)(ii)) of this section the loan or advance is entered into after May 8, 1986, and

(ii) After May 8, 1986, under a demand loan or advance between such controlled entities.

(2) Grandfather rule for existing loans. The safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the safe haven rates prescribed in 26 CFR § 1.482-2(a)(2)(iii) (revised as of April 1, 1985) shall apply to—

(i) Term loans or advances made before May 9, 1986, and

(ii) Term loans or advances made before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(B) Safe haven interest rate based on applicable Federal rate. Except as otherwise provided in this paragraph (a)(2), in the case of a loan or advance between members of a group of controlled entities, an arm's length rate of interest referred to in paragraph (a)(2)(i) of this section shall be for purposes of Chapter 1 of the Code—

(1) The rate of interest actually charged if that rate is—

(i) Not less than 100 percent of the applicable Federal rate (the "lower limit"), and

(ii) Not greater than 130 percent of the applicable Federal rate (the "upper limit'), or

(2) If either no interest is charged or if the rate of interest charged is less than the lower limit, then an arm's length rate of interest shall be equal to the lower limit, compounded semiannually, or

(3) If the rate of interest charged is greater than the upper limit, then an arm's length rate of interest shall be equal to the upper limit, compounded semiannually,

unless the taxpayer establishes a more appropriate compound rate of interest under paragraph (a)(2)(i) of this section. However, if the compound rate of interest actually charged is greater than the upper limit and less than the rate determined under paragraph (a)(2)(i) of this section, or if the compound rate actually charged is less than the lower limit and greater than the rate determined under paragraph (a)(2)(i) of this section, then the compound rate actually charged shall be deemed to be an arm's length rate under paragraph (a)(2)(i) of this section. In the case of any sale-leaseback described in section 1274(e), the lower limit shall be 110 percent of the applicable Federal rate, compounded semiannually.

(C) Applicable Federal rate. For purposes of paragraph (a)(2)(iii)(B) of this section, the term "applicable Federal rate" means, in the case of a loan or advance to which this section applies and having a term of—

(1) Not over 3 years, the Federal short-term rate.

(2) Over 3 years but not over 9 years, the Federal mid-term rate, or

(3) Over 9 years, the Federal long-term rate, as determined under section 1274(d) in effect on the date such loan or advance is made. In the case of any sale or exchange between controlled entities, the lower limit shall be the lowest of the applicable Federal rates in effect for any month in the 3-calendar-month period ending with the first calendar month in which there is a binding written contract in effect for such sale or exchange (the "lowest 3-month rate", as defined in section 1274(d)(2)). In the case of a demand loan or advance to which this section applies, the "applicable Federal rate" means the Federal short-term rate determined under section 1274(d) (determined without regard to the lowest 3-month short-term rate determined under section 1274(d)(2)) in effect for each day on which any amount of such loan or advance (including unpaid accrued interest determined under paragraph (a)(2) of this section) is outstanding.

(D) Lender in business of making loans. If the lender in a loan or advance transaction to which paragraph (a)(2) of this section applies is regularly engaged in the trade or business or making loans or advances to unrelated parties, the safe haven rates prescribed in paragraph (a)(2)(iii)(B) of this section shall not apply, and the arm's length interest rate to be used shall be determined under the standards described in paragraph (a)(2)(i) of this section, including reference to the interest rates charged in such trade or business by the lender on loans or advances of a similar type made to unrelated parties at and about the time the loan or advance to which paragraph (a)(2) of this section applies was made.

(E) Foreign currency loans. The safe haven interest rates prescribed in paragraph (a)(2)(iii)(B) of this section do not apply to any loan or advance the principal or interest of which is expressed in a currency other than U.S. dollars.

(3) Coordination with interest adjustments required under certain other Code sections. If the stated rate of interest on the stated principal amount of a loan or advance between controlled entities is subject to adjustment under section 482 and is also subject to adjustment under any other section of the Code (for example, section 467, 483, 1274 or 7872), section 482 and paragraph (a) of this section may be applied to such loan or advance in addition to such other Code section. After the enactment of the Tax Reform Act of 1984, Pub. L. 98-369, and the enactment of Pub. L. 99-121, such other Code sections include sections 467, 483, 1274 and 7872. The order in which the different provisions shall be applied is as follows:

(i) First, the substance of the transaction shall be determined; for this purpose, all the relevant facts and circumstances shall be considered and any law or rule of law (assignment of income, step transaction, etc.) may apply. Only the rate of interest with respect to the stated principal amount of the bona fide indebtedness (within the meaning of paragraph (a)(1) of this section), if any, shall be subject to adjustment under section 482, paragraph (a) of this section, and any other Code section.

(ii) Second, the other Code section shall be applied to the loan or advance to determine whether any amount other than stated interest is to be treated as interest, and if so, to determine such amount according to the provisions of such other Code section.

(iii) Third, whether or not the other Code section applies to adjust the amounts treated as interest under such loan or advance, section 482 and paragraph (a) of this section may then be applied by the district director to determine whether the rate of interest charged on the loan or advance, as adjusted by any other Code section, is greater or less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(iv) Fourth, section 482 and paragraphs (b) through (e) of this section, if applicable, may be applied by the district director to make any appropriate allocations, other than an interest rate adjustment, to reflect an arm's length transaction based upon the principal amount of the loan or advance and the interest rate as adjusted under paragraph (a)(3) (i), (ii) or (iii) of this section. For example, assume that two commonly controlled taxpayers enter into a deferred payment sale of tangible property and no interest is provided, and assume also that section 483 is applied to treat a portion of the stated sales price as interest, thereby reducing the stated sales price. If after this recharacterization of a portion of the stated sales price as interest, the recomputed sales price does not reflect an arm's length sales price under the principles of paragraph (e) of this section, the district director may make other appropriate allocations (other than an interest rate adjustment) to reflect an arm's length sales price.

(4) Examples. The principles of paragraph (a)(3) of this section may be illustrated by the following examples:

Example (1). An individual, A, transfers $20,000 to a corporation controlled by A in exchange for the corporation's note

which bears adequate stated interest. The district director recharacterizes the transaction as a contribution to the capital of the corporation in exchange for preferred stock. Under paragraph (a)(3)(i) of this section, section 1.482-2(a) does not apply to the transaction because there is no bona fide indebtedness.

Example (2). B, an individual, is an employee of Z corporation, and is also the controlling shareholder of Z. Z makes a term loan of $15,000 to B at a rate of interest that is less than the applicable Federal rate. In this instance the other operative Code section is section 7872. Under section 7872(b), the difference between the amount loaned and the present value of all payments due under the loan using a discount rate equal to 100 percent of the applicable Federal rate is treated as an amount of cash transferred from the corporation to B and the loan is treated as having original issue discount equal to such amount. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may also be applied by the district director to determine if the rate of interest charged on this $15,000 loan (100 percent of the AFR, compounded semiannually, as adjusted by section 7872) is an arm's length rate of interest. Because the rate of interest on the loan, as adjusted by section 7872, is within the safe haven range of 100-130 percent of the AFR, compounded semiannually, no further interest rate adjustments under section 482 and paragraph (a) of this section will be made to this loan.

Example (3). The facts are the same as in example (2) except that the amount lent by Z to B is 9,000, and that amount is the aggregate outstanding amount of loans between Z and B. Under the $10,000 de minimis exception of section 7872(c)(3), no adjustment for interest will be made to this $9,000 loan under section 7872. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $9,000 loan to determine whether the rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

Example (4). X and Y are commonly controlled taxpayers. At a time when the applicable Federal rate is 12 percent, compounded semiannually, X sells property to Y in exchange for a note with a stated rate of interest of 18 percent, compounded semiannually. Assume that the other applicable Code section to the transaction is section 483. Section 483 does not apply to this transaction because, under section 483(d), there is not total unstated interest under the contract using the test rate of interest equal to 100 percent of the applicable Federal rate. Under paragraph (a)(3)(iii) of this section, section 482 and paragraph (a) of this section may be applied by the district director to determine whether the rate of interest under the note is excessive, that is, to determine whether the 18 percent stated interest rate under the note exceeds an arm's length rate of interest.

Example (5). Assume that A and B are commonly controlled taxpayers and that the applicable Federal rate is 10 percent, compounded semiannually. On June 30, 1986, A sells property to B and receives in exchange B's purchase-money note in the amount of $2,000,000. The stated interest rate on the note is 9%, compounded semiannually, and the stated redemption price at maturity on the note is $2,000,000. Assume that the other applicable Code section to this transaction is section 1274. As provided in section 1274A(a) and (b), the discount rate for purposes of section 1274 will be nine percent, compounded semiannually, because the stated principal amount of B's note does not exceed $2,800,000. Section 1274 does not apply to this transaction because there is adequate stated interest on the debt instrument using a discount rate equal to 9%, compounded semiannually, and the stated redemption price at maturity does not exceed the stated principal amount. Under paragraph (a)(3)(iii) of this section, the district director may apply section 482 and paragraph (a) of this section to this $2,000,000 note to determine whether the 9% rate of interest charged is less than an arm's length rate of interest, and if so, to make appropriate allocations to reflect an arm's length rate of interest.

(b) Performance of services for another—(1) General rule. Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in subparagraph (3) of this paragraph, the district director may make appropriate allocations to reflect an arm's length charge for such services.

(2) Benefit test. (i) Allocations may be made to reflect arm's length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities, as well as with respect to services performed by one member of the group exclusively for the benefit of another member of the group. Any allocations made shall be consistent with the relative benefits intended from the services, based upon the facts known at the time the services were rendered, and shall be made even if the potential benefits anticipated are not realized. No allocations shall be made if the probable benefits to the other members were so indirect or remote that unrelated parties would not have charged for such services. In general, allocations may be made if the service, at the time it was performed, related to the carrying on of an activity by another member or was intended to benefit another member, either in the member's overall operations or in its day-to-day activities. The principles of this subdivision may be illustrated by the following examples in each of which it is assumed that X and Y are corporate members of the same group of controlled entities:

Example (1). X's International Division engages in a wide range of sales promotion activities. Although most of these activities are undertaken exclusively for the benefit of X's international operations, some are intended to jointly benefit both X and Y and others are undertaken exclusively for the benefit of Y. The district director may make an allocation to reflect an arm's length charge with respect to the activities undertaken for the joint benefit of X and Y consistent with the relative benefits intended as well as with respect to the services performed exclusively for the benefit of Y.

Example (2). X operates an international airline, and Y owns and operates hotels in several cities which are serviced by X. X, in conjunction with its advertising of the airline, often pictures Y's hotels and mentions Y's name. Although such advertising was primarily intended to benefit X's airline operations, it was reasonable to anticipate that there would be substantial benefits to Y resulting from patronage by travelers who responded to X's advertising. Since an unrelated hotel operator would have been charged for such advertising, the

district director may make an appropriate allocation to reflect an arm's length charge consistent with the relative benefits intended.

Example (3). Assume the same facts as in Example (2) except that X's advertising neither mentions nor pictures Y's hotels. Although it is reasonable to anticipate that increased air travel attributable to X's advertising will result in some benefit to Y due to increased patronage by air travelers, the district director will not make an allocation with respect to such advertising since the probable benefit to Y was so indirect and remote that an unrelated hotel operator would not have been charged for such advertising.

(ii) Allocations will generally not be made if the service is merely a duplication of a service which the related party has independently performed or is performing for itself. In this connection, the ability to independently perform the service (in terms of qualification and availability of personnel) shall be taken into account. The principles of this subdivision may be illustrated by the following examples, in each of which it is assumed that X and Y are corporate members of the same group of controlled entities:

Example (1). At the request of Y, the financial staff of X makes an analysis to determine the amount and source of the borrowing needs of Y. Y does not have personnel qualified to make the analysis, and it does not undertake the same analysis. The district director may make an appropriate allocation to reflect an arm's length charge for such analysis.

Example (2). Y, which has a qualified financial staff, makes an analysis to determine the amount and source of its borrowing needs. Its report, recommending a loan from a bank, is submitted to X. X's financial staff reviews the analysis to determine whether X should advise Y to reconsider its plan. No allocation should be made with respect to X's review.

(3) Arm's length charge. For the purpose of this paragraph an arm's length charge for services rendered shall be the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts. However, except in the case of services which are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services (as described in subparagraph (7) of this paragraph), the arm's length charge shall be deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services unless the taxpayer establishes a more appropriate charge under the standards set forth in the first sentence of this subparagraph. Where costs or deductions are a factor in applying the provisions of this paragraph adequate books and records must be maintained by taxpayers to permit verification of such costs or deductions by the Internal Revenue Service.

(4) Costs or deductions to be taken into account. (i) Where the amount of an arm's length charge for services is determined with reference to the costs or deductions incurred with respect to such services, it is necessary to take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the service performed.

(ii) Direct costs or deductions are those identified specifically with a particular service. These include, but are not limited to, costs or deductions for compensation, bonuses, and travel expenses attributable to employees directly engaged in performing such services, for material and supplies directly consumed in rendering such services, and for other costs such as the cost of overseas cables in connection with such services.

(iii) Indirect costs or deductions are those which are not specifically identified with a particular activity or service but which relate to the direct costs referred to in subdivision (ii) of this subparagraph. Indirect costs or deductions generally include costs or deductions with respect to utilities, occupancy, supervisory and clerical compensation, and other overhead burden of the department incurring the direct costs or deductions referred to in subdivision (ii) of this subparagraph. Indirect costs or deductions also generally include an appropriate share of the costs or deductions relating to supporting departments and other applicable general and administrative expenses to the extent reasonably allocable to a particular service or activity. Thus, for example, if a domestic corporation's advertising department performs services for the direct benefit of a foreign subsidiary, in addition to direct costs of such department, such as salaries of employees and fees paid to advertising agencies or consultants, which are attributable to such foreign advertising, indirect costs must be taken into account on some reasonable basis in determining the amount of costs or deductions with respect to which the arm's length charge to the foreign subsidiary is to be determined. These generally include depreciation, rent, property taxes, other costs of occupancy, and other overhead costs of the advertising department itself, and allocations of costs from other departments which service the advertising department, such as the personnel, accounting, payroll, and maintenance departments, and other applicable general and administrative expenses including compensation of top management.

(5) Costs and deductions not to be taken into account. Costs or deductions of the member rendering the services which are not to be taken into

account in determining the amount of an arm's length charge for services include—

(i) Interest expense on indebtedness not incurred specifically for the benefit of another member of the group,

(ii) Expenses associated with the issuance of stock and maintenance of shareholder relations, and

(iii) Expenses of compliance with regulations or policies imposed upon the member rendering the services by its government which are not directly related to the service in question.

(6) **Methods.** (i) Where an arm's length charge for services rendered is determined with reference to costs or deductions, and a member has allocated and apportioned costs or deductions to reflect arm's length charges by employing in a consistent manner a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice, such method will not be disturbed. If the member has not employed a method of allocation and apportionment which is reasonable and in keeping with sound accounting practice, the method of allocating and apportioning costs or deductions for the purpose of determining the amount of arm's length charges shall be based on the particular circumstances involved.

(ii) The methods of allocation and apportionment referred to in this subparagraph are applicable both in allocating and apportioning indirect costs to a particular activity or service (see subparagraph (4)(iii) of this paragraph), and in allocating and apportioning the total costs (direct and indirect) of a particular activity or service where such activity or service is undertaken for the joint benefit of two or more members of a group (see subparagraph (2)(i) of this paragraph). While the use of one or more bases may be appropriate under the circumstances in establishing the method of allocation and apportionment, appropriate consideration should be given to all bases and factors, including, for example, total expenses, asset size, sales, manufacturing expenses, payroll, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by means of application of reasonable departmental overhead rates. Allocations and apportionments of costs or deductions must be made on the basis of the full cost as opposed to the incremental cost. Thus, if an electronic data processing machine, which is rented by the taxpayer, is used for the joint benefit of itself and other members of a controlled group, the determination of the arm's length charge to each member must be made with reference to the full rent and cost of operating the machine by each member, even if the additional use of the machine for the benefit of the other members did not increase the cost to the taxpayer.

(iii) Practices actually employed to apportion costs or expenses in connection with the preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest shall be considered by the district director. Similarly, in determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members of a controlled group in apportioning costs between themselves shall also be considered if the relationships with the foreign members of the group are comparable to the relationships between the domestic members of the group. For example, if, for purposes of reporting to public stockholders or to a governmental agency, a corporation apportions the costs attributable to its executive officers among the domestic members of a controlled group on a reasonable and consistent basis, and such officers exercise comparable control over foreign members of such group, such domestic apportionment practice will be taken into consideration in determining the amount of allocations to be made to the foreign members.

(7) **Certain services.** An arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (referred to in this subparagraph as the "renderer") or the member receiving the benefit of the services (referred to in this subparagraph as the "recipient"). Subdivisions (i) through (iv) of this subparagraph describe those situations in which services shall be considered an integral part of the business activity of a member of a group of controlled entities.

(i) Services are an integral part of the business activity of a member of a controlled group where either the renderer or the recipient is engaged in the trade or business of rendering similar services to one or more unrelated parties.

(ii)(*a*) Services are an integral part of the business activity of a member of a controlled group where the renderer renders services to one or more related parties as one of its principal activities. Except in the case of services which constitute a

manufacturing, production, extraction, or construction activity, it will be presumed that the renderer does not render services to related parties as one of its principal activities if the cost of services of the renderer attributable to the rendition of services for the taxable year to related parties do not exceed 25 percent of the total costs or deductions of the renderer for the taxable year. Where the cost of services rendered to related parties is in excess of 25 percent of the total costs or deductions of the renderer for the taxable year or where the 25-percent test does not apply, the determination of whether the rendition of such services is one of the principal activities of the renderer will be based on the facts and circumstances of each particular case. Such facts and circumstances may include the time devoted to the rendition of the services, the relative cost of the services, the regularity with which the services are rendered, the amount of capital investment, the risk of loss involved, and whether the services are in the nature of supporting services or independent of the other activities of the renderer.

(b) For purposes of the 25-percent test provided in this subdivision (ii), the cost of services rendered to related parties shall include all costs or deductions directly or indirectly related to the rendition of such services including the cost of services which constitute a manufacturing, production, extraction, or construction activity; and the total costs or deductions of the renderer for the taxable year shall exclude amounts properly reflected in the cost of goods sold of the renderer. Where any of the costs or deductions of the renderer do not reflect arm's length consideration and no adjustment is made under any provision of the Internal Revenue Code to reflect arm's length consideration, the 25-percent test will not apply if, had an arm's-length charge been made, the costs or deductions attributable to the renderer's rendition of services to related entities would exceed 25 percent of the total costs or deductions of the renderer for the taxable year.

(c) For purposes of the 25-percent test in this subdivision (ii), a consolidated group (as defined in this subdivision (c)) may, at the option of the taxpayer, be considered as the renderer where one or more members of the consolidated group render services for the benefit of or on behalf of a related party which is not a member of the consolidated group. In such case, the cost of services rendered by members of the consolidated group to any related parties not members of the consolidated group, as well as the total costs or deductions of the members of the consolidated group, shall be considered in the aggregate to determine if such services constitute a principal activity of the renderer. Where a consolidated group is considered the renderer in accordance with this subdivision (c), the costs or deductions referred to in this subdivision (ii) shall not include costs or deductions paid or accrued to any member of the consolidated group. In addition to the preceding provisions of this subdivision (c), if part or all of the services rendered by a member of a consolidated group to any related party not a member of the consolidated group are similar to services rendered by any other member of the consolidated group to unrelated parties as part of a trade or business, the 25-percent test in this subdivision (ii) shall be applied with respect to such similar services without regard to this subdivision (c). For purposes of this subdivision (c), the term "consolidated group" means all members of a group of controlled entities created or organized within a single country and subjected to an income tax by such country on the basis of their combined income.

(iii) Services are an integral part of the business activity of a member of a controlled group where the renderer is peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient. The renderer is peculiarly capable of rendering the services where the renderer, in connection with the rendition of such services, makes use of a particularly advantageous situation or circumstance such as by utilization of special skills and reputation, utilization of an influential relationship with customers, or utilization of its intangible property (as defined in paragraph (d)(3) of this section). However, the renderer will not be considered peculiarly capable of rendering services unless the value of the services is substantially in excess of the costs or deductions of the renderer attributable to such services.

(iv) Services are an integral part of the business activity of a member of a controlled group where the recipient has received the benefit of a substantial amount of services from one or more related parties during its taxable year. For purposes of this subdivision, services rendered by one or more related parties shall be considered substantial in amount if the total costs or deductions of the related party or parties rendering services to the recipient during its taxable year which are directly or indirectly related to such services exceed an amount equal to 25 percent of the total costs or deductions of the recipient during its taxable year. For purposes of the preceding sentence, the total costs or deductions of the recipient shall include the renderers' costs or deductions directly or indirectly related to the rendition of such services and

shall exclude any amounts paid or accrued to the renderers by the recipient for such services and shall also exclude any amounts paid or accrued for materials the cost of which is properly reflected in the cost of goods sold to the recipient. At the option of the taxpayer, where the taxpayer establishes that the amount of the total costs or deductions of a recipient for the recipient's taxable year are abnormally low due to the commencement or cessation of an operation by the recipient, or other unusual circumstances of a nonrecurring nature, the costs or deductions referred to in the preceding two sentences shall be the total of such amount for the 3-year period immediately preceding the close of the taxable year of the recipient (or for the first 3 years of operation of the recipient if the recipient had been in operation for less than 3 years as of the close of the taxable year in which the services in issue were rendered).

(v) The principles of subdivisions (i) through (iv) of this subparagraph may be illustrated by the following examples:

Application of subdivision (i):

Example (1). Y is engaged in the business of selling merchandise and X, an entity related to Y, is a printing company regularly engaged in printing and mailing advertising literature for unrelated parties. X also prints circulars advertising Y's products, mails the circulars to potential customers of Y, and in addition, performs the art work involved in the preparation of the circulars. Since the printing, mailing, and art work services rendered by X to Y are similar to the printing and mailing services rendered by X as X's trade or business, the services rendered to Y are an integral part of the business activity of X as described in subdivision (i) of this subparagraph.

Application of subdivision (ii):

Example (2). V, W, X, and Y are members of the same group of controlled entities. Each member of the group files a separate income tax return. X renders wrecking services to V, W, and Y, and, in addition, sells building materials to unrelated parties. The total costs or deductions incurred by X for the taxable year (exclusive of amounts properly reflected in the cost of goods sold of X) are $4 million. The total costs or deductions of X for the taxable year which are directly or indirectly related to the services rendered to V, W, and Y are $650,000. Since $650,000 is less than 25 percent of the total costs or deductions of X (exclusive of amounts properly reflected in the cost of goods sold of X) for the taxable year ($4,000,000×25%=$1,000,000), the services rendered by X to V, W, and Y will not be considered one of X's principal activities within the meaning of subdivision (ii) of this subparagraph.

Example (3). Assume the same facts as in example (2), except that the total costs or deductions of X for the taxable year which are directly or indirectly related to the services rendered to V, W, and Y are $1,800,000. Assume in addition, that there is a high risk of loss involved in the rendition of the wrecking services by X, that X has a large investment in the wrecking equipment, and that a substantial amount of X's time is devoted to the rendition of wrecking services to V, W, and Y. Since $1,800,000 is greater than 25 percent of the total costs or deductions of X for the taxable year (exclusive of amounts properly reflected in the cost of goods sold of X), *i.e.*, $1 million, the services rendered by X to V, W, and Y will not be automatically excluded from classification as one of the principal activities of X as in example (2), and consideration must be given to the facts and circumstances of the particular case. Based on the facts and circumstances in this case, X would be considered to render wrecking services to related parties as one of its principal activities. Thus, the wrecking services are an integral part of the business activity of X as described in subdivision (ii) of this subparagraph.

Example (4). Z is a domestic corporation and has several foreign subsidiaries. Z and X, a domestic subsidiary of Z, have exercised the privilege granted under section 1501 to file a consolidated return and, therefore, constitute a "consolidated group" within the meaning of subdivision (ii)(c) of this subparagraph. Pursuant to (c) of subdivision (ii), the taxpayer treats X and Z as the renderer. The sole function of X is to provide accounting, billing, communication, and travel services to the foreign subsidiaries of Z. Z also provides some other services for the benefit of its foreign subsidiaries. The total costs or deductions of X and Z related to the services rendered for the benefit of the foreign subsidiaries is $750,000. Of that amount, $710,000 represents the costs of X, which are X's total operating costs. The total costs or deductions of X and Z for the taxable year with respect to their operations (exclusive of amounts properly reflected in the cost of goods sold of X and Z) is $6,500,000. Since the total costs or deductions related to the services rendered to the foreign subsidiaries ($750,000) is less than 25 percent of the total costs or deductions of X and Z (exclusive of amounts properly reflected in the costs of goods sold of X or Z) in the aggregate ($6,500,000×25%=$1,625,-000), the services rendered by X and Z to the foreign subsidiaries will not be considered one of the principal activities of X and Z within the meaning of subdivision (ii) of this subparagraph.

Example (5). Assume the same facts as in example (4), except that all the communication services rendered for the benefit of the foreign subsidiaries are rendered by X and that Z renders communication services to unrelated parties as part of its trade or business. X is regularly engaged in rendering communication services to foreign subsidiaries and devotes a substantial amount of its time to this activity. The costs or deductions of X related to the rendition of the communication services to the foreign subsidiaries are $355,000. By application of the provisions of (c) of subdivision (ii) of this subparagraph, the services provided by X and Z to related entities other than the communication services will not be considered one of the principal activities of X and Z. However, since Z renders communication services to unrelated parties as a part of its trade or business, the communication services rendered by X to the foreign subsidiaries will be subject to the provisions of subdivision (ii) without regard to (c) of subdivision (ii). Since, the cost or deductions of X related to the rendition of the communication services ($355,000) are in excess of 25 percent of the total costs or deductions of X (exclusive of amounts properly reflected in the cost of goods sold of X) for the taxable year ($710,000×25%=$177,500), the determination of whether X renders the communication services as one of its principal activities will depend on the particular facts and circumstances. The given facts and circumstances indicate that X renders the communication services as one of its principal activities.

Example (6). X and Y are members of the same group of controlled entities. Y produces and sells product D. As a part of the production process, Y sends materials to X who converts the materials into component parts. This conversion activity constitutes only a portion of X's operations. X then ships the component parts back to Y who assembles them (along with other components) into the finished product for

sale to unrelated parties. Since the services rendered by X to Y constitute a manufacturing activity, the 25-percent test in subdivision (ii) of this subparagraph does not apply.

Example (7). X and Y are members of the same group of controlled entities. X manufactures product D for distribution and sale in the United States, Canada, and Mexico. Y manufactures product D for distribution and sale in South and Central America. Due to a breakdown of machinery, Y is forced to cease its manufacturing operations for a 1-month period. In order to meet demand for product D during the shutdown period, Y sends partially finished goods to X. X, for that period, completes the manufacture of product D for Y and ships the finished product back to Y. The costs or deductions of X related to the manufacturing services rendered to Y are $750,000. The total costs or deductions of X are $24,000,000. Since the services in issue constitute a manufacturing activity, the 25-percent test in subdivision (ii) of this subparagraph does not apply. However, under these facts and circumstances—*i.e.*, the insubstantiality of the services rendered to Y in relation to X's total operations, the lack of regularity with which the services are rendered, and the short duration for which the services are rendered—X's rendition of manufacturing services to Y is not considered one of X's principal activities within the meaning of subdivision (ii) of this subparagraph.

Example (8). Assume the same facts as in example (7) except that, instead of temporarily ceasing operations, Y requests assistance from X in correcting the defects in the manufacturing equipment. In response, X sends a team of engineers to discover and correct the defects without the necessity of a shutdown. Although the services performed by the engineers were related to a manufacturing activity, the services are essentially supporting in nature and, therefore, do not constitute a manufacturing, production, extraction, or construction activity. Thus, the 25-percent test in subdivision (ii) of this subparagraph applies.

Example (9). X is a domestic manufacturing corporation. Y, a foreign subsidiary of X, has decided to construct a plant in Country A. In connection with the construction of Y's plant, X draws up the architectural plans for the plant, arranges the financing of the construction, negotiates with various Government authorities in Country A, invites bids from unrelated parties for several phases of construction, and negotiates, on Y's behalf, the contracts with unrelated parties who are retained to carry out certain phases of the construction. Although the unrelated parties retained by X for Y perform the physical construction, the aggregate services performed by X for Y are such that they, in themselves, constitute a construction activity. Thus, the 25-percent test in subdivision (ii) of this subparagraph does not apply with respect to such services.

Application of subdivision (iii):

Example (10). X and Y are members of the same group of controlled entities. X is a finance company engaged in financing automobile loans. In connection with such loans it requires the borrower to have life insurance in the amount of the loan. Although X's borrowers are not required to take out life insurance from any particular insurance company, at the same time that the loan agreement is being finalized, X's employees suggest that the borrower take out life insurance from Y, which is an agency for life insurance companies. Since there would be a delay in the processing of the loan if some other company were selected by the borrower, almost all of X's borrowers take out life insurance through Y. Because of this utilization of its influential relationship with its borrowers, X is peculiarly capable of rendering selling services to Y and, since a substantial amount of Y's business is derived from X's borrowers, such selling services are a principal element in the operation of Y's insurance business. In addition, the value of the services is substantially in excess of the costs incurred by X. Thus, the selling services rendered by X to Y are an integral part of the business activity of a member of the controlled group as described in subdivision (iii) of this subparagraph.

Example (11). X and Y are members of the same group of controlled entities. Y is a manufacturer of product E. In past years product E has not always operated properly because of imperfections present in the finished product. X owns an exclusive patented process by which such imperfections can be detected and removed prior to sale of the product, thereby greatly increasing the marketability of the product. In connection with its manufacturing operations Y sends its products to X for inspection which involves utilization of the patented process. The inspection of Y's products by X is not one of the principal activities of X. However, X is peculiarly capable of rendering the inspection services to Y because of its utilization of the patented process. Since this inspection greatly increases the marketability of product E it is extremely valuable. Such value is substantially in excess of the cost incurred by X in rendition of such services. Because of the impact of the inspection on sales, such services are a principal element in the operations of Y. Thus, the inspection services rendered by X to Y are an integral part of the business activity of a member of the controlled group as described in subdivision (iii) of this subparagraph.

Example (12). Assume the same facts as in example (11) except that Y owns the patented process for detecting the imperfections. Y, however, does not have the facilities to implement the inspection process. Therefore, Y sends its products to X for inspection which involves utilization of the patented process owned by Y. Since Y owns the patent, X is not peculiarly capable of rendering the inspection services to Y within the meaning of subdivision (iii) of this subparagraph.

Example (13). Assume the same facts as in example (12) except that X and Y both own interests in the patented process as a result of having developed the process pursuant to a bona fide cost sharing plan (within the meaning of paragraph (d)(4) of this section). Since Y owns the requisite interest in the patent, X is not peculiarly capable of rendering the inspection services to Y within the meaning of subdivision (iii) of this subparagraph.

Example (14). X and Y are members of the same group of controlled entities. X is a large manufacturing concern. X's accounting department has, for many years, maintained the financial records of Y, a distributor of X's products. Although X is able to render these accounting services more efficiently than others due to its thorough familiarity with the operations of Y, X is not peculiarly capable of rendering the accounting services to Y because such familiarity does not, in and of itself, constitute a particularly advantageous situation or circumstance within the meaning of subdivision (iii) of this subparagraph. Furthermore, under these circumstances, the accounting services are supporting in nature and, therefore, do not constitute a principal element in the operations of Y. Thus, the accounting services rendered by X to Y are not an integral part of the business activity of either X or Y within the meaning of subdivision (iii) of this subparagraph.

Application of subdivision (iv):

Example (15). Corporations X, Y, and Z are members of the same group of controlled entities. X is a manufacturer, and Y and Z are distributors of X's products. X provides a variety of services to Y including billing, shipping, accounting, and other general and administrative services. During Y's taxable year, on several occasions, Z renders selling and other promotional services to Y. None of the services rendered to Y constitute one of the principal activities of any of the renderers within the meaning of subdivision (ii) of this subparagraph.

Y's total costs and deductions for Y's taxable year (exclusive of amounts paid to X and Z for services rendered and amounts paid for goods purchased for resale) are $1,600,000. The total direct and indirect costs of X and Z for services rendered to Y during Y's taxable year are as follows:

Services provided by X:	
Billing	$50,000
Shipping	250,000
Accounting	150,000
Other	200,000
Services provided by Z: Selling	500,000
Total costs	1,150,000

Since the total costs or deductions of X and Z related to the rendition of services to Y exceed the amount equal to 25 percent of the total costs or deductions of Y (exclusive of amounts paid to X and Z for the services rendered and amounts paid for goods purchased for resale) plus the total costs or deductions of X and Z related to the rendition of services to Y ($1,150,000÷[$1,600,000+$1,150,000]=41.8%), the services rendered by X and Z to Y are substantial within the meaning of subdivision (iv) of this subparagraph. Thus, the services rendered by X and Z to Y are an integral part of the business activity of Y as described in subdivision (iv) of this subparagraph.

Example (16). Assume the same facts as in example (15) except that the taxpayer establishes that, due to a major change in the operations of Y, Y's total costs or deductions for Y's taxable year were abnormally low. Y has always used the calendar year as its taxable year. Y's total costs and deductions for the 2 years immediately preceding the taxable year in issue (exclusive of amounts paid to X and Z for services rendered and amounts paid for goods purchased for resale) were $6 million and $6,200,000, respectively. The total direct and indirect costs of X and Z for services rendered to Y were $1,150,000 for each of the 3 years. Applying the same formula to the costs or deductions for the 3 years immediately preceding the close of the taxable year in issue, the costs or deductions of X and Z related to the rendition of services to Y (3×$1,150,000=$3,450,000) amount to 20 percent of the sum of the total costs or deductions of Y (exclusive of amounts paid to X and Z for the services rendered and amounts paid for goods purchased for resale) plus the total costs or deductions of X and Z related to the rendition of services to Y ($3,450,000÷[$1,600,000+$6,000,000+$6,200,000+$3,450,000]=20%). If the taxpayer chooses to use the 3-year period, the services rendered by X and Z to Y are not substantial within the meaning of subdivision (iv) of this subparagraph. Thus, the services will not be an integral part of the business activity of a member of the controlled group as described in subdivision (iv) of this subparagraph.

(8) Services rendered in connection with the transfer of property. Where tangible or intangible property is transferred, sold, assigned, loaned, leased, or otherwise made available in any manner by one member of a group to another member of the group and services are rendered by the transferor to the transferee in connection with the transfer, the amount of any allocation that may be appropriate with respect to such transfer shall be determined in accordance with the rules of paragraph (c), (d), or (e) of this section whichever is appropriate and a separate allocation with respect to such services under this paragraph shall not be made. Services are rendered in connection with the transfer of property where such services are merely ancillary and subsidiary to the transfer of the property or to the commencement of effective use of the property by the transferee. Whether or not services are merely ancillary and subsidiary to a property transfer is a question of fact. Ancillary and subsidiary services could be performed, for example, in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective "starting-up" of the property transferred, or by performing under a guarantee relating to such effective starting-up. Thus, where an employee of one member of a group, acting under the instructions of his employer, reveals a valuable secret process owned by his employer to a related entity, and at the same time supervises the integration of such process into the manufacturing operation of the related entity, such services could be considered to be rendered in connection with the transfer, and, if so considered, shall not be the basis for a separate allocation. However, if the employee continues to render services to the related entity by supervising the manufacturing operation after the secret process has been effectively integrated into such operation, a separate allocation with respect to such additional services may be made in accordance with the rules of this paragraph.

(c) Use of tangible property—(1) General rule. Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in subdivision (i) of subparagraph (2) of this paragraph), the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) Arm's length charge—(i) In general. For purposes of paragraph (c) of this section, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of main-

taining the property, the type of property involved, its condition, and all other relevant facts.

(ii) Safe haven rental charge. See 26 CFR 1.482-2(c)(2)(ii) (revised as of April 1, 1985), for the determination of safe haven rental charges in the case of certain leases entered into before May 9, 1986, and for leases entered into before August 7, 1986, pursuant to a binding written contract entered into before May 9, 1986.

(iii) Subleases. (A) Except as provided in paragraph (c)(2)(iii)(B) of this section, where possession, use, or occupancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period. Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(B) The provisions of paragraph (c)(2)(iii)(A) of this section shall not apply if either—

(1) The taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (c)(2)(i) of this section, or

(2) During the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the same general type as the property in question to unrelated persons.

(d) Transfer or use of intangible property—(1) In general. (i) Except as otherwise provided in subparagraph (4) of this paragraph, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use. Subparagraph (2) of this paragraph provides rules for determining the form an amount of an appropriate allocation, subparagraph (3) of this paragraph provides a definition of "intangible property", and subparagraph (4) of this paragraph provides rules with respect to certain cost-sharing arrangements in connection with the development of intangible property. For purposes of this paragraph, an interest in intangible property may take the form of the right to use such property.

(ii)(a) In the absence of a bona fide cost-sharing arrangement (as defined in subparagraph (4) of this paragraph), where one member of a group of related entities undertakes the development of intangible property as a developer within the meaning of (c) of this subdivision, no allocation with respect to such development activity shall be made under the rules of this paragraph or any other paragraph of this section (except as provided in (b) of this subdivision) until such time as any property developed, or any interest therein, is or is deemed to be transferred, sold, assigned, loaned, or otherwise made available in any manner by the developer to a related entity in a transfer subject to the rules of this paragraph. Where a member of the group other than the developer acquires an interest in the property developed by virtue of obtaining a patent or copyright, or by any other means, the developer shall be deemed to have transferred such interest in such property to the acquiring member in a transaction subject to the rules of this paragraph. For example, if one member of a group (the developer) undertakes to develop a new patentable product and the costs of development are incurred by that entity over a period of 3 years, no allocation with respect to that entity's activity shall be made during such period. The amount of any allocation that may be appropriate at the expiration of such development period when, for example, the patent on the product is transferred, or deemed transferred, to a related entity for other than an arm's length consideration, shall be determined in accordance with the rules of this paragraph.

(b) Where one member of a group renders assistance in the form of loans, services, or the use of tangible or intangible property to a developer in connection with an attempt to develop intangible property, the amount of any allocation that may be appropriate with respect to such assistance shall be determined in accordance with the rules of the appropriate paragraph or paragraphs of this section. Thus, where one entity allows a related entity, which is the developer, to use tangible property, such as laboratory equipment, in connection with the development of intangible property,

the amount of any allocation that may be appropriate with respect to such use shall be determined in accordance with the rules of paragraph (c) of this section. In the event that the district director does not exercise his discretion to make allocations with respect to the assistance rendered to the developer, the value of the assistance shall be allowed as a set-off against any allocation that the district director may make under this paragraph as a result of the transfer of the intangible property to the entity rendering the assistance.

(c) The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all the facts and circumstances of the individual case. Of all the facts and circumstances to be taken into account in making this determination, greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group, and the relative values of the use of any intangible property of members of the group which is made available without adequate consideration for use in connection with the development activity, which property is likely to contribute to a substantial extent in the production of intangible property. For this purpose, the risk to be borne with respect to development activity is the possibility that such activity will not result in the production of intangible property or that the intangible property produced will not be of sufficient value to allow for the recovery of the costs of developing it. A member will not be considered to have borne the costs and corresponding risks of development unless such member is committed to bearing such costs in advance of, or contemporaneously with, their incurrence and without regard to the success of the project. Other factors that may be relevant in determining which member of the group is the developer include the location of the development activity, the capabilities of the various members to carry on the project independently, and the degree of control over the project exercised by the various members.

(d) The principles of this subdivision (ii) may be illustrated by the following examples in which it is assumed that X and Y are corporate members of the same group:

Example (1). X, at the request of Y, undertakes to develop a new machine which will function effectively in the climate in which Y's factory is located. Y agrees to bear all the direct and indirect costs of the project whether or not X successfully develops the machine. Assume that X does not make any of its own intangible property available for use in connection with the project. The machine is successfully developed and Y obtains possession of the intangible property necessary to produce such machine. Based on the facts and circumstances as stated, Y shall be considered to be the developer of the intangible property and, therefore, Y shall not be treated as having obtained the property in a transfer subject to the rules of this paragraph. Any amount which may be allocable with respect to the assistance rendered by X shall be determined in accordance with the rules of (b) of this subdivision.

Example (2). Assume the same facts as in example (1) except that Y agrees to reimburse X for its costs only in the event that the property is successfully developed. In such case X is the developer and Y is deemed to have received the property in a transfer subject to the rules of this paragraph. Therefore, the district director may make an allocation to reflect an arm's length consideration for such property.

Example (3). In 1967 X undertakes to develop product M in its research and development department. X incurs direct and indirect costs of $1 million per year in connection with the project in 1967, 1968, and 1969. In connection with the project, X employs the formula for compound N, which it owns, and which is likely to contribute substantially to the success of the project. The value of the use of the formula for compound N in connection with this project is $750,000. In 1968, 4 chemists employed by Y spent 6 months working on the project in X's laboratory. The salary and other expenses connected with the chemists' employment for that period ($100,000) are paid by Y, for which no charge is made to X. In 1969, product M is perfected and Y obtains patents thereon. X is considered to be the developer of product M since, among other things, it bore the greatest relative share of the costs and risks incurred in connection with this project and made available intangible property (formula for compound N) which was likely to contribute substantially in the development of product M. Accordingly, no allocation with respect to X's development activity should be made before 1969. The property is deemed to have been transferred to Y at that time by virtue of the fact that Y obtained the patent rights to product M. In such case the district director may make an allocation to reflect an arm's length consideration for such transfer. In the event that the district director makes such an allocation and he has not made or does not make an allocation for 1968 with respect to the services of the chemists in accordance with the principles of paragraph (b) of this section, the value of the assistance shall be allowed as a set-off against the amount of the allocation reflecting an arm's length consideration for the transfer of the intangible property.

(2) Arm's length consideration. (i) An arm's length consideration shall be in a form which is consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms: (a) Royalties based on the transferee's output, sales, profits, or any other measure; (b) lump-sum payments; or (c) any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them. However, where the transferee pays nominal or no consideration for the property or interest therein and where the

transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.

(ii) In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration.

(iii) Where a sufficiently similar transaction involving an unrelated party cannot be found, the following factors, to the extent appropriate (depending upon the type of intangible property and the form of the transfer), may be considered in arriving at the amount of the arm's length consideration:

(a) The prevailing rates in the same industry or for similar property,

(b) The offers of competing transferors or the bids of competing transferees,

(c) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted,

(d) The uniqueness of the property and the period for which it is likely to remain unique,

(e) The degree and duration of protection afforded to the property under the laws of the relevant countries,

(f) Value of services rendered by the transferor to the transferee in connection with the transfer within the meaning of paragraph (b)(8) of this section,

(g) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,

(h) The capital investment and starting up expenses required of the transferee,

(i) The next subdivision is (j),

(j) The availability of substitutes for the property transferred,

(k) The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,

(*l*) The costs incurred by the transferor in developing the property, and

(m) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

(3) Definition of intangible property. (i) Solely for the purposes of this section, intangible property shall consist of the items described in subdivision (ii) of this subparagraph, provided that such items have substantial value independent of the services of individual persons.

(ii) The items referred to in subdivision (i) of this subparagraph are as follows:

(a) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(b) Copyrights, literary, musical, or artistic compositions, and other similar items;

(c) Trademarks, trade names, brand names, and other similar items;

(d) Franchises, licenses, contracts, and other similar items;

(e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

(4) Sharing of costs and risks. Where a member of a group of controlled entities acquires an interest in intangible property as a participating party in a bona fide cost sharing arrangement with respect to the development of such intangible property, the district director shall not make allocations with respect to such acquisition except as may be appropriate to reflect each participant's arm's length share of the costs and risks of developing the property. A bona fide cost sharing arrangement is an agreement, in writing, between two or more members of a group of controlled entities providing for the sharing of the costs and risks of developing intangible property in return for a specified interest in the intangible property that may be produced. In order for the arrangement to qualify as a bona fide arrangement, it must reflect an effort in good faith by the participating members to bear their respective shares of all the costs and risks of development on an arm's length basis. In order for the sharing of costs and risk to be considered on an arm's length basis, the terms and conditions must be comparable to those which would have been adopted by unrelated parties similarly situated had they entered into such

an arrangement. If an oral cost sharing arrangement, entered into prior to April 16, 1968, and continued in effect after that date, is otherwise in compliance with the standards prescribed in this subparagraph, it shall constitute a bona fide cost sharing arrangement if it is reduced to writing prior to January 1, 1969.

(e) Sales of tangible property—(1) In general. (i) Where one member of a group of controlled entities (referred to in this paragraph as the "seller") sells or otherwise disposes of tangible property to another member of such group (referred to in this paragraph as the "buyer") at other than an arm's length price (such a sale being referred to in this paragraph as a "controlled sale"), the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

(ii) Subparagraphs (2), (3), and (4) of this paragraph describe three methods of determining an arm's-length price and the standards for applying each method. They are, respectively, the comparable uncontrolled price method, the resale price method, and the cost-plus method. In addition, a special rule is provided in subdivision (v) of this subparagraph for use (notwithstanding any other provision of this subdivision) in determining an arm's-length price for an ore or mineral. If there are comparable uncontrolled sales as defined in subparagraph (2) of this paragraph, the comparable uncontrolled price method must be utilized because it is the method likely to result in the most accurate estimate of an arm's-length price (for the reason that it is based upon the price actually paid by unrelated parties for the same or similar products). If there are no comparable uncontrolled sales, then the resale price method must be utilized if the standards for its application are met because it is the method likely to result in the next most accurate estimate in such instances (for the reason that, in such instances, the arm's-length price determined under such method is based more directly upon actual arm's-length transactions than is the cost-plus method). A typical situation where the resale price method may be required is where a manufacturer sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions. If all the standards for the mandatory application of the resale price method are not satisfied, then, as provided in subparagraph (3)(iii) of this paragraph, either that method or the cost-plus method may be used, depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's-length price. A typical situation where the cost-plus method may be appropriate is where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by reason of its utilization of its intangible property prior to resale in uncontrolled transactions.

(iii) Where the standards for applying one of the three methods of pricing described in subdivision (ii) of this subparagraph are met, such method must, for the purposes of this paragraph, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate. Where none of the three methods of pricing described in subdivision (ii) of this subparagraph can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.

(iv) The methods of determining arm's length prices described in this section are stated in terms of their application to individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the district director may determine or verify the arm's length price of all sales to a related entity by employing reasonable statistical sampling techniques.

(v) The price for a mineral product which is sold at the stage at which mining or extraction ends shall be determined under the provisions of §§ 1.613–3 and 1.613–4.

(2) Comparable uncontrolled price method. (i) Under the method of pricing described as the "comparable uncontrolled price method", the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales,

adjusted as provided in subdivision (ii) of this subparagraph.

(ii) "Uncontrolled sales" are sales in which the seller and the buyer are not members of the same controlled group. These include (a) sales made by a member of the controlled group to an unrelated party, (b) sales made to a member of the controlled group by an unrelated party, and (c) sales made in which the parties are not members of the controlled group and are not related to each other. However, uncontrolled sales do not include sales at unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a nonarm's length price on a large volume of controlled sales. Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved. The principles of this subdivision may be illustrated by the following examples, in each of which it is assumed that X makes both controlled and uncontrolled sales of the identical property:

Example (1). Assume that the circumstances surrounding the controlled and the uncontrolled sales are identical, except for the fact that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. X's factory. Since differences in terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

Example (2). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X affixes its valuable trademark in the controlled sales, and does not affix its trademark in uncontrolled sales. Since the effects on price of differences in intangible property associated with the sale of tangible property, such as trademarks, are normally not reasonably ascertainable, such differences would normally render the uncontrolled sales noncomparable.

Example (3). Assume that the circumstances surrounding the controlled and uncontrolled sales are identical, except for the fact that X, a manufacturer of business machines, makes certain minor modifications in the physical properties of the machines to satisfy safety specifications or other specific requirements of a customer in controlled sales, and does not make these modifications in uncontrolled sales. Since minor physical differences in the product generally have a definite and reasonably ascertainable effect on prices, such differences do not normally render the uncontrolled sales noncomparable to the controlled sales.

(iii) Where there are two or more comparable uncontrolled sales susceptible of adjustment as defined in subdivision (ii) of this subparagraph, the comparable uncontrolled sale or sales requiring the fewest and simplest adjustments provided in subdivision (ii) of this subparagraph should generally be selected. Thus, for example, if a taxpayer makes comparable uncontrolled sales of a particular product which differ from the controlled sale only with respect to the terms of delivery, and makes other comparable uncontrolled sales of the product which differ from the controlled sale with respect to both terms of delivery and terms of payment, the comparable uncontrolled sales differing only with respect to terms of delivery should be selected as the comparable uncontrolled sale.

(iv) One of the circumstances which may affect the price of property is the fact that the seller may desire to make sales at less than a normal profit for the primary purpose of establishing or maintaining a market for his products. Thus, a seller may be willing to reduce the price of a product, for a time, in order to introduce his product into an area or in order to meet competition. However, controlled sales may be priced in such a manner only if such price would have been charged in an uncontrolled sale under comparable circumstances. Such fact may be demonstrated by showing that the buyer in the controlled sale made corresponding reductions in the resale price to uncontrolled purchasers, or that such buyer engaged in substantially greater sales promotion activities with respect to the product involved in the controlled sale than with respect to other products. For example, assume X, a manufacturer of batteries, commences to sell car batteries to Y, a subsidiary of X, for resale in a new market. In its existing markets X's batteries sell to independent retailers at $20 per unit, and X sells them to wholesalers at $17 per unit. Y also sells X's batteries to independent retailers at $20 per unit. X's batteries are not known in the new market in which Y is operating. In order to engage compet-

itively in the new market Y incurs selling and advertising costs substantially higher than those incurred for its sales of other products. Under these circumstances X may sell to Y, for a time, at less than $17 to take into account the increased selling and advertising activities of Y in penetrating and establishing the new market. This may be done even though it may result in a transfer price from X to Y which is below X's full costs of manufacturing the product.

(3) **Resale price method.** (i) Under the pricing method described as the "resale price method", the arm's length price of a controlled sale is equal to the applicable resale price (as defined in subdivision (iv) or (v) of this subparagraph), reduced by an appropriate markup, and adjusted as provided in subdivision (ix) of this subparagraph. An appropriate markup is computed by multiplying the applicable resale price by the appropriate markup percentage as defined in subdivision (vi) of this subparagraph. Thus, where one member of a group of controlled entities sells property to another member which resells the property in uncontrolled sales, if the applicable resale price of the property involved in the uncontrolled sale is $100 and the appropriate markup percentage for resales by the buyer is 20 percent, the arm's length price of the controlled sale is $80 ($100 minus 20 percent × $100), adjusted as provided in subdivision (ix) of this subparagraph.

(ii) The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

(a) There are no comparable uncontrolled sales as defined in subparagraph (2) of this paragraph.

(b) An applicable resale price, as defined in subdivision (iv) or (v) of this subparagraph, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.

(c) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration.

(d) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property. See § 1.482–2(d)(3) for the definition of intangible property.

(iii) Notwithstanding the fact that one or both of the requirements of subdivision (ii)(c) or (d) of this subparagraph may not be met, the resale price method may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method. Thus, even though one of the requirements of such subdivision is not satisfied, the resale price method may nevertheless be more appropriate than the cost plus method because the computations and evaluations required under the former method may be fewer and easier to make than under the latter method. In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller). The principle of this subdivision may be illustrated by the following examples in each of which it is assumed that corporation X developed a valuable patent covering product M which it manufactures and sells to corporation Y in a controlled sale, and for which there is no comparable uncontrolled sale:

Example (1). Corporation Y adds a component to product M and resells the assembled product in an uncontrolled sale within a reasonable time after the controlled sale of product M. Assume further that the addition of the component added more than an insubstantial amount to the value of product M, but that Y's function in purchasing the component and assembling the product prior to sale was subject to reasonably precise valuation. Although the controlled sale and resale does not meet the requirements of subdivision (ii)(c) of this subparagraph, the resale price method may be used under the circumstances because that method involves computations and evaluations which are fewer and easier to make than under the cost plus method. This is because X's use of a patent may be more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of Y's assembling function in determining the appropriate markup percentage under the resale price method.

Example (2). Corporation Y resells product M in an uncontrolled sale within a reasonable time after the controlled sale after attaching its valuable trademark to it. Assume further that it can be demonstrated through comparison with other uncontrolled sales of Y that the addition of Y's trademark to a product usually adds 25 percent to the markup on its sales. On the other hand, the effect of X's use of its patent is difficult to evaluate in applying the cost plus method because no reasonable standard of comparison is available. Although the controlled sale and resale does not meet the requirements of subdivision (ii)(d) of this subparagraph, the resale price method may be used because that method involves computations and evaluation which are fewer and easier to make than under the cost plus method. That is because, under the circumstances, X's use of a patent is more difficult to evaluate in determining an appropriate gross profit percentage under the cost plus method, than is evaluation of the use of Y's trademark in determining the appropriate markup percentage under the resale price method.

(iv) For the purposes of this subparagraph the "applicable resale price" is the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an

uncontrolled sale. The "applicable resale price" will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved.

(v) Where the property purchased in the controlled sale is resold in another controlled sale, the "applicable resale price" is the price at which such property is finally resold in an uncontrolled sale, providing that the series of sales as a whole meets all the requirements of subdivision (ii) of this subparagraph or that the resale price method is used pursuant to subdivision (iii) of this subparagraph. In such case, the determination of the appropriate markup percentage shall take into account the function or functions performed by all members of the group participating in the series of sales and resales. Thus, if X sells a product to Y in a controlled sale, Y sells the product to Z in a controlled sale, and Z sells the product in an uncontrolled sale, the resale price method must be used if Y and Z together have not added more than an insubstantial amount to the value of the product through physical alteration or the application of intangible property, and the final resale occurs within a reasonable time of the sale from X to Y. In such case, the applicable resale price is the price at which Z sells the product in the uncontrolled sale, and the appropriate markup percentage shall take into account the functions performed by both Y and Z.

(vi) For the purposes of this subparagraph, the appropriate markup percentage is equal to the percentage of gross profit (expressed as a percentage of sales) earned by the buyer (reseller) or another party on the resale of property which is both purchased and resold in an uncontrolled transaction, which resale is most similar to the applicable resale of the property involved in the controlled sale. The following are the most important characteristics to be considered in determining the similarity of resales:

(a) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(b) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor assembly, advertising, selling at wholesale, selling at retail, billing, maintenance of accounts receivable, and servicing.

(c) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the reseller.

In general, the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and resales on the one hand and the controlled purchases and resales on the other hand. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.

(vii) Whenever possible, markup percentages should be derived from uncontrolled purchases and resales of the buyer (reseller) involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of resales by the same buyer (reseller) which meet the standards of subdivision (vi) of this subparagraph, evidence of an appropriate markup percentage may be derived from resales by other resellers selling in the same or a similar market in which the controlled buyer (reseller) is selling providing such resellers perform comparable functions. Where the function performed by the reseller is similar to the function performed by a sales agent which does not take title, such sales agent will be considered a reseller for the purpose of determining an appropriate markup percentage under this subparagraph and the commission earned by such sales agent, expressed as a percentage of the sales price of the goods, may constitute the appropriate markup percentage. If the controlled buyer (reseller) is located in a foreign country and information on resales by other resellers in the same foreign market is not available, then markup percentages earned by United States resellers performing comparable functions may be used. In the absence of data on markup percentages of particular sales or groups of sales, the prevailing markup percentage in the particular industry involved may be appropriate.

(viii) In calculating the markup percentage earned on uncontrolled purchases and resales, and in applying such percentage to the applicable resale price to determine the appropriate markup, the same elements which enter into the computation of the sales price and the costs of goods sold of the property involved in the comparable uncontrolled purchases and resales should enter into such computation in the case of the property

involved in the controlled purchases and resales. Thus, if freight-in and packaging expense are elements of the cost of goods sold in comparable uncontrolled purchases, then such elements should also be taken into account in computing the cost of goods sold of the controlled purchase. Similarly, if the comparable markup percentage is based upon net sales (after reduction for returns and allowances) of uncontrolled resellers, such percentage must be applied to net sales of the buyer (reseller).

(ix) In determining an arm's length price appropriate adjustment must be made to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resales of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price. The principles of this subdivision may be illustrated by the following example:

Example. Assume that X and Y are members of the same group of controlled entities and that Y purchases electric mixers from X and electric toasters from uncontrolled entities. Y performs substantially similar functions with respect to resales of both the mixers and the toasters, except that it does not warrant the toasters, but does provide a 90-day warranty for the mixers. Y normally earns a gross profit on toasters of 20 percent of gross selling price. The 20-percent gross profit on the resale of toasters is an appropriate markup percentage, but the price of the controlled sale computed with reference to such rate must be adjusted to reflect the difference in terms (the warranty).

(4) **Cost plus method.** (i) Under the pricing method described as the "cost plus method", the arm's length price of a controlled sale of property shall be computed by adding to the cost of producing such property (as computed in subdivision (ii) of this subparagraph), an amount which is equal to such cost multiplied by the appropriate gross profit percentage (as computed in subdivision (iii) of this subparagraph), plus or minus any adjustments as provided in subdivision (v) of this subparagraph.

(ii) For the purposes of this subparagraph, the cost of producing the property involved in the controlled sale, and the costs which enter into the computation of the appropriate gross profit percentage shall be computed in a consistent manner in accordance with sound accounting practices for allocating or apportioning costs, which neither favors nor burdens controlled sales in comparison with uncontrolled sales. Thus, if the costs used in computing the appropriate gross profit percentage are comprised of the full cost of goods sold, including direct and indirect costs, then the cost of producing the property involved in the controlled sales must be comprised of the full cost of goods sold, including direct and indirect costs. On the other hand, if the costs used in computing the appropriate gross profit percentage are comprised only of direct costs, the cost of producing the property involved in the controlled sale must be comprised only of direct costs. The term "cost of producing", as used in this subparagraph, includes the cost of acquiring property which is held for resale.

(iii) For the purposes of this subparagraph, the appropriate gross profit percentage is equal to the gross profit percentage (expressed as a percentage of cost) earned by the seller or another party on the uncontrolled sale or sales of property which are most similar to the controlled sale in question. The following are the most important characteristics to be considered in determining the similarity of the uncontrolled sale or sales:

(a) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.

(b) The functions performed by the seller with respect to the property sold. For example: contract manufacturing, product assembly, selling activity, processing, servicing, delivering.

(c) The effect of any intangible property used by the seller in connection with the property sold. For example: patents, trademarks, trade names.

(d) The geographic market in which the functions are performed by the seller. In general, the similarity to be sought relates to the probable effect upon the margin of gross profit of any differences in such characteristics between the uncontrolled sales and the controlled sale. Thus, close physical similarity of the property involved in the sales compared is not required under the cost plus method since a lack of close physical similarity is not necessarily indicative of dissimilar profit margins. See subparagraph (2)(iv) of this paragraph, relating to sales made at less than a normal profit for the primary purpose of establishing or maintaining a market.

(iv) Whenever possible, gross profit percentages should be derived from uncontrolled sales made by the seller involved in the controlled sale, because similar characteristics are more likely to be found among sales of property made by the same seller than among sales made by other sellers. In the absence of such sales, evidence of an appropriate gross profit percentage may be derived from similar uncontrolled sales by other sellers whether or

not such sellers are members of the controlled group. Where the function performed by the seller is similar to the function performed by a purchasing agent which does not take title, such purchasing agent will be considered a seller for the purpose of determining an appropriate gross profit percentage under this subparagraph and the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may constitute the appropriate gross profit percentage. In the absence of data on gross profit percentages of particular sales or groups of sales which are similar to the controlled sale, the prevailing gross profit percentages in the particular industry involved may be appropriate.

(v) Where the most similar sale or sales from which the appropriate gross profit percentage is derived differ in any material respect from the controlled sale, the arm's length price which is computed by applying such percentage must be adjusted to reflect such differences to the extent such differences would warrant an adjustment of price in uncontrolled transactions. The differences referred to in this subdivision are those differences which have a definite and reasonably ascertainable effect on price.

[T.D. 6952, 33 FR 5849, April 16, 1968; 33 FR 6290, April 25, 1968, as amended by T.D. 6964, 33 FR 10569, July 25, 1968; T.D. 6998, 84 FR 933, Jan. 22, 1969; 34 FR 1380, Jan. 29, 1969; T.D. 7170, 37 FR 5373, March 15, 1972; T.D. 7394, 41 FR 1280, Jan. 7, 1976; T.D. 7747, 46 FR 86459, Dec. 31, 1980; T.D. 7781, 46 FR 34569, July 2, 1981; T.D. 7920, 48 FR 50712, Nov. 3, 1983; T.D. 8204, 53 FR 18278, May 23, 1988; T.D. 8204, 53 FR 20718, June 6, 1988]

§ 1.483–1 Computation of interest on certain deferred payments.

(a) Computation of amount constituting interest —(1) General rule. For all purposes of the Internal Revenue Code, in the case of any contract for the sale or exchange of property, there shall be treated as interest that part of a payment to which section 483 applies (see paragraph (b) of this section) which bears the same ratio to the amount of such payment as the total unstated interest (as defined in paragraph (c) of this section) under such contract bears to the total of the payments to which section 483 applies which are due under such contract. Thus, the amount to be treated as interest under section 483 is determined by multiplying each payment to which such section applies by a fraction, the numerator of which is the total unstated interest under the contract, and the denominator of which is the total of all the payments to which section 483 applies which are due under such contract. The effect of this ratio is to allocate the total unstated interest on a pro rata basis among the total payments to which section 483 applies. Accordingly, the total amount to be treated as interest for a taxable year with respect to a contract under which there are payments which include unstated interest is an amount equal to the unstated interest allocated to the payments under the contract for such year plus any stated interest reportable under the contract for such year. See paragraph (b)(2) of this section for rules relating to allocation of contract price, payments, and stated interest; paragraph (e) of this section for rules relating to indefinite payments; paragraph (f) of this section for rules relating to changes in terms of contract; and paragraph (b) of § 1.483–2 for exceptions and limitations to the application of section 483.

(2) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). On December 31, 1963, A sells property to B under a contract which provides that B is to make three payments of $2,000 each, such payments being due, respectively, at the end of each year for the next 3 years. No interest is provided for in the contract. Assume that section 483 applies to each of the payments, and that the total unstated interest under the contract is $559.88. The portion of each $2,000 payment which is treated as interest is $186.63

($2,000 × $559.88 ÷ $6000.00).

Example (2). On December 31, 1963, A sells property to B under a contract which provides that B is to make payments of $4,000, $3,000, and $2,000, such payments being due, respectively, at the end of each year for the next 3 years. No interest is provided for in the contract. Assume that section 483 applies to each of the payments, and that the total unstated interest under the contract is $750.31. The portion of the $4,000 payment which is treated as interest is $333.47

($4,000 × $750.31 ÷ $9000.00),

the portion of the $3,000 payment which is treated as interest is $250.10

($3,000 × $750.30 ÷ $9000.00),

and the portion of the $2,000 payment which is treated as interest is $166.74

($2,000 × $750.31 ÷ $9000.00).

Example (3). On December 31, 1963, A sells property to B under a contract which provides that B is to make payments of $2,040 ($2,000 sales price plus $40 interest), $2,080 ($2,000 sales price plus $80 interest), and $2,120 ($2,000 sales price plus $120 interest), such payments being due, respectively, 1, 2, and 3 years from the date of sale. Assume that both A and B are calendar year taxpayers, that section 483 applies to each of the payments, and that the total unstated interest under the contract is $345.85. The portion of each $2,000 payment (sales price) which is treated as interest is $115.28

($2,000 × $345.85 ÷ $6,000.00).

Thus, for 1964, the total amount to be treated as interest by A and B with respect to the contract is $155.28 ($115.28 unstated interest plus $40 stated interest), for 1965 such total amount is

$195.28 ($115.28 unstated interest plus $80 stated interest), and for 1966 such total amount is $235.28 ($115.28 unstated interest plus $120 stated interest).

(b) **Payments to which section 483 applies—(1) In general.** Except as provided in subparagraph (4) of this paragraph, section 483 applies to any payment made after December 31, 1963, on account of the sale or exchange of property occurring after June 30, 1963, which payment constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(i) Under which one or more of the payments are due more than 1 year after the date of such sale or exchange, and

(ii) Under which there is "total unstated interest" (within the meaning of paragraph (d) of this section).

For purposes of the preceding sentence, the term "sales price" does not include any interest payments provided for in the contract. The term "sale or exchange" includes any transaction treated as a sale or exchange for purposes of the Code. For purposes of section 483, a payment may be made in cash, stock or securities, or other property (except as provided in subparagraph (5) of this paragraph). Section 483 does not apply to any deferred payments under a contract under which all of the payments are due no more than 1 year after the date of the sale or exchange. Section 483 does not apply to a distribution in complete liquidation of a corporation, regardless of whether the corporation is liquidated in one distribution or in a series of distributions. For special rules relating to the time a sale or exchange takes place in the case of a disposal of timber, coal, or domestic iron ore, which qualifies under section 631 (relating to gain or loss in the case of timber, coal, or domestic iron ore), see that section and the regulations thereunder. See paragraph (e) of this section for special rules relating to indefinite payments, and paragraph (f) of this section for rules relating to the effect of a late payment on the determination of the due date of such payment. Section 483 may apply whether the contract providing for deferred payments is expressed (whether written or oral) or implied. In general, for purposes of section 483, all sales or exchanges involving deferred payments are considered as made under a contract.

(2) **Allocation of contract price, payments, and stated interest.** If payments are due under a contract both for the sale or exchange of property to which section 483 applies (for example, capital assets) and for either the sale or exchange of property to which such section does not apply (for example, the transfer of patents described in section 1235(a)) or services rendered or to be rendered, the parties to the contract may agree at the time of the sale or exchange on a reasonable determination of the portion of the contract price and the stated interest (if any), and of each payment due under the contract, which is allocable to each such type of property and to services. However, if the parties do not so agree on a reasonable determination of the allocation of the contract price, or the stated interest (if any), or each payment due under the contract, the district director shall make such reasonable determination.

(3) **Effect of other provisions of law.** If there is total unstated interest under a contract, a portion of each payment to which section 483 applies shall be treated as interest to the extent provided in such section, notwithstanding that some other provision of law (for example, section 1245, relating to gain from dispositions of certain depreciable property) would, without regard to section 483, treat a portion of the payment as ordinary income or in some other manner. In such a case, section 483 shall apply first and the other provisions of law shall apply only to the remainder of the payment not treated as interest under section 483. For example, if a portion of a payment is treated as interest under section 483 and such portion would otherwise be treated as gain from the sale or exchange of property which is not a capital asset under section 1232(a)(2)(B) (relating to corporate bonds issued on or before May 27, 1969, and Government bonds), section 483 shall apply first and section 1232(a)(2)(B) shall apply only to the remainder of the payment after the interest portion has been determined. In such case, in order to avoid a double inclusion in income, for purposes of section 1232(b) the "stated redemption price at maturity" shall be reduced by any amount treated as interest under section 483. If, however, with respect to an evidence of indebtedness issued by a corporation after May 27, 1969, any amount of original issue discount is ratably includible in the gross income of the holder under section 1232(a)(3), there will be no unstated interest to which section 483 applies since paragraph (d)(3) of this section provides for a zero test rate of interest for determining whether there is total unstated interest with respect to such an evidence of indebtedness.

(4) **Effective date.** Section 483 does not apply to any payments on account of a sale or exchange made pursuant to a binding written contract (including an irrevocable written option) entered into before July 1, 1963. For purposes of the preced-

ing sentence, a restricted stock option (as defined in section 424(b)) shall be considered as irrevocable. For rules relating to certain stock options granted prior to January 1, 1965, see paragraph (a)(2) of § 1.483–2. For purposes of this subparagraph, if, after June 30, 1963 (or December 31, 1964, in the case of certain stock options granted prior to such date), there is a substantial change in the terms of such a contract or option, then any payments made pursuant to such changed contract or option shall not be considered as payments on account of a sale or exchange made pursuant to a contract or option entered into before July 1, 1963 (or January 1, 1965, as the case may be). For example, a payment made after December 31, 1963, pursuant to a "buy-sell" agreement entered into before July 1, 1963, between shareholders, is not subject to section 483 unless such agreement is substantially changed after June 30, 1963. For purposes of this subparagraph, a mere prepayment or early payment of part or all of the sales price or stated interest, or a change in the sales price arising from an independent appraisal or a mechanical formula, if such appraisal or formula is specified in the contract, or the mere transfer of the obligation to make or of the right to receive deferred payments under a contract, is not considered a substantial change in the terms of the contract. Furthermore, a late payment of part or all of the sales price or stated interest shall not be considered a substantial change in the terms of the contract if such payment is made no later than 90 days after the date the payment was due under the contract, or, if the payment is made after such 90-day period, any additional interest provided for under the terms of the contract or under local law is collected.

(5) Evidence of indebtedness. For purposes of section 483, an evidence of indebtedness (whether or not negotiable and whether or not includible in gross income) of the purchaser given in consideration for the sale or exchange of property is not a payment, and any payment due under such evidence of indebtedness shall be treated as due under the contract for the sale or exchange.

(6) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). On December 31, 1963, A sells property to B under a contract which provides that B is to pay $3,000 on the date of sale, $1,000 on June 1, 1964, and $1,000 on December 26, 1964. No interest is provided for in the contract. Since none of the payments under the contract is due more than 1 year after the date of the sale, section 483 does not apply to any of the payments due under the contract.

Example (2). The facts are the same as in example (1), except that there is an additional $1,000 payment due on June 1, 1965. Since, under the contract, there is at least one payment due more than 1 year after the date of the sale, section 483 applies to any definite payment under the contract which is due more than 6 months after the date of the sale. Thus, section 483 applies to the $1,000 payments due on December 26, 1964, and on June 1, 1965.

Example (3). On December 31, 1963, A sells property to which section 483 applies and renders services to B under a contract which provides that B is to pay $10,000 on the date of sale, $5,000 on December 31, 1964, and $5,000 on December 31, 1965. No interest is provided for in the contract. Assume that the parties make no allocation of the contract price between property and services but that a reasonable allocation of the $20,000 total contract price and of each $5,000 payment is 75 percent for the sale of the property and 25 percent for the services rendered. The district director may allocate the contract price and each payment in those proportions and section 483 would then apply to 75 percent of each $5,000 payment ($3,750) since this is the portion that was allocated to the sale of the property.

Example (4). On December 31, 1963, M Corporation redeems 500 shares of its stock from A, one of its shareholders. M pays A $10,000 on the date of redemption and gives A a non-interest bearing promissory note which provides that M is to pay A $2,000 at the end of each of the next 5 years. Section 483 applies to each of the $2,000 payments.

Example (5). On December 31, 1963, A sells property to B under a contract which provides that B is to pay A $10,000 on the date of sale and transfer to A a total of 4,000 shares of X Corporation stock owned by B, 2,000 of such shares being due on June 30, 1965, and 2,000 shares on June 30, 1966. No interest is provided for in the contract. Section 483 applies to each of the transfers of X stock to A. See paragraph (e) of this section for special rules relating to indefinite payments.

Example (6). On December 31, 1963, M Corporation sells 500 shares of its stock to A, one of its employees, for a lump-sum payment of $10,000. At the same time, A borrows $10,000 from M Corporation and gives M a non-interest bearing promissory note which provides that A is to pay M $2,000 at the end of each of the next 5 years. Section 483 applies to any payments made by A under the promissory note in the same manner as if such payments were being made under a deferred-payment contract for the sale or exchange of the stock.

Example (7). M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1963, pursuant to a reorganization qualifying under section 368(a)(1)(B), M contracts to acquire the one-half interest held by N for an initial distribution on such date of 30,000 shares of M voting stock, and a nonassignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O Corporation exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1964 or in 1965, but in 1966 the annual earnings of O Corporation exceed the specified amount and on December 31, 1966, an additional 3,000 M voting shares are transferred to N. Section 483 applies to the transfer of the 3,000 M voting shares to N on December 31, 1966. See example (2) of paragraph (e)(3) of this section for an illustration of the computation of total unstated interest in this case.

Example (8). P Corporation and Q Corporation each owns one-half of the stock of R Corporation. On December 31, 1963, pursuant to a reorganization qualifying under section 368(a)(1)(B), P contracts to acquire the one-half interest held by Q for a distribution on such date of 40,000 shares of P voting stock. As a part of the plan of reorganization, Q

immediately places 10,000 of such voting shares in escrow. The escrow agreement provides that all or a portion of the stock placed in escrow is to be returned to P within 3 years (together with dividends and earnings thereon) if R's net profits do not exceed certain amounts specified in the agreement and that Q Corporation is entitled to vote the escrowed stock until such time as it may be returned to P Corporation. The agreement further provides that the escrow will terminate at the end of 3 years and that any stock then remaining in escrow (together with dividends and earnings thereon) is to be redelivered to Q Corporation. Q Corporation currently includes in income all dividends and earnings thereon with respect to the escrowed stock. Since Q Corporation is treated as having received, on December 31, 1963, all payments due under the exchange, section 483 does not apply to the transfer of any of the escrowed stock to Q Corporation.

(c) **Total unstated interest—(1) In general.** For purposes of paragraph (a) of this section (that is, for purposes of determining the portion of a payment to which section 483 applies which is to be treated as interest), the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(i) The sum of the payments to which section 483 applies which are due under the contract (within the meaning of paragraph (b) of this section), over

(ii) The sum of the present values of such payments and the present values of any stated interest payments due under the contract.

(2) **Present value of a payment—(i) In general.** The present value of any interest payment due under the contract not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment. The present value of any other interest payment, and of any payment to which section 483 applies, which is due under the contract shall be determined by discounting such payment at the interest rate prescribed by paragraph (c)(2)(ii) of this section, from the nearest date (to the date such payment is actually due under the contract) which marks a 6-month interval from the date of the sale or exchange. For purposes of computing the present value of a payment at such rate, column (b) of the appropriate table set forth in paragraph (g)(2) of this section shall be used.

(ii) **Prescribed interest rates.** (A) For payments on account of a sale or exchange of property entered into before July 24, 1975, as well as a sale or exchange of property pursuant to a binding written contract (including an irrevocable written option) entered into before such date, the interest rate prescribed by paragraph (c)(2)(ii)(A) shall be 5 percent per annum compounded semiannually. (See paragraph (c)(4) of this section for special rules where there has been a substantial change in the terms of a binding written contract entered into before July 24, 1975.)

(B) For payments on account of a sale or exchange of property entered into on or after July 24, 1975, and before July 1, 1981, except a sale or exchange entered into pursuant to a binding written contract (including an irrevocable written option) entered into before July 24, 1975, the interest rate prescribed by paragraph (c)(2)(ii)(B) of this section shall be 7 percent per annum compounded semiannually. For payments on account of a sale or exchange of property entered into on or after July 1, 1981, pursuant to a binding written contract (including an irrevocable written option) entered into after July 23, 1975, and before September 29, 1980, the interest rate prescribed by paragraph (c)(2)(ii)(B) of this section shall be 7 percent per annum compounded semiannually. (See paragraph (c)(5) of this section for special rules where there has been a substantial change in the terms of a binding written contract entered into after July 23, 1975 and before September 29, 1980.)

(C) For payments on account of a sale or exchange of property entered into on or after July 1, 1981, except a sale or exchange entered into pursuant to a binding written contract (including an irrevocable written option) entered into before September 29, 1980, the interest rate described by paragraph (c)(2)(ii)(C) of this section shall be 10 percent per annum compounded semiannually. (See paragraph (c)(5) of this section for special rules where there has been a substantial change in the terms of a binding written contract entered into before September 29, 1980.)

(3) **Examples.** The provisions of this paragraph may be illustrated by the following examples: (Note that examples (1) through (6) use Tables I through VI because such tables generally apply to transactions entered into before July 1, 1981, and that the principles illustrated by such examples would apply for transactions entered into on or after July 1, 1981, in which case Tables VII through IX would generally be applied.):

Example (1). On December 31, 1963, A sells property to B under a contract which provides that B is to make three payments of $2,000 each, such payments being due, respectively, at the end of each year for the next 3 years. No interest is provided for in the contract. For purposes of paragraph (a) of this section, the total unstated interest under the contract is $559.88, computed as follows:

Sum of payments to which sec. 483 applies...	$6,000.00
Less: Present value of $2,000 due every 12 months for 3 years ($2,000 × 2.72006 (factor for 3 years, col. (b), Table III))..........	5,440.12
Total unstated interest................	559.88

Example (2). On December 31, 1963, A sells property to B under a contract which provides that B is to make two payments of $1,000 each, payable August 1, 1964 and November 1, 1964, and a third payment of $2,000, payable March 1, 1965. No interest is provided for in the contract. For purposes of paragraph (a) of this section, the total unstated interest under the contract is $168.96, computed as follows:

Sum of payments to which sec. 483 applies...		$4,000.00
Less:		
Present value of $1,000 due August 1, 1964 ($1,000 × 0.97561 (factor 6 to 9 months col. (b), Table I))	$975.61	
Present value of $1,000 due November 1, 1964 ($1,000 × 0.95181 (factor for 9 to 15 months, col. (b), Table I)).	951.81	
Present value of $2,000 due March 1, 1965 ($2,000 × 0.95181 (factor for 9 to 15 months, col. (b), Table I))	1,903.62	3,831.04
Total unstated interest		168.96

Example (3). On December 31, 1963, A sells property to B under a contract which provides that B is to make payments of $2,040 ($2,000 sales price plus $40 interest), $2,080 ($2,000 sales price plus $80 interest), and $2,120 ($2,000 sales price plus $120 interest), such payments being due, respectively, 1, 2, and 3 years from the date of sale. For purposes of paragraph (a) of this section, the total unstated interest under the contract is $345.85, computed as follows:

Sum of payments to which sec. 483 applies...		$6,000.00
Less:		
Present value of $2,040 due 1 year from date of sale ($2,040 × 0.95181 (factor for 9 to 15 months, col. (b), Table I))	$1,941.69	
Present value of $2,080 due 2 years from date of sale ($2,080 × 0.90595 (factor for 21 to 27 months, col. (b), Table I))	1,884.38	
Present value of $2,120 due 3 years from date of sale ($2,120 × 0.86230 (factor for 33 to 39 months, col. (b), Table I))	1,828.08	5,654.15
Total unstated interest		345.85

Example (4). The facts are the same as in example (3), except that the first payment of $2,040 ($2,000 sales price plus $40 interest) is due on March 1, 1964. Since this payment is not due more than 6 months after the date of the sale, the $2,000 payment of sales price is not a payment to which section 483 applies. For purposes of paragraph (a) of this section, the total unstated interest under the contract is $247.54, computed as follows:

Sum of payments to which sec. 483 applies...		$4,000.00
Less:		
Present value of $40 stated interest due March 1, 1964 ($40 × 1.00000 (0 to 6 months, col. (b), Table I))	$40.00	
Present value of $2,080 due 2 years from date of sale ($2,080 × 0.90595 (factor for 21 to 27 months, col. (b), Table I))	1,884.38	
Present value of $2,120 due 3 years from date of sale ($2,120 × 0.86230 (factor for 33 to 39 months, col. (b), Table I))	$1,828.08	$3,752.46
Total unstated interest		247.54

Example (5). On December 31, 1974, A sells property to B under a contract which provides that B is to make four payments of $2,000 each, such payments being due, respectively, at the end of each year for the next four years. No interest is provided for in the contract. For purposes of paragraph (a) of this section, the total unstated interest under the contract is $918.38 (using Table III because the sale occurred before July 24, 1975). The computation is as follows:

Sum of payments to which sec. 483 applies...	$8,000.00
Less: Present value of $2,000 due every 12 months for 4 years ($2,000 × 3.54081 (factor for 4 years, col. (b), Table III))	7,081.62
Total unstated interest	918.38

Example (6). On December 31, 1975, A sells property to B under a contract which provides that B is to make three payments of $2,000 each, such payments being due, respectively, at the end of each year for the next 3 years. No interest is provided for in the contract. For purposes of paragraph (a) of this section, the total unstated interest under the contract is $763.10 (using Table VI rather than Table III because the contract was entered into after July 24, 1975). The computation is as follows:

Sum of payments to which sec. 483 applies...	$6,000.00
Less: Present value of $2,000 due every 12 months for 3 years ($2,000 × 2.61845 (factor for 3 years, col. (b), Table VI))	5,236.90
Total unstated interest	763.10

Example (7). On December 31, 1981, A sells property to B under a contract which provides that B is to make two payments of $1,000 each, payable August 1, 1982, and November 1, 1982, and a third payment of $2,000, payable March 1, 1983. No interest is provided for in the contract. For purposes of paragraph (a) of this section, the total unstated interest under the contract is $326.53 computed as follows:

Sum of payments to which sec. 483 applies...		$4,000.00
Less:		
Present value of $1,000 due August 1, 1982 ($1,000 × .95238 (factor for 6 to 9 months, col. (b), Table VII))	$952.38	
Present value of $1,000 due November 1, 1982 ($1,000 × .90703 (factor for 9 to 15 months, col. (b), Table VII))	907.03	
Present value of $2,000 due March 1, 1983 ($2,000 × .90703 (factor for 9 to 15 months, col. (b), Table VII))	1,814.06	3,673.47
Total unstated interest		326.53

(4) Special rules for binding contracts entered into before July 24, 1975. (i) Payments made pursuant to a sale or exchange occurring before July 24, 1975, shall continue to be subject to the 5 percent prescribed interest rate of paragraph

(c)(2)(ii)(A) of this section and the 4 percent prescribed test rate of paragraph (d)(1)(ii)(A) of this section even though there has been a change in the terms of the contract.

(ii) Where payments are made pursuant to the sale or exchange of property on or after July 24, 1975, and before July 1, 1981, but under the terms of a binding written contract (including an irrevocable written option) entered into before July 24, 1975, and there has been a substantial change (within the meaning of paragraph (b)(4) of this section) in terms of such contract, then if the change occurs on or after July 24, 1975, the 7 percent prescribed interest rate of paragraph (c)(2)(ii)(B) of this section and the 6 percent prescribed test rate of paragraph (d)(1)(ii)(B) of this section shall be applied to payments made after the occurrence of such substantial change. If the change occurs before July 24, 1975, the payments shall continue to be subject to the 5 percent prescribed interest rate of paragraph (c)(2)(ii)(A) of this section and the 4 percent prescribed test rate of paragraph (d)(1)(ii)(A) of this section.

(iii) Where payments are made pursuant to a sale or exchange occurring on or after July 1, 1981, but under the terms of a binding written contract (including an irrevocable written option) entered into before July 24, 1975, and there has been a substantial change (within the meaning of paragraph (b)(4) of this section) in the terms of such contract on or after July 24, 1975, then the prescribed interest rate and the prescribed test rate applied to payments made after the occurrence of the substantial change shall be 7 percent and 6 percent, respectively, if the change is made before September 29, 1980, and 10 percent and 9 percent, respectively, if the change is made after September 29, 1980. If the change occurs before July 24, 1975, the payments shall continue to be subject to the 5 percent prescribed interest rate of paragraph (c)(2)(ii)(A) of this section and the 4 percent prescribed test rate of paragraph (d)(1)(ii)(A) of this section.

(5) Special rule for binding contracts entered into on or after July 24, 1975, and before September 29, 1980. Payments made pursuant to a sale or exchange occurring after July 23, 1975, and before July 1, 1981, except a sale or exchange entered into pursuant to a binding written contract (including an irrevocable written option) entered into before July 24, 1975, shall continue to be subject to the 7 percent prescribed interest rate of paragraph (c)(2)(ii)(B) of this section and the 6 percent prescribed test rate of paragraph (d)(1)(ii)(B) of this section even though there has been a change in the terms of the contract. However, where payments are made pursuant to a sale or exchange occurring on or after July 1, 1981, but under the terms of a binding written contract entered into after July 24, 1975 and before September 29, 1980, and there has been a substantial change (within the meaning of paragraph (b)(4) of this section) in the terms of such contract on or after September 29, 1980, then the 10 percent prescribed interest rate of paragraph (c)(2)(ii)(C) of this section and the 9 percent prescribed test rate of paragraph (d)(1)(ii)(C) of this section shall be applied to payments made after the occurrence of such substantial change. If the substantial change occurs before September 29, 1980, then the payments shall continue to be subject to the 7 percent interest rate of paragraph (c)(2)(ii)(B) of this section and the 6 percent test rate of paragraph (d)(1)(ii)(B) of this section.

(d) Test of whether there is total unstated interest under a contract—(1) In general—(i) How to apply prescribed test rate. Except as provided in paragraph (d)(2) and (3) of this section for purposes of determining whether section 483 applies to payments under a contract (that is, for purposes of paragraph (b)(1)(ii) of this section), the determination of whether there is total unstated interest under a contract shall be made in accordance with the method for computing total unstated interest provided in paragraph (c) of this section, except that column (a) of the appropriate table contained in paragraph (g)(2) of this section (which provides for discounting payments at the appropriate test rate prescribed by paragraph (d)(1)(ii) of this section) shall be used to determine the present value of a payment. If, after applying the appropriate test rate, there is total unstated interest (regardless of amount) with respect to a contract, section 483 applies to the payments described in paragraph (b) of this section which are due under the contract. In such case, the amount of total unstated interest under the contract which is includible in or deductible from income must be computed by using the higher interest rate prescribed in paragraph (c) of this section, and then allocating such amount among the payments due under the contract in the manner provided in paragraph (a) of this section.

(ii) Prescribed test rates. (A) For payments on account of a sale or exchange of property entered into before July 24, 1975, as well as a sale or exchange of property entered into pursuant to a binding written contract (including an irrevocable written option) entered into before such date, the test rate prescribed by paragraph (d)(1)(ii)(A) of this section shall be 4 percent per annum simple

interest. (See paragraph (c)(4) of this section for special rules where there has been a substantial change in the terms of a binding written contract entered into before July 24, 1975.)

(B) For payments on account of a sale or exchange of property entered into on or after July 24, 1975, and before July 1, 1981, except a sale or exchange entered into pursuant to a binding written contract (including an irrevocable written option) entered into before July 24, 1975, the test rate prescribed by paragraph (d)(1)(ii)(B) of this section shall be 6 percent per annum simple interest. For payments on account of a sale or exchange of property entered into on or after July 1, 1981, pursuant to a binding written contract (including an irrevocable written option) entered into after July 23, 1975, and before September 29, 1980, the test rate prescribed by paragraph (d)(1)(ii)(B) of this section shall be 6 percent per annum simple interest. (See paragraph (c)(5) of this section for special rules where there has been a substantial change in the terms of a contract entered into after July 23, 1975 and before September 29, 1980.)

(C) For payments on account of a sale or exchange of property entered into on or after July 1, 1981, except a sale or exchange entered into pursuant to a binding written contract (including an irrevocable written option) entered into before September 29, 1980, the test rate prescribed by paragraph (d)(1)(ii)(C) of this section shall be 9 percent per annum simple interest. (See paragraph (c)(5) of this section for special rules where there has been a substantial change in the terms of a contract entered into before September 29, 1980).

(2) Alternative test where contract rate is at least that prescribed in paragraph (d)(1)(ii) of this section. The method provided in paragraph (d)(1) of this section for determining whether there is total unstated interest need not be used in the case of a contract which provides for interest at a rate of at least that prescribed in paragraph (d)(1)(ii) of this section, payable on each installment of principal at the time such installment is payable. For purposes of paragraph (b)(1)(ii) of this section, there is no total unstated interest under such a contract and, therefore, section 483 does not apply to payments under such a contract. For purposes of this paragraph, simple interest means straight interest computed on the principal amount of a payment from the time of the sale or exchange to the time the payment is required to be made. As an illustration of the meaning of simple interest, if a contract provides for payments totaling $6,000 in 3 equal installments of $2,000 plus 4 percent per annum simple interest, such installments of principal and interest being due 1, 2, and 3 years, respectively, from the date of the sale, the amount of interest due with the first installment is $80 ($2,000×0.04×1), the amount of interest due with the second installment is $160 ($2,000×0.04×2), and the amount of interest due with the third installment is $240 ($2,000×0.04×3).

(3) Test rate for certain obligations. The test rate of interest for determining whether there is total unstated interest shall be zero in the case of—

(i) A contract under which the purchaser is the United States, a State, or any other governmental body described in section 103 (relating to interest on certain governmental obligations), and under which the deferred payments are made pursuant to an obligation to which section 103 applies, or

(ii) An evidence of indebtedness which is issued after May 27, 1969, by a corporation in an exchange for property (other than money) which results under paragraph (b)(2)(iii) of § 1.1232–3 in creating original issue discount subject to ratable inclusion under section 1232(a)(3) in the holder's gross income.

(4) Examples. The provisions of this paragraph may be illustrated by the following examples (Note that examples (1) through (6) use Tables I through VI, because such tables apply generally to transactions entered into before July 1, 1981, and that the principles illustrated by such examples would apply for transactions entered into on or after July 1, 1981, in which case Tables VII through IX would generally be applied.):

Example (1). On December 31, 1963, A sells property to B under a contract which provides that B is to make payments at the end of each of the next 3 years of $2,000 principal, plus 5 percent per annum simple interest. Since the interest rate specified in the contract with respect to each payment is higher than the test rate (4 percent per annum simple interest), it is not necessary to compute whether there is total unstated interest under subparagraph (1) of this paragraph, and section 483 does not apply to any payments due under the contract.

Example (2). The facts are the same as in example (1), except that the interest rate provided in the contract is 2 percent per annum simple interest. Since the interest rate specified in the contract is less than the test rate (4 percent per annum simple interest), section 483 applies to each of the payments of sales price due under the contract. For the method of computing the amount of total unstated interest which is includible in or deductible from income, see paragraph (c) of this section.

Example (3). On December 31, 1963, A sells property to B under a contract which provides that B is to make payments of $2,040 ($2,000 sales price plus $40 interest), $2,080 ($2,000 sales price plus $80 interest), and $2,120 ($2,000 sales price plus $120 interest), such payments being due, respectively, 1, 2,

and 3 years from the date of sale. The determination of whether there is total unstated interest under the contract is made in the following manner:

(i) Sum of payments to which sec. 483 applies		$6,000.00
(ii) Sum of:		
Present value of $2,040 due 1 yr. from date of sale ($2,040 × 0.96154 (factor for 9 to 15 months, col. (a), Table I)) ..	$1,961.54	
Present value of $2,080 due 2 years from date of sale ($2,080 × 0.92593 (factor for 21 to 27 months, col. (a), Table I)) ..	1,925.93	
Present value of $2,120 due 3 years from date of sale ($2,120 × 0.89286 (factor for 33 to 39 months, col. (a), Table I)) ..	1,892.86	
Total		5,780.33

Since the sum of the payments to which section 483 applies ($6,000) exceeds the sum of the present values of such payments and the present values of the stated interest payments ($5,780.33), there is total unstated interest under the contract and the provisions of section 483 apply to the payments of sales price due under the contract. For the method of computing the amount of total unstated interest which is includible in or deductible from income, see paragraph (c) of this section.

Example (4). (i) On December 31, 1963, A sells property to B under a contract which provides that B is to make four $1,000 payments, each payment bearing 4 percent per annum simple interest. Such payments are due, respectively, 1, 2, 3, and 4 years from the date of sale. Thus, the payments would be: $1,040 ($1,000 sales price plus $40 interest), $1,080 ($1,000 sales price plus $80 interest), $1,120 ($1,000 sales price plus $120 interest), and $1,160 ($1,000 sales price plus $160 interest). The total interest stated in the contract for the 4-year period is $400. Since the interest rate specified in the contract between A and B is equal to the test rate (4 percent per annum simple interest), subparagraph (2) of this paragraph applies. Therefore, it is not necessary to compute whether there is total unstated interest under subparagraph (1) of this paragraph, and section 483 does not apply to any payments due under the contract.

(ii) On the same date, A sells property to C under a contract which provides that C is to make four payments of $1,000 each, such payments being due, respectively, 1, 2, 3, and 4 years from the date of sale. No interest is due until the last payment at which time C is to pay $400 interest. Since the contract between A and C does not provide for interest at a rate of at least 4 percent per annum, payable on each installment of principal at the time such installment is payable, subparagraph (2) of this paragraph does not apply and the determination of whether there is total unstated interest must be made under subparagraph (1) of this paragraph, as follows:

(*a*) Sum of payments to which sec. 483 applies		$4,000.00
(*b*) Sum of:		
Present value of $1,000 due every 12 months for 4 years ($1,000 × 3.64240 (factor for 4 years, col. (a), Table III))	$3,642.40	
Present value of $400 stated interest due 4 years from date of sale ($400 × 0.86207 (factor for 45 to 51 months, col. (a), Table I))	344.83	
Total		3,987.23

Since the sum of the payments to which section 483 applies ($4,000) exceeds the sum of the present values of such payments and the present value of the stated interest payment ($3,987.23), there is total unstated interest under the contract, and the provisions of section 483 apply to the payments of sales price due under the contract. For the method of computing the amount of total unstated interest which is includible in or deductible from income, see paragraph (c) of this section.

Example (5). (i) The facts are the same as in Example (4), except that the date of the sale of property to both B and C is December 31, 1973. Although three of the four payments under the contracts between A and B and between A and C are to be made after July 24, 1975, the test rate of 4 percent per annum simple interest is still applied to all payments in determining for purposes of this paragraph whether there is total unstated interest under either contract because in each case the sale occurred before July 24, 1975.

(ii) Since the interest rate specified in the contract between A and B is equal to the test rate of 4 percent per annum simple interest, paragraph (d)(2) of this section applies. Therefore, it is not necessary to compute whether there is total unstated interest under paragraph (d)(1) of this section, and section 483 does not apply to any payments due under the contract.

(iii) Since the contract between A and C does not provide for interest at a rate of at least 4 percent per annum, payable on each installment of principal at the time such installment is payable, paragraph (d)(2) of this section does not apply and the determination of whether there is total unstated interest must be made under paragraph (d)(1) of this section, in the same manner, and using the same tables, as computed in Example (4)(ii). Since the sum of the payments to which section 483 applies ($4,000) exceeds the sum of the present value of such payments and the present value of the stated interest payment ($3,987.23), there is total unstated interest under the contract and the provisions of section 483 apply to the payments of sales price due under the contract. For the method of computing the amount of total unstated interest which is includible in or deductible from gross income, the rules in paragraph (c) of this section are applied, using Tables I and III and not Tables IV and VI.

Example (6). On December 31, 1975, A sells property to B under a contract which provides that B is to make payments of $2,040 ($2,000 sales price plus $40 interest), $2,080 ($2,000 sales price plus $80 interest), and $2,120 ($2,000 sales price plus $120 interest), such payments being due, respectively, 1, 2, and 3 years from the date of sale. Because the contract was entered into after July 24, 1975, the determination of whether there is total unstated interest under the contract is made using Table IV instead of Table I in the following manner:

(i) Sum of payments to which sec. 483 applies	$6,000.00
(ii) Sum of:	
Present value of $2,040 due 1 yr. from date of sale ($2,040 × 0.94340 (factor for 9 to 15 months, col. (a), Table IV))	1,924.54
Present value of $2,080 due 2 yrs. from date of sale ($2,080 × 0.89286 (factor for 21 to 27 months, col. (a), Table IV))	1,857.15
Present value of $2,120 due 3 yrs. from date of sale ($2,120 × 0.84746 (factor for 33 to 39 months, col. (a), Table IV))	1,796.62
Total	5,578.31

Since the sum of the payments to which section 483 applies ($6,000) exceeds the sum of the present values of such payments and the present values of the stated interest payments

($5,578.31), there is total unstated interest under the contract and the provisions of section 483 apply to the payments of sales price due under the contract. For the method of computing the amount of total unstated interest which is includible in or deductible from income, see paragraph (c) of this section.

Example (7). On December 31, 1981, A sells property to B under a contract which provides that B is to make payments of $2,040 ($2,000 sales price plus $40 interest), $2,080 ($2,000 sales price plus $80 interest), and $2,120 ($2,000 sales price plus $120 interest), such payments being due, respectively, 1, 2, and 3 years from the date of sale. Because the contract was entered into after July 1, 1981, the determination of whether there is total unstated interest under the contract is made using Table VII in the following manner:

(i) Sum of payment to which sec. 483 applies		$6,000.00
(ii) Sum of:		
Present value of $2,040 due 1 yr. from date of sale ($2,040 × .91743 (factor for 9 to 15 months, col. (a), Table VII))	$1,871.56	
Present value of $2,080 due 2 yrs. from date of sale ($2,080 × .84746 (factor for 21 to 27 months, col. (a), Table VII))	1,762.72	
Present value of $2,120 due 3 yrs. from date of sale ($2,120 × .78740 (factor for 33 to 39 months, col. (a), Table VII))	1,669.29	5,303.57
Total unstated interest		696.43

Since the sum of the payments to which section 483 applies ($6,000) exceeds the sum of the present values of such payments and the present values of the stated interest payments ($5,303.57), there is total unstated interest under the contract, and the provisions of section 483 apply to the payments of sales price due under the contract. For the method of computing the amount of total unstated interest which is includible in or deductible from income, see paragraph (c) of this section.

(e) Payments that are indefinite as to time, liability, or amount—(1) In general. In the case of a contract for the sale or exchange of property under which there are any indefinite payments, section 483 shall be separately applied to each such indefinite payment as if it (and any amount of interest attributable to such indefinite payment) was the only payment due under the contract, and the effect of the application of section 483 shall be determined at the time such payment is made. For purposes of section 483, a payment shall be considered as indefinite if the liability for, or the amount or due date of, such payment cannot be determined at the time of the sale or exchange. Thus, if, at the time of the sale or exchange, some or all of the payments under the contract are indefinite, the determination as to whether there is total unstated interest (see paragraph (d) of this section), and if so, the computation of the amount of total unstated interest which is includible in or deductible from income (see paragraph (c) of this section), shall be made separately with respect to each indefinite payment as of the time it is received, taking into account the time interval between the sale or exchange and the receipt of the payment (to the nearest 6-month interval). Section 483 shall be applied separately to the aggregate of any definite payments which may also be due under the contract. Section 483 does not apply to any indefinite payment which is made no more than 1 year after the date of the sale or exchange even if there are other payments (definite or indefinite) under the contract made more than a year after such date. The provisions of this subparagraph shall apply notwithstanding the fact that the obligation under which such payment is made has been valued and the transaction treated as "closed" for purposes of determining gain or loss. See paragraph (b)(5) of this section for rules relating to evidence of indebtedness. See paragraph (b)(1)(i) of § 1.483–2 for rule relating to the effect on indefinite payments of the exception for contracts with a sales price of $3,000 or less.

(2) Contingent interest. If a deferred-payment contract provides for contingent interest, no part of such contingent interest shall be taken into account for purposes of section 483 until it is actually paid. For example, contingent interest shall not be taken into account in determining whether there is total unstated interest under the contract. For purposes of section 483, interest shall be considered as contingent if the liability for, or the amount or due date of, such interest cannot be determined at the time of the sale or exchange. If any part of the interest provided for in the contract is not contingent interest, such part shall be taken into account as stated interest for purposes of section 483. In case any amount of contingent interest is actually paid, such payment shall be treated in accordance with the rules prescribed for indefinite payments in subparagraph (1) of this paragraph if the payment of the portion of the sales price to which the interest is attributable is indefinite, or in accordance with the rules prescribed for changes in the terms of the contract (see paragraph (f) of this section) if the payment of the portion of the sales price to which the interest is attributable is definite. If the contract provides that all or a definite part of the interest must in all events be paid by a date specified in the contract (whether or not in certain circumstances it must be paid earlier), then such interest (or the definite part thereof) shall not be considered contingent interest and shall be taken into account as stated interest due on such specified date. If any amount of interest described in the preceding sentence is actually paid before such specified date then such

payment shall be treated in accordance with the rules prescribed for indefinite payments in subparagraph (1) of this paragraph if the payment of the portion of the sales price to which the interest is attributable is indefinite, or in accordance with the rules prescribed for changes in the terms of the contract (see paragraph (f) of this section) if the payment of the portion of the sales price to which the interest is attributable is definite.

(3) **Examples.** The provisions of this paragraph may be illustrated by the following examples (Note that examples (1) through (7) use Tables I through VI, because such tables apply generally to transactions entered into before July 1, 1981, and that the principles illustrated by such examples would apply for transactions entered into on or after July 1, 1981, in which case Tables VII and IX would generally be applied.):

Example (1). On December 31, 1963, A sells property to B under a contract which provides that B is to pay $40,000 at the time of sale and $10,000 on December 29th of each year for the next 3 years, unless profits derived from the property exceed a specified amount during the year, in which case, in such year, B is to pay $12,000. No interest is provided for in the contract. For the year 1964, profits have exceeded the specified amount and B pays $12,000. For 1965 B pays only $10,000, but for 1966 profits have again exceeded the specified amount and B pays $12,000. Since, on the date of sale, there are definite payments due under the contract, total unstated interest is computed with respect to the aggregate of such definite payments. The total unstated interest under the contract, determined as of December 31, 1963, is $2,799.40, computed as follows:

Sum of definite payments to which sec. 483 applies	$30,000.00
Less: Present value of $10,000 due every 12 months for 3 years ($10,000 × 2.72006 (factor for 3 years, col. (b), Table III))	27,200.60
Total unstated interest	2,799.40

At the time of receipt of the indefinite portion ($2,000) of the first payment ($12,000), additional unstated interest is not computed on the amount of such indefinite portion since payment was made no more than 1 year after the date of the sale. At the time of receipt of the indefinite portion ($2,000) of the last payment ($12,000), additional unstated interest is computed based on the amount of such indefinite portion. The additional unstated interest at the end of the third year is $275.40, computed as follows:

Indefinite portion of payment to which sec. 483 applies	$2,000.00
Less: Present value of such portion ($2,000 × 0.86230 (factor for 33 to 39 months, col. (b), Table I))	1,724.60
Total unstated interest	275.40

Example (2). M Corporation and N Corporation each own one-half of the stock of O Corporation. On December 31, 1963, pursuant to a reorganization qualifying under section 368(a)(1)(B), M contracts to acquire the one-half interest held by N for an initial distribution on such date of 30,000 shares of M voting stock, and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O Corporation exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1964 or in 1965, but in 1966 the annual earnings of O Corporation exceed the specified amount and on December 31, 1966, an additional 3,000 M voting shares are transferred to N. The fair market value of such shares on the date of transfer is $60,000 ($20 per share). The total unstated interest applicable to the indefinite payment is $8,262, computed as follows:

Indefinite payment to which sec. 483 applies	$60,000.00
Less: Present value of such payment ($60,000 × 0.86230 (factor for 33 to 39 months, col. (b), Table I))	51,738.00
Total unstated interest	8,262.00

See paragraph (a)(2) of § 1.483–2 for the effect on a reorganization defined in section 368(a)(1) of treating a portion of voting stock as interest under section 483.

Example (3). On December 31, 1963, A sells property to B under a contract which provides that B is to make one payment on May 1, 1965. No interest is provided for in the contract and, at the time of sale, the adjusted basis of the property to A is $2,000. Assume that the amount of the payment is indefinite but that the contract has an ascertainable fair market value of $8,000. For the year 1963, A includes $6,000 ($8,000 value of contract minus $2,000 adjusted basis) in gross income from the sale of the property and the transaction is treated as "closed" for purposes of determining gain or loss. On May 1, 1965, A collects $9,000 on the contract (which is more than the valuation that was placed on the contract in 1963). Section 483 applies to the $9,000 payment and $642.60 is treated as total unstated interest, computed as follows:

Indefinite payment to which sec. 483 applies	$9,000.00
Less: Present value of such payment ($9,000 × 0.92860 (factor for 15 to 21 months, col. (b), Table I))	8,357.40
Total unstated interest	642.60

The excess of the amount collected ($9,000) reduced by the amount treated as unstated interest ($642.60) under section 483 is $8,357.40. The excess of such amount ($8,357.40) over the value of the contract as determined in 1963 ($8,000) shall be included in income in accordance with the other applicable provisions of the Code. Thus, $357.40 is included in income.

Example (4). The facts are the same as in example (3), except that on May 1, 1965, A collects only $6,000 on the contract (which is less than the valuation that was placed on the contract in 1963). Section 483 applies to the $6,000 payment and $428.40 is treated as total unstated interest, computed as follows:

Indefinite payment to which sec. 483 applies	$6,000.00
Less: Present value of such payment ($6,000 × 0.92860 (factor for 15 to 21 months, col. (b), Table I))	5,571.60
Total unstated interest	428.40

The amount collected ($6,000) reduced by the amount treated as unstated interest ($428.40) under section 483 is $5,571.60. The excess of the value of the contract as determined in 1963 ($8,000) over such amount ($5,571.60) shall be treated as a loss in accordance with the other applicable provisions of the Code. Thus, $2,428.40 is treated as a loss.

Example (5). On December 31, 1963, A sells a capital asset which has an adjusted basis in A's hands of $100,000 to B

under a contract which provides that B is to make payments on January 15th of 1965, 1966 and 1967, the amount of such payments being dependent solely on the profits derived from the property. No interest is provided for in the contract. Assume that this is a rare and extraordinary case (see paragraph (a)(2) of § 1.453–6) in which the contract does not have an ascertainable fair market value and that A is permitted to apply payments of sales price in reduction of basis before being required to include any amount as gain on the transaction. For 1965, B pays A $50,000, for 1966 $100,000, and for 1967 $100,000.

(i) For the year 1965, the $50,000 payment would be allocated $2,409.50 as total unstated interest and $47,590.50 as return of capital, computed as follows:

(*a*) Indefinite payment to which sec. 483 applies	$50,000.00
Less: Present value of such payment ($50,000 × 0.95181 (factor for 9 to 15 months, col. (b), Table I))	47,590.50
Total unstated interest	2,409.50
(*b*) Return of capital	47,590.50

(ii) For the year 1966, the $100,000 payment would be allocated $9,405 as total unstated interest, $52,409.50 as return of capital, and $38,185.50 as capital gain, computed as follows:

(*a*) Indefinite payment to which sec. 483 applies	$100,000.00
Less: Present value of such payment ($100,000 × 0.90595 (factor for 21 to 27 mos., col. (b), Table I))	90,595.00
Total unstated interest	9,405.00
(*b*) Payment of principal	90,595.00
Plus: Amount of capital returned in 1965	47,590.50
	138,185.50
Less: Adjusted basis of property	100,000.00
Capital gain	38,185.50

(iii) For the year 1967, the $100,000 payment would be allocated $13,770 as total unstated interest and $86,230 as capital gain, computed as follows:

(*a*) Indefinite payment to which sec. 483 applies	$100,000.00
Less: Present value of such payment ($100,000 × 0.86230 (factor for 33 to 39 months, col. (b), Table I))	86,230.00
Total unstated interest	13,770.00
(*b*) Capital gain	86,230.00

Example (6). The facts are the same as those in Example (1), except that the property is sold on December 31, 1973, and all other relevant dates are 10 years later. Although two of the three payments due under the contract are to be made after July 24, 1975, total unstated interest is computed in the same manner, and using the same tables as in Example (1), because the sale of property occurred before July 24, 1975. Thus, total unstated interest under the contract, determined as of December 31, 1973, is $2,799.40, and the additional unstated interest at the end of the third year (1976) is $275.40.

Example (7). On December 31, 1975, A sells property to B under a contract which provides that B is to pay $40,000 at the time of the sale and $10,000 on December 29th of each year for the next three years, unless profits exceed a specified amount during the year, in which case, B is to pay $12,000 in that year. No interest is provided for in the contract. For the year 1976 profits have exceeded the specified amount and B pays $12,000. For 1977 B pays only $10,000, but for 1978 profits have again exceeded the specified amount and B pays $12,000. Since, on the date of sale, there are definite payments due under the contract, total unstated interest is computed with respect to the aggregate of such definite payments. The total unstated interest under the contract, determined as of December 31, 1975 is $3,815.50 (using Tables IV and VI rather than Tables I and III because the contract was entered into after July 24, 1975). The computation is as follows:

Sum of definite payments to which sec. 483 applies	$30,000.00
Less: Present value of $10,000 due every 12 months for 3 years ($10,000 × 2.61845 (factor for 3 years, col. (b), Table VI))	26,184.50
Total unstated interest	3,815.50

At the time of receipt of the indefinite portion ($2,000) of the first payment ($12,000), additional unstated interest is not computed on the amount of such indefinite portion since payment was made no more than 1 year after the date of the sale. At the time of receipt of the indefinite portion ($2,000) of the last payments ($12,000), additional unstated interest is computed based on the amount of such indefinite portion.

The additional *unstated interest at the end of the third year is $373.00, computed as follows:*

Indefinite portion of payment to which sec. 483 applies	$2,000.00
Less: Present value of such portion ($2,000 × 0.81350 (factor for 33 to 39 months, col. (b), Table IV))	1,627.00
Total unstated interest	373.00

Example (8). M Corporation and N Corporation each own one-half of the stock of O Corporation. On December 31, 1981, pursuant to a reorganization qualifying under section 368(a)(1)(b), M contracts to acquire the one half interest held by N for an initial distribution on such date of 30,000 shares of M voting stock, and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years provided the net profits of O Corporation exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1982, or 1983, but in 1984, the annual earnings of O Corporation exceed the specified amount and on December 31, 1984, an additional 3,000 voting shares are transferred to N. The fair market value of such shares on the date of transfer is $60,000 ($20 per share). The total unstated interest applicable to the indefinite payment is computed as follows:

Indefinite payment to which sec. 483 applies	$60,000.00
Less:	
Present value of such payment ($60,000 × .74622 (factor for 33 to 39 months, col. (b), Table VII))	44,773.20
Total unstated interest	$15,226.80

See paragraph (a)(2) of § 1.483–2 for the effect on a reorganization defined in section 368(a)(1) of treating a portion of voting stock as interest under section 483.

(f) **Changes in terms of contract—(1) In general.** If the liability for, or the amount or due date of, any payment (including interest) under a contract for the sale or exchange of property is changed during any taxable year (referred to as the "year of change"), the total unstated interest under the contract shall be recomputed under the

rules of paragraphs (c) and (d) of this section (as if the original contract had contained the changed terms) and allocated (in the manner provided in subparagraph (4) of this paragraph) with adjustment for prior interest (including unstated interest) payments. The provisions of this paragraph apply regardless of whether there was total unstated interest under the original contract. In general, a late payment or an early payment (including a prepayment) is considered a change in the due date of such payment to the date on which the payment is actually made, and therefore is considered a change in the terms of the contract. However, for purposes of the preceding sentence, the due date of a payment shall not be considered changed merely because the payment is late (or early), provided the payment is made no later (or earlier) than 90 days after (or before) the date the payment was due under the contract. Furthermore, any additional interest which is paid by the purchaser because of a late payment, either under the terms of the contract or under the provisions of local law, shall be taken into account as stated interest for purposes of any recomputation of total unstated interest under the contract. In general, a novation is considered a change in the terms of the contract. However, for special rules relating to the transfer of the obligation to make deferred payments or of the right to receive deferred payments, see subparagraph (6) of this paragraph. A default in remaining payments under a contract (regardless of whether the property is repossessed or the debtor is released from liability under the contract) is also considered a change in the terms of the contract for purposes of section 483. In such case, the contract shall be considered as having been changed so as to provide for a reduction in the stated sales price to the amount that has actually been paid by the debtor as of the date of the default, and total unstated interest shall be recomputed based on such revised contract. Any payments subsequently made by or on behalf of the debtor with respect to his obligation (including payments on a deficiency judgment) shall be treated as indefinite payments under the contract in accordance with the rules prescribed in paragraph (e) of this section. For purposes of section 483, the value of the repossessed property is not considered a payment under the contract.

(2) Effect of change in terms of contract on characterization as principal or interest. Except as otherwise provided in this paragraph, the characterization as principal or interest of any portion of a payment under a contract for the sale or exchange of property is not changed as a result of events occurring after the close of the taxable year in which the payment is made. Thus, for example, if a portion of a payment was characterized as interest for a prior year, and such characterization resulted in a corporation being treated as a personal holding company for such prior year, any change in the terms of the contract does not decrease the portion of such payment characterized as interest for purposes of redetermining personal holding company status for such prior year. However, the parties to a contract may change its terms so as to alter for the year of change and for any subsequent years the characterization as principal and interest of any portion of a payment under the contract.

(3) Effect on basis of change in terms of contract. If the terms of the contract are changed so that the amount of total unstated interest (if any) under the revised contract differs from the amount of total unstated interest (if any) under the original contract, the basis to the purchaser of any property which was sold or exchanged under the original contract (or to any other person whose basis for such property is determined in whole or in part by reference to the basis of the purchaser) shall be redetermined as of the date of the change by taking into account any recomputation of total unstated interest. Thus, such purchaser (or such other person) shall redetermine his basis only if he has not sold, exchanged, or otherwise disposed of such property at the time the change in the terms of the contract is made.

(4) Allocation of recomputed total unstated interest. **(i)** If the amount of total unstated interest recomputed under the contract (as changed) exceeds the amount of total unstated interest previously returned as income or deducted under the contract (prior to the change in terms), such excess amount shall be allocated on a pro rata basis among the remaining definite payments due under the revised contract; that is, there shall be treated as interest that part of a definite payment (due under the revised contract) to which section 483 applies which bears the same ratio to the amount of such payment as such excess amount bears to the total of the remaining definite payments to which section 483 applies which are due under such revised contract. For purposes of this subdivision, the determination of whether a payment is definite shall be made at the time the contract is changed.

(ii) If the amount of total unstated interest recomputed under the contract (as changed) is less than the amount of total unstated interest previously returned as income or deducted (under the contract prior to the change in terms) the amount

of the difference shall be deducted from the income of the seller or added to the income of the purchaser for the year of the change.

(5) Examples. The provisions of paragraph (f)(1) through (5) of this section may be illustrated by the following examples (Note that the examples use Tables I through III because the examples deal with transactions to which these tables apply. These tables generally apply to transactions entered into after July 30, 1963, and before July 24, 1975. The principles illustrated by the examples also apply to all other transactions to which section 483 applies. However, Tables IV through VI are used for transactions to which those tables apply, generally transactions entered into after July 23, 1975, and before July 1, 1981. In addition, Tables VII through IX are used for transactions to which those tables apply, generally transactions entered into on or after July 1, 1981):

Example (1). (i) On December 31, 1963, A, a calendar year taxpayer, sells a capital asset (which A has held more than 6 months and which has an adjusted basis to A of $4,000) to B under a contract which provides that B is to make three payments of $2,000 each, such payments being due on December 31st of 1964, 1965, and 1966. No interest is provided for in the contract. After applying section 483, total unstated interest is determined to be $559.88, and the amount of each $2,000 payment which is treated as interest is determined to be $186.63. For the year 1963, A includes $1,440.12 ($5,440.12 ($6,000 value of B's obligation minus $559.88 total unstated interest) minus $4,000 adjusted basis) as long-term capital gain on the sale of the property. In 1964, A includes $186.63 as interest income. On June 1, 1965, A and B change the terms of the contract making the balance of the payments due immediately. Total unstated interest under the revised contract is $381.98, computed as follows:

Sum of payments to which sec. 483 applies...		$6,000.00
Less:		
Present value of $2,000 due December 31, 1964 ($2,000 × 0.95181 (factor for 9 to 15 months, col. (b), Table I))..	$1,903.62	
Present value of $4,000 due June 1, 1965 ($4,000 × 0.92860 (factor for 15 to 21 months, col. (b), Table I))..........	3,714.40	5,618.02
Total unstated interest (recomputed)............	381.98	

(ii) The portion of the recomputed total unstated interest to be allocated to the final definite payment of $4,000 is $195.35, computed as follows:

Total unstated interest (recomputed)	$381.98
Less: Portion of original total unstated interest previously included in income	186.63
Total unstated interest allocated to final definite payment	195.35

(iii) Since after the change in the terms of the contract a lesser portion of B's payments is treated as interest, a correspondingly greater portion of B's payments is treated as part of the sales price. Accordingly, for the year 1965, A includes as long-term capital gain an additional $177.90, which may be computed as follows:

Total unstated interest (original).............	$559.88
Less: Total unstated interest (recomputed)....	381.98
Additional long-term capital gain for 1965	177.90

Example (2). (i) The facts are the same as in example (1), except that on June 1, 1965, A and B change the terms of the contract by providing that the last two payments shall be due on December 31st of 1966 and 1968. The total unstated interest under the revised contract is $809.38, computed as follows:

Sum of payments to which sec. 483 applies...		$6,000.00
Less:		
Present value of $2,000 due December 31, 1964 ($2,000 × 0.95181 (factor for 9 to 15 months, col. (b), Table I))..	$1,903.62	
Present value of $2,000 due December 31, 1966 ($2,000 × 0.86230 (factor for 33 to 39 months, col. (b), Table I))..	1,724.60	
Present value of $2,000 due December 31, 1968 ($2,000 × 0.78120 (factor for 57 to 63 months, col. (b), Table I))..	1,562.40	5,190.62
Total unstated interest (recomputed) ...		809.38

(ii) The portion of the recomputed total unstated interest to be allocated among the remaining payments under the contract is $622.75, computed as follows:

Total unstated interest (recomputed)	$809.88
Less: Portion of original total unstated interest previously included in income	186.63
Total unstated interest allocated to remaining payments..................	622.75

(iii) The portion of each remaining $2,000 payment which is treated as interest under the revised contract is $311.38

($2,000×$622.75÷$4,000.00)

(iv) Since after the change in the term of the contract a greater portion of B's payments is treated as interest, a correspondingly lesser portion of B's payments is treated as part of the sales price. Accordingly, for the year 1965, A would treat as long-term capital loss the amount of $249.50, which may be computed as follows:

Total unstated interest (recomputed)	$809.38
Less: Total unstated interest (original)	559.88
Amount treated as long-term capital loss for 1965	249.50

Example (3). (i) The facts are the same as in example (1), except that in May 1965 A and B change the terms of the contract by reducing the sales price to a total of $3,000, and by agreeing that B is to pay the remaining balance of $1,000 on June 1, 1965. Total unstated interest under the revised contract is $167.78, computed as follows:

Sum of payments to which sec. 483 applies...		$3,000.00
Less:		
Present value of $2,000 due December 31, 1964 ($2,000 × 0.95181 (factor for 9 to 15 months, col. (b), Table I))..	$1,903.62	

Present value of $1,000 due June 1, 1965 ($1,000 × 0.92860 (factor for 15 to 21 months, col. (b), Table I))	$928.60	$2,832.22
Total unstated interest (recomputed) ...		167.78

(ii) Since the amount of the recomputed total unstated interest under the contract as changed ($167.78) is less than the amount of total unstated interest previously returned as income ($186.63), the amount of the difference ($18.85) shall be deducted from A's income for 1965, and such amount shall be added to B's income for such year.

Example (4). (i) The facts are the same as in example (1), except that B fails to make the payment due on December 31, 1965, and A repossesses the property. The contract is considered as having been changed in 1965 to provide for one $2,000 payment due at the end of 1964. Total unstated interest under the revised contract is $96.38, computed as follows:

Sum of payments to which sec. 483 applies...	$2,000.00
Less: Present value of $2,000 due December 31, 1964 ($2,000 × 0.95181 (factor for 9 to 15 months, col. (b), Table I))	1,903.62
Total unstated interest (recomputed) ...	96.33

(ii) Since the amount of the recomputed total unstated interest under the contract as changed ($96.38) is less than the amount of total unstated interest previously returned as income ($186.63), the amount of the difference ($90.25) shall be deducted from A's income for 1965, and such amount shall be added to B's income for such year.

Example (5). (i) On December 31, 1963, A sells property to B under a contract which provides that B is to make a $1,000 payment at the end of each year for the next 4 years, each payment bearing 4 percent per annum simple interest. Thus, the payments will be in the following amounts: $1,040 ($1,000 sales price plus $40 interest), $1,080 ($1,000 sales price plus $80 interest), $1,120 ($1,000 sales price plus $120 interest), and $1,160 ($1,000 sales price plus $160 interest). Since the interest rate specified in the contract is equal to the test rate (4 percent per annum simple interest) provided in paragraph (d)(2) of this section, it is determined, as of December 31, 1963, that there is no total unstated interest under the contract. B makes the first two payments on time, but the third payment, which is due on December 31, 1966, is not made until December 31, 1967, a year late. At the same time, B makes the final payment. A does not collect any additional interest on the late payment. Since the third payment is more than 90 days late, the date of the payment is considered changed to December 31, 1967. Accordingly, a new determination of whether there is total unstated interest under the revised contract must be made by applying the method provided in paragraph (d)(1) of this section, as follows:

(a) Sum of payments to which sec. 483 applies		$4,000.00
(b) Sum of:		
Present value of $1,040 due 1 year from date of sale ($1,040 × 0.96154 (factor for 9 to 15 months, col. (a), Table I)) ..	$1,000.00	
Present value of $1,080 due 2 years from date of sale ($1,080 × 0.92593 (factor for 21 to 27 months, col. (a), Table I)) ..	1,000.00	
Present value of $2,280 due 4 years from date of sale ($2,280 × 0.86207 (factor for 45 to 51 months, col. (a), Table I)) ..	1,965.52	3,965.52

Since the sum of the payments to which section 483 applies ($4,000) exceeds the sum of the present values of such payments and the present values of the stated interest payments ($3,965.52), there is total unstated interest under the revised contract and the provisions of section 483 now apply to the payments due under the contract.

(ii) The amount of total unstated interest to be allocated to the final $2,000 payment of sales price under the contract and which is includible in A's income and deductible from B's income for 1967 is $160.38, computed as follows:

Sum of payments to which sec. 483 applies...		$4,000.00
Less:		
Present value of $1,040 due 1 year from date of sale ($1,040 × 0.95181 (factor for 9 to 15 months, col. (b), Table I)) ..	$989.88	
Present value of $1,080 due 2 years from date of sale ($1,080 × 0.90595 (factor for 21 to 27 months, col. (b), Table I)) ..	978.43	
Present value of $2,280 due 4 years from date of sale ($2,280 × 0.82075 (factor for 45 to 51 months, col. (b), Table I)) ..	1,871.31	3,839.62
Total unstated interest		160.38

Example (6). The facts are the same as in example (5). On December 31, 1963 (the date of the sale), the basis of the property in the hands of B is $4,000. On March 1, 1968, after all the payments have been made under the contract, B sells the property. Assuming that there were no adjustments to the basis of the property, B's basis for purposes of determining gain or loss on the sale of the property would be $3,839.62 ($4,000 original basis minus $160.38 unstated interest). On the other hand, if B sold the property on November 1, 1966 (prior to the date of the change) his basis for the property would be $4,000.

Example (7). The facts are the same as in example (5), except that the property is sold on December 31, 1973, and all other relevant dates are 10 years later. Although the change in the contract takes place after July 24, 1975, on December 31, 1977, under this paragraph the recomputation of total unstated interest is required to be made as if the original contract had contained the changed terms. Since the sale occurred before July 24, 1975, the test rate for purposes of applying paragraph (d) to the revised contract is still 4 percent per annum simple interest, and the interest rate to be used in computing the amount of total unstated interest under paragraph (c) is still 5 percent per annum compounded semiannually. Thus, the determination of whether there is total unstated interest under the revised contract, and the computation of total unstated interest to be allocated to the final $2,000 payment, are both made by applying Table I (and not Table IV), in the same manner as in example (5). Therefore, the total unstated interest to be allocated to the final $2,000 payment is $160.38.

Example (8). The facts are the same as in example (5), except that the property is sold on December 31, 1973, and all other relevant dates are 10 years later. In addition, when the final $2,000 payment is made on December 31, 1977, interest of $320 is also paid on such amount. Although the change in the contract takes place after July 24, 1975, on December 31, 1977, under this paragraph the recomputation of total unstated interest is required to be made as if the original contract had contained the changed terms. Since the sale occurred before July 24, 1975, the test rate for purposes of applying paragraph (d) to the revised contract is still 4 percent per annum simple interest. Since the $320 of interest which is paid in addition to

the final $2,000 payment is equal to the test rate of 4 percent per annum simple interest, paragraph (d)(2) of this section applies. Therefore, it is not necessary to compute whether there is total unstated interest under paragraph (d)(1) of this section, and section 483 does not apply to the final $2,000 payment.

(6) Transfer of obligation to make or contract right to receive deferred payments. (i) If an obligation to make deferred payments (whether definite or indefinite) under a contract under which there is total unstated interest is transferred by sale, exchange, distribution, or other disposition (for example, if the purchaser under a deferred-payment contract for the sale or exchange of property later transfers that property and the transferee either assumes the purchaser's obligation to the seller or takes the property subject to such obligation), the following rules shall apply—

(a) The person who has the right to receive payments under the obligation shall not be affected with respect to section 483 merely by reason of such transfer.

(b) The transferor of the obligation to make deferred payments shall not be entitled to any deductions for unstated interest with respect to payments due under the obligation after the date of the transfer, unless, by reason of the default of the transferee, the transferor is liable for and makes payments under the obligation.

(c) Section 483 shall apply to the transferee in the same manner that it applied to the transferor; that is, the transferee is entitled to the same deductions (if otherwise allowable) for unstated interest as the transferor would have been entitled to if the transfer had not occurred. Thus, the transferee may be entitled to deduct unstated interest notwithstanding that the sales price to the transferee is no more than $3,000. However, if section 163(b) (relating to deduction for interest on certain installment purchases) applies to the transferee, he shall compute his interest deductions under that section (see paragraph (b)(2) of § 1.483–2) regardless of whether the transferor so computed his interest deductions.

(d) A separate determination must be made, in accordance with the rules prescribed in this section and in § 1.483–2, as to the application of section 483 to the contract between the transferor and the transferee under which the obligation to make the deferred payments is transferred. For purposes of such separate determination, the assumption by the transferee of the obligation of the transferor shall be treated as a payment made at the time of the transfer.

The rules set forth in this subdivision shall apply regardless of whether the transferor is completely released from liability with respect to the person having the right to receive the payments, or remains liable to such person under the obligation if the transferee defaults.

(ii) If a right to receive deferred payments (whether definite or indefinite) under a contract under which there is total unstated interest is transferred by sale, exchange, distribution, or other disposition, the following rules shall apply (except to the extent that such transfer constitutes an assignment of future income)—

(a) The person who has the obligation to make payments under the contract shall not be affected with respect to section 483 merely by reason of such transfer.

(b) The transferor of the contract right to receive deferred payments shall treat any amount realized (as defined in section 1001(b)) from the transferee as the final payment under his contract with the person having the obligation to make the payments, and shall recompute his total unstated interest under such contract under the rules provided in subparagraphs (1) through (5) of this paragraph.

(c) The transferee of such contract right shall treat the payments he receives from the person having the obligation to make the payments as if they were received under a contract for the sale or exchange of property entered into with such person on the date of the transfer. Thus, the transferee shall determine, in accordance with the rules prescribed in this section and in § 1.483–2, the applicability of section 483 to such payments.

(d) A separate determination must be made, in accordance with the rules prescribed in this section and in § 1.483–2, as to the application of section 483 to the contract between the transferor and transferee under which the contract right to receive the deferred payments is transferred.

The rules set forth in this subdivision shall apply regardless of whether the transferor is made liable (under the contract with the transferee) for any payments which are not received by the transferee by reason of the default of the person having the obligation to make such payments.

(iii) If section 483 does not apply to an obligation to make or a contract right to receive deferred payments (for example, because of an exception set forth in section 483(f)), the following rules shall apply in the case of a transfer of such

obligation or contract right, whether by sale, exchange, distribution, or other disposition—

(a) Section 483 shall not become applicable to the obligation or contract right merely by reason of such a transfer. However, if the transferee and the person having the obligation to make (or the right to receive) the payments under the contract change its terms, a determination must be made as to whether section 483 applies to the contract as changed. For example, if the only reason section 483 did not apply to a deferred-payment contract was because no payment was due more than 1 year after the date of the sale or exchange, any change in the terms of the contract by the transferee and such person, which makes a payment fall due more than 1 year after the date of such sale or exchange would make section 483 apply to the contract. For special rules relating to the application of the effective date provisions to transfer, see paragraph (b)(4) of this section.

(b) A separate determination must be made as to the application of section 483 to the contract between the transferor and the transferee under which an obligation to make or a contract right to receive deferred payments is transferred. For purposes of such separate determination, the assumption by the transferee of the obligation of the transferor shall be treated as an evidence of indebtedness of the transferee.

(iv) The provisions of paragraph (f)(6) of this section may be illustrated by the following examples (Note that the examples use Tables I through III because the examples deal with transactions to which these tables apply. These tables apply generally to transactions entered into after July 30, 1963, and before July 24, 1975. The principles illustrated by the examples also apply to all other transactions to which section 483 applies. However, Tables IV and VI are used for transactions to which these tables apply, generally transactions entered into after July 23, 1975, and before July 1, 1981. In addition, Tables VII through IX are used for transactions to which those tables apply, generally transactions entered into on or after July 1, 1981):

Example (1). (a) On December 31, 1963, A sells property to B under a contract which provides that B is to make four payments of $2,000 each, such payments being due, respectively, at the end of each year for the next 4 years. No interest is provided for in the contract. Assume that section 483 applies to each of the payments and that the portion of each payment which is treated as interest is $229.60. On January 1, 1966, B transfers other property to C in exchange for C's non-interest-bearing promissory note which provides that C is to pay B $1,000 at the end of each of the next 4 years, and C's assumption of the obligation to make the two remaining $2,000 payments to A.

(b) With respect to each of the two remaining $2,000 payments, C may deduct $229.60 and A continues to include such amount in income. B has no deductions with respect to the payments by C.

(c) With respect to the contract between B and C, section 483 applies to each of the $1,000 payments to be made by C at the end of each of the next 4 years, and total unstated interest with respect to such payments must be computed in the manner provided in paragraph (c) of this section and then allocated in the manner provided in paragraph (a) of this section. Because the assumption of B's obligation by C is treated as a payment made at the time of the transfer, section 483 does not apply to the two remaining $2,000 payments for purposes of the contract between B and C.

Example (2). (a) The facts are the same as in example (1), except that on January 1, 1966, A transfers his contract right to receive the two remaining $2,000 payments to C in exchange for property having a fair market value of $3,000.

(b) B is not affected by the transaction and continues to deduct $229.60 with respect to each of the two remaining $2,000 payments. A treats his contract with B as having been changed to provide for two payments of $2,000 each, due December 31st of 1964 and 1965, respectively, and a final payment of $3,000 (the fair market value of the property transferred by C to A), due January 1, 1966. A recomputes his total unstated interest in accordance with the rules provided in paragraph (c) of this section (as if the original contract with B had contained the changed terms) and allocates such unstated interest in the manner provided in subparagraph (4) of this paragraph.

(c) C treats the two remaining $2,000 payments from B as if they are due under a contract for the sale of property entered into with B on January 1, 1966. Thus, C computes total unstated interest under paragraph (c) of this section as if he had entered into a contract subject to section 483 which provided for $2,000 due December 31, 1966, and $2,000 due December 31, 1967, and then allocates such total unstated interest in the manner provided in paragraph (a) of this section.

(d) With respect to the contract between A and C, section 483 does not apply because there are no deferred payments.

Example (3). (a) On December 31, 1963, A, a holder described in section 1235(b), sells property, consisting of all substantial rights to a patent, to B under a contract which provides that B is to pay A $1,000 at the end of each year for the next 10 years. No interest is provided for in the contract, but section 483 does not apply because the deferred payments are made pursuant to a transfer described in section 1235(a) (see paragraph (b)(4) of § 1.483–2). On January 1, 1972, B, who is not a holder described in section 1235(b), sells the patent right to C under a contract which provides that C is to assume B's remaining obligation to pay A $1,000 at the end of each year for the next 2 years. There is no other consideration and no interest provided for in the contract between B and C.

(b) Since section 483 did not apply to the contract between A and B, B was not entitled to a deduction for unstated interest with respect to his obligation. Accordingly, section 483 does not become applicable to the obligation merely by reason of its transfer to C. Thus, C is not entitled to a deduction for unstated interest with respect to the obligation he has assumed and A is not required to include any unstated interest income.

(c) With respect to the contract between B and C, section 483 does not apply because the sales price under such contract is no more than $3,000, so that the exception set forth in section 483(f)(1) is applicable.

Example (4). (a) The facts are the same as in example (3), except that B sells the patent right to C on January 1, 1966, under a separate contract which provides that C is to assume B's remaining obligation to pay A $1,000 at the end of each year for the next 8 years. There is no other consideration and no interest provided for in the contract between B and C.

(b) Since section 483 did not apply to the contract between A and B, B was not entitled to a deduction for unstated interest with respect to his obligation. Accordingly, section 483 does not become applicable to the obligation merely by reason of its transfer to C. Thus, C is not entitled to a deduction for unstated interest because he is B's transferee.

(c) With respect to the contract between B and C, section 483 applies, and for purposes of paragraph (a) of this section, total unstated interest under such contract is $1,553.09, computed as follows:

Sum of payments to which sec. 483 applies...	$8,000.00
Less: Present value of $1,000 due every 12 months for 8 years ($1,000 × 6.44691 (factor for 8 years, col. (b), Table III))	6,446.91
Total unstated interest	1,553.09

Thus, C may deduct and B must include in income, $194.14—

($1,000×$1,553.09÷$8,000.00)

with respect to each payment C makes to A.

Example (5). (a) The facts are the same as in example (1), except that A sells property to B on December 31, 1973, and all other relevant dates are 10 years later.

(b) Although the transfer of property by B to C takes place after July 24, 1975, A is not affected with respect to section 483 merely by reason of such transfer (see paragraph (f)(6)(i)(a) of this section), and section 483 is applied to C in the same manner as it applied to B as if the transfer of the obligation to make the two remaining $2,000 payments had not been made (see paragraph (f)(6)(i)(c) of this section). With respect to each of the two remaining $2,000 payments, therefore, C may deduct $229.60, and A continues to include such amount in income. B has no deductions with respect to such payments by C.

(c) With respect to the contract between B and C, section 483 applies to each of the $1,000 payments to be made by C at the end of the next 4 years, and total unstated interest with respect to such payments must be computed in the manner provided in paragraph (c) of this section. Since the contract between B and C is treated as a new contract (see paragraph (f)(6)(i)(d) of this section), Tables IV to VI (and not Tables I to III) are used in making the computation because the transfer of property by B to C takes place on January 1, 1976, which is after July 24, 1975. Because the assumption of B's obligation is treated as a payment made at the time of the transfer, section 483 does not apply to the two remaining payments for purposes of the contract between B and C.

Example (6). (a) The facts are the same as in example (1), except that A sells property to B on January 31, 1973, and all other relevant dates are 10 years later. In addition, on January 1, 1976, A transfers his contract right to receive the two remaining $2,000 payments to C in exchange for property having a fair market value of $3,000.

(b) Although the transfer of his contract right by A to C takes place after July 24, 1975, B is not affected by the transaction (See paragraph (f)(6)(ii)(a) of this section) and B continues to deduct $229.60 with respect to each of the two remaining $2,000 payments. A treats his contract with B as having been changed to provide for two payments of $2,000 each, due December 31st of 1974 and 1975, respectively, and a final payment of $3,000 (the fair market value of the property transferred by C to A) due January 1, 1976. A recomputes his total unstated interest in accordance with the rules provided in paragraph (c) of this section and allocates such unstated interest in the manner provided in paragraph (f)(4) of this section. Since the sale to B took place before July 24, 1975, and since the recomputation is made as if the original contract with B had contained the changed terms, Tables I to III are used in making the recomputation and not Tables IV to VI.

(c) C treats the two remaining $2,000 payments from B as if they are due under a contract for the sale of property entered into with B on January 1, 1976. Thus, C, computes total unstated interest under paragraph (c) of the section as if he had entered into a contract subject to section 483 which provided for $2,000 due December 31, 1976, and $2,000 due December 31, 1977, and then allocates such total unstated interest in the manner provided in paragraph (a) of this section. Since January 1, 1976, is after July 24, 1975, Tables IV to VI (and not Tables I to III) are applied in computing such total unstated interest.

(d) With respect to the contract between A and C, section 483 does not apply because there are no deferred payments.

(g) Present value tables—(1) Computation of present value. If the purpose of the present value computation is to determine under paragraph (d) of this section whether there is total unstated interest under a contract, column (a) of the appropriate table set forth in paragraph (g)(2) of this section shall be used. For the rules relating to certain governmental obligations, see paragraph (d)(3) of this section. If the purpose of the present value computation is to determine under paragraph (c) of this section the amount of total unstated interest under a contract to be included in or deducted from income (that is, after it has already been determined by using column (a) of the appropriate table that the contract contains total unstated interest), column (b) of the appropriate table set forth in paragraph (g)(2) of this section shall be used. If a contract provides for deferred payments for a period in excess of 60 years, the factor (or factors) necessary may be obtained upon request to the Commissioner of Internal Revenue, Washington, D.C. 20224. In general, such request must be accompanied by a copy of the contract (or the proposed contract) and other relevant instruments.

(2) Tables. The following tables shall be used for computing the present value of a payment to which section 483 applies and the present value of any interest payment due under a contract:

TABLE I—PRESENT VALUE OF DEFERRED PAYMENT—APPLICABLE TO CONTRACTS ENTERED INTO BEFORE JULY 24, 1975 TO WHICH PARAGRAPHS (c)(2)(ii)(A) AND (d)(1)(ii)(A) OF THIS SECTION APPLY

[COL. (A) 4 PERCENT SIMPLE INTEREST—COL. (B) 5 PERCENT INTEREST, COMPOUNDED SEMIANNUALLY]

Number of months deferred: More than	But not more than	Col. (a)—Present value of $1 at 4 percent simple interest	Col. (b)—Present value of $1 at 5 percent compounded semiannually
0	6	1.00000	1.00000
6	9	.98039	.97561

Number of months deferred: More than	But not more than	Col. (a)—Present value of $1 at 4 percent simple interest	Col. (b)—Present value of $1 at 5 percent compounded semiannually
9	15	.96154	.95181
15	21	.94340	.92860
21	27	.92593	.90595
27	33	.90909	.88385
33	39	.89286	.86230
39	45	.87719	.84127
45	51	.86207	.82075
51	57	.84746	.80073
57	63	.83333	.78120
63	69	.81967	.76214
69	75	.80645	.74356
75	81	.79365	.72542
81	87	.78125	.70773
87	93	.76923	.69047
93	99	.75758	.67362
99	105	.74627	.65720
105	111	.73529	.64117
111	117	.72464	.62553
117	123	.71429	.61027
123	129	.70423	.59539
129	135	.69444	.58086
135	141	.68493	.56670
141	147	.67568	.55288
147	153	.66667	.53939
153	159	.65789	.52623
159	165	.64935	.51340
165	171	.64103	.50088
171	177	.63291	.48866
177	183	.62500	.47674
183	189	.61728	.46511
189	195	.60976	.45377
195	201	.60241	.44270
201	207	.59524	.43191
207	213	.58824	.42137
213	219	.58140	.41109
219	225	.57471	.40107
225	231	.56818	.39128
231	237	.56180	.38174
237	243	.55556	.37243
243	249	.54945	.36335
249	255	.54348	.35448
255	261	.53763	.34584
261	267	.53191	.33740
267	273	.52632	.32917
273	279	.52083	.32115
279	285	.51546	.31331
285	291	.51020	.30567
291	297	.50505	.29822
297	303	.5000	.29094
303	309	.49505	.28385
309	315	.49020	.27692
315	321	.48544	.27017
321	327	.48077	.26358
327	333	.47619	.25715
333	339	.47170	.25088
339	345	.46729	.24476
345	351	.46296	.23879
351	357	.45872	.23297
357	363	.45455	.22728
363	369	.45045	.22174
369	375	.44643	.21633
375	381	.44248	.21106
381	387	.43860	.20591
387	393	.43478	.20089
393	399	.43103	.19599
399	405	.42735	.19121
405	411	.42373	.18654
411	417	.42017	.18199
417	423	.41667	.17755
423	429	.41322	.17322
429	435	.40984	.16900
435	441	.40650	.16488
441	447	.40323	.16085
447	453	.40000	.15693
453	459	.39683	.15310
459	465	.39370	.14937
465	471	.39063	.14573
471	477	.38760	.14217
477	483	.38462	.13870
483	489	.38168	.13532
489	495	.37879	.13202
495	501	.37594	.12880
501	507	.37313	.12566
507	513	.37037	.12259
513	519	.36765	.11960
519	525	.36496	.11669
525	531	.36232	.11384
531	537	.35971	.11106
537	543	.35714	.10836
543	549	.35461	.10571
549	555	.35211	.10313
555	561	.34965	.10062
561	567	.34722	.09816
567	573	.34483	.09577
573	579	.34247	.09343
579	585	.34014	.09116
585	591	.33784	.08893
591	597	.33557	.08676
597	603	.33333	.08465
603	609	.33113	.08258
609	615	.32895	.08057
615	621	.32680	.07860
621	627	.32468	.07669
627	633	.32258	.07482
633	639	.32051	.07299
639	645	.31847	.07121
645	651	.31646	.06947

Number of months deferred: More than	But not more than	Col. (a)—Present value of $1 at 4 percent simple interest	Col. (b)—Present value of $1 at 5 percent compounded semiannually
651	657	.31447	.06778
657	663	.31250	.06613
663	669	.31056	.06451
669	675	.30864	.06294
675	681	.30675	.06140
681	687	.30488	.05991
687	693	.30303	.05845
693	699	.30120	.05702
699	705	.29940	.05563
705	711	.29762	.05427
711	717	.29586	.05295
717	723	.29412	.05166

TABLE II—PRESENT VALUE OF ANNUITY CERTAIN: $1 EVERY 6 MONTHS—APPLICABLE TO CONTRACTS ENTERED INTO BEFORE JULY 24, 1975 TO WHICH PARAGRAPHS (c)(2)(ii)(A) AND (d)(1)(ii)(A) OF THIS SECTION APPLY

[COL. (A) 4 PERCENT SIMPLE INTEREST—COL. (B) 5 PERCENT INTEREST, COMPOUNDED SEMIANNUALLY]

Number of years final payment deferred	Col. (a)—Present value at 4 percent simple interest	Col. (b)—Present value at 5 percent compounded semiannually
[1]0.5	0.98039	0.97561
1.0	1.94193	1.92742
1.5	2.88533	2.85602
2.0	3.81126	3.76197
2.5	4.72035	4.64583
3.0	5.61321	5.50813
3.5	6.49040	6.34939
4.0	7.35247	7.17014
4.5	8.19993	7.97087
5.0	9.03326	8.75206
5.5	9.85293	9.51421
6.0	10.65938	10.25776
6.5	11.45303	10.98318
7.0	12.23428	11.69091
7.5	13.00351	12.38138
8.0	13.76109	13.05500
8.5	14.50736	13.71220
9.0	15.24265	14.35336
9.5	15.96729	14.97889
10.0	16.68158	15.58916
10.5	17.38581	16.18455
11.0	18.08025	16.76541
11.5	18.76518	17.33211
12.0	19.44086	17.88499
12.5	20.10753	18.42438
13.0	20.76542	18.95061
13.5	21.41477	19.46401
14.0	22.05580	19.96489
14.5	22.68871	20.45355
15.0	23.31371	20.93029
15.5	23.93099	21.39541
16.0	24.54075	21.84918
16.5	25.14316	22.29188
17.0	25.73840	22.72379
17.5	26.32664	23.14516
18.0	26.90804	23.55625
18.5	27.48275	23.95732
19.0	28.05093	24.34860
19.5	28.61273	24.73034
20.0	29.16829	25.10278
20.5	29.71774	25.46612
21.0	30.26122	25.82061
21.5	30.79885	26.16645
22.0	31.33076	26.50385
22.5	31.85708	26.83302
23.0	32.37791	27.15417
23.5	32.89337	27.46748
24.0	33.40357	27.77315
24.5	33.90862	28.07137
25.0	34.40862	28.36231
25.5	34.90367	28.64616
26.0	35.39387	28.92308
26.5	35.87931	29.19325
27.0	36.36008	29.45683
27.5	36.83627	29.71398
28.0	37.30797	29.96486
28.5	37.77526	30.20962
29.0	38.23822	30.44841
29.5	38.69694	30.68137
30.0	39.15149	30.90866
30.5	39.60194	31.13040
31.0	40.04837	31.34673
31.5	40.49085	31.55778
32.0	40.92945	31.76369
32.5	41.36423	31.96458
33.0	41.79526	32.16056
33.5	42.22261	32.35177
34.0	42.64634	32.53831
34.5	43.06651	32.72030
35.0	43.48318	32.89786
35.5	43.89640	33.07108
36.0	44.30624	33.24008
36.5	44.71274	33.40495
37.0	45.11597	33.56581
37.5	45.51597	33.72274
38.0	45.91280	33.87584
38.5	46.30650	34.02521
39.0	46.69713	34.17094
39.5	47.08473	34.31311
40.0	47.46935	34.45182
40.5	47.85103	34.58714
41.0	48.22982	34.71916
41.5	48.60576	34.84796
42.0	48.97889	34.97362
42.5	49.34926	35.09621

Number of years final payment deferred	Col. (a)—Present value at 4 percent simple interest	Col. (b)—Present value at 5 percent compounded semiannually
43.0	49.71691	35.21582
43.5	50.08187	35.33251
44.0	50.44419	35.44635
44.5	50.80390	35.55741
45.0	51.16104	35.66577
45.5	51.51565	35.77148
46.0	51.86776	35.87462
46.5	52.21741	35.97524
47.0	52.56463	36.07340
47.5	52.90946	36.16917
48.0	53.25193	36.26261
48.5	53.59207	36.35376
49.0	53.92991	36.44269
49.5	54.26548	36.52946
50.0	54.59881	36.61411
50.5	54.92994	36.69669
51.0	55.25889	36.77726
51.5	55.58569	36.85586
52.0	55.91037	36.93255
52.5	56.23295	37.00736
53.0	56.55346	37.08035
53.5	56.87193	37.15156
54.0	57.18839	37.22104
54.5	57.50286	37.28882
55.0	57.81536	37.35494
55.5	58.12592	37.41946
56.0	58.43456	37.48240
56.5	58.74131	37.54380
57.0	59.04619	37.60371
57.5	59.34922	37.66216
58.0	59.65042	37.71918
58.5	59.94982	37.77481
59.0	60.24744	37.82908
59.5	60.54330	37.88203
60.0	60.83742	37.93369

[1] The factor for 0.5 years is applicable to a payment due more than 6 months but not more than 9 months from the date of the sale or exchange. In the case of a payment due not more than 6 months from the date of the sale or exchange, see the instructions in subparagraph (4)(iii) of this paragraph.

TABLE III—PRESENT VALUE OF ANNUITY CERTAIN: $1 EVERY 12 MONTHS—APPLICABLE TO CONTRACTS ENTERED INTO BEFORE JULY 24, 1975 TO WHICH PARAGRAPHS (c)(2)(A)(ii) AND (d)(1)(ii)(A) OF THIS SECTION APPLY

[COL. (A) 4 PERCENT SIMPLE INTEREST—COL. (B) 5 PERCENT INTEREST, COMPOUNDED SEMIANNUALLY]

Number of years final payment deferred	Col. (a)—Present value at 4 percent simple interest	Col. (b)—Present value at 5 percent compounded semiannually
1	0.96154	0.95181
2	1.88747	1.85777
3	2.78033	2.72006
4	3.64240	3.54081
5	4.47573	4.32201
6	5.28218	5.06556
7	6.06343	5.77329
8	6.82101	6.44691
9	7.55630	7.08808
10	8.27059	7.69835
11	8.96503	8.27922
12	9.64071	8.83209
13	10.29860	9.35833
14	10.93963	9.85920
15	11.56463	10.33595
16	12.17439	10.78972
17	12.76963	11.22162
18	13.35103	11.63272
19	13.91921	12.02400
20	14.47477	12.39643
21	15.01825	12.75092
22	15.55016	13.08832
23	16.07099	13.40947
24	16.58119	13.71514
25	17.08119	14.00608
26	17.57139	14.28300
27	18.05216	14.54658
28	18.52386	14.79746
29	18.98682	15.03625
30	19.44137	15.26353
31	19.88780	15.47987
32	20.32640	15.68577
33	20.75743	15.88176
34	21.18116	16.06830
35	21.59783	16.24586
36	22.00767	16.41485
37	22.41090	16.57571
38	22.80773	16.72881
39	23.19836	16.87454
40	23.58298	17.01324
41	23.96177	17.14526
42	24.33490	17.27092
43	24.70255	17.39053
44	25.06487	17.50437
45	25.42201	17.61273
46	25.77412	17.71586
47	26.12134	17.81402
48	26.46381	17.90746
49	26.80165	17.99639
50	27.13498	18.08104
51	27.46393	18.16161
52	27.78861	18.23829
53	28.10912	18.31129
54	28.42558	18.38076
55	28.73808	18.44689
56	29.04672	18.50983
57	29.35160	18.56973
58	29.65280	18.62675
59	29.95042	18.68103
60	30.24454	18.73268

TABLE IV—PRESENT VALUE OF DEFERRED PAYMENT—APPLICABLE TO CONTRACTS ENTERED INTO AFTER JULY 23, 1975, AND BEFORE JULY 1, 1981, TO WHICH PARAGRAPHS (c)(2)(ii)(B) AND (d)(1)(ii)(B) OF THIS SECTION APPLY

[COL. (A) 6 PERCENT SIMPLE INTEREST—COL. (B) 7 PERCENT INTEREST, COMPOUNDED SEMIANNUALLY]

Number of months deferred		Col. (a)—Present value of $1 at 6 percent simple interest	Col. (b)—Present value of $1 at 7 percent compounded semiannually
More than	But not more than		
0	6	1.00000	1.00000
6	9	.97087	.96618
9	15	.94340	.93351
15	21	.91743	.90194
21	27	.89286	.87144
27	33	.86957	.84197
33	39	.84746	.81350
39	45	.82645	.78599
45	51	.80645	.75941
51	57	.78740	.73373
57	63	.76923	.70892
63	69	.75188	.68495
69	75	.73529	.66178
75	81	.71942	.63940
81	87	.70423	.61778
87	93	.68966	.59689
93	99	.67568	.57671
99	105	.66225	.55720
105	111	.64935	.53836
111	117	.63694	.52016
117	123	.62500	.50257
123	129	.61350	.48557
129	135	.60241	.46915
135	141	.59172	.45329
141	147	.58140	.43796
147	153	.57143	.42315
153	159	.56180	.40884
159	165	.55249	.39501
165	171	.54348	.38165
171	177	.53476	.36875
177	183	.52632	.35628
183	189	.51813	.34423
189	195	.51020	.33259
195	201	.50251	.32134
201	207	.49505	.31048
207	213	.48780	.29998
213	219	.48077	.28983
219	225	.47393	.28003
225	231	.46729	.27056
231	237	.46083	.26141
237	243	.45455	.25257
243	249	.44843	.24403
249	255	.44248	.23578
255	261	.43668	.22781
261	267	.43103	.22010
267	273	.42553	.21266
273	279	.42017	.20547
279	285	.41494	.19852
285	291	.40984	.19181
291	297	.40486	.18532
297	303	.40000	.17905
303	309	.39526	.17300
309	315	.39062	.16715
315	321	.38610	.16150
321	327	.38168	.15603
327	333	.37736	.15076
333	339	.37313	.14566
339	345	.36900	.14073
345	351	.36496	.13598
351	357	.36101	.13138
357	363	.35714	.12693
363	369	.35336	.12264
369	375	.34965	.11849
375	381	.34602	.11449
381	387	.34247	.11062
387	393	.33898	.10688
393	399	.33557	.10326
399	405	.33223	.09977
405	411	.32895	.09640
411	417	.32573	.09314
417	423	.32258	.08999
423	429	.31949	.08694
429	435	.31646	.08400
435	441	.31348	.08116
441	447	.31056	.07842
447	453	.30769	.07577
453	459	.30488	.07320
459	465	.30211	.07073
465	471	.29940	.06834
471	477	.29674	.06603
477	483	.29412	.06379
483	489	.29155	.06146
489	495	.28902	.05955
495	501	.28653	.05754
501	507	.28409	.05559
507	513	.28169	.05371
513	519	.27933	.05190
519	525	.27701	.05014
525	531	.27473	.04845
531	537	.27248	.04681
537	543	.27027	.04522
543	549	.26810	.04369
549	555	.26596	.04222
555	561	.26385	.04079
561	567	.26178	.03941
567	573	.25974	.03808
573	579	.25773	.03679
579	585	.25575	.03555
585	591	.25381	.03434
591	597	.25189	.03318

Number of months deferred — More than	Number of months deferred — But not more than	Col. (a)—Present value of $1 at 6 percent simple interest	Col. (b)—Present value of $1 at 7 percent compounded semiannually
597	603	.25000	.03206
603	609	.24814	.03098
609	615	.24631	.02993
615	621	.24450	.02892
621	627	.24272	.02794
627	633	.24096	.02699
633	639	.23923	.02608
639	645	.23753	.02520
645	651	.23585	.02435
651	657	.23419	.02352
657	663	.23256	.02273
663	669	.23095	.02196
669	675	.22936	.02122
675	681	.22779	02050
681	687	.22624	.01981
687	693	.22472	.01914
693	699	.22321	.01849
699	705	.22173	.01786
705	711	.22026	.01726
711	717	.21882	.01668
717	723	.21739	.01611

TABLE V—PRESENT VALUE OF ANNUITY CERTAIN $1 EVERY 6 MONTHS—APPLICABLE TO CONTRACTS ENTERED INTO AFTER JULY 23, 1975, AND BEFORE JULY 1, 1981, TO WHICH PARAGRAPHS (c)(2)(ii)(B) AND (d)(1)(ii)(B) OF THIS SECTION APPLY

[COL. (A) 6 PERCENT SIMPLE INTEREST—COL. (B) 7 PERCENT INTEREST, COMPOUNDED SEMIANNUALLY]

Number of years final payment deferred	Col. (a)—Present value at 6 percent simple interest	Col. (b)—Present value at 7 percent compounded semiannually
[1]0.5	0.97087	0.96618
1.0	1.91427	1.89969
1.5	2.83170	2.80164
2.0	3.72456	3.67308
2.5	4.59413	4.51505
3.0	5.44159	5.32855
3.5	6.26804	6.11454
4.0	7.07449	6.87396
4.5	7.86189	7.60769
5.0	8.63112	8.31661
5.5	9.38300	9.00155
6.0	10.11829	9.66333
6.5	10.83771	10.30274
7.0	11.54194	10.92052
7.5	12.23160	11.51741
8.0	12.90728	12.09412
8.5	13.56953	12.65132
9.0	14.21888	13.18968
9.5	14.85582	13.70984
10.0	15.48082	14.21240
10.5	16.09432	14.69797
11.0	16.69673	15.16712
11.5	17.28845	15.62041
12.0	17.86985	16.05837
12.5	18.44128	16.48151
13.0	19.00308	16.89035
13.5	19.55557	17.28536
14.0	20.09905	17.66702
14.5	20.63381	18.03577
15.0	21.16013	18.39205
15.5	21.67826	18.73628
16.0	22.18846	19.06887
16.5	22.69097	19.39021
17.0	23.18602	19.70068
17.5	23.67382	20.00066
18.0	24.15459	20.29049
18.5	24.62852	20.57053
19.0	25.09581	20.84109
19.5	25.55664	21.10250
20.0	26.01119	21.35507
20.5	26.45962	21.59910
21.0	26.90210	21.83488
21.5	27.33878	22.06269
22.0	27.76981	22.28279
22.5	28.19534	22.49545
23.0	28.61551	22.70092
23.5	29.03045	22.89944
24.0	29.44029	23.09124
24.5	29.84515	23.27656
25.0	30.24515	23.45562
25.5	30.64041	23.62862
26.0	31.03103	23.79576
26.5	31.41713	23.95726
27.0	31.79881	24.11330
27.5	32.17617	24.26405
28.0	32.54930	24.40971
28.5	32.91830	24.55045
29.0	33.28326	24.68642
29.5	33.64427	24.81780
30.0	34.00141	24.94473
30.5	34.35477	25.06738
31.0	34.70442	25.18587
31.5	35.05044	25.30036
32.0	35.39291	25.41097
32.5	35.73189	25.51785
33.0	36.06746	25.62111
33.5	36.39969	25.72088
34.0	36.72864	25.81727
34.5	37.05437	25.91041
35.0	37.37695	26.00040
35.5	37.69644	26.08734
36.0	38.01290	26.17134
36.5	38.32638	26.25251
37.0	38.63694	26.33092
37.5	38.94463	26.40669
38.0	39.24951	26.47989

Number of years final payment deferred	Col. (a)—Present value at 6 percent simple interest	Col. (b)—Present value at 7 percent compounded semiannually
38.5	39.55162	26.55062
39.0	39.85102	26.61896
39.5	40.14776	26.68498
40.0	40.44188	26.74878
40.5	40.73343	26.81041
41.0	41.02245	26.86996
41.5	41.30898	26.92750
42.0	41.59307	26.98309
42.5	41.87476	27.03680
43.0	42.15409	27.08870
43.5	42.43110	27.13884
44.0	42.70583	27.18728
44.5	42.97831	27.23409
45.0	43.24858	27.27932
45.5	43.51668	27.32301
46.0	43.78264	27.36523
46.5	44.04649	27.40602
47.0	44.30827	27.44543
47.5	44.56801	27.48350
48.0	44.82574	27.52029
48.5	45.08149	27.55584
49.0	45.33530	27.59018
49.5	45.58719	27.62337
50.0	45.83719	27.65543
50.5	46.08533	27.68640
51.0	46.33164	27.71633
51.5	46.57614	27.74525
52.0	46.81886	27.77318
52.5	47.05982	27.80018
53.0	47.29905	27.82626
53.5	47.53658	27.85146
54.0	47.77243	27.87581
54.5	48.00662	27.89933
55.0	48.23918	27.92206
55.5	48.47013	27.94402
56.0	48.69949	27.96523
56.5	48.92728	27.98573
57.0	49.15352	28.00554
57.5	49.37824	28.02467
58.0	49.60145	28.04316
58.5	49.82318	28.06103
59.0	50.04344	28.07829
59.5	50.26226	28.09496
60.0	50.47965	28.11108

[1] The factor for 0.5 year is applicable to a payment due more than 6 months but not more than 9 months from the date of sale or exchange. In the case of a payment due not more than 6 months from the date of the sale or exchange, see the instructions in subparagraph (7)(ii) of this section.

TABLE VI—PRESENT VALUE OF ANNUITY CERTAIN: $1 EVERY 12 MONTHS—APPLICABLE TO CONTRACTS ENTERED INTO AFTER JULY 23, 1975, AND BEFORE JULY 1, 1981, TO WHICH PARAGRAPHS (c)(2)(ii)(B) AND (d)(1)(ii)(B) OF THIS SECTION APPLY

[COL. (A) 6 PERCENT SIMPLE INTEREST—COL. (B) 7 PERCENT INTEREST, COMPOUNDED SEMIANNUALLY]

Number of years final payment deferred	Col. (a)—Present value at 6 percent simple interest	Col. (b)—Present value at 7 percent compounded semiannually
1.0	0.94340	0.93351
2.0	1.83626	1.80495
3.0	2.68372	2.61845
4.0	3.49017	3.37787
5.0	4.25940	4.08678
6.0	4.99469	4.74857
7.0	5.69892	5.36635
8.0	6.37460	5.94305
9.0	7.02395	6.48142
10.0	7.64895	6.98398
11.0	8.25136	7.45313
12.0	8.83276	7.89109
13.0	9.39456	8.29993
14.0	9.93804	8.68158
15.0	10.46436	9.03786
16.0	10.97456	9.37045
17.0	11.46961	9.68093
18.0	11.95038	9.97076
19.0	12.41767	10.24132
20.0	12.87222	10.49389
21.0	13.31470	10.72967
22.0	13.74573	10.94977
23.0	14.16590	11.15524
24.0	14.57574	11.34705
25.0	14.97574	11.52610
26.0	15.36636	11.69325
27.0	15.74804	11.84929
28.0	16.12117	11.99495
29.0	16.48613	12.13092
30.0	16.84327	12.25785
31.0	17.19292	12.37635
32.0	17.53539	12.48697
33.0	17.87096	12.59023
34.0	18.19991	12.68662
35.0	18.52249	12.77661
36.0	18.83895	12.86061
37.0	19.14951	12.93903
38.0	19.45439	13.01223
39.0	19.75379	13.08057
40.0	20.04791	13.14436
41.0	20.33693	13.20391
42.0	20.62102	13.25950
43.0	20.90035	13.31140
44.0	21.17508	13.35985
45.0	21.44535	13.40507
46.0	21.71131	13.44729
47.0	21.97309	13.48670
48.0	22.23082	13.52349
49.0	22.48463	13.55783
50.0	22.73463	13.58989
51.0	22.98094	13.61982
52.0	23.22366	13.64776

Number of years final payment deferred	Col. (a)—Present value at 6 percent simple interest	Col. (b)—Present value at 7 percent compounded semi-annually
53.0	23.46289	13.67384
54.0	23.69874	13.69818
55.0	23.93130	13.72091
56.0	24.16066	13.74213
57.0	24.38690	13.76194
58.0	24.61011	13.78042
59.0	24.83037	13.79768
60.0	25.04776	13.81380

TABLE VII—PRESENT VALUE OF DEFERRED PAYMENT—APPLICABLE TO CONTRACTS ENTERED INTO ON OR AFTER JULY 1, 1981, TO WHICH PARAGRAPHS (c)(2)(ii)(C) AND (d)(1)(ii)(C) OF THIS SECTION APPLY

[COL. (A) 9 PERCENT SIMPLE INTEREST—COL. (B) 10 PERCENT, COMPOUNDED SEMIANNUALLY]

Number of months deferred			
More than	But not more than	Col. (a)[1]	Col. (b)[2]
0	6	1.00000	1.00000
6	9	.95694	.95238
9	15	.91743	.90703
15	21	.88106	.86384
21	27	.84746	.82270
27	33	.81633	.78353
33	39	.78740	.74622
39	45	.76046	.71068
45	51	.73529	.67684
51	57	.71174	.64461
57	63	.68966	.61391
63	69	.66890	.58468
69	75	.64935	.55684
75	81	.63091	.53032
81	87	.61350	.50507
87	93	.59701	.48102
93	99	.58140	.45811
99	105	.56657	.43630
105	111	.55249	.41552
111	117	.53908	.39573
117	123	.52632	.37689
123	129	.51414	.35894
129	135	.50251	.34185
135	141	.49140	.32557
141	147	.48077	.31007
147	153	.47059	.29530
153	159	.46083	.28124
159	165	.45147	.26785
165	171	.44248	.25509
171	177	.43384	.24295
177	183	.42553	.23138
183	189	.41754	.22036
189	195	.40984	.20987
195	201	.40241	.19987
201	207	.39526	.19035
207	213	.38835	.18129
213	219	.38168	.17266
219	225	.37523	.16444
225	231	.36900	.15661
231	237	.36298	.14915
237	243	.35714	.14205
243	249	.35149	.13528
249	255	.34602	.12884
255	261	.34072	.12270
261	267	.33557	.11686
267	273	.33058	.11130
273	279	.32573	.10600
279	285	.32103	.10095
285	291	.31646	.09614
291	297	.31201	.09156
297	303	.30769	.08720
303	309	.30349	.08305
309	315	.29940	.07910
315	321	.29542	07533
321	327	.29155	.07174
327	333	.28777	.06833
333	339	.28409	.06507
339	345	.28050	.06197
345	351	.27701	.05902
351	357	.27360	.05621
357	363	.27027	.05354
363	369	.26702	.05099
369	375	.26385	.04856
375	381	.26076	.04625
381	387	.25773	.04404
387	393	.25478	.04195
393	399	.25189	.03995
399	405	.24907	.03805
405	411	.24631	.03623
411	417	.24361	.03451
417	423	.24096	.03287
423	429	.23838	.03130
429	435	.23585	.02961
435	441	.23337	.02839
441	447	.23095	.02704
447	453	.22857	.02575
453	459	.22624	.02453
459	465	.22396	.02336
465	471	.22173	.02225
471	477	.21954	.02119
477	483	.21739	.02018
483	489	.21529	.01922
489	495	.21322	.01830
495	501	.21119	.01743
501	507	.20921	.01660
507	513	.20725	.01581
513	519	.20534	.01506
519	525	.20346	.01434
525	531	.20161	.01366
531	537	.19980	.01301
537	543	.19802	.01239
543	549	.19627	.01180
549	555	.19455	.01124
555	561	.19286	.01070
561	567	.19120	.01019
567	573	.18957	.00971
573	579	.18797	.00924
579	585	.18639	.00880
585	591	.18484	.00838
591	597	.18332	.00798
597	603	.18182	.00760
603	609	.18034	.00724
609	615	.17889	.00690
615	621	.17746	.00657
621	627	.17606	.00626
627	633	.17467	.00596
633	639	.17331	.00567
639	645	.17197	.00540

Number of months deferred			
More than	But not more than	Col. (a)[1]	Col. (b)[2]
645	651	.17065	.00515
651	657	.16935	.00490
657	663	.16807	.00467
663	669	.16681	.00445
669	675	.16556	.00423
675	681	.16434	.00403
681	687	.16313	.00384
687	693	.16194	.00366
693	699	.16077	.00348
699	705	.15962	.00332
705	711	.15848	.00316
711	717	.15736	.00301
717	723	.15625	.00287

[1] Present value of $1 at 9 percent simple interest.
[2] Present value of $1 at 10 percent compounded semiannually.

TABLE VIII—PRESENT VALUE OF ANNUITY CERTAIN: $1 EVERY 6 MONTHS—APPLICABLE TO CONTRACTS ENTERED INTO ON OR AFTER JULY 1, 1981, TO WHICH PARAGRAPHS (c)(2)(ii)(C) AND (d)(1)(ii)(C) OF THIS SECTION APPLY

[COL. (A) 9 PERCENT SIMPLE INTEREST—COL. (B) 10 PERCENT, COMPOUNDED SEMIANNUALLY]

Number of years final payment deferred	Col. (a)[1]	Col. (b)[2]
.5	.95694	.95238
1.0	1.87437	1.85941
1.5	2.75543	2.72325
2.0	3.60289	3.54595
2.5	4.41922	4.32948
3.0	5.20662	5.07569
3.5	5.96708	5.78637
4.0	6.70237	6.46321
4.5	7.41411	7.10782
5.0	8.10377	7.72173
5.5	8.77267	8.30641
6.0	9.42202	8.86325
6.5	10.05293	9.39357
7.0	10.66643	9.89864
7.5	11.26344	10.37966
8.0	11.84484	10.83777
8.5	12.41141	11.27407
9.0	12.96390	11.68959
9.5	13.50298	12.08532
10.0	14.02930	12.46221
10.5	14.54344	12.82115
11.0	15.04595	13.16300
11.5	15.53735	13.48857
12.0	16.01812	13.79864
12.5	16.48871	14.09394
13.0	16.94954	14.37519
13.5	17.40101	14.64303
14.0	17.84349	14.89813
14.5	18.27733	15.14107
15.0	18.70286	15.37245
15.5	19.12040	15.59281
16.0	19.53024	15.80268
16.5	19.93265	16.00255
17.0	20.32791	16.19290
17.5	20.71626	16.37419
18.0	21.09794	16.54685
18.5	21.47317	16.71129
19.0	21.84217	16.86789
19.5	22.20515	17.01704
20.0	22.56229	17.15909
20.5	22.91378	17.29437
21.0	23.25980	17.42321
21.5	23.60052	17.54591
22.0	23.93609	17.66277
22.5	24.26667	17.77407
23.0	24.59240	17.88007
23.5	24.91343	17.98102
24.0	25.22989	18.07716
24.5	25.54190	18.16872
25.0	25.84959	18.25593
25.5	26.15308	18.33898
26.0	26.45248	18.41807
26.5	26.74790	18.49340
27.0	27.03945	18.56515
27.5	27.32722	18.63347
28.0	27.61131	18.69854
28.5	27.89181	18.76052
29.0	28.16882	18.81954
29.5	28.44242	18.87575
30.0	28.71269	18.92929
30.5	28.97971	18.98028
31.0	29.24356	19.02883
31.5	29.50432	19.07508
32.0	29.76205	19.11912
32.5	30.01683	19.16107
33.0	30.26872	19.20102
33.5	30.51779	19.23907
34.0	30.76410	19.27530
34.5	31.00771	19.30981
35.0	31.24867	19.34268
35.5	31.48705	19.37398
36.0	31.72290	19.40379
36.5	31.95627	19.43218
37.0	32.18722	19.45922
37.5	32.41579	19.48497
38.0	32.64203	19.50950
38.5	32.86599	19.53285
39.0	33.08772	19.55510
39.5	33.30726	19.57628
40.0	33.52465	19.59646
40.5	33.73994	19.61568
41.0	33.95316	19.63398
41.5	34.16435	19.65141
42.0	34.37356	19.66801
42.5	34.58081	19.68382
43.0	34.78615	19.69887
43.5	34.98961	19.71321
44.0	35.19122	19.72687
44.5	35.39102	19.73987
45.0	35.58904	19.75226
45.5	35.78531	19.76406
46.0	35.97986	19.77529
46.5	36.17272	19.78599
47.0	36.36392	19.79619
47.5	36.55349	19.80589
48.0	36.74146	19.81513
48.5	36.92785	19.82394
49.0	37.11269	19.83232
49.5	37.29601	19.84031
50.0	37.47783	19.84791
50.5	37.65817	19.85515
51.0	37.83706	19.86205
51.5	38.01452	19.86862
52.0	38.19058	19.87488
52.5	38.36525	19.88083
53.0	38.53856	19.88651

Number of years final payment deferred	Col. (a)[1]	Col. (b)[2]
53.5	38.71053	19.89191
54.0	38.88116	19.89706
54.5	39.05053	19.90196
55.0	39.21860	19.90663
55.5	39.38541	19.91108
56.0	39.55097	19.91531
56.5	39.71531	19.91934
57.0	39.87844	19.92318
57.5	40.04038	19.92684
58.0	40.20115	19.93033
58.5	40.36077	19.93364
59.0	40.51925	19.93680
59.5	40.67661	19.93981
60.0	40.83286	19.94268

[1] Present value of $1 at 9 percent simple interest.
[2] Present value of $1 at 10 percent compounded semiannually.

TABLE IX—PRESENT VALUE OF ANNUITY CERTAIN: $1 EVERY 12 MONTHS—APPLICABLE TO CONTRACTS ENTERED INTO ON OR AFTER JULY 1, 1981, TO WHICH PARAGRAPHS (c)(2)(ii)(C) AND (d)(1)(ii)(C) OF THIS SECTION APPLY

[COL. (A) 9 PERCENT SIMPLE INTEREST—COL. (B) 10 PERCENT, COMPOUNDED SEMIANNUALLY]

Number of years final payment deferred	Col. (a)[1]	Col. (b)[2]
1.0	0.91743	0.90703
2.0	1.76489	1.72973
3.0	2.55229	2.47595
4.0	3.28758	3.15279
5.0	3.97724	3.76670
6.0	4.62659	4.32354
7.0	5.24009	4.82861
8.0	5.82149	5.28672
9.0	6.37398	5.70224
10.0	6.90030	6.07913
11.0	7.40261	6.42098
12.0	7.88358	6.73104
13.0	8.34441	7.01229
14.0	8.78689	7.26738
15.0	9.21242	7.49876
16.0	9.62226	7.70862
17.0	10.01752	7.89898
18.0	10.39920	8.07163
19.0	10.76820	8.22824
20.0	11.12534	8.37029
21.0	11.47136	8.49913
22.0	11.80693	8.61599
23.0	12.13266	8.72198
24.0	12.44912	8.81813
25.0	12.75681	8.90533
26.0	13.05621	8.98443
27.0	13.34776	9.05617
28.0	13.63185	9.12124
29.0	13.90886	9.18026
30.0	14.17913	9.23380
31.0	14.44296	9.28236
32.0	14.70071	9.32640
33.0	14.95260	9.36635
34.0	15.19691	9.40259
35.0	15.43987	9.43545
36.0	15.67572	9.46526
37.0	15.90667	9.49230
38.0	16.13291	9.51683
39.0	16.35464	9.53907
40.0	16.57203	9.55925
41.0	16.78525	9.57755
42.0	16.99446	9.59415
43.0	17.19980	9.60921
44.0	17.40141	9.62286
45.0	17.59943	9.63525
46.0	17.79398	9.64648
47.0	17.98518	9.65668
48.0	18.17315	9.66592
49.0	18.35799	9.67430
50.0	18.53981	9.68191
51.0	18.71870	9.68880
52.0	18.89476	9.69506
53.0	19.06807	9.70074
54.0	19.23872	9.70588
55.0	19.40679	9.71055
56.0	19.57235	9.71479
57.0	19.73548	9.71863
58.0	19.89625	9.72211
59.0	20.05473	9.72527
60.0	20.21098	9.72814

[1] Present value of $1 at 9 percent simple interest.
[2] Present value of $1 at 10 percent compounded semiannually.

(3) Instructions for Table I. Table I is the basic present value table, and may be used for computing the present value of any payment or payments regardless of the amount of the payments or the interval the payments are deferred. The present value of a payment is computed under Table I as follows:

(i) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the appropriate number of months the payment under the contract is deferred; and

(ii) Multiply the amount of the payment by the factor determined under subdivision (i) of this subparagraph.

For example, the present value, using a rate of 4 percent per annum simple interest, of a payment of $1,000 due 3 years (36 months) from the date of sale is $892.86 ($1,000×0.89286 (factor for 33 to 39 months, col. (a), Table I)).

(4) Instructions for Table II. (i) Table II shows the present value of a series of equal deferred payments due at 6-month intervals. For purposes of determining whether the payments under a contract are due at 6-month intervals and whether such payments are equal in amount, a payment shall be treated as due on the nearest date (to the date such payment is actually due under the contract) which marks a 6-month interval from the date of the sale or exchange. For example, a payment due 13 months, 14 months, or exactly 15 months from the date of sale would be treated as due 12 months from such date, and a payment due 15 months and 1 day, 16 months, or 17 months from the date of sale would be treated as due 18 months from such date. In the case of a

payment due 6 months or less from the date of the sale or exchange, see subdivision (iii) of this subparagraph.

(ii) Table II may be used, without adjustment, for computing the present value of a series of equal payments, under a contract under which the first payment is actually due more than 6 months but not more than 9 months from the date of the sale or exchange, and all payments thereafter are due at regular 6-month intervals with respect to the date of the first payment (all such payments being treated under the rule of subdivision (i) of this subparagraph as due on the nearest date which marks a 6-month interval from the date of the sale or exchange). The present value of such a series of equal payments is computed under Table II as follows:

(a) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the appropriate number of years the final payment under the contract is deferred; and

(b) Multiply the amount of a single payment under the contract by the factor determined under (a) of this subdivision.

For example, the present value, using a rate of 4 percent per annum simple interest, of a series of eight $1,000 payments, the first payment being due 7 months from the date of sale, and the remaining seven payments being due, respectively, every 6 months thereafter (so that under the rule of subdivision (i) of this subparagraph the final payment is deferred 4 years), is $7,352.47 ($1,000×7.35247 (factor for 4 years, col. (a), Table II)).

(iii) Table II may also be used, with adjustment, for computing the present value of a series of equal payments under a contract under which the first payment is actually due not more than 6 months from the date of the sale or exchange, and all payments thereafter are due at regular 6-month intervals with respect to the date of the first payment (all such payments being treated under the rule of subdivision (i) of this subparagraph as due on the nearest date which marks a 6-month interval from the date of the sale or exchange), provided that no payment is actually due (before application of subdivision (i) of this subparagraph) more than 6 months but not more than 9 months from the date of the sale or exchange. The present value of such a series of equal payments is computed under Table II as follows:

(a) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the appropriate number of years the final payment under the contract is deferred;

(b) Adjust the factor determined under (a) of this subdivision by increasing such factor either by 0.01961 (1 minus the column (a) factor for deferral of payment for 0.5 years; in this case 0.98039) if the present value computation is made under column (a), or by 0.02439 (1 minus the column (b) factor for the deferral of payment for 0.5 years; in this case 0.97561) if the present value computation is made under column (b); and

(c) Multiply the amount of a single payment under the contract by the adjusted factor determined under (b) of this subdivision.

For example, the present value, using a rate of 4 percent per annum simple interest, of a series of eight $1,000 payments, the first payment being due exactly 6 months from the date of sale, and the remaining seven payments being due, respectively every 6 months thereafter (so that under the rule of subdivision (i) of this subparagraph the final payment is deferred 4 years), is $7,372.08 ($1,000×7.35247 plus 0.01961).

(iv) Table II may also be used, with adjustment, for computing the present value of a series of equal payments under a contract under which the first payment is due more than 6 months from the date of the sale or exchange and is due on the anniversary (that is, the exact multiple of a 6-month interval) of the date of the sale or exchange, and all payments thereafter are due at regular 6-month intervals with respect to the date of the first payment (all such payments being treated under the rule of subdivision (i) of this subparagraph as due on the nearest date which marks a 6-month interval from the date of the sale or exchange). The present value of such a series of equal payments is computed as follows:

(a) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the appropriate number of years the final payment under the contract is deferred;

(b) Multiply the amount of a single payment under the contract by the factor determined under (a) of this subdivision;

(c) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the 6-month period immediately preceding the 6-month period in which the initial payment under the contract is due;

(d) Multiply the amount of a single payment under the contract by the factor determined under (c) of this subdivision; and

(e) Subtract the amount determined under (d) of this subdivision from the amount determined under (b) of this subdivision to obtain the present value.

For example, Table II may be used to compute the present value, using a rate of 4 percent per annum simple interest, of a series of eight $1,000 payments, the first payment being due exactly 12 months from the date of sale, and the remaining seven payments being due, respectively, every 6 months thereafter (so that under the rule of subdivision (i) of this subparagraph the final payment is deferred 4.5 years). Such computation, including the adjustment, is made as follows:

$1,000 × 8.19993 (factor for 4.5 years, col. (a), Table II)	$8,199.93
Less adjustment: $1,000 × 0.98039 (factor for 0.5 year, col. (a), Table II)	980.39
Present value	7,219.54

(5) Instructions for Table III. (i) Table III shows the present value of a series of equal deferred payments due at 12-month intervals with respect to the date of the sale or exchange. For purposes of determining whether the payments under a contract are due at 12-month intervals and whether such payments are equal in amount, a payment shall be treated as due on the nearest date (to the date such payment is actually due under the contract) which marks a 6-month interval from the date of the sale or exchange. For example, a payment due 13 months, 14 months, or exactly 15 months from the date of sale would be treated as due 12 months from such date, and a payment due 21 months and 1 day, 22 months, or 23 months from the date of sale would be treated as due 24 months from such date.

(ii) Table III may be used, without adjustment, for computing the present value of a series of equal payments, under a contract under which the first payment is actually due more than 9 months but not more than 15 months from the date of the sale or exchange, and all payments thereafter are due at regular 12-month intervals with respect to the date of the first payment (all such payments being treated under the rule of subdivision (i) of this subparagraph or due on the nearest date which marks a 6-month interval from the date of the sale or exchange). The present value of such a series of equal payments is computed under Table III as follows:

(a) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the appropriate number of years the final payment under the contract is deferred; and

(b) Multiply the amount of a single payment under the contract by the factor determined under (a) of this subdivision.

For example, the present value, using an interest rate of 5 percent per annum compounded semiannually of a series of eight $1,000 payments, the first payment being due 12 months from the date of sale, and the remaining seven payments being due, respectively, every 12 months thereafter (so that under the rule of subdivision (i) of this subparagraph the final payment is deferred 8 years) is $6,446.91 ($1,000×6.44691 (factor for 8 years, col. (b), Table III)).

(iii) Table III may also be used, with adjustment, for computing the present value of a series of equal payments under a contract in which the first payment is due more than 12 months from the date of the sale or exchange and is due on the anniversary (that is, the exact multiple of a 12-month interval) of the date of the sale or exchange, and all payments thereafter are due at regular 12-month intervals with respect to the date of the first payment (all such payments being treated under the rule of subdivision (i) of this subparagraph as due on the nearest date which marks a 6-month interval from the date of the sale or exchange). The present value of such a series of equal payments is computed under Table III as follows:

(a) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the appropriate number of years the final payment under the contract is deferred;

(b) Multiply the amount of a single payment under the contract by the factor determined under (a) of this subdivision;

(c) Determine the factor contained in the applicable present value column (that is, col. (a) or col. (b)) for the year immediately preceding the year in which the initial payment under the contract is due;

(d) Multiply the amount of a single payment under the contract by the factor determined under (c) of this subdivision; and

(e) Subtract the amount determined under (d) of this subdivision from the amount determined under (b) of this subdivision to obtain the present value.

For example, Table III may be used to compute the present value, using an interest rate of 5 percent, compounded semiannually, of a series of eight $1,000 payments, the first payment being due

exactly 3 years from the date of sale, and the remaining seven payments being due, respectively, every 12 months thereafter (so that under the rule of subdivision (i) of this subparagraph the final payment is deferred 10 years). Such computation, including the adjustment, is made as follows:

$1,000 × 7.69335 (factor for 10 years, col. (b), Table III)	$7,698.35
Less adjustment: $1,000 × 1.85777 (factor for 2 years, col. (b), Table III)	1,857.77
Present value	5,840.58

If, in the preceding example, the first payment had been due 3½ years (instead of 3 years) from the date of sale, the method of computation described could not be used and Table I should be used for the present value computation.

(6) **Instructions for Table IV.** In general, the instructions for Table I are applicable to Table IV, taking into account the change in the rate of imputed interest for contracts entered into after July 23, 1975, and before July 1, 1981, to which paragraphs (c)(2)(ii)(B) and (d)(1)(ii)(B) of this section apply.

(7) **Instructions for Table V.** (i) In general, the instructions for Table II are applicable to Table V, taking into account the change in the rate of imputed interest for contracts entered into after July 23, 1975, and before July 1, 1981, to which paragraphs (c)(2)(ii)(B) and (d)(1)(ii)(B) of this section apply.

(ii) Notwithstanding the preceding subdivision, where a contract entered into after July 23, 1975, and before July 1, 1981, is otherwise described in paragraph (g)(4)(iii) of this section, then the present value of a series of equal payments described in that subsection shall be computed under Table V as follows:

(a) Determine the factor contained in the applicable present rate column (that is, col. (a) or col. (b)) for the appropriate number of years the final payment under the contract is deferred;

(b) Adjust the factor determined under (a) of this subdivision by increasing such factor either by 0.02913 (1 minus the column (a) factor for deferral of payment for 0.5 years; in this case 0.97087) if the present value computation is made under column (a), or by 0.03382 (1 minus the column (b) factor for deferral of payment for 0.5 years; in this case 0.96618) if the present value computation is made under column (b); and

(c) Multiply the amount of a single payment under the contract by the adjusted factor determined under paragraph (g)(7)(ii)(b) of this section.

For example, the present value, using a rate of 6 percent per annum simple interest, of a series of eight $1,000 payments, the first payment being due exactly 6 months from the date of sale, and the remaining seven payments being due, respectively every 6 months thereafter (so that under the rule of paragraph (g)(7)(i) of this section the final payment is deferred 4 years), is $7,103.62 ($1,000×(7.07449 plus 0.02913)).

(8) **Instructions for Table VI.** In general, the instructions for Table III are applicable to Table VI, taking into account the change in the rate of imputed interest for contracts entered into after July 23, 1975, and before July 1, 1981, to which paragraphs (c)(2)(ii)(B) and (d)(1)(ii)(B) of this section apply.

(9) **Instructions for Table VII.** In general, the instructions for Table I are applicable to Table VII, taking into account the change in the rate of imputed interest for contracts entered into on or after July 1, 1981, to which paragraphs (c)(2)(ii)(C) and (d)(1)(ii)(C) of this section apply.

(10) **Instructions for Table VIII.** (i) In general, the instructions for Table II are applicable to Table VIII, taking into account the change in the rate of imputed interest for contracts entered into on or after July 1, 1981, to which paragraphs (c)(2)(ii)(C) and (d)(1)(ii)(C) of this section apply.

(ii) Notwithstanding the preceding subdivision, where a contract entered into on or after July 1, 1981, is otherwise described in paragraph (g)(4)(iii) of this section, then the present value of a series of equal payments described in that subsection shall be computed under Table VIII as follows:

(a) Determine the factor contained in the applicable present rate column (that is, col. (a) or col. (b)) for the appropriate number of years the final payment under the contract is deferred;

(b) Adjust the factor determined under (a) of this subdivision by increasing such factor either by .04306 (1 minus the column (a) factor for deferral of payment for 0.5 years; in this case .95694) if the present value computation is made under column (a), or by .04762 (1 minus the column (b) factor for deferral of payment for 0.5 years; in this case .95238) if the present value computation is made under column (b); and

(c) Multiply the amount of a single payment under the contract by the adjusted factor determined under paragraph (g)(10)(ii) of this section.

For example, the present value, using a rate of 9 percent per annum simple interest, of a series of

eight $1,000 payments, the first payment being due exactly 6 months from the date of sale and the remaining seven payments being due, respectively, every 6 months thereafter (so that under the rule of paragraph (g)(10)(i) of this section the final payment is deferred 4 years), is $6,745.43 ($1,000 × (6.70237 plus .04306)).

(11) Instructions for Table IX. In general, the instructions for Table III are applicable to Table IX, taking into account the change in the rate of imputed interest for contracts entered into on or after July 1, 1981, to which paragraphs (c)(2)(ii)(C) and (d)(1)(ii)(C) of this section apply.
[T.D. 6873, 31 FR 942, Jan. 25, 1966; 31 FR 2427, Feb. 5, 1966, as amended by T.D. 7164, 36 FR 24997, Dec. 28, 1971; T.D. 7394, 41 FR 1281, Jan. 7, 1976; 41 FR 2642, Jan. 19, 1976; T.D. 7781, 46 FR 34570, July 2, 1981]

§ 1.483–2 Treatment as interest for purposes of Code; exceptions and limitations to application of section 483.

(a) Treatment as interest for purposes of Code—(1) Effect on income, deductions, basis, etc.—(i) In general. Generally, a contract under which there is total unstated interest (within the meaning of section 483(a)) shall be treated as if such interest were actually provided for in the contract, and such unstated interest shall constitute interest for all purposes of the Code. Thus, for example, except as provided in paragraph (b)(1) of this section, in the case of a sale of property, total unstated interest shall not be treated as part of the selling price of such property. Unless unstated interest is charged to the capital account under section 266 (relating to carrying charges), the basis to the purchaser of property sold or exchanged shall not include any amount treated by the purchaser as total unstated interest under the contract pursuant to section 483. For rules relating to the effect on basis of a change in the terms of the contract, see paragraph (f)(3) of § 1.483–1.

(ii) Cash and accrual method of reporting unstated interest income and deductions. Any amount treated as interest under section 483 by the seller shall be included as interest income for the taxable year in which the payment is received in the case of a cash method taxpayer and for the taxable year in which the payment is due in the case of an accrual method taxpayer. Any amount treated as interest under section 483 by the purchaser shall (if otherwise allowable) be deducted as interest for the taxable year in which the payment is made in the case of a cash method taxpayer and for the taxable year in which the payment is due in the case of an accrual method taxpayer. Notwithstanding the rules of this subdivision with respect to unstated interest, interest which is stated in the contract shall be treated in accordance with the rules of the Code otherwise applicable. For rules relating to defaults, see paragraph (f)(1) of § 1.483–1.

(iii) Example. The provisions of subdivision (ii) of this subparagraph may be illustrated by the following example:

Example. On December 31, 1963, A, a calendar year accrual method taxpayer, sells property to B, a calendar year cash method taxpayer, under a contract which provides that B is to make three payments of $2,000 each, such payments being due, respectively, as of December 31, 1966, 1967, and 1968. No interest is provided for in the contract. Assume that the total unstated interest under the contract is $1,071.50 and that the portion of each payment which is treated as interest is $357.17. B makes the first two payments on time, but the third payment is not made until January 31, 1969. For 1964 and 1965, A does not include, nor does B deduct, any amount as interest with respect to the contract. For 1966 and 1967, A includes $357.17 each year as interest income and B deducts the same amount each year as an interest expense. For 1968, A includes $357.17 as accrued interest income but B is not entitled to an interest deduction. For 1969, B may deduct $357.17 as an interest expense with respect to the contract.

(2) Other effects of treating portion of sales price as unstated interest. This subparagraph sets forth some illustrations of the effects of treating a portion of the sales price as unstated interest. These illustrations are not all-inclusive. The treatment as unstated interest under section 483 of a portion of a payment which would otherwise be treated as part of the sales price may have the effect of increasing the amount of a nondeductible loss because of the application of section 165(c) (relating to limitation on losses of individuals) or of an unallowable deduction because of section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers), or of changing the character of gains and losses or increasing the amount of an allowable loss under section 1231 (relating to property used in the trade or business). Such treatment may affect eligibility to use the installment method of accounting under section 453(b)(2) (relating to limitation on installment method), except that section 483 shall have no effect in determining whether payments received prior to January 1, 1964, in the taxable year of sale exceed 30 percent of the selling price of the property. Furthermore, the application of section 483 may affect the treatment of a stock option under part II, subchapter D, chapter 1 of the Code, except that section 483 shall have no effect in determining whether options granted prior to January 1, 1965, meet the requirements of section 422(b)(4), 423(b)(6), 424(b)(1), or 424(c).

Amounts treated as unstated interest under section 483 may, if otherwise qualified under section 266 (relating to carrying charges), be charged to the capital account. The treatment of any portion of voting stock as interest under section 483 will not prevent an otherwise eligible acquisition from qualifying as a reorganization under section 368(a)(1) (relating to definitions of corporate reorganizations), although the payment of cash or property other than voting stock will prevent certain acquisitions from so qualifying. See section 368(a)(1)(B) and (C) and the regulations thereunder for rules relating to the extent to which voting stock must be exchanged by the acquiring corporation in certain reorganizations. Unstated interest shall be treated as interest for purposes of applying the source rules contained in section 861(a)(1) (relating to income from sources within the United States) and section 862(a)(1) (relating to income from sources without the United States), and for purposes of computing the amount of personal holding company income under section 543 (relating to personal holding company income) and section 1372(e)(5) (relating to election by a small business corporation).

(b) Exceptions and limitations to the application of section 483—(1) Sales price of $3,000 or less—(i) Determination of sales price. Section 483 shall not apply to any payment on account of the sale or exchange of property if it can be determined at the time of such sale or exchange that the sales price cannot exceed $3,000. For purposes of determining the amount of the sales price, the amount of any downpayment and any amount treated as unstated interest under section 483 shall be included, but interest provided for in the contract shall not be included. If property which is encumbered by a liability is sold or exchanged, the amount of the liability (whether the property is merely taken subject to the liability or whether the liability is assumed by the purchaser) shall be included as a part of the sales price. The $3,000 exception provided by this subparagraph does not apply to a contract under which payments are indefinite as to liability or amount if the total of the payments (exclusive of interest specified in the contract) due under the contract could exceed $3,000, notwithstanding that such payments do not subsequently exceed such amount. If the district director ascertains from the surrounding facts and circumstances that a single transaction with a sales price in excess of $3,000 has been fragmented into more than one separate transaction each with a sales price less than $3,000 in order to avoid the operation of the provisions of section 483, he may determine that section 483 applies.

(ii) Examples. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). On December 31, 1963, A sells property to B under a contract which provides that B is to make four payments of $700 each, such payments being due, respectively, every 6 months for the next 2 years. No interest is provided for in the contract. Since the total sales price ($2,800) under the contract is not in excess of $3,000, section 483 does not apply.

Example (2). On December 31, 1963, A sells property to B under a contract which provides that B is to make four payments as follows: $721 ($700 principal plus $21 interest), $742 ($700 principal plus $42 interest), $763 ($700 principal plus $63 interest), and $784 ($700 principal plus $84 interest), such payments being due, respectively, every 6 months for the next 2 years. Since the total sales price ($2,800) exclusive of stated interest ($210) does not exceed $3,000, section 483 does not apply, even though the total dollar amount of the contract, including both principal and stated interest ($3,010), exceeds $3,000.

Example (3). On December 31, 1963, A sells property to B under a contract which provides that B is to make three payments of $800 each, such payments being due June 30, 1964, December 31, 1964, and June 30, 1965. A fourth payment of $800 is to be made on December 31, 1965, but only if the profit derived from the property exceeds an amount specified in the contract. No interest is provided for in the contract. Section 483 applies to the contract even though the three definite payments ($2,400) do not exceed $3,000, because the total payments due under the contract could exceed such amount. Furthermore, section 483 applies even though, subsequently, the profit derived from the property does not exceed the amount specified in the contract, so that only $2,400 is actually paid under the contract.

Example (4). A divides a 100 acre tract of unimproved real property into four equal parcels and sells them to B under four separate contracts dated, respectively, December 31, 1963, January 31, 1964, February 29, 1964, and March 30, 1964. Each contract provides for payments of $1,000 at the time of sale and $1,000 at the end of 1 year. No interest is provided in any of the contracts. The district director may determine that section 483 applies to the four contracts if he ascertains that a single transaction with a sales price in excess of $3,000 has been fragmented into four separate transactions each with a sales price less than $3,000 in order to avoid the operation of the provisions of section 483.

(2) Carrying charges. In the case of the purchaser, the tax treatment of amounts paid on account of the sale or exchange of property shall be determined without regard to section 483 if such amounts are treated under section 163(b) (relating to deduction for interest on certain installment purchases) as if they included interest. Accordingly, if the provisions of section 163(b) apply to a contract, the purchaser shall, with respect to payments under the contract, compute his interest deductions under that section (without regard to section 483), even though such amount differs from the amount to be treated as interest

income by the seller as computed under the provisions of section 483.

(3) Capital asset or section 1231 property—(i) Treatment of seller. In the case of the seller, the determination of the tax treatment of any amounts received on account of the sale or exchange of property shall be made without regard to section 483 if no part of any gain on such sale or exchange would (if the property were sold at a gain) be considered as gain from the sale or exchange of a capital asset or property described in section 1231 (relating to property used in the trade or business and involuntary conversions). The determination of whether the exception of the preceding sentence applies shall be made without regard to whether any gain or loss is realized on the sale or exchange, whether any realized gain or loss would be recognized, or whether some other provision of law, such as section 1245 (relating to gain from dispositions of certain depreciable property) or section 1250 (relating to gain from dispositions of certain depreciable realty) applies, or would apply, to some or all of the gain. For example, the provisions of section 483 apply to deferred payments of stock or securities by a corporation which is a party to a reorganization, notwithstanding that under section 354(a) no gain or loss is recognized on the transaction. Similarly, the provisions of section 483 apply to deferred payments made to a corporation for its stock, notwithstanding the nonrecognition of gain or loss to the corporation under section 1032 (relating to exchange of stock for property).

(ii) Treatment of purchaser. The purchaser under a contract under which there are payments to which section 483 applies shall determine the amount of any interest deduction under such section, notwithstanding that section 483 does not apply to the seller because of the provisions of subdivision (i) of this subparagraph.

(4) Sales or exchanges of patents. Section 483 does not apply to any payments made pursuant to a transfer described in section 1235(a) (relating to sale or exchange of patents). The preceding sentence does not apply to transfers which are not described in section 1235(a) but which receive capital gain treatment under another section of the Code.

(5) Annuities. Section 483 does not apply to any amount the liability for which depends in whole or in part on the life expectancy of one or more individuals and which constitutes an amount received as an annuity to which section 72 (relating to annuities, etc.) applies. Thus, in the case of both the purchaser and the seller, any such amount is not considered a payment to which section 483 applies.

[T.D. 6873, 31 FR 952, Jan. 25, 1966]

§ 1.483–2T Adequate stated interest for certain contracts entered into after February 28, 1985 (temporary).

A contract entered into after February 28, 1985, to which section 483 applies shall not be treated as having unstated interest provided that the contract would not have unstated interest if, in lieu of the applicable Federal rate computed under the statutory method of section 1274(d), there were substituted the lowest of—

(a) The applicable Federal rate computed under the alternate method set forth in § 1.1274–6T for the month for which the determination is being made;

(b) The applicable Federal rate computed under the alternate method for the month preceding the month for which the determination is being made; or

(c) The applicable Federal rate computed under the alternate method for the second month preceding the month for which the determination is being made.

The rates described in paragraphs (b) and (c) of this section do not apply in determining total unstated interest under section 483(b). For illustrations of the application of this section, see § 1.1274–3T(b).

[T.D. 8010, 50 FR 6938, Feb. 19, 1985]

EXEMPT ORGANIZATIONS

General Rule

§ 1.501(a)–1 Exemption from taxation.

(a) In general; proof of exemption. (1) Section 501(a) provides an exemption from income taxes for organizations which are described in section 501(c) or (d) and section 401(a), unless such organization is a "feeder organization" (see section

502), or unless it engages in a transaction described in section 503. However, the exemption does not extend to "unrelated business taxable income" of such an organization (see part III (Section 511 and following), subchapter F, chapter 1 of the Code).

(2) An organization, other than an employees' trust described in section 401(a), is not exempt from tax merely because it is not organized and operated for profit. In order to establish its exemption, it is necessary that every such organization claiming exemption file an application form as set forth below with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. Subject only to the Commissioner's inherent power to revoke rulings because of a change in the law or regulations or for other good cause, an organization that has been determined by the Commissioner or the district director to be exempt under section 501(a) or the corresponding provision of prior law may rely upon such determination so long as there are no substantial changes in the organization's character, purposes, or methods of operation. An organization which has been determined to be exempt under the provisions of the Internal Revenue Code of 1939 or prior law is not required to secure a new determination of exemption merely because of the enactment of the Internal Revenue Code of 1954 unless affected by substantive changes in law made by such Code.

(3) An organization claiming exemption under section 501(a) and described in any paragraph of section 501(c) other than section 501(c)(1) shall file the form of application prescribed by the Commissioner and shall include thereon such information as required by such form and the instructions issued with respect thereto. For rules relating to the obtaining of a determination of exempt status by an employees' trust described in section 401(a), see the regulations under section 401.

(b) Additional proof by particular classes of organizations. (1) Organizations mentioned below shall submit with and as a part of their applications the following information:

(i) Mutual insurance companies shall submit copies of the policies or certificates of membership issued by them.

(ii) In the case of title holding companies described in section 501(c)(2), if the organization for which title is held has not been specifically notified in writing by the Internal Revenue Service that it is held to be exempt under section 501(a), the title holding company shall submit the information indicated herein as necessary for a determination of the status of the organization for which title is held.

(iii) An organization described in section 501(c)(3) shall submit with, and as a part of, an application filed after July 26, 1959, a detailed statement of its proposed activities.

(2) In addition to the information specifically called for by this section, the Commissioner may require any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 501(a), and when deemed advisable in the interest of an efficient administration of the internal revenue laws, he may in the cases of particular types of organizations prescribe the form in which the proof of exemption shall be furnished.

(3) An organization claiming to be specifically exempted by section 6033(a) from filing annual returns shall submit with and as a part of its application a statement of all the facts on which it bases its claim.

(c) "Private shareholder or individual" defined. The words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization.

(d) Requirement of annual returns. For the annual return requirements of organizations exempt under section 501(a), see section 6033 and § 1.6033–1.

(e) Certain Puerto Rican pension, etc., trusts. Effective for taxable years beginning after December 31, 1973, section 1022(i)(1) of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 942) provides that trusts under certain Puerto Rican pension, etc., plans (as defined under P.R. Laws Ann. tit. 13, section 3165, and the articles thereunder), all of the participants of which are residents of the Commonwealth of Puerto Rico, are to be treated only for purposes of section 501(a) as trusts described in section 401(a). The practical effect of section 1022(i)(1) is to exempt these trusts from U.S. income tax on income from their U.S. investments. For purposes of section 1022(i)(1), the term "residents of the Commonwealth of Puerto Rico" means bona fide residents of Puerto Rico, and persons who perform labor or services primarily within the Commonwealth of Puerto Rico, regardless of residence for other purposes, and the term "participants" is

restricted to current employees who are not excluded under the eligibility provisions of the plan.
[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6972, 33 FR 12899, Sept. 12, 1968; T.D. 7428, 41 FR 34619, Aug. 16, 1976; T.D. 7859, 47 FR 54298, Dec. 2, 1982]

§ 1.501(c)(2)–1 Corporations organized to hold title to property for exempt organizations.

(a) A corporation described in section 501(c)(2) and otherwise exempt from tax under section 501(a) is taxable upon its unrelated business taxable income. For taxable years beginning before January 1, 1970, see § 1.511–2(c)(4). Since a corporation described in section 501(c)(2) cannot be exempt under section 501(a) if it engages in any business other than that of holding title to property and collecting income therefrom, it cannot have unrelated business taxable income as defined in section 512 other than income which is treated as unrelated business taxable income solely because of the applicability of section 512(a)(3)(C); or debt financed income which is treated as unrelated business taxable income solely because of section 514; or certain interest, annuities, royalties, or rents which are treated as unrelated business taxable income solely because of section 512(b)(3)(B)(ii) or (13). Similarly, exempt status under section 501(c)(2) shall not be affected where certain rents from personal property leased with real property are treated as unrelated business taxable income under section 512(b)(3)(A)(ii) solely because such rents attributable to such personal property are more than incidental when compared to the total rents received or accrued under the lease, or under section 512(b)(3)(B)(i) solely because such rents attributable to such personal property exceed 50 percent of the total rents received or accrued under the lease.

(b) A corporation described in section 501(c)(2) cannot accumulate income and retain its exemption, but it must turn over the entire amount of such income, less expenses, to an organization which is itself exempt from tax under section 501(a).
[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7658, 45 FR 33972, May 21, 1980]

§ 1.501(c)(3)–1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(a) Organizational and operational tests. (1) In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

(2) The term "exempt purpose or purposes", as used in this section, means any purpose or purposes specified in section 501(c)(3), as defined and elaborated in paragraph (d) of this section.

(b) Organizational test—(1) In general. (i) An organization is organized exclusively for one or more exempt purposes only if its articles of organization (referred to in this section as its "articles") as defined in subparagraph (2) of this paragraph:

(a) Limit the purposes of such organization to one or more exempt purposes; and

(b) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

(ii) In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes stated in section 501(c)(3). Therefore, an organization which, by the terms of its articles, is formed "for literary and scientific purposes within the meaning of section 501(c)(3) of the Code" shall, if it otherwise meets the requirements in this paragraph, be considered to have met the organizational test. Similarly, articles stating that the organization is created solely "to receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a)" are sufficient for purposes of the organizational test. Moreover, it is sufficient if the articles set for the purpose of the organization to be the operation of a school for adult education and describe in detail the manner of the operation of such school. In addition, if the articles state that the organization is formed for "charitable purposes", such articles ordinarily shall be sufficient for purposes of the organizational test (see subparagraph (5) of this paragraph for rules relating to construction of terms).

(iii) An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more

exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c)(3). Thus, an organization that is empowered by its articles "to engage in a manufacturing business", or "to engage in the operation of a social club" does not meet the organizational test regardless of the fact that its articles may state that such organization is created "for charitable purposes within the meaning of section 501(c)(3) of the Code."

(iv) In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c)(3). The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intend to operate only in furtherance of one or more exempt purposes.

(v) An organization must, in order to establish its exemption, submit a detailed statement of its proposed activities with and as a part of its application for exemption (see paragraph (b) of § 1.501(a)–1).

(2) Articles of organization. For purposes of this section, the term "articles of organization" or "articles" includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created.

(3) Authorization of legislative or political activities. An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it—

(i) To devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise; or

(ii) Directly or indirectly to participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office; or

(iii) To have objectives and to engage in activities which characterize it as an "action" organization as defined in paragraph (c)(3) of this section. The terms used in subdivisions (i), (ii), and (iii) of this subparagraph shall have the meanings provided in paragraph (c)(3) of this section.

(4) Distribution of assets on dissolution. An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will be considered dedicated to an exempt purpose, for example, if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal Government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized. However, an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

(5) Construction of terms. The law of the State in which an organization is created shall be controlling in construing the terms of its articles. However, any organization which contends that such terms have under State law a different meaning from their generally accepted meaning must establish such special meaning by clear and convincing reference to relevant court decisions, opinions of the State attorney-general, or other evidence of applicable State law.

(6) Applicability of the organizational test. A determination by the Commissioner or a district director that an organization is described in section 501(c)(3) and exempt under section 501(a) will not be granted after July 26, 1959 (regardless of when the application is filed), unless such organization meets the organizational test prescribed by this paragraph. If, before July 27, 1959, an organization has been determined by the Commissioner or district director to be exempt as an organization described in section 501(c)(3) or in a corresponding provision of prior law and such determination has not been revoked before such date, the fact that such organization does not meet the organizational test prescribed by this paragraph shall not be a basis for revoking such determination. Accordingly, an organization which has been determined to be exempt before July 27, 1959, and which does not seek a new determination of exemption is not required to amend its articles of organization to conform to the rules of this paragraph, but any organization which seeks a

determination of exemption after July 26, 1959, must have articles of organization which meet the rules of this paragraph. For the rules relating to whether an organization determined to be exempt before July 27, 1959, is organized exclusively for one or more exempt purposes, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167; C.B. 1954–2, 47).

(c) Operational test—(1) Primary activities. An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

(2) Distribution of earnings. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words "private shareholder or individual", see paragraph (c) of § 1.501(a)–1.

(3) "Action" organizations. (i) An organization is not operated exclusively for one or more exempt purposes if it is an "action" organization as defined in subdivisions (ii), (iii), or (iv) of this subparagraph.

(ii) An organization is an "action" organization if a substantial part of its activities is attempting to influence legislation by propaganda or otherwise. For this purpose, an organization will be regarded as attempting to influence legislation if the organization—

(a) Contacts, or urges the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or

(b) Advocates the adoption or rejection of legislation.

The term "legislation", as used in this subdivision, includes action by the Congress, by any State legislature, by any local council or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. An organization will not fail to meet the operational test merely because it advocates, as an insubstantial part of its activities, the adoption or rejection of legislation.

(iii) An organization is an "action" organization if it participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate for public office.

The term "candidate for public office" means an individual who offers himself, or is proposed by others, as a contestant for an elective public office, whether such office be national, State, or local. Activities which constitute participation or intervention in a political campaign on behalf of or in opposition to a candidate include, but are not limited to, the publication or distribution of written or printed statements or the making of oral statements on behalf of or in opposition to such a candidate.

(iv) An organization is an "action" organization if it has the following two characteristics: (a) Its main or primary objective or objectives (as distinguished from its incidental or secondary objectives) may be attained only by legislation or a defeat of proposed legislation; and (b) it advocates, or campaigns for, the attainment of such main or primary objective or objectives as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public. In determining whether an organization has such characteristics, all the surrounding facts and circumstances, including the articles and all activities of the organization, are to be considered.

(v) An "action" organization, described in subdivisions (ii) or (iv) of this subparagraph, though it cannot qualify under section 501(c)(3), may nevertheless qualify as a social welfare organization under section 501(c)(4) if it meets the requirements set out in paragraph (a) of § 1.501(c)(4)–1.

(d) Exempt purposes—(1) In general. (i) An organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

(a) Religious,

(b) Charitable,

(c) Scientific,

(d) Testing for public safety,

(e) Literary,

(f) Educational, or

(g) Prevention of cruelty to children or animals.

(ii) An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private

interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

(iii) Since each of the purposes specified in subdivision (i) of this subparagraph is an exempt purpose in itself, an organization may be exempt if it is organized and operated exclusively for any one or more of such purposes. If, in fact, an organization is organized and operated exclusively for an exempt purpose or purposes, exemption will be granted to such an organization regardless of the purpose or purposes specified in its application for exemption. For example, if an organization claims exemption on the ground that it is "educational", exemption will not be denied if, in fact, it is "charitable".

(2) Charitable defined. The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes. The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501(c)(3) so long as it is not an "action" organization of any one of the types described in paragraph (c)(3) of this section.

(3) Educational defined—(i) In general. The term "educational", as used in section 501(c)(3), relates to—

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.

(ii) Examples of educational organizations. The following are examples of organizations which, if they otherwise meet the requirements of this section, are educational:

Example (1). An organization, such as a primary or secondary school, a college, or a professional or trade school, which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on.

Example (2). An organization whose activities consist of presenting public discussion groups, forums, panels, lectures, or other similar programs. Such programs may be on radio or television.

Example (3). An organization which presents a course of instruction by means of correspondence or through the utilization of television or radio.

Example (4). Museums, zoos, planetariums, symphony orchestras, and other similar organizations.

(4) Testing for public safety defined. The term "testing for public safety", as used in section 501(c)(3), includes the testing of consumer products, such as electrical products, to determine whether they are safe for use by the general public.

(5) Scientific defined. (i) Since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a "scientific" organization must be organized and operated in the public interest (see subparagraph (1)(ii) of this paragraph). Therefore, the term "scientific", as used in section 501(c)(3), includes the carrying on of scientific research in the public interest. Research when taken alone is a word with various meanings; it is not synonymous with "scientific"; and the nature of particular research depends upon the purpose which it serves. For research to be "scientific", within the meaning of section 501(c)(3), it must be

carried on in furtherance of a "scientific" purpose. The determination as to whether research is "scientific" does not depend on whether such research is classified as "fundamental" or "basic" as contrasted with "applied" or "practical". On the other hand, for purposes of the exclusion from unrelated business taxable income provided by section 512(b)(9), it is necessary to determine whether the organization is operated primarily for purposes of carrying on "fundamental", as contrasted with "applied", research.

(ii) Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc.

(iii) Scientific research will be regarded as carried on in the public interest—

(a) If the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis;

(b) If such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or

(c) If such research is directed toward benefiting the public. The following are examples of scientific research which will be considered as directed toward benefiting the public, and, therefore, which will be regarded as carried on in the public interest: (1) Scientific research carried on for the purpose of aiding in the scientific education of college or university students; (2) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; (3) scientific research carried on for the purpose of discovering a cure for a disease; or (4) scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area. Scientific research described in this subdivision will be regarded as carried on in the public interest even though such research is performed pursuant to a contract or agreement under which the sponsor or sponsors of the research have the right to obtain ownership or control of any patents, copyrights, processes, or formulae resulting from such research.

(iv) An organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under section 501(c)(3) as a "scientific" organization, if—

(a) Such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3), or

(b) Such organization retains (directly or indirectly) the ownership or control of more than an insubstantial portion of the patents, copyrights, processes, or formulae resulting from its research and does not make such patents, copyrights, processes, or formulae available to the public. For purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public. In such a case, however, the research from which the patent, copyright, process, or formula resulted will be regarded as carried on in the public interest (within the meaning of subdivision (iii) of this subparagraph) only if it is carried on for a person described in subdivision (iii)(b) of this subparagraph or if it is scientific research described in subdivision (iii)(c) of this subparagraph.

(v) The fact that any organization (including a college, university, or hospital) carries on research which is not in furtherance of an exempt purpose described in section 501(c)(3) will not preclude such organization from meeting the requirements of section 501(c)(3) so long as the organization meets the organizational test and is not operated for the primary purpose of carrying on such research (see paragraph (e) of this section, relating to organizations carrying on a trade or business). See paragraph (a)(5) of § 1.513-2, with respect to research which constitutes an unrelated trade or business, and section 512(b)(7), (8), and (9), with respect to income derived from research which is excludable from the tax on unrelated business income.

(vi) The regulations in this subparagraph are applicable with respect to taxable years beginning after December 31, 1960.

(e) Organizations carrying on trade or business—(1) In general. An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. See, however, section 501(d) and § 1.501(d)–1, relating to religious and apostolic organizations.

(2) Taxation of unrelated business income. For provisions relating to the taxation of unrelated business income of certain organizations described in section 501(c)(3), see sections 511 to 515, inclusive, and the regulations thereunder.

(f) Applicability of regulations in this section. The regulations in this section are, except as otherwise expressly provided, applicable with respect to taxable years beginning after July 26, 1959. For the rules applicable with respect to taxable years beginning before July 27, 1959, see 26 CFR (1939) 39.101(6)–1 (Regulations 118) as made applicable to the Code by Treasury Decision 6091, approved August 16, 1954 (19 FR 5167; C.B. 1954–2, 47).
[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6525, 26 FR 189, Jan. 11, 1961; T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7428, 41 FR 34620, Aug. 16, 1976]

§ 1.501(c)(4)–1 Civic organizations and local associations of employees.

(a) Civic organizations—(1) In general. A civic league or organization may be exempt as an organization described in section 501(c)(4) if—

(i) It is not organized or operated for profit; and

(ii) It is operated exclusively for the promotion of social welfare.

(2) Promotion of social welfare—(i) In general. An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements. A "social welfare" organization will qualify for exemption as a charitable organization if it falls within the definition of "charitable" set forth in paragraph (d)(2) of § 1.501(c)(3)–1 and is not an "action" organization as set forth in paragraph (c)(3) of § 1.501(c)(3)–1.

(ii) Political or social activities. The promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office. Nor is an organization operated primarily for the promotion of social welfare if its primary activity is operating a social club for the benefit, pleasure, or recreation of its members, or is carrying on a business with the general public in a manner similar to organizations which are operated for profit. See, however, section 501(c)(6) and § 1.501(c)(6)–1, relating to business leagues and similar organizations. A social welfare organization may qualify under section 501(c)(4) even though it is an "action" organization described in paragraph (c)(3)(ii) or (iv) of § 1.501(c)(3)–1 if it otherwise qualifies under this section.

(b) Local associations of employees. Local associations of employees described in section 501(c)(4) are expressly entitled to exemption under section 501(a). As conditions to exemption, it is required (1) that the membership of such an association be limited to the employees of a designated person or persons in a particular municipality, and (2) that the net earnings of the association be devoted exclusively to charitable, educational, or recreational purposes. The word "local" is defined in paragraph (b) of § 1.501(c)(12)–1. See paragraph (d)(2) and (3) of § 1.501(c)(3)–1 with reference to the meaning of "charitable" and "educational" as used in this section.

§ 1.501(c)(5)–1 Labor, agricultural, and horticultural organizations.

(a) The organizations contemplated by section 501(c)(5) as entitled to exemption from income taxation are those which:

(1) Have no net earnings inuring to the benefit of any member, and

(2) Have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

(b) Organizations described in section 501(c)(5) and otherwise exempt from tax under section 501(a) are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.501(c)(6)–1 Business leagues, chambers of commerce, real estate boards, and boards of trade.

A business league is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax. Organizations otherwise exempt from tax under this section are taxable upon their unrelated business taxable income. See part II (section 511 and following), subchapter F, chapter 1 of the Code, and the regulations thereunder.

§ 1.501(c)(7)–1 Social clubs.

(a) The exemption provided by section 501(a) for organizations described in section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if any part of its net earnings inures to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

(b) A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

§ 1.501(c)(8)–1 Fraternal beneficiary societies.

(a) A fraternal beneficiary society is exempt from tax only if operated under the "lodge system" or for the exclusive benefit of the members so operating. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits.

(b) Revoked by: T.D. 7061, 35 FR 74770, Sept. 23, 1970.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7061, 35 FR 14770, Sept. 23, 1970]

§ 1.501(c)(9)–1 Voluntary employees' beneficiary associations, in general.

To be described in section 501(c)(9) an organization must meet all of the following requirements:

(a) The organization is an employees' association,

(b) Membership in the association is voluntary,

(c) The organization provides for the payment of life, sick, accident, or other benefits to its members or their dependents or designated benefi-

ciaries, and substantially all of its operations are in furtherance of providing such benefits, and

(d) No part of the net earnings of the organization inures, other than by payment of the benefits referred to in paragraph (c) of this section, to the benefit of any private shareholder or individual. [T.D. 7750, 45 FR 1721, Jan. 7, 1981]

§ 1.501(c)(9)–2 Membership in a voluntary employees' beneficiary association; employees; voluntary association of employees.

(a) Membership—(1) In general. The membership of an organization described in section 501(c)(9) must consist of individuals who become entitled to participate by reason of their being employees and whose eligibility for membership is defined by reference to objective standards that constitute an employment-related common bond among such individuals. Typically, those eligible for membership in an organization described in section 501(c)(9) are defined by reference to a common employer (or affiliated employers), to coverage under one or more collective bargaining agreements (with respect to benefits provided by reason of such agreement(s)), to membership in a labor union, or to membership in one or more locals of a national or international labor union. For example, membership in an association might be open to all employees of a particular employer, or to employees in specified job classifications working for certain employers at specified locations and who are entitled to benefits by reason of one or more collective bargaining agreements. In addition, employees of one or more employers engaged in the same line of business in the same geographic locale will be considered to share an employment-related bond for purposes of an organization through which their employees provide benefits. Employees of a labor union also will be considered to share an employment-related common bond with members of the union, and employees of an association will be considered to share an employment-related common bond with members of the association. Whether a group of individuals is defined by reference to a permissible standard or standards is a question to be determined with regard to all the facts and circumstances, taking into account the guidelines set forth in this paragraph. Exemption will not be denied merely because the membership of an association includes some individuals who are not employees (within the meaning of paragraph (b) of this section), provided that such individuals share an employment-related bond with the employee-members. Such individuals may include, for example, the proprietor of a business whose employees are members of the association. For purposes of the preceding two sentences, an association will be considered to be composed of employees if 90 percent of the total membership of the association on one day of each quarter of the association's taxable year consists of employees (within the meaning of paragraph (b) of this section).

(2) Restrictions—(i) In general. Eligibility for membership may be restricted by geographic proximity, or by objective conditions or limitations reasonably related to employment, such as a limitation to a reasonable classification of workers, a limitation based on a reasonable minimum period of service, a limitation based on maximum compensation, or a requirement that a member be employed on a full-time basis. Similarly, eligibility for benefits may be restricted by objective conditions relating to the type or amount of benefits offered. Any objective criteria used to restrict eligibility for membership or benefits may not, however, be selected or administered in a manner that limits membership or benefits to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Similarly, eligibility for benefits may not be subject to conditions or limitations that have the effect of entitling officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association to benefits that are disproportionate in relation to benefits to which other members of the association are entitled. See § 1.501(c)(9)–4(b). Whether the selection or administration of objective conditions has the effect of providing disproportionate benefits to officers, shareholders, or highly compensated employees generally is to be determined on the basis of all the facts and circumstances.

(ii) Generally permissible restrictions or conditions. In general the following restrictions will not be considered to be inconsistent with § 1.501(c)(9)–2(a)(2)(i) or § 1.501(c)(9)–4(b):

(A) In the case of an employer-funded organization, a provision that excludes or has the effect of excluding from membership in the organization or participation in a particular benefit plan employees who are members of another organization or covered by a different plan, funded or contributed to by the employer, to the extent that such other organization or plan offers similar benefits on comparable terms to the excluded employees.

(B) In the case of an employer funded-organization, a provision that excludes from membership, or limits the type or amount of benefits provided to, individuals who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that the benefit or benefits provided by the organization were the subject of good faith bargaining between such employee representatives and such employer or employers.

(C) Restrictions or conditions on eligibility for membership or benefits that are determined through collective bargaining, by trustees designated pursuant to a collective bargaining agreement, or by the collective bargaining agents of the members of an association or trustees named by such agent or agents.

(D) The allowance of benefits only on condition that a member or recipient contribute to the cost of such benefits, or the allowance of different benefits based solely on differences in contributions, provided that those making equal contributions are entitled to comparable benefits.

(E) A requirement that a member (or a member's dependents) meet a reasonable health standard related to eligibility for a particular benefit.

(F) The provision of life benefits in amounts that are a uniform percentage of the compensation received by the individual whose life is covered.

(G) The provision of benefits in the nature of wage replacement in the event of disability in amounts that are a uniform percentage of the compensation of the covered individuals (either before or after taking into account any disability benefits provided through social security or any similar plan providing for wage replacement in the event of disability).

(3) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). Pursuant to a collective bargaining agreement entered into by X Corporation and W, a labor union which represents all of X Corporation's hourly-paid employees, the X Corporation Union Benefit Plan is established to provide life insurance benefits to employees of X represented by W. The Plan is funded by contributions from X, and is jointly administered by X and W. In order to provide its non-unionized employees with comparable life insurance benefits, X also establishes and funds the X Corporation Life Insurance Trust. The Trust will not be ineligible for exemption as an organization described in section 501(c)(9) solely because membership is restricted to those employees of X who are not members of W.

Example (2). The facts are the same as in Example (1) except that the life insurance benefit provided to the non-unionized employees of X differs from the life insurance benefit provided to the unionized employees of X pursuant to the collective bargaining agreement. The trust will not be ineligible for exemption as an organization described in section 501(c)(9) solely because the life insurance benefit provided to X's non-unionized employees is not same as the life insurance benefit provided to X's unionized employees.

Example (3). S corporation established a plan to provide health benefits to all its employees. In accordance with the provisions of the plan each employee may secure insurance coverage by making an election under which the employee agrees to contribute periodically to the plan an amount which is determined solely by whether the employee elects a high option coverage or a low option coverage and on whether the employee is unmarried or has a family. As an alternative, the employee may elect high or low options, self only or self and family, coverage through a local prepaid group medical plan. The contributions required of those electing the prepaid group medical plan also vary with the type of coverage selected, and differ from those required of employees electing insurance. The difference between the amount contributed by employees electing the various coverages and the actual cost of purchasing the coverage is made up through contributions by S to the plan, and under the plan, S provides approximately the same proportion of the cost for each coverage. To fund the plan, S established an arrangement in the nature of a trust under applicable local law and contributes all employee contributions, and all amounts which by the terms of the plan it is required to contribute, to the trust. The terms of the plan do not provide for disproportionate benefits to the employees of S and will not be considered inconsistent with § 1.501(c)(9)–2(a)(2)(i).

Example (4). The facts are the same as in Example (3) except that, for those employees or former employees covered by Medicare, the plan provides a distinct coverage which supplements Medicare benefits. Eligibility for Medicare is an objective condition relating to a type of benefit offered, and the provision of separate coverage for those eligible for Medicare will not be considered inconsistent with § 1.501(c)(9)–2(a)(2)(i).

(b) Meaning of "employee". Whether an individual is an "employee" is determined by reference to the legal and bona fide relationship of employer and employee. The term "employee" includes the following:

(1) An individual who is considered an employee:

(i) For employment tax purposes under Subtitle C of the Internal Revenue Code and the regulations thereunder, or

(ii) For purposes of a collective bargaining agreement,

whether or not the individual could qualify as an employee under applicable common law rules. This would include any person who is considered an employee for purposes of the Labor Management Relations Act of 1947, 61 Stat. 136, as amended, 29 U.S.C. 141 (1979).

(2) An individual who became entitled to membership in the association by reason of being or having been an employee. Thus, an individual

who would otherwise qualify under this paragraph will continue to qualify as an employee even though such individual is on leave of absence, works temporarily for another employer or has an independent contractor, or has been terminated by reason of retirement, disability or layoff. For example, an individual who in the normal course of employment is employed intermittently by more than one employer in an industry characterized by short-term employment by several different employers will not, by reason of temporary unemployment, cease to be an employee within the meaning of this paragraph.

(3) The surviving spouse and dependents of an employee (if, for purposes of the 90-percent test of § 1.501(c)(9)–2(a)(1) they are considered to be members of the association).

(c) Description of voluntary association of employees—(1) Association. To be described in section 501(c)(9) and this section there must be an entity, such as a corporation or trust established under applicable local law, having an existence independent of the member-employees or their employer.

(2) Voluntary. Generally, membership in an association is voluntary if an affirmative act is required on the part of an employee to become a member rather than the designation as a member due to employee status. However, an association shall be considered voluntary although membership is required of all employees, provided that the employees do not incur a detriment (for example, in the form of deductions from pay) as the result of membership in the association. An employer is not deemed to have imposed involuntary membership on the employee if membership is required as the result of a collective bargaining agreement or as an incident of membership in a labor organization.

(3) Of employees. To be described in this section, an organization must be controlled—

(i) By its membership,

(ii) By independent trustee(s) (such as a bank), or

(iii) By trustees or other fiduciaries at least some of whom are designated by, or on behalf of, the membership. Whether control by or on behalf of the membership exists is a question to be determined with regard to all of the facts and circumstances, but generally such control will be deemed to be present when the membership (either directly or through its representative) elects, appoints or otherwise designates a person or persons to serve as chief operating officer(s), administrator(s), or trustee(s) of the organization. For purposes of this paragraph an organization will be considered to be controlled by independent trustees if it is an "employee welfare benefit plan", as defined in section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA), and, as such, is subject to the requirements of Parts 1 and 4 of Subtitle B, Title I of ERISA. Similarly, a plan will be considered to be controlled by its membership if it is controlled by one or more trustees designated pursuant to a collective bargaining agreement (whether or not the bargaining agent of the represented employees bargained for and obtained the right to participate in selecting the trustees).

(4) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). X, a labor union, represents all the hourly-paid employees of Y Corporation. A health insurance benefit plan was established by X and Y as the result of a collective bargaining agreement entered into by them. The plan established the terms and conditions of membership in, and the benefits to be provided by, the plan. In accordance with the terms of the agreement, Y Corporation is obligated to establish a trust fund and make contributions thereto at specified rates. The trustees, some of whom are designated by X and some by Y, are authorized to hold and invest the assets of the trust and to make payments on instructions issued by Y Corporation in accordance with the conditions contained in the plan. The interdependent benefit plan agreement and trust indenture together create a voluntary employees' beneficiary association over which the employees possess the requisite control through the trustees designated by their representative X.

Example (2). Z Corporation unilaterally established an educational benefit plan for its employees. The purpose of the plan is to provide payments for job-related educational or training courses, such as apprenticeship training programs, for Z Corporation employees, according to objective criteria set forth in the plan. Z establishes a separate bank account which it uses to fund payments to the plan. Contributions to the account are to be made at the discretion of and solely by Z Corporation, which also administers the plan and retains control over the assets in the fund. Z Corporation's educational benefit plan and the related account do not constitute an association having an existence independent of Z Corporation and therefore do not constitute a voluntary employees' beneficiary association.

Example (3). A, an individual, is the incorporator and chief operating officer of Lawyers' Beneficiary Association (LBA). LBA is engaged in the business of providing medical benefits to members of the Association and their families. Membership is open only to practicing lawyers located in a particular metropolitan area who are neither self-employed nor partners in a law firm. Membership in LBA is solicited by insurance agents under the control of X Corporation (owned by A) which, by contract with LBA, is the exclusive sales agent. Medical benefits are paid from a trust account containing periodic "contributions" paid by the members, together with proceeds from the investment of those contributions. Contribution and benefit levels are set by LBA. The "members" of LBA do not hold meetings, have no right to elect officers or directors of the Association, and no right to replace trustees. Collectively, the

subscribers for medical benefits from LBA cannot be said to control the association and membership is neither more than nor different from the purchase of an insurance policy from a stock insurance company. LBA is not a voluntary employees' beneficiary association.

Example (4). U corporation unilaterally established a plan to provide benefits to its employees. In accordance with the provisions of the plan, each employee may secure insurance or benefit coverage by making an election under which the employee agrees to contribute to the plan an amount which is determined solely by whether the employee elects a high option coverage or a low option coverage and on whether the employee elects self only or self and family coverage. The difference between the amount contributed by employees electing the various coverages and the actual cost of the coverage is made up through contributions by U to the plan. To fund the plan, U established an arrangement in the nature of a trust under applicable local law and contributed all employee contributions, and all amounts which by the term of the plan it was required to provide to the plan, to the trust. The trust constitutes an "employee welfare benefit plan" within the meaning of, and subject to relevant requirements of, ERISA. It will be considered to meet the requirements of § 1.501(c)(9)–2(c)(3).

[T.D. 7750, 46 FR 1723, Jan. 7, 1981]

§ 1.501(c)(9)–3 Voluntary employees' beneficiary associations; life, sick, accident, or other benefits.

(a) **In general.** The life, sick, accident, or other benefits provided by a voluntary employees' beneficiary association must be payable to its members, their dependents, or their designated beneficiaries. For purposes of section 501(c)(9), "dependent" means the member's spouse; any child of the member or the member's spouse who is a minor or a student (within the meaning of section 151(e)(4)); any other minor child residing with the member; and any other individual who an association, relying on information furnished to it by a member, in good faith believes is a person described in section 152(a). Life, sick, accident, or other benefits may take the form of cash or noncash benefits. A voluntary employees' beneficiary association is not operated for the purpose of providing life, sick, accident, or other benefits unless substantially all of its operations are in furtherance of the provision of such benefits. Further, an organization is not described in this section if it systematically and knowingly provides benefits (of more than a *de minimis* amount) that are not permitted by paragraphs (b), (c), (d), or (e) of this section.

(b) **Life benefits.** The term "life benefits" means a benefit (including a burial benefit or a wreath) payable by reason of the death of a member or dependent. A "life benefit" may be provided directly or through insurance. It generally must consist of current protection, but also may include a right to convert to individual coverage on termination of eligibility for coverage through the association, or a permanent benefit as defined in, and subject to the conditions in, the regulations under section 79. A "life benefit" also includes the benefit provided under any life insurance contract purchased directly from an employee-funded association by a member or provided by such an association to a member. The term "life benefit" does not include a pension, annuity or similar benefit, except that a benefit payable by reason of the death of an insured may be settled in the form of an annuity to the beneficiary in lieu of a lump-sum death benefit (whether or not the contract provides for settlement in a lump sum).

(c) **Sick and accident benefits.** The term "sick and accident benefits" means amounts furnished to or on behalf of a member or a member's dependents in the event of illness or personal injury to a member or dependent. Such benefits may be provided through reimbursement to a member or a member's dependents for amounts expended because of illness or personal injury, or through the payment of premiums to a medical benefit or health insurance program. Similarly, a sick and accident benefit includes an amount paid to a member in lieu of income during a period in which the member is unable to work due to sickness or injury. Sick benefits also include benefits designed to safeguard or improve the health of members and their dependents. Sick and accident benefits may be provided directly by an association to or on behalf of members and their dependents, or may be provided indirectly by an association through the payment of premiums or fees to an insurance company, medical clinic, or other program under which members and their dependents are entitled to medical services or to other sick and accident benefits. Sick and accident benefits may also be furnished in noncash form, such as, for example, benefits in the nature of clinical care services by visiting nurses, and transportation furnished for medical care.

(d) **Other benefits.** The term "other benefits" includes only benefits that are similar to life, sick, or accident benefits. A benefit is similar to a life, sick, or accident benefit if—

(1) It is intended to safeguard or improve the health of a member or a member's dependents, or

(2) It protects against a contingency that interrupts or impairs a member's earning power.

(e) **Examples of "other benefits".** Paying vacation benefits, providing vacation facilities, reimbursing vacation expenses, and subsidizing recreational activities such as athletic leagues are con-

sidered "other benefits". The provision of child-care facilities for preschool and school-age dependents are also considered "other benefits." The provision of job readjustment allowances, income maintenance payments in the event of economic dislocation, temporary living expense loans and grants at times of disaster (such as fire or flood), supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D)(i) of the Code), severance benefits (under a severance pay plan within the meaning of 29 CFR 2510.3–2(b)) and education or training benefits or courses (such as apprentice training programs) for members, are considered "other benefits" because they protect against a contingency that interrupts earning power. Personal legal service benefits which consist of payments or credits to one or more organizations or trusts described in section 501(c)(20) are considered "other benefits". Except to the extent otherwise provided in these regulations, as amended from time to time, "other benefits" also include any benefit provided in the manner permitted by paragraphs (5) et seq. of section 302(c) of the Labor Management Relations Act of 1947, 61 Stat. 136, as amended, 29 U.S.C. 186(c) (1979).

(f) Examples of nonqualifying benefits. Benefits that are not described in paragraphs (d) or (e) of this section are not "other benefits". Thus, "other benefits" do not include the payment of commuting expenses, such as bridge tolls or train fares, the provision of accident or homeowner's insurance benefits for damage to property, the provision of malpractice insurance, or the provision of loans to members except in times of distress (as permitted by § 1.501(c)(9)–3(e)). "Other benefits" also do not include the provision of savings facilities for members. The term "other benefits" does not include any benefit that is similar to a pension or annuity payable at the time of mandatory or voluntary retirement, or a benefit that is similar to the benefit provided under a stock bonus or profit-sharing plan. For purposes of section 501(c)(9) and these regulations, a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit-sharing plan if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event. Thus, for example, supplemental unemployment benefits, which generally become payable by reason of unanticipated layoff, are not, for purposes of these regulations, considered similar to the benefit provided under a pension, annuity, stock bonus or profit-sharing plan.

(g) Examples. The provisions of this section may be further illustrated by the following examples:

Example (1). V was organized in connection with a vacation plan created pursuant to a collective bargaining agreement between M, a labor union, which represents certain hourly paid employees of T corporation and T. The agreement calls for the payment by T to V of a specified sum per hour worked by T employees who are covered by the collective bargaining agreement. T includes the amounts in the covered employees' wages and withholds income and FICA taxes. The amounts are paid by T to V to provide vacation benefits provided under the collective bargaining agreement. Generally, each covered employee receives a check in payment of his or her vacation benefit during the year following the year in which contributions were made by T to V. The amount of the vacation benefit is determined by reference to the contributions during the prior year to V by T on behalf of each employee, and is distributed in cash to each such employee. If the earnings on investments by V during the year preceding distribution are sufficient after deducting the expenses of administering the plan, each recipient of a vacation benefit is paid an amount, in addition to the contributions on his or her behalf, equal to his/her ratable share of the net earnings of V during such year. The plan provides a vacation benefit that constitutes an eligible "other benefit" described in section 501(c)(9) and § 1.501(c)(9)–3(e).

Example (2). The facts are the same as in Example 1, except that each covered employee of T is entitled, at his or discretion, to contribute up to an additional $1,000 each year to V, which agrees in respect of such sum to pay interest at a stated rate from the time of contribution until the time at which the contributing employee's vacation benefit is distributed. In addition, each employee may elect to leave all or a portion of his/her distributable benefit on deposit past the time of distribution, in which case interest will continue to accrue. Because the plan more closely resembles a savings arrangement than a vacation plan, the benefit payable to the covered employees of T is not a "vacation benefit" and is not an eligible "other benefit" described in section 501(c)(9) and § 1.501(c)(9)–3(d) or (e).

[T.D. 7750, 46 FR 1724, Jan. 7, 1981]

§ 1.501(c)(9)–4 Voluntary employees' beneficiary associations; inurement.

(a) General rule. No part of the net earnings of an employees' association may inure to the benefit of any private shareholder or individual other than through the payment of benefits permitted by § 1.501(c)(9)–3. The disposition of property to, or the performance of services for, a person for less than the greater of fair market value or cost (including indirect costs) to the association, other than as a life, sick, accident or other permissible benefit, constitutes prohibited inurement. Generally, the payment of unreasonable compensation to the trustees or employees of the association, or the purchase of insurance or services for amounts in excess of their fair market value from a company in which one or more of the association's trustees, officers or fiduciaries has an interest, will constitute prohibited inurement. Whether prohibited

inurement has occurred is a question to be determined with regard to all of the facts and circumstances, taking into account the guidelines set forth in this section. The guidelines and examples contained in this section are not an exhaustive list of the activities that may constitute prohibited inurement, or the persons to whom the association's earnings could impermissibly inure. See § 1.501(a)–1(c).

(b) Disproportionate benefits. For purposes of subsection (a), the payment to any member of disproportionate benefits, where such payment is not pursuant to objective and nondiscriminatory standards, will not be considered a benefit within the meaning of § 1.501(c)(9)–3 even though the benefit otherwise is one of the type permitted by that section. For example, the payment to highly compensated personnel of benefits that are disproportionate in relation to benefits received by other members of the association will constitute prohibited inurement. Also, the payment to similarly situated employees of benefits that differ in kind or amount will constitute prohibited inurement unless the difference can be justified on the basis of objective and reasonable standards adopted by the association or on the basis of standards adopted pursuant to the terms of a collective bargaining agreement. In general, benefits paid pursuant to standards or subject to conditions that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees will not be considered disproportionate. See § 1.501(c)(9)–2(a)(2) and (3).

(c) Rebates. The rebate of excess insurance premiums, based on the mortality or morbidity experience of the insurer to which the premiums were paid, to the person or persons whose contributions were applied to such premiums, does not constitute prohibited inurement. A voluntary employees' beneficiary association may also make administrative adjustments strictly incidental to the provision of benefits to its members.

(d) Termination of plan or dissolution of association. It will not constitute prohibited inurement if, on termination of a plan established by an employer and funded through an association described in section 501(c)(9), any assets remaining in the association, after satisfaction of all liabilities to existing beneficiaries of the plan, are applied to provide, either directly or through the purchase of insurance, life, sick, accident or other benefits within the meaning of § 1.501(c)(9)–3 pursuant to criteria that do not provide for disproportionate benefits to officers, shareholders, or highly compensated employees of the employer. See § 1.501(c)(9)–2(a)(2). Similarly, a distribution to members upon the dissolution of the association will not constitute prohibited inurement if the amount distributed to members are determined pursuant to the terms of a collective bargaining agreement or on the basis of objective and reasonable standards which do not result in either unequal payments to similarly situated members or in disproportionate payments to officers, shareholders, or highly compensated employees of an employer contributing to or otherwise funding the employees' association. Except as otherwise provided in the first sentence of this paragraph, if the association's corporate charter, articles of association, trust instrument, or other written instrument by which the association was created, as amended from time to time, provides that on dissolution its assets will be distributed to its members' contributing employers, or if in the absence of such provision the law of the state in which the association was created provides for such distribution to the contributing employers, the association is not described in section 501(c)(9).

(e) Example. The provisions of this section may be illustrated by the following example:

Example. Employees A, B and C, members of the X voluntary employees' beneficiary association, are unemployed. They receive unemployment benefits from X. Those to A include an amount in addition to those provided to B and C, to provide for A's retraining. B has been found pursuant to objective and reasonable standards not to qualify for the retraining program. C, although eligible for retraining benefits has declined X's additional payment to A for retraining does not constitute prohibited inurement.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–5 Voluntary employees' beneficiary associations; recordkeeping requirements.

(a) Records. In addition to such other records which may be required (for example, by section 512(a)(3) and the regulations thereunder), every organization described in section 501(c)(9) must maintain records indicating the amount contributed by each member and contributing employer, and the amount and type of benefits paid by the organization to or on behalf of each member.

(b) Cross reference. For provisions relating to annual information in returns with respect to payments, see section 6041 and the regulations thereunder.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–6 Voluntary employees' beneficiary associations; benefits includible in gross income.

(a) In general. Cash and noncash benefits realized by a person on account of the activities of an

organization described in section 501(c)(9) shall be included in gross income to the extent provided in the Internal Revenue Code of 1954, including, but not limited to, sections 61, 72, 101, 104 and 105 of the Code and regulations thereunder.

(b) Availability of statutory exclusions from gross income. The availability of any statutory exclusion from gross income with respect to contributions to, or the payment of benefits from, an organization described in section 501(c)(9) is determined by the statutory provision conferring the exclusion, and the regulations and rulings thereunder, not by whether an individual is eligible for membership in the organization or by the permissibility of the benefit paid. Thus, for example, if a benefit is paid by an employer-funded organization described in section 501(c)(9) to a member who is not an "employee", a statutory exclusion from gross income that is available only for "employees" would be unavailable in the case of a benefit paid to such individual. Similarly, the fact that, for example, under some circumstances educational benefits constitute "other benefits" does not of itself mean that such benefits are eligible for the exclusion of either section 117 or section 127 of the Code.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–7 Voluntary employees' beneficiary associations; section 3(4) of ERISA.

The term "voluntary employees' beneficiary association" in section 501(c)(9) of the Internal Revenue Code is not necessarily coextensive with the term "employees' beneficiary association" as used in section 3(4) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1002(4), and the requirements which an organization must meet to be an "employees' beneficiary association" within the meaning of section 3(4) of ERISA are not necessarily identical to the requirements that an organization must meet in order to be a "voluntary employees' beneficiary association" within the meaning of section 501(c)(9) of the Code.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981]

§ 1.501(c)(9)–8 Voluntary employees' beneficiary associations; effective date.

(a) General rule. Except as otherwise provided in this section, the provisions of §§ 1.501(c)(9)–1 through 7 shall apply with respect to taxable years beginning after December 31, 1954.

(b) Pre-1970 taxable years. For taxable years beginning before January 1, 1970, section 501(c)(9)(B) (relating to the requirement that 85 percent or more of the association's income consist of amounts collected from members and contributed by employers), as in effect for such years, shall apply.

(c) Existing associations. Except as otherwise provided in paragraph (d), the provisions of §§ 1.501(c)(9)–2(a)(1) and (c)(3) shall apply with respect to taxable years beginning after December 31, 1980.

(d) Collectively-bargained plans. In the case of a voluntary employees' beneficiary association which receives contributions from one or more employers pursuant to one or more collective bargaining agreements in effect on December 31, 1980, the provisions of §§ 1.501(c)(9)–1 through 5 shall apply with respect to taxable years beginning after the date on which the agreement terminates (determined without regard to any extension thereof agreed to after December 31, 1980).

(e) Election. Notwithstanding paragraphs (c) and (d) of this section, an organization may choose to be subject to all or a portion of one or more of the provisions of these regulations for any taxable year beginning after December 31, 1954.

[T.D. 7750, 46 FR 1725, Jan. 7, 1981; 46 FR 11971, Feb. 12, 1981]

§ 1.501(c)(10)–1 Certain fraternal beneficiary societies.

(a) For taxable years beginning after December 31, 1969, an organization will qualify for exemption under section 501(c)(10) if it—

(1) Is a domestic fraternal beneficiary society order, or association, described in section 501(c)(8) and the regulations thereunder except that it does not provide for the payment of life, sick, accident, or other benefits to its members, and

(2) Devotes its net earnings exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes.

Any organization described in section 501(c)(7), such as, for example, a national college fraternity, is not described in section 501(c)(10) and this section.

[T.D. 7172, 37 FR 5618, March 17, 1972]

§ 1.501(c)(12)–1 Local benevolent life insurance associations, mutual irrigation and telephone companies, and like organizations.

(a) An organization described in section 501(c)(12) must receive at least 85 percent of its

income from amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

(b) The phrase "of a purely local character" applies to benevolent life insurance associations, and not to the other organizations specified in section 501(c)(12). It also applies to any organization seeking exemption on the ground that it is an organization similar to a benevolent life insurance association. An organization of a purely local character is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. If the activities of an organization are limited only by the borders of a State it cannot be considered to be purely local in character.

(c) For taxable years of a mutual or cooperative telephone company beginning after December 31, 1974, the 85 percent member-income test described in paragraph (a) of this section is applied without taking into account income received or accrued from another telephone company for the performance of communication services involving the completion of long distance calls to, from, or between members of the mutual or cooperative telephone company. For example, if, in one year, a cooperative telephone company receives $85x from its members for telephone calls, $15x as interest income, and $20x as credits under long distance interconnection agreements with other telephone companies for the performance of communication services involving the completion of long distance calls to, from, or between the cooperative's members (whether or not the credits may be offset, in whole or in part, by amounts due the other companies under the interconnection agreements), the member-income fraction is calculated without taking into account, either in the numerator or denominator, the $20x credits received from the other telephone companies.

In this example, the 85 percent member-income test is satisfied because at least 85 percent

$$\frac{\text{member income}}{\text{total income}} = \frac{85x}{85x + 15x} = \frac{85}{100} = 85\%$$

of the cooperative's total income is derived from member income.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended at 44 FR 59523, Oct. 16, 1979]

§ 1.501(c)(13)–1 Cemetery companies and crematoria.

(a) **Nonprofit mutual cemetery companies.** A nonprofit cemetery company may be entitled to exemption if it is owned by and operated exclusively for the benefit of its lot owners who hold such lots for bona fide burial purposes and not for the purpose of resale. A mutual cemetery company which also engages in charitable activities, such as burial of paupers, will be regarded as operating in conformity with this standard. Further, the fact that a mutual cemetery company limits its membership to a particular class of individuals, such as members of a family, will not affect its status as mutual so long as all the other requirements of section 501(c)(13) are met.

(b) **Nonprofit cemetery companies and crematoria.** Any nonprofit corporation, chartered solely for the purpose of the burial, or (for taxable years beginning after December 31, 1970) the cremation of bodies, and not permitted by its charter to engage in any business not necessarily incident to that purpose, is exempt from income tax, provided that no part of its net earnings inures to the benefit of any private shareholder or individual.

(c) **Preferred stock—(1) In general.** Except as provided in subparagraph (3) of this paragraph, a cemetery company or crematorium is not described in section 501(c)(13) if it issues preferred stock on or after November 28, 1978.

(2) **Transitional rule for preferred stock issued prior to November 28, 1978.** In the case of preferred stock issued prior to November 28, 1978, a cemetery company or crematorium which issued such stock shall not fail to be exempt from income tax solely because it issued preferred stock which entitled the holders to dividends at a fixed rate, not exceeding the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, if its articles of incorporation require:

(i) That the preferred stock be retired at par as rapidly as funds therefor become available from operations, and

(ii) That all funds not required for the payment of dividends upon or for the retirement of preferred stock be used by the company for the care and improvement of the cemetery property. The term "legal rate of interest" shall mean the rate of interest prescribed by law in the State of incorporation which prevails in the absence of an agreement between contracting parties fixing a rate.

(3) Transitional rule for preferred stock issued on or after November 28, 1978. In the case of preferred stock issued on or after November 28, 1978, a cemetery company or crematorium shall not fail to be exempt from income tax if its articles of incorporation and the preferred stock meet the requirements of paragraph (c)(2) and if such stock is issued pursuant to a plan which has been reduced to writing and adopted prior to November 28, 1978. The adoption of the plan must be shown by the acts of the duly constituted responsible officers and appear upon the official records of the cemetery company or crematorium.

(d) Sales to exempt cemetery companies and crematoria. Except as provided in paragraph (c)(2) or (c)(3) of this section (relating to transitional rules for preferred stock), no person may have any interest in the net earnings of a tax-exempt cemetery company or crematorium. Thus, a cemetery company or crematorium is not exempt from tax if property is transferred to such organization in exchange for an interest in the net earnings of the organization so long as such interest remains outstanding. An interest in a cemetery company or crematorium that constitutes an equity interest within the meaning of section 385 will be considered an interest in the net earnings of the cemetery. However, an interest in a cemetery company or crematorium that does not constitute an equity interest within the meaning of section 385 may nevertheless constitute an interest in the net earnings of the organization. Thus, for example, a bond or other evidence of indebtedness issued by a cemetery company or crematorium which provides for a fixed rate of interest but which, in addition, provides for additional interest payments contingent upon the revenues or income of the organization is considered an interest in the net earnings of the organization. Similarly, a convertible debt obligation issued by a cemetery company or crematorium after July 7, 1975, is considered an interest in the net earnings of the organization.

[T.D. 7698, 45 FR 33972, May 21, 1980]

§ 1.501(c)(14)-1 Credit unions and mutual insurance funds.

Credit unions (other than Federal credit unions described in section 501(c)(1)) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 501(a). Corporations or associations without capital stock organized before September 1, 1951 and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of, shares or deposits in:

(a) Domestic building and loan associations as defined in section 7701(a)(19),

(b) Cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(c) Mutual savings banks not having capital stock represented by shares,

are also exempt from tax under section 501(a). In addition, corporations or associations of the type described in the preceding sentence which were organized on or after September 1, 1951, but before September 1, 1957, are exempt from tax under section 501(a) for taxable years beginning after December 31, 1959.

[T.D. 6493, 25 FR 9219, Sept. 27, 1960]

§ 1.501(c)(15)-1 Mutual insurance companies or associations.

(a) Taxable years beginning after December 31, 1962. An insurance company or association described in section 501(c)(15) is exempt under section 501(a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from the sum of the following items does not exceed $150,000:

(1) The gross amount of income during the taxable year from—

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61-7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and the regulations thereunder.

(ii) Dividends, as described in § 1.61-9.

(iii) Rents and royalties, as described in § 1.61-8.

(iv) The entering into of any lease, mortgage, or other instrument or agreement from which the company may derive interest, rents, or royalties.

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph.

(2) The gross income from any trade or business (other than an insurance business) carried on by the company or association, or by a partnership of which the company or association is a partner.

(3) Premiums (including deposits and assessments).

(b) Taxable years beginning after December 31, 1954, and before January 1, 1963. An insurance company or association described in section 501(c)(15) and paragraph (a) of this section is exempt under section 501(a) if the gross amount received during the taxable year from the sum of the items described in paragraph (a)(1), (2), and (3) of this section does not exceed $75,000.

(c) No double inclusion of income. In computing the gross income from any trade or business (other than an insurance business) carried on by the company or association, or by a partnership of which the company or association is a partner, any item described in section 822(b)(1)(A), (B), or (C) and paragraph (a)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1)(A), (B), or (C) and paragraph (a)(1) of this section.

(d) Taxable years beginning after December 31, 1953, and before January 1, 1955. An insurance company or association described in section 501(c)(15) is exempt under section 501(a) if it is a mutual company or association (other than life or marine) or if it is a mutual interinsurer or reciprocal underwriter (other than life or marine) and if the gross amount received during the taxable year from the sum of the following items does not exceed $75,000:

(1) The gross amount of income during the taxable year from—

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–3.

(ii) Dividends, as described in § 1.61–9.

(iii) Rents (but excluding royalties), as described in § 1.61–8.

(2) Premiums (including deposits and assessments).

(e) Exclusion of capital gains. Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses), chapter 1 of the Code, shall be excluded from the amounts described in this section.

[T.D. 6662, 28 FR 6972, July 29, 1963]

§ 1.501(c)(16)–1 Corporations organized to finance crop operations.

A corporation organized by a farmers' cooperative marketing or purchasing association, or the members thereof, for the purpose of financing the ordinary crop operations of such members or other producers is exempt, provided the marketing or purchasing association is exempt under section 521 and the financing corporation is operated in conjunction with the marketing or purchasing association. The provisions of § 1.521–1 relating to a reserve or surplus and to capital stock shall also apply to corporations coming under this section.

§ 1.501(c)(17)–1 Supplemental unemployment benefit trusts.

(a) Requirements for qualification. (1) A supplemental unemployment benefit trust may be exempt as an organization described in section 501(c)(17) if the requirements of subparagraphs (2) through (6) of this paragraph are satisfied.

(2) The trust is a valid, existing trust under local law and is evidenced by an executed written document.

(3) The trust is part of a written plan established and maintained by an employer, his employees, or both the employer and his employees, solely for the purpose of providing supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D) and paragraph (b)(1) of § 1.501(c)(17)–1).

(4) The trust is part of a plan which provides that the corpus and income of the trust cannot (in the taxable year, and at any time thereafter, before the satisfaction of all liabilities to employees covered by the plan) be used for, or diverted to, any purpose other than the providing of supplemental unemployment compensation benefits. Thus, if the plan provides for the payment of any benefits other than supplemental unemployment compensation benefits as defined in paragraph (b) of this section, the trust will not be entitled to exemption as an organization described in section 501(c)(17). However, the payment of any necessary or appropriate expenses in connection with the administra-

tion of a plan providing supplemental unemployment compensation benefits shall be considered a payment to provide such benefits and shall not affect the qualification of the trust.

(5) The trust is part of a plan whose eligibility conditions and benefits do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. See sections 401(a)(3)(B) and 401(a)(4) and §§ 1.401–3 and 1.401–4. However, a plan is not discriminatory within the meaning of section 501(c)(17)(A)(iii), relating to the requirement that the benefits paid under the plan be nondiscriminatory, merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan. Accordingly, the benefits provided for highly paid employees may be greater than the benefits provided for lower paid employees if the benefits are determined by reference to their compensation; but, in such a case, the plan will not qualify if the benefits paid to the higher paid employees bear a larger ratio to their compensation than the benefits paid to the lower paid employees bear to their compensation. In addition, section 501(c)(17)(B) sets forth certain other instances in which a plan will not be considered discriminatory (see paragraph (c) of § 1.501(c)(17)–2).

(6) The trust is part of a plan which requires that benefits are to be determined according to objective standards. Thus, a plan may provide similarly situated employees with benefits which differ in kind and amount, but may not permit such benefits to be determined solely in the discretion of the trustees.

(b) **Meaning of terms.** The following terms are defined for purposes of section 501(c)(17):

(1) **Supplemental unemployment compensation benefits.** The term "supplemental unemployment compensation benefits" means only—

(i) Benefits paid to an employee because of his involuntary separation from the employment of the employer, whether or not such separation is temporary, but only when such separation is one resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions; and

(ii) Sick and accident benefits subordinate to the benefits described in subdivision (i) of this subparagraph.

(2) **Employee.** The term "employee" means an individual whose status is that of an employee under the usual common-law rules applicable in determining the employer-employee relationship. The term "employee" also includes an individual who qualifies as an "employee" under the State or Federal unemployment compensation law covering his employment, whether or not such an individual could qualify as an employee under such common-law rules.

(3) **Involuntary separation from the employment of the employer.** Whether a "separation from the employment of the employer" occurs is a question to be decided with regard to all the facts and circumstances. However, for purposes of section 501(c)(17), the term "separation" includes both a temporary separation and a permanent severance of the employment relationship. Thus, for example, an employee may be separated from the employment of his employer even though at the time of separation it is believed that he will be reemployed by the same employer. Whether or not an employee is "involuntarily" separated from the employment of the employer is a question of fact. However, normally, an employee will not be deemed to have separated himself voluntarily from the employment of his employer merely because his collective bargaining agreement provides for the termination of his services upon the happening of a condition subsequent and that condition does in fact occur. For example, if the collective bargaining agreement provides that the employer may automate a given department and thereby dislocate several employees, the fact that the employees' collective bargaining agent has consented to such a condition will not render any employee's subsequent unemployment for such cause voluntary.

(4) **Other similar conditions.** Involuntary separation directly resulting from "other similar conditions" includes, for example, involuntary separation from the employment of the employer resulting from cyclical, seasonal, or technological causes. Some causes of involuntary separation from the employment of the employer which are not similar to those enumerated in section 501(c)(17)(D)(i) are separation for disciplinary reasons or separation because of age.

(5) **Subordinate sick and accident benefits.** In general, a sick and accident benefit payment is an amount paid to an employee in the event of his illness or personal injury (whether or not such illness or injury results in the employee's separation from the service of his employer). In addition, the phrase "sick and accident benefits" in-

cludes amounts provided under the plan to reimburse an employee for amounts he expends because of the illness or injury of his spouse or a dependent (as defined in section 152). Sick and accident benefits may be paid by a trust described in section 501(c)(17) only if such benefits are subordinate to the separation payments provided under the plan of which the trust forms a part. Whether the sick and accident benefits provided under a supplemental unemployment compensation benefit plan are subordinate to the separation benefits provided under such plan is a question to be decided with regard to all the facts and circumstances.

[T.D. 6972, 33 FR 12900, Sept. 12, 1968]

§ 1.501(c)(17)–2 General rules.

(a) Supplemental unemployment compensation benefits. Supplemental unemployment compensation benefits as defined in section 501(c)(17)(D) and paragraph (b)(1) of § 1.501(c)(17)–1 may be paid in a lump sum or installments. Such benefits may be paid to an employee who has, subsequent to his separation from the employment of the employer, obtained other part-time, temporary, or permanent employment. Furthermore, such payments may be made in cash, services, or property. Thus, supplemental unemployment compensation benefits provided to involuntarily separated employees may include, for example, the following: Furnishing of medical care at an established clinic, furnishing of food, job training and schooling, and job counseling. If such benefits are furnished in services or property, the fair market value of the benefits must satisfy the requirements of section 501(c)(17)(A)(iii), relating to nondiscrimination as to benefits. However, supplemental unemployment compensation benefits may be provided only to an employee and only under circumstances described in paragraph (b)(1) of § 1.501(c)(17)–1. Thus, a trust described in section 501(c)(17) may not provide, for example, for the payment of a death, vacation, or retirement benefit.

(b) Sick and accident benefits. If a trust described in section 501(c)(17) provides for the payment of sick and accident benefits, such benefits may only be provided for employees who are eligible for receipt of separation benefits under the plan of which the trust is a part. However, the sick and accident benefits need not be provided for all the employees who are eligible for receipt of separation benefits, so long as the plan does not discriminate in favor of persons with respect to whom discrimination is proscribed in section 501(c)(17)(A)(ii) and (iii). Furthermore, the portion of the plan which provides for the payment of sick and accident benefits must satisfy the nondiscrimination requirements of section 501(c)(17)(A)(ii) and (iii) without regard to the portion of the plan which provides for the payment of benefits because of involuntary separation.

(c) Correlation with other plans. **(1)** In determining whether a plan meets the requirements of section 501(c)(17)(A)(ii) and (iii), any benefits provided under any other plan shall not be taken into consideration except in the particular instances enumerated in section 501(c)(17)(B)(i), (ii), and (iii). In general, these three exceptions permit a plan providing for the payment of supplemental unemployment compensation benefits to satisfy the nondiscrimination requirements in section 501(c)(17)(A)(ii) and (iii) if the plan is able to satisfy such requirements when it is correlated with one or more of the plans described in section 501(c)(17)(B).

(2) Under section 501(c)(17)(B)(i), a plan will not be considered discriminatory merely because the benefits under the plan which are first determined in a nondiscriminatory manner (within the meaning of section 501(c)(17)(A)) are then reduced by any sick, accident, or unemployment compensation benefits received under State or Federal law, or are reduced by a portion of these benefits if determined in a nondiscriminatory manner. Under this exception, a plan may, for example, satisfy the requirements of section 501(c)(17)(A)(iii) if it provides for the payment of an unemployment benefit and the amount of such benefit is determined as a percentage of the employee's compensation which is then reduced by any unemployment benefit which the employee receives under a State plan. In addition, a plan could provide for the reduction of such a plan benefit by a percentage of the State benefit. Furthermore, a plan may also satisfy the requirements of section 501(c)(17)(A) if it provides for the payment to an employee of an amount which when added to any State unemployment benefit equals a percentage of the employee's compensation.

(3) Under section 501(c)(17)(B)(ii), a plan will not be considered discriminatory merely because the plan provides benefits only for employees who are not eligible to receive sick, accident, or unemployment compensation benefits under State or Federal law. In such a case, however, the benefits provided under the plan seeking to satisfy the requirements of section 501(c)(17) must be the same benefits, or a portion of the same benefits if determined in a nondiscriminatory manner, which

such ineligible employees would receive under State or Federal law if they were eligible for such benefits. Under this exception, for example, an employer may establish a plan only for employees who have exhausted their benefits under the State law, and, if the plan provides for such employees the same benefits which they would receive under the State plan, the State plan and the plan of the employer will be considered as one plan in determining whether the requirements relating to nondiscrimination in section 501(c)(17)(A) are satisfied. Furthermore, such a plan could also qualify even though it does not provide all of the benefits provided under the State plan. Thus, a plan could provide for the payment of a reduced amount of the benefits, or for the payment of only certain of the types of benefits, provided by the State plan. For example, if the State plan provides for the payment of sick, accident, and separation benefits, the plan of the employer may provide for the payment of only separation benefits, or for the payment of an amount equal to only one-half of the State provided benefit. However, if a plan provides benefits for employees who are not eligible to receive the benefits provided under a State plan and such benefits are greater or of a different type than those under the State plan, the plan of the employer must satisfy the requirements of section 501(c)(17)(A) without regard to the benefits and coverage provided by the State plan.

(4) Under section 501(c)(17)(B)(iii), a plan is not considered discriminatory merely because the plan provides benefits only for employees who are not eligible to receive benefits under another plan which satisfies the requirements of section 501(c)(17)(A) and which is funded solely by contributions of the employer. In such a case, the plan seeking to qualify under section 501(c)(17) must provide the same benefits, or a portion of such benefits if determined in a nondiscriminatory manner, as are provided for the employees under the plan funded solely by employer contributions. Furthermore, this exception only applies if the employees eligible to receive benefits under both plans would satisfy the requirements in section 501(c)(17)(A)(ii), relating to nondiscrimination as to coverage. The plan of the employer which is being correlated with the plan seeking to satisfy the requirements of section 501(c)(17) may be a plan which forms part of a voluntary employees' beneficiary association described in section 501(c)(9), if such plan satisfies all the requirements of section 501(c)(17)(A). Under this exception, for example, if an employer has established a plan providing for the payment of supplemental unemployment compensation benefits for his hourly wage employees and such plan satisfies the requirements of section 501(c)(17)(A) (even though the plan forms part of a voluntary employees' beneficiary association described in section 501(c)(9)), the salaried employees of such employee may establish a plan for themselves, and, if such plan provides for the same benefits as the plan covering hourly-wage employees, both plans may be considered as one plan in determining whether the plan covering the salaried employees satisfies the requirement that it be nondiscriminatory as to coverage. The foregoing example would also be applicable if the benefits provided for the salaried employees were funded solely or in part by employer contributions.

(d) **Permanency of the plan.** A plan providing for the payment of supplemental unemployment compensation benefits contemplates a permanent as distinguished from a temporary program. Thus, although there may be reserved the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the purpose of providing supplemental unemployment compensation benefits to employees. Whether or not a particular plan constitutes a permanent arrangement will be determined by all of the surrounding facts and circumstances. However, merely because a collective bargaining agreement provides that a plan may be modified at the termination of such agreement, or that particular provisions of the plan are subject to renegotiation during the duration of such agreement, does not necessarily imply that the plan is not a permanent arrangement. Moreover, the fact that the plan provides that the assets remaining in the trust after the satisfaction of all liabilities (including contingent liabilities) under the plan may be returned to the employer does not imply that the plan is not a permanent arrangement nor preclude the trust from qualifying under section 501(c)(17).

(e) **Portions of years.** A plan must satisfy the requirements of section 501(c)(17) throughout the entire taxable year of the trust in order for the trust to be exempt for such year. However, section 501(c)(17)(C) provides that a plan will satisfy the nondiscrimination as to classification requirements of section 501(c)(17)(A) if on at least one day in each quarter of the taxable year of the trust it satisfies such requirements.

(f) **Several trusts constituting one plan.** Several trusts may be designated as constituting part of

one plan which is intended to satisfy the requirements of section 501(c)(17), in which case all of such trusts taken as a whole must meet the requirements of such section. The fact that a combination of trusts fails to satisfy the requirements of section 501(c)(17) as one plan does not prevent such of the trusts as satisfy the requirements of section 501(c)(17) from qualifying for exemption under that section.

(g) Plan of several employers. A trust forming part of a plan of several employers, or the employees of several employers, will be a supplemental unemployment benefit trust described in section 501(c)(17) if all the requirements of that section are otherwise satisfied.

(h) Investment of trust funds. No specific limitations are provided in section 501(c)(17) with respect to investments which may be made by the trustees of a trust qualifying under that section. Generally, the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law. However, the tax-exempt status of the trust will be forfeited if the investments made by the trustees constitute "prohibited transactions" within the meaning of section 503. See section 503 and the regulations thereunder. In addition, such a trust will be subject to tax under section 511 with respect to any "unrelated business taxable income" (as defined in section 512) realized by it from its investments. See sections 511 to 515, inclusive, and the regulations thereunder.

(i) Allocations. If a plan which provides sick and accident benefits is financed solely by employer contributions to the trust, and such sick and accident benefits are funded by payment of premiums on an accident or health insurance policy (whether on a group or individual basis) or by contributions to a separate fund which pays such sick and accident benefits, the plan must specify that portion of the contributions to be used to fund such benefits. If a plan which is financed in whole or in part by employee contributions provides sick and accident benefits, the plan must specify the portion, if any, of employee contributions allocated to the cost of funding such benefits, and must allocate the cost of funding such benefits between employer contributions and employee contributions.

(j) Required records and returns. Every trust described in section 501(c)(17) must maintain records indicating the amount of separation benefits and sick and accident benefits which have been provided to each employee. If a plan is financed, in whole or in part, by employee contributions to the trust, the trust must maintain records indicating the amount of each employee's total contributions allocable to separation benefits. In addition, every trust described in section 501(c)(17) which makes one or more payments totaling $600 or more in 1 year to an individual must file an annual information return in the manner described in paragraph (b)(1) of § 1.6041–2. However, if the payments from such trust are subject to income tax withholding under section 3402(*o*) and the regulations thereunder, the trust must file, in lieu of such annual information return, the returns of income tax withheld from wages required by section 6011 and the regulations thereunder. In such circumstances, the trust must also furnish the statements to the recipients of trust distributions required by section 6051 and the regulations thereunder.

[T.D. 6972, 33 FR 12901, Sept. 12, 1968, as amended by T.D. 7068, 35 FR 17328, Nov. 11, 1970]

§ 1.501(c)(17)–3 Relation to other sections of the Code.

(a) Taxability of benefit distributions—(1) Separation benefits. If the separation benefits described in section 501(c)(17)(D)(i) are funded entirely by employer contributions, then the full amount of any separation benefit payment received by an employee is includible in his gross income under section 61(a). If any such separation benefit is funded by both employer and employee contributions, or solely by employee contributions, the amount of any separation benefit payment which is includible in the gross income of the employee is the amount by which such distribution and any prior distributions of such separation payments exceeds the employee's total contributions to fund such separation benefits.

(2) Sick and accident benefits. Any benefit payment received from the trust under the part of the plan, if any, which provides for the payment of sick and accident benefits must be included in gross income under section 61(a), unless specifically excluded under section 104 or 105 and the regulations thereunder. See section 105(b) and § 1.105–2 for benefit payments expended for medical care, benefit payments in excess of actual medical expenses, and benefit payments which an employee is entitled to receive irrespective of whether or not he incurs expenses for medical care. See section 213 and § 1.213–1(g) for benefit payments representing reimbursement for medical expenses paid in prior years. See § 1.501(c)(17)–2(i) for the requirement that a trust described in section 501(c)(17) which receives em-

ployee contributions must be part of a written plan which provides for the allocation of the cost of funding sick and accident benefits.

(b) Exemption as a voluntary employees' beneficiary association. Section 501(c)(17)(E) contemplates that a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits may, if it qualifies, apply for exemption from income tax under section 501(a) either as a voluntary employees' beneficiary association described in section 501(c)(9) or as a trust described in section 501(c)(17).

(c) Returns. A trust which is described in section 501(c)(17) and which is exempt from tax under section 501(a) must file a return in accordance with section 6033 and the regulations thereunder. If such a trust realizes any unrelated business taxable income, as defined in section 512, the trust is also required to file a return with respect to such income.

(d) Effective date. Section 501(c)(17) shall apply to taxable years beginning after December 31, 1959, and shall apply to supplemental unemployment benefit trusts regardless of when created or organized.

[T.D. 6972, 33 FR 12902, Sept. 12, 1968]

§ 1.501(c)(18)–1 Certain funded pension trusts.

(a) In general. Organizations described in section 501(c)(18) are trusts created before June 25, 1959, forming part of a plan for the payment of benefits under a pension plan funded only by contributions of employees. In order to be exempt, such trusts must also meet the requirements set forth in section 501(c)(18)(A), (B), and (C), and in paragraph (b) of this section.

(b) Requirements for qualification. A trust described in section 501(c)(18) must meet the following requirements—

(1) Local law. The trust must be a valid, existing trust under local law, and must be evidenced by an executed written document.

(2) Funding. The trust must be funded solely from contributions of employees who are members of the plan. For purposes of this section, the term "contributions of employees" shall include earnings on, and gains derived from, the assets of the trust which were contributed by employees.

(3) Creation before June 25, 1959—(i) In general. The trust must have been created before June 25, 1959. A trust created before June 25, 1959 is described in section 501(c)(18) and this section even though changes in the makeup of the trust have occurred since that time so long as these are not fundamental changes in the character of the trust or in the character of the beneficiaries of the trust. Increases in the beneficiaries of the trust by the addition of employees in the same or related industries, whether such additions are of individuals or of units (such as local units of a union) will generally not be considered a fundamental change in the character of the trust. A merger of a trust created after June 25, 1959 into a trust created before such date is not in itself a fundamental change in the character of the latter trust if the two trusts are for the benefit of employees of the same or related industries.

(ii) Examples. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Assume that trust C, for the benefit of members of participating locals of National Union X, was established in 1950 and adopted by 29 locals before June 25, 1959. The subsequent adoption of trust C by additional locals of National Union X in 1962 will not constitute a fundamental change in the character of trust C, since such subsequent adoption is by employees in a related industry.

Example (2). Assume the facts as stated in example (1), except that in 1965 National Union X merged with National Union Y, whose members are engaged in trades related to those engaged in by X's members. Assume further that trust D, the employee funded pension plan and fund for employees of Y, was subsequently merged into trust C. The merger of trust D into trust C would not in itself constitute a fundamental change in the character of trust C, since both C and D are for the benefit of employees of related industries.

(4) Payment of benefits. The trust must provide solely for the payment of pension or retirement benefits to its beneficiaries. For purposes of this section, the term "retirement benefits" is intended to include customary and incidental benefits, such as death benefits within the limits permissible under section 401.

(5) Diversion. The trust must be part of a plan which provides that, before the satisfaction of all liabilities to employees covered by the plan, the corpus and income of the trust cannot (within the taxable year and at any time thereafter) be used for, or diverted to, any purpose other than the providing of pension or retirement benefits. Payment of expenses in connection with the administration of a plan providing pension or retirement benefits shall be considered a payment to provide such benefits and shall not affect the qualification of the trust.

(6) Discrimination. The trust must be part of a plan whose eligibility conditions and benefits do not discriminate in favor of employees who are

officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. See sections 401(a)(3)(B) and 401(a)(4) and §§ 1.401–3 and 1.401–4. However, a plan is not discriminatory within the meaning of section 501(c)(18) merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan. Accordingly, the benefits provided for highly paid employees may be greater than the benefits provided for lower paid employees if the benefits are determined by reference to their compensation; but, in such a case, the plan will not qualify if the benefits paid to the higher paid employees are a larger portion of compensation than the benefits paid to lower paid employees.

(7) Objective standards. The trust must be part of a plan which requires that benefits be determined according to objective standards. Thus, while a plan may provide similarly situated employees with benefits which differ in kind and amount, these benefits may not be determined solely in the discretion of the trustees.

(c) Effective date. The provisions of section 501(c)(18) and this section shall apply with respect to taxable years beginning after December 31, 1969.

[T.D. 7172, 37 FR 5618, March 17, 1972]

§ 1.501(c)(19)–1 War veterans organizations.

(a) In general. (1) For taxable years beginning after December 31, 1969, a veterans post or organization which is organized in the United States or any of its possessions may be exempt as an organization described in section 501(c)(19) if the requirements of paragraphs (b) and (c) of this section are met and if no part of its net earnings inures to the benefit of any private shareholder or individual. Paragraph (b) of this section contains the membership requirements such a post or organization must meet in order to qualify under section 501(c)(19). Paragraph (c) of this section outlines the purposes, at least one of which such a post or organization must have in order to so qualify.

(2) In addition, an auxiliary unit or society described in paragraph (d) of this section of such a veterans post or organization and a trust or foundation described in paragraph (e) of this section for such post or organization may be exempt as an organization described in section 501(c)(19).

(b) Membership requirements. (1) In order to be described in section 501(c)(19) under paragraph (a)(1) of this section, an organization must meet the membership requirements of section 501(c)(19)(B) and this paragraph. There are two requirements that must be met under this paragraph. The first requirement is that at least 75 percent of the members of the organization must be war veterans. For purposes of this section the term "war veterans" means persons, whether or not present members of the United States Armed Forces, who have served in the Armed Forces of the United States during a period of war (including the Korean and Vietnam conflicts).

(2) The second requirement of this paragraph is that at least 97.5 percent of all members of the organization must be described in one or more of the following categories:

(i) War veterans,

(ii) Present or former members of the United States Armed Forces,

(iii) Cadets (including only students in college or university ROTC programs or at Armed Services academies), or

(iv) Spouses, widows, or widowers of individuals referred to in paragraph (b)(2)(i), (ii) or (iii) of this section.

(c) Exempt purposes. In addition to the requirements of paragraphs (a)(1) and (b) of this section, in order to be described in section 501(c)(19) under paragraph (a)(1) of this section an organization must be operated exclusively for one or more of the following purposes:

(1) To promote the social welfare of the community as defined in § 1.501(c)(4)–1(a)(2).

(2) To assist disabled and needy war veterans and members of the United States Armed Forces and their dependents, and the widows and orphans of deceased veterans,

(3) To provide entertainment, care, and assistance to hospitalized veterans or members of the Armed Forces of the United States,

(4) To carry on programs to perpetuate the memory of deceased veterans and members of the Armed Forces and to comfort their survivors,

(5) To conduct programs for religious, charitable, scientific, literary, or educational purposes,

(6) To sponsor or participate in activities of a patriotic nature,

(7) To provide insurance benefits for their members or dependents of their members or both, or

(8) To provide social and recreational activities for their members.

(d) Auxiliary units or societies for war veterans organizations. A unit or society may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is an auxiliary unit or society of a post or organization of war veterans described in paragraph (a)(1) of this section. A unit or society is an auxiliary unit or society or such a post or organization if it meets the following requirements:

(1) It is affiliated with, and organized in accordance with, the bylaws and regulations formulated by an organization described in paragraph (a)(1) of this section,

(2) At least 75 percent of its members are either war veterans, or spouses of war veterans, or are related to a war veteran within two degrees of consanguinity (*i.e.*, grandparent, brother, sister, grandchild, represent the most distant allowable relationships),

(3) All of its members are either members of an organization described in paragraph (a)(1) of this section, or spouses of a member of such an organization or are related to a member of such an organization, within two degrees of consanguinity, and

(4) No part of its net earnings inures to the benefit of any private shareholder or individual.

(e) Trusts or foundations. A trust or foundation may be exempt as an organization described in section 501(c)(19) and paragraph (a)(2) of this section if it is a trust or foundation for a post or organization of war veterans described in paragraph (a)(1) of this section. A trust or foundation is a trust or foundation for such a post or organization if it meets the following requirements:

(1) The trust or foundation is in existence under local law and, if organized for charitable purposes, has a dissolution provision described in § 1.501(c)(3)–1(b)(4).

(2) The corpus or income cannot be diverted or used other than for the funding of a post or organization of war veterans described in paragraph (a)(1) of this section, for section 170(c)(4) purposes, or as an insurance set aside (as defined in § 1.512(a)–4(b)).

(3) The trust income is not unreasonably accumulated and, if the trust or foundation is not an insurance set aside, a substantial portion of the income is in fact distributed to such post or organization or for section 170(c)(4) charitable purposes, and

(4) It is organized exclusively for one or more of those purposes enumerated in paragraph (c) of this section.

[T.D. 7438, 41 FR 44392, Oct. 8, 1976]

§ 1.501(c)(21)–1 Black lung trusts—certain terms.

(a) Created or organized in the United States. A trust is not "created or organized in the United States" unless it is maintained at all times as a domestic trust in the United States. For this purpose, section 7701(a)(9) limits the term "United States" to the District of Columbia and States of the United States.

(b) Insurance company. The term "insurance company" means an insurance, surety, bonding or other company whose liability for the kinds of claims to which section 501(c)(21)(A)(i) applies is as an insurer or guarantor of the liabilities of another.

(c) Black Lung Acts. The term "Black Lung Acts" includes any State law providing compensation for disability or death due to pneumoconiosis even though the State law compensates for other kinds of injuries. In such a case, section 501(c)(21) applies only to the extent that the liability is attributable to disability or death due to pneumoconiosis. For this purpose, the term "pneumoconiosis" has the same meaning as it has under federal law. See 30 U.S.C. 902.

(d) Insurance exclusively covering such liability. The term "insurance exclusively covering such liability" includes insurance that covers risk for liabilities in addition to the liabilities to which section 501(c)(21)(A)(i) applies. In such a case, payment for premiums may be made from the trust only to the extent of that portion of the premiums that has been separately allocated and stated by the insurer as attributable solely to coverage of the liabilities to which section 501(c)(21)(A)(i) applies.

(e) Administrative and other incidental expenses. The term "administrative and other incidental expenses" means expenditures that are appropriate and helpful to the trust making them in carrying out the purposes for which its assets may be used under section 501(c)(21)(B). The term includes any excise tax imposed on the trust under section 4952 (relating to taxes on taxable expendi-

tures) and reasonable expenses, such as legal expenses, incurred by the trust in connection with an assertion against the trust of liability for a taxable expenditure. The term does not include an excise tax imposed on the trustee or on other disqualified persons under section 4951 (relating to taxes on self-dealing) or under section 4953 (relating to tax on excess contributions to black lung benefit trusts) or any expenses incurred in connection with the assertion of these taxes other than expenses that are treated as part of reasonable compensation under section 4951(d)(2)(C). See §§ 53.4941(d)–2(f)(3) and (d)–3(c) for interpretations of similar provisions under section 4941(d)(2)(E), relating to reasonable compensation for private foundation disqualified persons.

(f) **Public debt securities of the United States.** The term "public debt securities of the United States" means obligations that are taken into consideration for purposes of the public debt limit. See, for example 31 U.S.C. 757b.

(g) **Obligations of a State or local government.** The term "obligations of a State or local government" means the obligations of a State or local governmental unit the interest on which is exempt from tax under section 103(a). See § 1.103–1(a).

(h) **Time or demand deposits.** The term "time or demand deposits" includes checking accounts, savings accounts, certificates of deposit or other time or demand deposits. The term does not include common or collective trust funds such as a common trust fund as defined in section 584.
[44 FR 52197, Sept. 7, 1979]

§ 1.501(c)(21)–2 Same—trust instrument.

As trust does not meet the requirements of section 501(c)(21) if it is not established and maintained pursuant to a written instrument. The trust instrument must definitely and affirmatively prohibit a diversion or use of trust assets that is not permitted under section 501(c)(21)(B) or section 4953(c), whether by operation or natural termination of the trust, by power of revocation or amendment by the happening of a contingency by collateral arrangement, or by any other means. No particular form for the trust instrument is required. A trust may meet the requirements of section 501(c)(21) although the trust instrument fails to contain provisions the effects of which are to prohibit acts that are subject to section 4951 (relating to taxes on self-dealing), section 4952 (relating to taxes on taxable expenditures) or the retention of contributions subject to section 4953 (relating to tax on excess contributions to black lung benefit trusts).
[44 FR 52197, Sept. 7, 1979]

§ 1.501(d)–1 Religious and apostolic associations or corporations.

(a) Religious or apostolic associations or corporations are described in section 501(d) and are exempt from taxation under section 501(a) if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(b) For annual return requirements of organizations described in section 501(d), see section 6033 and paragraph (a)(5) of § 1.6033–1.

§ 1.501(e)–1 Cooperative hospital service organizations.

(a) **General rule.** Section 501(e) is the exclusive and controlling section under which a cooperative hospital service organization can qualify as a charitable organization. A cooperative hospital service organization which meets the requirements of section 501(e) and this section shall be treated as an organization described in section 501(c)(3), exempt from taxation under section 501(a), and referred to in section 170(b)(1)(A)(iii) (relating to percentage limitations on charitable contributions). In order to qualify for tax exempt status, a cooperative hospital service organization must—

(1) Be organized and operated on a cooperative basis,

(2) Perform, on a centralized basis, only one or more specifically enumerated services which, if performed directly by a tax exempt hospital, would constitute activities in the exercise or performance of the purpose or function constituting the basis for its exemption, and

(3) Perform such service or services solely for two or more patron-hospitals as described in paragraph (d) of this section.

(b) **Organized and operated on a cooperative basis**—(1) **In general.** In order to meet the requirements of section 501(e), the organization must be organized and operated on a cooperative

basis (whether or not under a specific statute on cooperatives) and must allocate or pay all of its net earnings within 8½ months after the close of the taxable year to its patron-hospitals on the basis of the percentage of its services performed for each patron. To "allocate" its net earnings to its patron-hospitals, the organization must make appropriate bookkeeping entries and provide timely written notice to each patron-hospital disclosing to the patron-hospital the amount allocated to it on the books of the organization. For the record-keeping requirements of a section 501(e) organization, see § 1.521-1(a)(1).

(2) Percentage of services defined. The percentage of services performed for each patron-hospital may be determined on the basis of either the value or the quantity of the services provided by the organization to the patron-hospital, provided such basis is realistic in terms of the actual cost of the services to the organization.

(3) Retention of net earnings. Exemption will not be denied a cooperative hospital service organization solely because the organization, instead of paying all net earnings to its patron-hospitals, retains an amount for such purposes as retiring indebtedness, expanding the services of the organization, or for any other necessary purpose and allocates such amounts to its patrons. However, such funds may not be accumulated beyond the reasonably anticipated needs of the organization. See, § 1.537-1(b). Whether there is an improper accumulation of funds depends upon the particular circumstances of each case. Moreover, where an organization retains net earnings for necessary purposes, the organization's records must show each patron's rights and interests in the funds retained. For purposes of this paragraph, the term "net earnings" does not include capital contributions to the organization and such contributions need not satisfy the allocation or payment requirements.

(4) Nonpatronage and other income. An organization described in section 501(e) may, in addition to net earnings, receive membership dues and related membership assessment fees, gifts, grants and income from nonpatronage sources such as investment of retained earnings. However, such an organization cannot be exempt if it engages in any business other than that of providing the specified services, described in paragraph (c), for the specified patron-hospitals, described in paragraph (d). Thus, an organization described in section 501(e) generally cannot have unrelated business taxable income as defined in section 512, although it may earn certain interest, annuities, royalties, and rents which are excluded from unrelated business taxable income because of the modifications contained in sections 512(b)(1), (2) or (3). An organization described in section 501(e) may, however, have debt-financed income which is treated as unrelated business taxable income solely because of the applicability of section 514. In addition, exempt status under section 501(e) will not be affected where rent from personal property leased with real property is treated as unrelated business taxable income under section 512(b)(3)(A)(ii) solely because the rent attributable to the personal property is more than incidental or under section 512(b)(3)(B)(i) solely because the rent attributable to the personal property exceeds 50 percent of the total rent received or accrued under the lease. Exemption will not be affected solely because the determination of the amount of rent depends in whole or in part on the income or profits derived from the property leased. See, section 512(b)(3)(B)(ii). An organization described in section 501(e) may also derive nonpatronage income from sources that are incidental to the conduct of its exempt purposes or functions. For example, income derived from the operation of a cafeteria or vending machines primarily for the convenience of its employees or the disposition of by-products in substantially the same state they were in on completion of the exempt function (e.g., the sale of silver waste produced in the processing of x-ray film) will not be considered unrelated business taxable income. See, section 513(a)(2) and § 1.513–1(d)(4)(ii). The nonpatronage and other income permitted under this subparagraph (4) must be allocated or paid as provided in subparagraph (1) or retained as provided in subparagraph (3).

(5) Stock ownership—(i) Capital stock of organization. An organization does not meet the requirements of section 501(e) unless all of the organization's outstanding capital stock, if there is such stock, is held solely by its patron-hospitals. However, no amount may be paid as dividends on the capital stock of the organization. For purposes of the preceding sentence, the term "capital stock" includes common stock (whether voting or nonvoting), preferred stock, or any other form evidencing a proprietary interest in the organization.

(ii) Stock ownership as a condition for obtaining credit. If by statutory requirement a cooperative hospital service organization must be a shareholder in a United States or state chartered corporation as a condition for obtaining credit from that corporate-lender, the ownership of shares and the

payment of dividends thereon will not for such reason be a basis for the denial of exemption to the organization. See, e.g., National Consumer Cooperative Bank, 12 U.S.C. 3001 et seq.

(c) **Scope of services—(1) Permissible services.** An organization meets the requirements of section 501(e) only if the organization performs, on a centralized basis, one or more of the following services and only such services: data processing, purchasing (including the purchasing and dispensing of drugs and pharmaceuticals to patron-hospitals), warehousing, billing and collection, food, clinical (including radiology), industrial engineering (including the installation, maintenance and repair of biomedical and similar equipment), laboratory, printing, communications, record center, and personnel (including recruitment, selection, testing, training, education and placement of personnel) services. An organization is not described in section 501(e) if, in addition to or instead of one or more of these specified services, the organization performs any other service (other than services referred to under paragraph (b)(4) that are incidental to the conduct of exempt purposes or functions).

(2) **Illustration.** The provisions of this subparagraph may be illustrated by the following example.

Example. An organization performs industrial engineering services on a cooperative basis solely for patron-hospitals each of which is an organization described in section 501(c)(3) and exempt from taxation under section 501(a). However, in addition to this service, the organization operates laundry services for its patron-hospitals. This cooperative organization does not meet the requirements of this paragraph because it performs laundry services not specified in this paragraph.

(d) **Patron-hospitals—(1) Defined.** Section 501(e) only applies if the organization performs its services solely for two or more patron-hospitals each of which is—

(i) An organization described in section 501(c)(3) which is exempt from taxation under section 501(a),

(ii) A constituent part of an organization described in section 501(c)(3) which is exempt from taxation under section 501(a) and which, if organized and operated as a separate entity, would constitute an organization described in section 501(c)(3), or

(iii) Owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing.

(2) **Business with nonvoting patron-hospitals.** Exemption will not be denied a cooperative hospital service organization solely because the organization (whether organized on a stock or membership basis) transacts business with patron-hospitals which do not have voting rights in the organization and therefore do not participate in the decisions affecting the operation of the organization. Where the organization has both patron-hospitals with voting rights and patron-hospitals without such rights, the organization must provide at least 50 percent of its services to patron-hospitals with voting rights in the organization. Thus, the percentage of services provided to nonvoting patrons may not exceed the percentage of such services provided to voting patrons. A patron-hospital will be deemed to have voting rights in the cooperative hospital service organization if the patron-hospital may vote directly on matters affecting the operation of the organization or if the patron-hospital may vote in the election of cooperative board members. Notwithstanding that an organization may have both voting and nonvoting patron-hospitals, patronage refunds must nevertheless be allocated or paid to all patron-hospitals solely on the basis specified in paragraph (b) of this section.

(3) **Services to other organizations.** An organization does not meet the requirements of section 501(e) if, in addition to performing services for patron-hospitals (entities described in subdivisions (i), (ii) or (iii) of subparagraph (1)), the organization performs any service for any other organization. For example, a cooperative hospital service organization is not exempt if it performs services for convalescent homes for children or the aged, vocational training facilities for the handicapped, educational institutions which do not provide hospital care in their facilities, and proprietary hospitals. However, the provision of the specified services between or among cooperative hospital service organizations meeting the requirements of section 501(e) and this section is permissible. Also permissible is the provision of the specified services to entities which are not patron-hospitals, but only if such services are de minimis and are mandated by a governmental unit as, for example, a condition for licensing.

(e) **Effective dates.** An organization, other than an organization performing clinical services, may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after June 28, 1968. An organization performing clinical services may meet the requirements of section 501(e) and be a tax exempt organization for taxable years ending after December 31, 1976.

However, pursuant to the authority contained in section 7805(b) of the Internal Revenue Code, these regulations shall not become effective with respect to an organization which has received a ruling or determination letter from the Internal Revenue Service recognizing its exemption under section 501(e) until January 2, 1987.

[T.D. 8100, 51 FR 31615, Sept. 4, 1986; 51 FR 33593, Sept. 22, 1986]

§ 1.501(k)–1 Communist-controlled organizations.

Under section 11(b) of the Internal Security Act of 1950 (50 U.S.C. 790(b)), as amended, which is made applicable to the Code by section 7852(b) of that Code, no organization is entitled to exemption under sections 501(a) or 521(a) for any taxable year if at any time during such year such organization is registered under section 7 of such Act or if there is in effect a final order of the Subversive Activities Control Board established by section 12 of such Act requiring such organization to register under section 7 of such Act, or determining that it is a Communist-infiltrated organization.

[T.D. 8100, 51 FR 31615, Sept. 4, 1986]

§ 1.502–1 Feeder organizations.

(a) In the case of an organization operated for the primary purpose of carrying on a trade or business for profit, exemption is not allowed under section 501 on the ground that all the profits of such organization are payable to one or more organizations exempt from taxation under section 501. In determining the primary purpose of an organization, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of those activities of such organization which are specified in the applicable paragraph of section 501.

(b) If a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because, as a matter of accounting between the two organizations, the subsidiary derives a profit from its dealings with its parent organization, for example, a subsidiary organization which is operated for the sole purpose of furnishing electric power used by its parent organization, a tax-exempt educational organization, in carrying on its educational activities. However, the subsidiary organization is not exempt from tax if it is operated for the primary purpose of carrying on a trade or business which would be an unrelated trade or business (that is, unrelated to exempt activities) if regularly carried on by the parent organization. For example, if a subsidiary organization is operated primarily for the purpose of furnishing electric power to consumers other than its parent organization (and the parent's tax-exempt subsidiary organizations), it is not exempt since such business would be an unrelated trade or business if regularly carried on by the parent organization. Similarly, if the organization is owned by several unrelated exempt organizations, and is operated for the purpose of furnishing electric power to each of them, it is not exempt since such business would be an unrelated trade or business if regularly carried on by any one of the tax-exempt organizations. For purposes of this paragraph, organizations are related only if they consist of—

(1) A parent organization and one or more of its subsidiary organizations; or

(2) Subsidiary organizations having a common parent organization.

An exempt organization is not related to another exempt organization merely because they both engage in the same type of exempt activities.

(c) In certain cases an organization which carries on a trade or business for profit but is not operated for the primary purpose of carrying on such trade or business is subject to the tax imposed under section 511 on its unrelated business taxable income.

(d) Exception—(1) Taxable years beginning before January 1, 1970. For purposes of section 502 and this section, for taxable years beginning before January 1, 1970, the term "trade or business" does not include the rental by an organization of its real property (including personal property leased with the real property).

(2) Taxable years beginning after December 31, 1969. For purposes of section 502 and this section, for taxable years beginning after December 31, 1969, the term "trade or business" does not include—

(i) The deriving of rents described in section 512(b)(3)(A),

(ii) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation, or

(iii) Any trade or business (such as a "thrift shop") which consists of the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

For purposes of the exception described in subdivision (i) of this subparagraph, if the rents derived by an organization would not be excluded from unrelated business income pursuant to section 512(b)(3) and the regulations thereunder, the deriving of such rents shall be considered a "trade or business".

(3) **Cross references and special rules.** (i) For determination of when rents are excluded from the tax on unrelated business income see section 512(b)(3) and the regulations thereunder.

(ii) The rules contained in § 1.513-1(e)(1) shall apply in determining whether a trade or business is described in section 502(b)(2) and subparagraph (2)(ii) of this paragraph.

(iii) The rules contained in § 1.513-1(e)(3) shall apply in determining whether a trade or business is described in section 502(b)(3) and subparagraph (2)(iii) of this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6662, 28 FR 6973, July 29, 1963; T.D. 7033, 35 FR 19997, Dec. 31, 1970]

§ 1.503(a)-1 Denial of exemption to certain organizations engaged in prohibited transactions.

(a)(1) Prior to January 1, 1970, section 503 applies to those organizations described in sections 501(c)(3), 501(c)(17), and section 401(a) except—(i) A religious organization (other than a trust);

(ii) An educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;

(iii) An organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public,

(iv) An organization which is operated, supervised, controlled or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and

(v) An organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research or agricultural research.

(2) Effective January 1, 1970, and prior to January 1, 1975, section 503 shall apply only to organizations described in section 501(c)(17) or (18) or section 401(a).

(3) Effective January 1, 1975, section 503 shall apply only to organization described in section 501(c)(17) or (18) or described in section 401(a) and referred to in section 4975(g)(2) or (3).

(b) The prohibited transactions enumerated in section 503(b) are in addition to and not in limitation of the restrictions contained in section 501(c)(3), (17), or (18) or section 401(a). Even though an organization has not engaged in any of the prohibited transactions referred to in section 503(b), it still may not qualify for tax exemptions in view of the general provisions of section 501(c)(3), (17), or (18) or section 401(a). Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creator of such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purpose.

(c) **An organization—(1)** Described in section 501(c)(3) which after July 1, 1950, but before January 1, 1970, has engaged in any prohibited transaction as defined in section 503(b), unless it is excepted by the provisions of paragraph (a)(1) of this section;

(2) Described in section 401(a) and referred to in section 4975(g)(2) or (3) which after March 1, 1954, has engaged in any prohibited transaction as defined in section 503(b);

(3) Described in section 401(a) and not referred to in section 4975(g)(2) or (3) which after March 1, 1954, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(b) or which after December 31, 1962, but before January 1, 1975, has engaged in any prohibited transaction as defined in section 503(g) prior to its repeal by section 2003(b)(5) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978);

(4) Described in section 501(c)(17) which after December 31, 1959, has engaged in any prohibited transaction as defined in section 503(b); or

(5) Described in section 501(c)(18) which after December 31, 1969, has engaged in any prohibited transaction described in section 503(b);

shall not be exempt from taxation under section 501(a) for any taxable year subsequent to the taxable year in which there is mailed to it a notice in writing by the Commissioner that it has engaged in such prohibited transactions. Such notification by the Commissioner shall be by registered or certified mail to the last known name and address of the organization. However, notwithstanding the requirement of notification by the Commissioner, the exemption shall be denied with respect to any taxable year if such organization during or prior to such taxable year commenced the prohibited transaction with the purpose of diverting income or corpus from its exempt purposes and such transaction involved a substantial party of the income or corpus of such organization. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organizations means a calendar year. See 26 CFR § 1.503(j)–1 (rev. as of Apr. 1, 1974) for provisions relating to the definition of prohibited transactions in the case of trusts benefitting certain owner-employees after December 31, 1962, but prior to January 1, 1975. See also section 2003(c)(1)(B) of the Employee Retirement Income Security Act of 1974 (88 Stat. 978) in the case of an organization described in section 401(a) with respect to which a disqualified person elects to pay a tax in the amount and manner provided with respect to the tax imposed by section 4975 of the Code so that the organization may avoid denial of exemption under section 503.

(d) The application of section 503(b) may be illustrated by the following examples:

Example (1). A creates a foundation in 1954 ostensibly for educational purposes. B, a trustee, accumulates the foundation's income from 1957 until 1959 and then uses a substantial part of this accumulated income to send A's children to college. The foundation would lose its exemption for the taxable years 1957 through 1959 and for subsequent taxable years until it regains its exempt status.

Example (2). If under the facts in example (1) such private benefit was the purpose of the foundation from its inception, such foundation is not exempt by reason of the general provisions of section 501(c)(3), without regard to the provisions of section 503, for all years since its inception, that is, for the taxable years 1954 through 1959 and subsequent taxable years, since under section 501(c)(3) the organization must be organized and operated exclusively for exempt purposes. See § 1.501(c)(3)–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5074, Apr. 14, 1964; T.D. 6972, 33 FR 12902, Sept. 12, 1968; T.D. 7428, 41 FR 34621, Aug. 16, 1976]

§ 1.503(b)–1 Prohibited transactions.

(a) In general. The term "prohibited transaction" means any transaction set forth in section 503(b) engaged in by any organization described in paragraph (a) of § 1.503(a)–1. Whether a transaction is a prohibited transaction depends on the facts and circumstances of the particular case. This section is intended to deny tax-exempt status to such organizations which engage in certain transactions which inure to the private advantage of (1) the creator of such organization (if it is a trust); (2) any substantial contributor to such organization; (3) a member of the family (as defined in section 267(c)(4) of an individual who is such creator of or such substantial contributor to such organization; or (4) a corporation controlled, as set forth in section 503(b), by such creator or substantial contributor.

(b) Loans as prohibited transactions under section 503(b)(1)—(1) Adequate security. For the purposes of section 503(b)(1), which treats as prohibited transactions certain loans by an organization without receipt of adequate security and a reasonable rate of interest, the term "adequate security" means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower may constitute security for a loan to the persons or organizations described in section 503(b). Stock of a borrowing corporation does not constitute adequate security. A borrower's evidence of indebtedness, irrespective of its name, is not security for a loan, whether or not it was issued directly to the exempt organization. However, if any such evidence of indebtedness provides for security that may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, there may be adequate security for such loan. If an organization subject to section 503(b) purchases debentures issued by a person specified in section 503(b), the purchase is considered, for purposes of section 503(b)(1), as a loan made by the purchaser to the issuer on the date of such purchase. For example, if an exempt organization subject to section 503(b) makes a purchase

through a registered security exchange of debentures issued by a person described in section 503(b), and owned by an unknown third party, the purchase will be considered as a loan to the issuer by the purchaser. For rules relating to loan of funds to, or investment of funds in stock or securities of, persons described in section 503(b) by an organization described in section 401(a), see paragraph (b)(5) of § 1.401–1.

(2) **Effective dates.** The effective dates for the application of the definition of adequate security in paragraph (b)(1) of this paragraph are:

(i) March 15, 1956, for loans (other than debentures) made after March 15, 1956;

(ii) January 31, 1957, for loans (other than debentures) made before March 16, 1956, and continued after January 31, 1957;

(iii) November 8, 1956, for debentures which were purchased after November 8, 1956;

(iv) December 1, 1958, for debentures which were purchased before November 9, 1956, and held after December 1, 1958;

(v) If an employees' pension, stock bonus, or profit-sharing trust described in section 401(a) made a loan before March 1, 1954, repayable by its terms after December 31, 1955, and which would constitute a prohibited transaction if made on or after March 1, 1954, the loan shall not constitute a prohibited transaction if held until maturity (determined without regard to any extension or renewal thereof);

(vi) January 1, 1960, for loans (including the purchase of debentures) made by supplemental unemployment benefit trusts, described in section 501(c)(17);

(vii) January 1, 1970, for loans (including the purchase of debentures) made by employees' contribution pension plan trusts described in section 501(c)(18).

(3) **Certain exceptions to section 503(b)(1).** See section 503(e) and § 1.503(e)–1, 1.503(e)–2, and 1.503(e)–3 for special rules providing that certain obligations acquired by trusts described in section 401(a) or section 501(c)(17) or (18) shall not be treated as loans made without the receipt of adequate security for purposes of section 503(b)(1). See section 503(f) and § 1.503(f)–1 for an exception to the application of sections 503(b)(1) for certain loans made by employees' trusts described in section 401(a).

(c) **Examples.** The principles of this section are illustrated by the following examples: (Assume that section 503(e) and (f) are not applicable.)

Example (1). A, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his unsecured promissory note. The net worth of A is $1,000,000. The net worth of A is not "security" for such loan and the transaction is a prohibited transaction. If, however, the note is secured by a mortgage on property of sufficient value, or is accompanied by acceptable collateral of sufficient value, or carries with it the secondary promise of repayment by an accommodation endorser financially capable of meeting the indebtedness, it may be adequately secured. However, subordinated debentures bonds of a partnership which are guaranteed by the general partners are not adequately secured since the general partners are liable for the firm's debt and their guaranty adds no additional security.

Example (2). Assume the same facts as in example (1) except that A's promissory note in the amount of $100,000 to the trust is secured by property which has a fair market value of $75,000. A's promissory note secured to the extent of $75,000 is not adequately secured within the meaning of section 503(b)(1) since the security at the time of the transaction must be sufficient to repay the indebtedness, interest, and charges which may pertain thereto.

Example (3). Corporation M, a substantial contributor to an exempt organization subject to section 503, borrows $150,000 from such organization in 1960, giving its promissory note accompanied by stock of the borrowing corporation with a fair market value of $200,000. Since promissory notes and debentures have priority over stock in the event of liquidation of the corporation, stock of a borrowing corporation is not adequate security. Likewise, debenture bonds which are convertible on default into voting stock of the issuing corporation do not constitute "adequate security" under section 503(b)(1).

Example (4). B, creator of an exempt trust subject to section 503, borrows $100,000 from such trust in 1960, giving his secured promissory note at the rate of 3 percent interest. The prevailing rate of interest charged by financial institutions in the community where the transaction takes place is 5 percent for a loan of the same duration and similarly secured. The loan by the trust to the grantor is a prohibited transaction since section 503(b)(1) requires both adequate security and a reasonable rate of interest. Further, a promise to repay the loan plus a percentage of future profits which may be greater than the prevailing rate of interest does not meet the reasonable rate of interest requirement.

Example (5). N Corporation, a substantial contributor to an exempt organization subject to section 503 borrows $50,000 on or after March 16, 1956, from the organization. If the loan is not adequately secured, the organization has committed a prohibited transaction at the time the loan was made. If the loan had been made on or before March 15, 1956, and is continued after January 31, 1957, it must be adequately secured on February 1, 1957, or it will be considered a prohibited transaction on that date. However, if the exempt organization were an employees' trust, described in section 401(a), and the loan were made before March 1, 1954, repayable by its terms after December 31, 1955, it would not have to be adequately secured on February 1, 1957. Moreover, if the exempt organization were a supplemental unemployment benefit trust, described in section 501(c)(17), and the loan were made before January 1, 1960, repayable by its terms after December 31, 1959, it would not have to be adequately secured on January 1, 1960.

Example (6). An exempt organization subject to section 503 purchases a debenture issued by O Corporation, which is a substantial contributor to the organization. The organization purchases the debenture in an arm's length transaction from a third person on or after November 9, 1956. The purchase is considered as a loan by the organization to O Corporation. The loan must be adequately secured when it is made, or it is considered as a prohibited transaction at that time. If the organization purchased the debenture before November 9, 1956, and holds it after December 1, 1958, the debenture must be adequately secured on December 2, 1958, or it will then be considered as a prohibited transaction. However, if the organization were an employees' trust described in section 401(a), and if the debenture were purchased before March 1, 1954, and its maturity date is after December 31, 1955, the debenture does not have to be adequately secured. Moreover, if the organization were an employees' contribution pension plan trust described in section 501(c)(18), and if the debenture were purchased before January 1, 1970, and its maturity date is after December 31, 1969, the debenture does not have to be adequately secured.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5074, Apr. 14, 1964; T.D. 6972, 33 FR 12903, Sept. 12, 1968; T.D. 7428, 41 FR 34621, Aug. 16, 1976]

§ 1.503(c)–1 Future status of organizations denied exemption.

(a) Any organization described in section 501(c)(3), (17), or (18), or an employees' trust described in section 401(a), which is denied exemption under section 501(a) by reason of the provisions of section 503(a), may file, in any taxable year following the taxable year in which notice of denial was issued, a claim for exemption. In the case of organizations described in section 501(c)(3), (17), or (18), the appropriate exemption application shall be used for this purpose, and shall be filed with the district director. In the case of an employees' trust described in section 401(a), the information described in § 1.404(a)–2 shall be submitted with a letter claiming exemption. All employees' trust described in section 401(a) shall submit this information to the district director with whom a request for a determination as to its qualification under section 401 and exemption under section 501 may be submitted under paragraph (s) of § 601.201 of this chapter (Statement of Procedural Rules). A claim for exemption must contain or have attached to it, in addition to the information generally required of such an organization claiming exemption as an organization described in section 501(c)(17), or (18), or section 401(a) (or section 501(c)(3) prior to January 1, 1970), a written declaration made under the penalties of perjury by principal officer of such organization authorized to make such declaration that the organization will not knowingly again engage in a prohibited transaction, (as defined in section 503(b) (or 4975(c) if such section applies to such organization)). In the case of section 501(c)(3) organizations which have lost their exemption after December 31, 1969, pursuant to section 503, a claim for exemption must contain or have attached to it a written agreement made under penalties of perjury by a principal officer of such organization authorized to make such agreement that the organization will not violate the provisions of chapter 42. In addition, such organization must comply with the rules for governing instruments as prescribed in § 1.508–3. See § 1.501(a)–1 for proof of exemption requirements in general.

(b) If the Commissioner is satisfied that such organization will not knowingly again engage in a prohibited transaction (as defined under section 503(b) or 4975(c), as applicable to such organization) or in the case of a section 501(c)(3) organization, will not violate the provisions of chapter 42, and the organization also satisfied all the other requirements under section 501(c)(3), (17), or (18), or section 401(a), the organization will be so notified in writing. In such case the organization will be exempt (subject to the provisions of section 501(c)(3), or sections 501(c)(17), (18) or 401(a), and 503, and 504 when applicable) with respect to the taxable years subsequent to the taxable year in which the claim described in section 503(c) is filed. Section 503 contemplates that an organization denied exemption because of the terms of such section will be subject to taxation for at least one full taxable year. For the purpose of this section, the term "taxable year" means the established annual accounting period of the organization; or, if the organization has no such established annual accounting period, the "taxable year" of the organization means the calendar year.

(c) For taxable years beginning after December 31, 1969, the denial of an exemption pursuant to this section, for a taxable year prior to January 1, 1970, of an organization described in section 501(c)(3) shall not cause such organization to cease to be described in section 501(c)(3) for purposes of part II of subchapter F, chapter 1 and for purposes of the application of chapter 42 taxes.

(d) In the case of an organization described in section 501(c)(3), which has lost its exemption pursuant to section 503, and which has not notified the Commissioner that it is applying for recognition of its exempt status under section 508(a) and this section, no gift or contribution made after December 31, 1969, which would otherwise be deductible under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction. For rules relating to the denial of deductions with respect to gifts or

contributions made before January 1, 1970, see, § 1.503(e)–4.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6972, 33 FR 12904, Sept. 12, 1968; T.D. 7428, 41 FR 34622, Aug. 16, 1976; T.D. 7896, 48 FR 23815, May 27, 1983]

§ 1.503(d)–1 Cross references.

For provisions relating to loans described in section 503(b)(1) by a trust described in section 401(a), see § 1.503(b)–1 and section 503 (e) and (f) and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6722, 29 FR 5074, Apr. 14, 1964; T.D. 7428, 41 FR 34623, Aug. 16, 1976]

§ 1.503(e)–1 Special rules.

(a) In general. **(1)** Section 503(e) provides that for purposes of section 503(b)(1)(relating to loans made without the receipt of adequate security and a reasonable rate of interest) the acquisition of a bond, debenture, note, or certificate or other evidence of indebtedness shall not be treated as a loan made without the receipt of adequate security if certain requirements are met. Those requirements are described in § 1.503(e)–2.

(2) Section 503(e) does not affect the requirement in section 503(b)(1) of a reasonable rate of interest. Thus, although the acquisition of a certificate of indebtedness which meets all of the requirements of section 503(e) and of § 1.503(e)–2 will not be considered as a loan made without the receipt of adequate security, the acquisition of such an indebtedness does constitute a prohibited transaction if the indebtedness does not bear a reasonable rate of interest.

(3) The provisions of section 503(e) do not limit the effect of section 401(a) and § 1.401–2, section 501(c)(17)(A)(i), or section 501(c)(18)(A), all relating to the use of diversion of corpus or income of the respective employee trusts. Furthermore, the provisions of section 503(e) do not limit the effect of any of the provisions of section 503 other than section 503(b)(1). Thus, for example, although a loan made by employees' trust described in section 503(a)(1)(B) meets all the requirements of section 503(e) and therefore is not treated as a loan made without the receipt of adequate security, such an employees' trust making such a loan will lose its exempt status if the loan is not considered as made for the exclusive benefit of the employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(e) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) Definitions. For purposes of section 503(e):

(1) The term "obligation" means bond, debenture, note, or certificate or other evidence of indebtedness.

(2) The term "issuer" includes any person described in section 503(b) who issues an obligation.

(3)(i) The term "person independent of the issuer" means a person who is not related to the issuer by blood, by marriage, or by reason of any substantial business interests. Persons who will be considered not to be independent of the issuer include but are not limited to:

(a) The spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer of an obligation;

(b) A corporation controlled directly or indirectly by an individual who is the issuer, or directly or indirectly by the spouse, ancestor, lineal descendant, or brother or sister (whether by whole or half blood) of an individual who is the issuer;

(c) A corporation which directly or indirectly controls, or is controlled by, a corporate issuer;

(d) A controlling shareholder of a corporation which is the issuer, or which controls the issuer;

(e) An officer, director, or other employee of the issuer, of a corporation controlled by the issuer, or of a corporation which controls the issuer;

(f) A fiduciary of any trust created by the issuer, by a corporation which controls the issuer, or by a corporation which is controlled by the issuer; or

(g) A corporation controlled by a person who controls a corporate issuer.

(ii) For purposes of paragraph (b)(3)(i) of this section, the term "control" means, with respect to a corporation, direct or indirect ownership of 50 percent or more of the total combined voting power of all voting stock or 50 percent or more of the total value of shares of all classes of stock. If the aggregate amount of stock in a corporation owned by an individual and by the spouse, ancestors, lineal descendants, brothers and sisters (whether by whole or half blood) of the individual is 50 percent or more of the total combined voting power of all voting stock or is 50 percent or more of the total value of all classes of stock, then each

of these persons shall be considered as the controlling shareholder of the corporation.

(iii) In determining family relationships for purposes of paragraph (b)(3)(i) of this subparagraph, a legally adopted child of an individual shall be treated as a child of such individual by blood.

(4) The term "issue" means all the obligations of a issuer which are offered for sale on substantially the same terms. Obligations shall be considered offered for sale on substantially the same terms if such obligation would, at the same time and under the same circumstances, be traded on the market at the same price. On the other hand, if the terms on which obligations are offered for sale differ in such manner as would cause such obligations to be traded on the market at different prices, then such obligations are not part of the same issue. The following are examples of terms which, if different, would cause obligations to be traded on the market at different prices: (i) Interest rate; (ii) Maturity date; (iii) Collateral; and (iv) Conversion provisions.

The fact that obligations are offered for sale on different dates will not preclude such obligations from being part of the same issue if they all mature on the same date and if the terms on which they are offered for sale are otherwise the same, since such obligations would, at the same time and under the same conditions, be traded on the market at the same price. Obligations shall not be considered part of the same issue merely because they are part of the same authorization or because they are registered as part of the same issue with the Securities and Exchange Commission.

[T.D. 6493, 25 FR 9216, Sept. 27, 1960, as amended by T.D. 6972, 33 FR 12904, Sept. 12, 1968; T.D. 7428, 41 FR 34623, Aug. 16, 1976]

§ 1.503(e)–2 Requirements.

(a) In general. The requirements which must be met under section 503(e) for an obligation not to be treated as a loan made without the receipt of adequate security for purposes of section 503(b)(1) are described in paragraphs (b), (c), and (d) of this section. For purposes of this section, the term "employee trust" shall mean any of the three kinds of organizations described in section 503(a)(1).

(b) Methods of acquisition—(1) In general. The employee trust must acquire the obligation of the market, by purchase from an underwriter, or by purchase from the issuer, in the manner described in subparagraph (2), (3), or (4) of this paragraph.

(2) On the market. **(i)** An obligation is acquired on the market when it is purchased through a national securities exchange which is registered with the Securities and Exchange Commission, or when it is purchased in an over-the-counter transaction. For purposes of the preceding sentence, securities purchased through an exchange which is not a national securities exchange registered with the Securities and Exchange Commission shall be treated as securities purchased in an over-the-counter transaction.

(ii)(a) If the obligation is listed on a national securities exchange registered with the Securities and Exchange Commission, it must be purchased through such an exchange or in an over-the-counter transaction at a price not greater than the price of the obligation prevailing on such an exchange at the time of the purchase by the employee trust.

(b) For purposes of section 503(e), the price of the obligation prevailing at the time of the purchase means the price which accurately reflects the market value of the obligation. In the case of an obligation purchased through a national securities exchange which is registered with the Securities and Exchange Commission, the price paid for the obligation will be considered the prevailing price of the obligation. In the case of an obligation purchased in an over-the-counter transaction, the prevailing price may be the price at which the last sale of the obligation was affected on such national securities exchange immediately before the employee trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales were effected on such exchange on the same day or on the immediately preceding day or on the last day during which there were sales of such obligation or may be a price determined by any other method which accurately reflects the market value of the obligation.

(iii)(a) If the obligation is not listed on a national securities exchange which is registered with the Securities and Exchange Commission, it must be purchased in an over-the-counter transaction at a price not greater than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer.

(b) For purposes of section 503(e) the offering price for the obligation at the time of the purchase means the price which accurately reflects the market value of the obligation. The offering price may be the price at which the last sale of the obligation to a person independent of the issuer was effected immediately before the employee

trust's purchase of such obligation on the same day or may be the mean between the highest and lowest prices at which sales to persons independent of the issuer were effected on the same day or on the last day during which they were sales of such obligation or may be a price determined by any other method which accurately reflects the market value of the obligation. The offering price for an obligation must be a valid price for the amount of the obligations which the trust is purchasing. For example, if an employees' trust described in section 503(a)(1)(B) purchases 1,000 bonds of the employer corporation at the offering price established by current prices for a lot of 10 such bonds, such offering price may not be a valid price for 1,000 bonds and the purchase may therefore not meet the requirements of this subdivision. For a purchase of an obligation to qualify under this subdivision, there must be sufficient current prices quoted by persons independent of the issuer to establish accurately the current value of the obligation. Thus, if there are no current prices quoted by persons independent of the issuer, an over-the-counter transaction will not qualify under this subparagraph even though the obligation was purchased in an arms's length transaction from a person independent of the issuer.

(iv) For purposes of this section, an over-the-counter transaction is one not executed on a national securities exchange which is registered with the Securities and Exchange Commission. An over-the-counter transaction may be made through a dealer or an exchange which is not such a national securities exchange or may be made directly from the seller to the purchaser.

(3) From an underwriter. An obligation may be purchased from an underwriter if it is purchased at a price not greater than:

(i) The public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, or

(ii) The price at which a substantial portion of the issue including such obligation is acquired by persons independent of the issuer,

whichever is the lesser price. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchasers of such portion by persons independent of the issuer are sufficient to establish that fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding facts and circumstances will be considered, including the number of independent purchasers, the aggregate amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The requirement in paragraph (b)(3)(ii) of this section contemplates purchase of the obligations by persons independent of the issuer contemporaneously with the purchase by the employee trust. If a substantial portion has been purchased at different prices, the price of the portion may be based on the average of such prices, and if several substantial portions have been sold to persons independent of the issuer, the price of any of the substantial portions may be used for purposes of this subparagraph.

(4) From the issuer. An obligation may be purchased directly from the issuer at a price not greater than the price paid currently for a substantial portion of the same issue by persons independent of the issuer. This requirement contemplates purchase of a substantial portion of the same issue by persons independent of the issuer contemporaneously with the purchase by the employee trust. For purposes of this subparagraph, a portion of the issue will be considered substantial if the purchases of such portion by persons independent of the issuer are sufficient to establish the fair market value of the obligations included in such issue. In determining whether the purchases are sufficient to establish the fair market value, all the surrounding facts and circumstances will be considered, including the number of independent purchasers, the aggregate amount purchased by each such independent purchaser, and the number of transactions. In the case of a large issue, purchases of a small percentage of the outstanding obligations may be considered purchases of a substantial portion of the issue; whereas, in the case of a small issue, purchases of a larger percentage of the outstanding obligations will ordinarily be required. The price paid for a substantial portion of the issue may be determined in the manner provided in paragraph (b)(3) of this section.

(c) Limitations on holdings of obligations. (1) Immediately following acquisition of the obligation by the employee trust:

(i) Not more than 25 percent of the aggregate amount of the obligations issued in such issue and outstanding immediately after acquisition by the trust may be held by the trust, and

(ii) At least 50 percent of such aggregate amount must be held by persons independent of the issuer.

(2)(i) For purposes of paragraph (c)(1) of this section, an obligation is not considered as outstanding if it is held by the issuer. For example, if an obligation which has been issued and outstanding is repurchased and held by the issuer, without cancellation or retirement, such an obligation is not considered outstanding.

(ii) For purposes of paragraph (c)(1) of this section, the amounts of the obligations held by the trust and by persons independent of the issuer shall be computed on the basis of the face amount of the obligations.

(d) Limitation on amount invested in obligations. (1)(i) Immediately following acquisition of the obligation, not more 25 percent of the assets of the employee trust may be invested in all obligations of all persons described in section 503(b). For purposes of determining the amount of the trust's assets which are invested in obligations of persons described in section 503(b) immediately following acquisition of the obligation, those obligations shall be valued as follows:

(a) Those obligations included in the acquisition in respect of which the percentage test in the first sentence of this subdivision is being applied shall be valued at their adjusted basis, as provided in section 1011, relating to adjusted basis for determining gain or loss; and

(b) All other obligations of persons described in section 503(b) which were part of the trust's assets immediately before the acquisition of the obligations described in (d)(1)(i)(a) of this section shall be valued at their fair market value on the day that the obligations described in (d)(1)(i)(a) of this section were acquired. For purposes of determining the total amount of the assets of the trust (including obligations of persons described in section 503(b)), there shall be used the fair market value of those assets on the day the obligation is acquired.

(ii) The application of the rules in paragraph (d)(1)(i) of this section may be illustrated by the following example:

Example. On February 1, 1960, an exempt employees' trust described in section 401(a) purchases unsecured debentures issued by the employer corporation for $1,000. At the time of this purchase, such debentures have a fair market value of $1,200. Immediately after the purchase of such unsecured debentures, the assets of the trust consist of the following:

	Cost	Fair market value on Feb. 1, 1960
(a) Assets other than obligations of persons described in sec. 503(b)	$5,000	$7,800
(b) Obligations of persons described in sec. 503(b) acquired before Feb. 1, 1960	500	1,000
(c) Unsecured debentures of employer purchased on Feb. 1, 1960	1,000	1,200

Immediately following acquisition of the unsecured debentures by the trust, the percent of the assets of the trust that are invested in all obligations of all persons described in section 503(b) is computed as follows:

(1) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960 (valued at fair market value)	$1,000
(2) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at cost)	1,000
(3) Total amount of trust's assets invested in obligations of persons described in section 503(b) ((1) plus (2))	2,000
(4) Assets of the trust other than obligations of persons described in section 503(b) (valued at fair market value on Feb. 1, 1960)	7,800
(5) Obligations of persons described in section 503(b) acquired before Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960)	1,000
(6) Unsecured debentures of employer purchased on Feb. 1, 1960 (valued at fair market value on Feb. 1, 1960)	$1,200
(7) Total assets of the trust valued at fair market value on Feb. 1, 1960 (sum of (4), (5), and (6))	10,000
(8) Percent of assets of the trust invested in all obligations of all persons described in section 503(b) immediately following purchase of unsecured debentures on Feb. 1, 1960 ((3) ÷ (7), that is, $2,000 ÷ $10,000))	20%

(2) In determining for purposes of subparagraph (1) of this paragraph the amount invested in obligations of persons described in section 503(b), there shall be included amounts invested in any obligations issued by any such person, irrespective of whether the obligation is secured, and irrespective of whether the obligation meets the conditions of section 503(e) or section 503(f). Obligations of persons described in section 503(b) other than the issuer of the obligation to which section 503(e) applies are also included within the 25 percent limitation. For example, if on February 19, 1959, an exempt employees' trust described in section 401(a) purchases unsecured debentures issued by the employer corporation in a transaction effected on the New York Stock Exchange, and if immediately after the purchase 10 percent of the trust's assets is invested in such debentures and 20 percent of its assets is invested in a loan made with

adequate security on January 12, 1959, to the wholly-owned subsidiary of the employer corporation, then the purchase of the employer's debentures will not qualify under section 503(e), since 30 percent of the trust's assets are then invested in obligations of persons described in section 503(b).

(e) **Change of terms of an obligation.** A change in terms of an obligation is considered as the acquisition of a new obligation. If such new obligation is not adequately secured, the requirements of section 503(e) must be met at the time the terms of the obligation are changed for such section to be applicable to such new loan.

[T.D. 6493, 25 FR 9217, Sept. 27, 1960, as amended by T.D. 6972, 33 FR 12904, Sept. 12, 1968; T.D. 7428, 41 FR 34624, Aug. 16, 1976]

§ 1.503(e)–3 Effective dates.

(a) Section 503(e) and §§ 1.503(e)–1 and 1.503(e)–3 are effective in the case of an employees' trust described in section 401(a) for taxable years ending after March 15, 1956. Thus, if during a taxable year ending before March 16, 1956, an employees' trust made a loan which meets the requirements of section 503(e), such loan will not be treated as made without the receipt of adequate security and will not cause the loss of exemption for taxable years ending after March 15, 1956, although such loan was not considered adequately secured when made. (However, section 503 does not apply to organizations described in section 401(a) not referred to in section 4975(g)(2) or (3) for transactions occurring after December 31, 1974.)

(b)(1) In the case of obligations acquired by an employees' trust described in section 401(a) before September 2, 1958, which were held on that date, the requirements described in paragraphs (c) and (d) of § 1.503(e)–2 which were not satisfied immediately following the acquisition shall be treated as satisfied at that time if those requirements would have been satisfied had the obligations been acquired on September 2, 1958. For example, on January 3, 1955, an employees' trust described in section 401(a) purchased through the New York Stock Exchange unsecured debentures issued by the employer corporation. Under section 503(e) the acquisition of such debentures by the trust will not be treated for taxable years ending after March 15, 1956, as a loan made without the receipt of adequate security if the debentures were held by the employees' trust on September 2, 1958, and if the requirements of paragraphs (c) and (d) of § 1.503(e)–2 which were not met on January 3, 1955, were met on September 2, 1958, as if that date were the date of acquisition.

(2) In the case of obligations acquired before September 2, 1958, which were not held by the employees' trust described in section 401(a) on that date, only the requirements described in paragraph (b) of § 1.503(e)–2 must be satisfied for section 503(e) to be applicable to such acquisition. For example, if on December 5, 1956, an employees' trust lent money to the employer corporation by purchasing a debenture issued by the employer and if the trust sold the debenture on August 1, 1958, such loan would not be treated as made without the receipt of adequate security if the requirement described in paragraph (b) of § 1.503(e)–2 was met on December 5, 1956.

(c) Section 503(e) and §§ 1.503(e)–1 and 1.503(e)–2 are effective in the case of trusts described in section 501(c)(17) with respect to loans made, renewed, or, in the case of demand loans, continued after December 31, 1959, and in the case of trusts described in section 501(c)(18) with respect to loans made, renewed or, in the case of demand loans, continued after December 31, 1969.

(d) See paragraph (b)(2) of § 1.503(b)–1 for the effective dates for the application of the definition of adequate security.

[T.D. 6493, 25 FR 9218, Sept. 27, 1960, as amended by T.D. 6972, 33 FR 12905, Sept. 12, 1968; T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§ 1.503(e)–4 Disallowance of charitable deductions for certain gifts made before January 1, 1970.

Paragraphs (a), (b), and (c) of this section shall apply only to gifts or contributions made before January 1, 1970, to an organization described in section 501(c)(3). For rules relating to the denial of deductions with respect to gifts or contributions made after December 31, 1969, see § 1.503(c)–1(d).

(a) No gift or contribution which would otherwise be allowable as a charitable or other deductions under section 170, 642(c), or 545(b)(2) shall be allowed as a deduction if made to an organization described in section 501(c)(3) which at the time the gift or contribution is made is not exempt under section 501(a) by reason of the provisions of section 503.

(b) If an organization which is described in section 501(c)(3) is not exempt because it engaged in a prohibited transaction involving a substantial part of its income of corpus with the purpose of diverting its income or corpus from its exempt

purposes, and if the organization receives a gift or contribution during, or prior to, its taxable year in which such prohibited transaction occurred, then a deduction by the donor with respect to the gift or contribution shall not be disallowed under section 503(b) unless the donor (or any member of his family if the donor is an individual) is a party to such prohibited transaction. For the purpose of the preceding sentence "family" is defined in section 267(c)(4) and includes brothers and sisters, whether by whole or half blood, spouse, ancestors, and lineal descendants. See the regulations under section 267(c).

(c) The application of § 1.503(e)–4 may be illustrated by the following example:

Example. In 1954, Corporation M, which files its income tax returns on the calendar year basis, creates a foundation purportedly for charitable purposes and deducts from its gross income for that year the amount of the gift to the foundation. Corporation M makes additional gifts to this foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. B, an individual, also contributes to the foundation in 1955, 1956, and 1957, and takes charitable deductions for such years. In 1955, the foundation commences purposely to divert its corpus to the benefit of Corporation M, and a substantial amount of such corpus is so diverted by the close of the taxable year 1956. For 1955 and subsequent taxable years, the exemption allowed the foundation as an organization described in section 501(c)(3) is denied by reason of the provisions of section 503(a). Both Corporation M and individual B would be disallowed any deduction for the contributions made during 1957 to the foundation. Moreover, the charitable deductions taken by Corporation M for contributions to the foundation in the years 1955 and 1956 would also be disallowed since Corporation M was a party to the prohibited transactions. If the facts and surrounding circumstances indicate that the contribution in 1954 by Corporation M was for the purpose of the prohibited transaction, then the charitable deduction for the year 1954 shall also be disallowed with respect to Corporation M, since the prohibited transaction would then have commenced with the making of such contribution and the exemption allowed the foundation would then be denied for 1954 by reason of the provisions of § 1.503(e)–4. B's deductions for his contributions for the years 1955 and 1956 will not be disallowed since he was not a party to the prohibited transaction.

[T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§ 1.503(f)–1 Loans by employers who are prohibited from pledging assets.

(a) In general. (1) Section 503(f) provides that section 503(b)(1) shall not apply to a loan made to the employer by an employees' trust described in section 401(a) if the loan bears a reasonable rate of interest and certain conditions are met. Section 503(f) also applies to the renewal of loans to the employer and, in the case of demand loans, to the continuation of such loans.

(2) The provisions of section 503(f) do not limit the effect of section 401(a) and § 1.401–2, relating to use or diversion of corpus or income of an employees' trust, or the effect of any of the provisions of section 503 other than section 503(b)(1). Consequently, although a loan made by an employees' trust described in section 503(a)(1)(B) meets all the requirements of section 503(f) and therefore is not treated as a loan made without the receipt of adequate security, an employees' trust making such a loan will lose its exempt status if the loan is not considered as made for the exclusive benefit of the employees or their beneficiaries. Similarly, a loan which meets the requirements of section 503(f) will constitute a prohibited transaction within the meaning of section 503(b)(6) if it results in a substantial diversion of the trust's income or corpus to a person described in section 503(b).

(b) Conditions. (1) Section 503(f) applies to a loan only if, with respect to the making or renewal of the loan, the conditions described in paragraphs (b)(2), (3), and (4) of this section are met. For purpose of this paragraph, the mere continuance of a demand loan is not considered as the making or renewal of such a loan.

(2) The employer must be prohibited (at the time of the making or renewal of the loan) by any law of the United States or regulations thereunder from directly or indirectly pledging, as security for such a loan, a particular class or classes of his assets the value of which (at such time) represents more than one-half of the value of all his assets. If a loan is made or renewed when the employer is prohibited by a law of the United States (or the regulations thereunder) from pledging a class of his assets, the qualification of such a loan under section 503(f) will not be affected by a subsequent change in such law or regulations permitting the employer to pledge such assets, unless such loan is renewed after such change. See section 8(a) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78h(a)), which prohibits certain persons from pledging a class of assets as security for loans, and 12 CFR 220.5(a) (credit by brokers, dealers, and members of national securities exchanges).

(3) The making or renewal, as the case may be, must be approved in writing as an investment which is consistent with the exempt purposes of the trust by a trustee who is independent of the employer, and such written approval must not have been previously refused by any other such trustee. A trustee is independent of the employer, for purposes of this subparagraph, if he is entirely free of influence or controlled by the employer. For example, if the employer is a partnership, then

a partner in such partnership, or a member of a partner's family would not be considered independent of the employer. Similarly, an employee of the employer would not be considered independent of the employer. For purposes of this subparagraph, the term "trustee" means, with respect to any trust for which there are two trustees who are independent of the employer, both of such trustees and, with respect to any trust for which there are more than two such independent trustees, a majority of the trustees independent of the employer.

(4)(i) Immediately following the making or renewal, as the case may be, the aggregate amount lent by the trust to the employer, without the receipt of adequate security must not exceed 25 percent of the value of all the assets of the trust.

(ii) For purposes of paragraph (b)(4)(i) of this section, the determination as to whether any amount lent by the trust to the employer is a loan made without the receipt of adequate security shall be made without regard to section 503(e). Thus, if an employees' trust makes a loan on January 2, 1959, to the employer without adequate security (but which loan is not considered as made without adequate security under section 503(e)), and if immediately after making such loan 10 percent of the value of all its assets is invested in such loan, then the trust may on that day invest not more than an additional 15 percent of its assets in a loan which would be considered made without adequate security if it were not for the provisions of section 503(f).

(iii) For purposes of paragraph (b)(4)(i) of this section, in determining the value of all the assets of the trust, there shall be used the fair market value of those assets on the day of the making or renewal.

(c) Reasonable rate of interest. Section 503(f) only applies if, in addition to meeting the conditions described in paragraph (b) of this section, the loan bears a reasonable rate of interest when it is made, renewed, or, in the case of demand loans, during the period of its existence.

(d) Change of terms of loan. A change in the terms of a loan (including a reduction in the security for a loan) is considered as the making of a new loan. If such a new loan is not adequately secured, the requirements of section 503(f) must be met at the time the terms of the loan are changed for such section to be applicable to such new loan.

(e) Effective date. (1) This section and section 503(f) are effective for taxable years ending after September 2, 1958, but only with respect to periods after such date. Thus, if a loan was made on or before September 2, 1958, without the receipt of adequate security and if, when such loan was made, it met all of the requirements of section 503(f) and this section, then the loan is not subject to section 503(b)(1) after September 2, 1958, and would not constitute a prohibited transaction after that date because of a lack of adequate security.

(2) See paragraph (b)(2) of § 1.503(b)–1 for the effective dates for application of the definition of adequate security.

[T.D. 6493, 25 FR 9219, Sept. 27, 1960, renumbered and amended by T.D. 7428, 41 FR 34626, Aug. 16, 1976]

§ 1.504–1 Denial of exemption.

(a) The restrictions enumerated in section 504 are in addition to and not in limitation of the restrictions contained in section 501(c)(3). Even though an organization has not violated any of the terms of section 504, it still may not qualify for tax exemption in view of the general provisions of section 501(c)(3). Thus, if a trustee or other fiduciary of the organization (whether or not he is also a creator of such organization) enters into a transaction with the organization, such transaction will be closely scrutinized in the light of the fiduciary principle requiring undivided loyalty to ascertain whether the organization is in fact being operated for the stated exempt purposes.

(b)(1) Any organization described in section 501(c)(3) other than an organization described in section 503(b)(1) through (5), inclusive, shall not be exempt under section 501(a) if the amounts accumulated out of income during the taxable year, or any prior taxable year, and not actually paid out for exempt purposes by the end of the taxable year, are unreasonable. Amounts accumulated out of income become unreasonable when more income is accumulated than is needed, or when the duration of the accumulation is longer than is needed in order to carry out the purpose constituting the basis for the organization's exemption. Furthermore, such an organization shall not be exempt under section 501(a) if amounts accumulated out of income are used to a substantial degree for purposes or functions other than those constituting the basis for the organization's exemption, or if such amounts are invested in such a manner as to jeopardize the carrying out of the purpose or function constituting the basis for the organization's exemption.

(2) The provisions for the denial of exemption for unreasonable accumulations of income will not apply to income attributable to property of a

decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, where income is required to be accumulated by the trust, the denial of exemption for unreasonable accumulations of income under paragraph (b)(1) of this section will apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

(c) For the purpose of section 504, the term "income" means gains, profits, and income determined under the principles applicable in determining the earnings or profits of a corporation. The amount accumulated out of income during the taxable year or any prior taxable year shall be determined under the principles applicable in determining the accumulated earnings or profits of a corporation. In determining the reasonableness of an accumulation out of income, there will be disregarded the following:

(1) The accumulation of gain upon the sale or exchange of a donated asset to the extent that such gain represents the excess of the fair market value of such asset when acquired by the organization over its substituted basis in the hands of the organization;

(2) The accumulation of gain upon the sale or exchange of property held for the production of investment income, such as dividends, interest, and rents, where the proceeds of such sale or exchange are within a reasonable time reinvested in property acquired and held in good faith for the production of investment income.

(d) Whether the conditions specified in paragraphs (1), (2), and (3) of section 504(a) are present in any case must be determined from all the facts. The conditions specified in section 504(a)(1), (2), and (3) may result from the use of only one organization or of a chain of two or more organizations.

(e) An organization that has lost its exemption by reason of the provisions of section 504 may, in order to reestablish its exemption, file a claim for exemption with the district director. Form 1023, the exemption application, shall be used for this purpose in accordance with the provisions of § 1.501(a)–1.

(f) In the case of an organization described in section 501(c)(3) denied exemption under section 501(a) solely by reason of the provisions of section 504, deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for gifts or contributions to such organization shall not be disallowed for the year during which the exemption is denied and prior years.

(g) In the case of an organization described in section 501(c)(3) denied exemption under section 501(a) solely by reason of the provisions of section 504, such organization will not cease to be described in section 501(c)(3) for purposes of Part II of subchapter F, chapter 1 and for purposes of the application of chapter 42 taxes.

(h) Section 504 shall result in a loss of exemption to any organization only as a result of a transaction occurring prior to January 1, 1970. [T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.505(c)–1T Questions and answers relating to the notification requirement for recognition of exemption under paragraphs (9), (17) or (20) of section 501(c) (temporary).

Q–1: What does section 505(c) of the Internal Revenue Code provide?

A–1: Section 505(c) provides that an organization will not be recognized as exempt under section 501(c)(9) as a voluntary employees' beneficiary association, under section 501(c)(17) as a trust forming part of a plan providing for the payment of supplemental unemployment compensation benefits, or under section 501(c)(20) as a trust forming part of a qualified group legal services plan unless notification is given to the Internal Revenue Service. The notification required of a trust created pursuant to section 501(c)(20) and forming part of a qualified group legal services plan is set forth in Q&A-2. The notification required of an organization organized after July 18, 1984, and applying for exempt status as an organization described in section 501(c)(9) or (17) is set forth in Q&A-3 through Q&A-8. The notification required of an organization organized on or before July 18, 1984, and claiming exemption as an organization described in section 501(c)(9) or (17) is set forth in Q&A-9 through Q&A-11. However, an organization that has previously notified the Internal Revenue Service of its claim to exemption under section 501(c)(9), (17), or (20) or its claim to exemption under those sections pursuant to another provision of the Code, is not required, under section 505(c), to submit a renotification (See Q&A-2 and Q&A-12).

Section 501(c)(20) Trusts

Q–2: What is the notice required of a trust created pursuant to section 501(c)(20) and forming part of a qualified group legal services plan under section 120?

A–2: (a) A trust claiming exemption as an organization described in section 501(c)(20) will be recognized as exempt if the exclusive function of the trust is to form part of a qualified group legal services plan or plans. Exemption of the trust under section 501(c)(20) will generally be dependent upon and coextensive with recognition of the plan as a qualified group legal services plan. Therefore, a trust organized pursuant to section 501(c)(20) after July 18, 1984, need not file a separate notice with the Internal Revenue Service of its claim to exemption because the notice required by section 120(c)(4) will suffice for purposes of section 505(c), provided a copy of the trust instrument is filed with the Form 1024 submitted by the group legal services plan. If the trust instrument has not been filed with the Form 1024 submitted by the group legal services plan, the trust must comply with (and exemption will be dependent upon) the filing applicable to a trust organized on or before July 18, 1984. For the notice required and effective dates of exemption of a qualified group legal services plan under section 120, see § 1.120-3.

(b) A trust organized on or before July 18, 1984, that claims exempt status as a trust described in section 501(c)(20) and that forms part of a qualified group legal services plan which has been recognized as exempt under section 120, must file a copy of its trust instrument with the Internal Revenue Service before February 4, 1987. If a copy of the trust instrument is filed within the time provided, the trust's exemption will be recognized retroactively to the date the qualified group legal services plan was recognized as exempt under section 120. However, if a copy of the trust instrument is filed after the time provided, exemption will be recognized only for the period after the copy of the trust instrument is filed with the Internal Revenue Service. See Q&A-7 for a further discussion of "date of filing." A trust that has previously filed a copy of its trust instrument with the Service need not refile that document.

Section 501(c) (9) and (17) Organizations Organized After July 18, 1984

Q–3: What is the notice required of an organization or trust, organized after July 18, 1984, that is applying for recognition of tax exempt status under section 501(c)(9) or (17)?

A–3: An organization or trust that is organized after July 18, 1984, will not be treated as described in paragraphs (9) or (17) of section 501(c), unless the organization notifies the Internal Revenue Service that it is applying for recognition of exemption. In addition, unless the required notice is given in the manner and within the time prescribed by these regulations, an organization will not be treated as exempt for any period before the giving of the required notice. The notice is filed by submitting a properly completed and executed Form 1024, "Application for Recognition of Exemption Under Section 501(a) or for Determination Under Section 120" together with the additional information required under Q&A-4 and Q&A-5. The notice is filed with the district director for the key district in which the organization's principal place of business or principal office is located.

The notice may be filed by either the plan administrator (as defined in section 414(g)) or the trustee. The Internal Revenue Service will not accept a Form 1024 for any organization or trust before such entity has been organized.

Q–4: What information, in addition to the information required by Form 1024, must be submitted by an organization or trust seeking recognition of exemption under section 501(c) (9) or (17)?

A–4: A notice will not be considered complete unless, in addition to a properly completed and executed Form 1024, the organization or trust submits a full description of the benefits available to participants under section 501(c)(9) or (17). Moreover, both the terms and conditions of eligibility for membership and the terms and conditions of eligibility for benefits must be set forth. This information may be contained in a separate document, such as a "plan document," or it may be contained in the creating document of the entity (e.g., the articles of incorporation or association, or a trust indenture). For benefits provided through a policy or policies of insurance, all such policies must be included with the notice. Where individual policies of insurance are provided to the participants, single exemplar copies, typical of policies generally issued to participants, are acceptable, provided they adequately describe all forms of insurance available to participants. In providing a full description of the benefits available, the benefits provided must be sufficiently described so that each benefit is definitely determinable. A benefit is definitely determinable if the amount of the benefit, its duration, and the persons eligible to receive it are ascertainable from the plan document or other instrument. Thus, a benefit is not definitely determinable if the rules governing either

its amount, its duration, or its recipients are not ascertainable from the plan document or other instrument but are instead subject to the discretion of a person or committee. Likewise, a benefit is not definitely determinable if the amount for any individual is based upon a percentage share of any item that is within the discretion of the employer. However, a disability benefit will not fail to be considered definitely determinable merely because the determination of whether an individual is disabled is made under established guidelines by an authorized person or committee.

Q–5: What is the notice required of collectively bargained plans?

A–5: If an organization or trust claiming exemption under section 501(c)(9) or (17) is organized and maintained pursuant to a collective bargaining agreement between employee representatives and one or more employer, only one Form 1024 is required to be filed for the organization or trust, regardless of the number of employers originally participating in the agreement. Moreover, once a Form 1024 is filed pursuant to a collective bargaining agreement, an additional Form 1024 is not required to be filed by an employer who thereafter participates in that agreement. When benefits are provided pursuant to a collective bargaining agreement, the notice will not be considered complete unless, in addition to a properly completed and executed Form 1024, a copy of the collective bargaining agreement is also submitted together with the additional information delineated in Q&A-4.

Q–6: When must the required notice be filed by an organization or trust, organized after July 18, 1984, that seeks recognition of exemption under section 501(c)(9) or (17)?

A–6: An organization or trust applying for exemption must file the required notice by the later of February 4, 1987 or 15 months from the end of the month in which the organization or trust was organized. An extension of time for filing the required notice may be granted by the district director if the request is submitted before the end of the applicable period and it is demonstrated that additional time is needed.

Q–7: What is the effective date of exemption for a new organization or trust, organized after July 18, 1984, that has submitted the required notice?

A–7: If the required notice is filed within the time provided by these regulations, the organization's exemption will be recognized retroactively to the date the organization was organized, provided its purpose, organization and operation (including compliance with the applicable nondiscrimination requirements) during the period prior to the date of the determination letter are in accordance with the applicable law. However, if the required notice is filed after the time provided by these regulations, exemption will be recognized only for the period after the application is filed with the Internal Revenue Service. The date of filing is the date of the United States postmark on the cover in which an exemption application is mailed or, if no postmark appears on the cover, the date the application is stamped as received by the Service. If an extension for filing the required notice has been granted to the organization, a notice filed on or before the last day specified in the extension will be considered timely and not the otherwise applicable date under Q&A-6.

Q–8: What is the effect on exemption of the filing of an incomplete notice?

A–8: Although a properly completed and executed Form 1024 together with the required additional information (See Q&A-4 and Q&A-5) must be submitted to satisfy the notice required by section 505(c), the failure to file, within the time specified, all of the information necessary to complete such notice will not alone be sufficient to deny recognition of exemption from the date of organization to the date the completed information is submitted to the Service. If the notice which is filed with the Service within the required time is substantially complete, and the organization supplies the necessary additional information requested by the Service within the additional time allowed, the original notice will be considered timely. However, if the notice is not substantially complete or the additional information is not provided within the additional time allowed, exemption will be recognized only from the date of filing of the additional information.

Section 501(c)(9) and (17) Organizations Organized on or Before July 18, 1984

Q–9: What is the notice required of an organization or trust organized on or before July 18, 1984, that claims exempt status as an organization described in section 501(c)(9) or (17)?

A–9: Section 505(c) provides a special rule for existing organizations and trusts organized on or before July 18, 1984. Such an organization or trust will not be treated as described in paragraphs (9) or (17) of section 501(c) unless the organization or trust notifies the Internal Revenue Service in the manner and within the time prescribed in these regulations that it is claiming exemption under the particular section. The type of notice, the manner for filing that notice, and the addition-

al information required is the same as that set forth in Q&A-3 through Q&A-5 for new organizations.

Q–10: When must the required notice be filed by an organization or trust organized on or before July 18, 1984?

A–10: An organization or trust organized on or before July 18, 1984, that claims exempt status as an organization described in section 501(c)(9) or (17), must file the required notice before February 4, 1987. An extension of time for filing the required notice may be granted by the district director if the request is submitted before the due date of the notice and it is demonstrated that additional time is needed.

Q–11: What is the effective date of exemption for an organization or trust organized on or before July 18, 1984, that has submitted the required notice?

A–11: If the required notice is filed within the time provided by these regulations, the organization's exemption will be recognized retroactively to the date the organization was organized, provided its purpose, organization and operation (including compliance with the applicable nondiscrimination requirements) during the period prior to the date of the determination letter are in accordance with the applicable law. If, on the other hand, the required notice is filed after the time provided by these regulations, exemption will be recognized only for the period after the notice is received by the Internal Revenue Service. See Q&A-7 for a further discussion of "date of filing." See also Q&A-8 for the effect on exemption of a notice that has been timely filed but is incomplete.

Exceptions to Notice Requirement

Q–12: Are any organizations or trusts claiming recognition of exemption as an organization described in section 501(c)(9) or (17) excepted from the notice requirement of section 505(c)?

A–12: An organization or trust that has previously notified the Internal Revenue Service of its claim to exemption by filing Form 1024 is not required, under section 505(c), to renotify the Service. Thus, an organization that has filed a Form 1024 that is pending with the Service need not refile that form. Also, an organization that has received a ruling or determination letter from the Service recognizing its exemption from taxation need not submit the notification required by section 505(c).

[T.D. 8073, 51 FR 4330, Feb. 4, 1986]

Private Foundations

§ 1.507–1 General rule.

(a) In general. Except as provided in § 1.507–2, the status of any organization as a private foundation shall be terminated only if—

(1) Such organization notifies the district director of its intent to accomplish such termination, or

(2)(i) With respect to such organization, there have been either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under chapter 42, and

(ii) The Commissioner notifies such organization that, by reason of subdivision (i) of this subparagraph, such organization is liable for the tax imposed by section 507(c),

and either such organization pays the tax imposed by section 507(c) (or any portion not abated under section 507(g)) or the entire amount of such tax is abated under section 507(g).

(b) Termination under section 507(a)(1). **(1)** In order to terminate its private foundation status under paragraph (a)(1) of this section, an organization must submit a statement to the district director of its intent to terminate its private foundation status under section 507(a)(1). Such statement must set forth in detail the computation and amount of tax imposed under section 507(c). Unless the organization requests abatement of such tax pursuant to section 507(g), full payment of such tax must be made at the time the statement is filed under section 507(a)(1). An organization may request the abatement of all of the tax imposed under section 507(c), or may pay any part thereof and request abatement of the unpaid portion of the amount of tax assessed. If the organization requests abatement of the tax imposed under section 507(c) and such request is denied, the organization must pay such tax in full upon notification by the Internal Revenue Service that such tax will not be abated. For purposes of subtitle F of the Code, the statement described in this subparagraph, once filed, shall be treated as a return.

(2) Termination of private foundation status under section 507(a)(1) does not relieve a private foundation, or any disqualified person with respect

thereto, of liability for tax under chapter 42 with respect to acts or failures to act prior to termination or for any additional taxes imposed for failure to correct such acts or failures to act. See subparagraph (8) of this paragraph as to the possible imposition of transferee liability in cases not involving termination of private foundation status.

(3) In the case of an organization which has terminated its private foundation status under section 507(a) and continues in operation thereafter, if such organization wishes to be treated as described in section 501(c)(3), then pursuant to section 509(c) and § 1.509(c)–1 such organization must apply for recognition of exemption as an organization described in section 501(c)(3) in accordance with the provisions of section 508(a).

(4) See § 53.4947–1(c)(7) of this chapter as to the application of section 507(a) to certain split-interest trusts.

(5) For purposes of section 508(d)(1), the Internal Revenue Service shall make notice to the public (such as by publication in the Internal Revenue Bulletin) of any notice received from a private foundation pursuant to section 507(a)(1) or of any notice given to a private foundation pursuant to section 507(a)(2).

(6) If a private foundation transfers all or part of its assets to one or more other private foundations (or one or more private foundations and one or more section 509(a)(1), (2), (3), or (4) organizations) pursuant to a transfer described in section 507(b)(2) and § 1.507–3(c), such transferor foundation will not have terminated its private foundation status under section 507(a)(1). See § 1.507–3, however, for the special rules applicable to private foundations participating in section 507(b)(2) transfers.

(7) Neither a transfer of all of the assets of a private foundation nor a significant disposition of assets (as defined in § 1.507–3(c)(2)) by a private foundation (whether or not any portion of such significant disposition of assets is made to another private foundation) shall be deemed to result in a termination of the transferor private foundation under section 507(a) unless the transferor private foundation elects to terminate pursuant to section 507(a)(1) or section 507(a)(2) is applicable. Thus, if a private foundation transfers all of its assets to one or more persons, but less than all of its net assets to one or more organizations described in section 509(a)(1) which have been in existence and so described for a continuous period of 60 calendar months, for purposes of this paragraph such transferor foundation will not be deemed by reason of such transfer to have terminated its private foundation status under section 507(a) or (b) unless section 507(a)(2) is applicable. Such foundation will continue to be treated as a private foundation for all purposes. For example, if a private foundation transfers all of its net assets to a section 509(a)(2) organization in 1971 and receives a bequest in 1973, the bequest will be regarded as having been made to a private foundation and the foundation will be subject to the provisions of chapter 42 with respect to such funds. If a private foundation makes a transfer of all of its net assets to a section 509(a)(2) or (3) organization, for example, it must retain sufficient income or assets to pay the tax imposed under section 4940 for that portion of its taxable year prior to such transfer. For additional rules applicable to a transfer by a private foundation of all of its net assets to a section 509(a)(1) organization which has not been in existence and so described for a continuous period of 60 calendar months, see § 1.507–3(e).

(8) If a private foundation makes a transfer described in subparagraph (7) of this paragraph and prior to, or in connection with, such transfer, liability for any tax under chapter 42 is incurred by the transferor foundation, transferee liability may be applied against the transferee organization for payment of such taxes. For purposes of this subparagraph, liability for any tax imposed under chapter 42 for failure to correct any act or failure to act shall be deemed incurred on the date on which the act or failure to act giving rise to the initial tax liability occurred.

(9) A private foundation which transfers all of its net assets is required to file the annual information return required by section 6033, and the foundation managers are required to file the annual report of a private foundation required by section 6056, for the taxable year in which such transfer occurs. However, neither such foundation nor its foundation managers will be required to file such returns for any taxable year following the taxable year in which the last of any such transfers occurred, if at no time during the subsequent taxable years in question the foundation has either legal or equitable title to any assets or engages in any activity.

(c) Involuntary termination under section 507(a)(2). (1) For purposes of section 507(a)(2)(A), the term "willful repeated acts (or failures to act)" means at least two acts or failures to act both of which are voluntary, conscious, and intentional.

(2) For purposes of section 507(a)(2)(A), a "willful and flagrant act (or failure to act)" is one which is voluntarily, consciously, and knowingly committed in violation of any provision of chapter 42 (other than section 4940 or 4948(a)) and which appears to a reasonable man to be a gross violation of any such provision.

(3) An act (or failure to act) may be treated as an act (or failure to act) by the private foundation for purposes of section 507(a)(2) even though tax is imposed upon one or more foundation managers rather than upon the foundation itself.

(4) For purposes of section 507(a)(2), the failure to correct the act or acts (or failure or failures to act) which gave rise to liability for tax under any section of chapter 42 by the close of the correction period for such section may be a willful and flagrant act (or failure to act).

(5) No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make an act (or failure to act) willful. However, a foundation's act (or failure to act) is not willful if the foundation (or a foundation manager, if applicable) does not know that it is an act of self-dealing, a taxable expenditure, or other act (or failure to act) to which chapter 42 applies. Rules similar to the regulations under chapter 42 (see, for example, § 53.4945–1(a)(2)(iii) of this chapter) shall apply in determining whether a foundation or a foundation manager "knows" that an act (or failure to act) is an act of self-dealing a taxable expenditure or other such act (or failure to act). [T.D. 7233, 37 FR 28157, Dec. 21, 1972, as amended by T.D. 7290, 38 FR 31833, Nov. 19, 1973]

§ 1.507–2 Special rules; transfer to, or operation as, public charity.

(a) Transfer to public charities—(1) General rule. Under section 507(b)(1)(A) a private foundation, with respect to which there have not been either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under chapter 42, may terminate its private foundation status by distributing all of its net assets to one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months immediately preceding such distribution. Since section 507(a) does not apply to such a termination, a private foundation which makes such a termination is not required to give the notification described in section 507(a)(1). A private foundation which terminates its private foundation status under section 507(b)(1)(A) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

(2) Effect of current ruling—(i) Distributions before final regulations. With respect to distributions made before (insert day after the date these regulations are filed by the Office of the Federal Register), an organization to which a distribution of net assets is made will qualify as an organization "described in section 170(b)(1)(A) (other than clauses (vii) and (viii))" for purposes of meeting the requirements of section 507(b)(1)(A) without a further showing if such distributee organization:

(A) Has been in existence for a continuous period of at least 60 calendar months preceding the distribution described in subparagraph (1) of this paragraph;

(B) Has received a ruling or determination letter that it is an organization described in clause (i), (ii), (iii), (iv), (v), or (vi) of section 170(b)(1)(A);

(C) The facts and circumstances forming the basis for the issuance of the ruling have not substantially changed during the 60-month period referred to in (A) of this subdivision; and

(D) The ruling or determination letter referred to in (B) of this subdivision has not been revoked expressly or by a subsequent change of the law or regulations under which the ruling was issued.

(ii) Distributions after final regulations. With respect to distributions made after December 29, 1972, a private foundation seeking to terminate its private foundation status pursuant to section 507(b)(1)(A) may rely on a ruling or determination letter issued to a potential distributee organization that such distributee organization is an organization described in clause (i), (ii), (iii), (iv), (v), or (vi) of section 170(b)(1)(A) in accordance with the provisions of § 1.509(a)–7.

(3) Organizations described in more than one clause of section 170(b)(1)(A). For purposes of this paragraph and section 507(b)(1)(A), the parenthetical term "other than in clauses (vii) and (viii)" shall refer only to an organization which is described only in section 170(b)(1)(A)(vii) or (viii). Thus, an organization described in clause (i), (ii), (iii), (iv), (v), or (vi) of section 170(b)(1)(A) will not be precluded from being a distributee described in section 507(b)(1)(A) merely because it also appears to meet the description of an organization described in section 170(b)(1)(A)(vii) or (viii).

(4) Applicability of chapter 42 to foundations terminating under section 507(b)(1)(A). Except as provided in subparagraph (5) of this paragraph, an organization which terminates its private foundation status pursuant to section 507(b)(1)(A) will remain subject to the provisions of chapter 42 until the distribution of all of its net assets to distributee organizations described in section 507(b)(1)(A) has been completed.

(5) Special transitional rule. (i) Section 4940(a) imposes a tax upon private foundations with respect to the carrying on of activities for each taxable year. For purposes of section 4940, an organization which terminates its private foundation status under section 507(b)(1)(A) by the end of the period described in subdivision (ii) of this subparagraph will not be considered as carrying on activities within the meaning of section 4940 during such period. Such organization will therefore not be subject to the tax imposed under section 4940(a) for such period.

(ii) The period referred to in subdivision (i) of this subparagraph is the 12-month period beginning with the first day of the organization's first taxable year which begins after December 31, 1969, but such period shall not be treated as ending before February 20, 1973. In the case of a private foundation distributing assets pursuant to section 507(b)(1)(A) to a medical research organization or a community trust (or in the case of a private foundation seeking to terminate into such an organization or trust pursuant to section 507(b)(1)(B)), the period described in this subdivision shall not be treated as ending before—

(A) In the case of a distribution to a medical research organization, March 29, 1976; or

(B) In the case of a community trust, May 11, 1977.

(iii) If the period described in subdivision (ii) of this subparagraph has not expired prior to the due date for the organization's annual return required to be filed by section 6033 or 6012 (determined with regard to any extension of time for filing the return) for its first taxable year which begins after December 31, 1969 (or for any other taxable year ending before the expiration of the period referred to in subdivision (ii) of this subparagraph), and if the organization has not terminated its private foundation status under section 507(b)(1)(A) by such date, then notwithstanding the provisions of subdivision (ii) of this subparagraph, the organization must take either of the following courses of action:

(A) Complete and file its annual return, including the line relating to excise taxes on investment income, by such date, and pay the tax on investment income imposed under section 4940 at the time it files its annual return. If such organization subsequently terminates its private foundation status under section 507(b)(1)(A) within the period specified in subdivision (ii) of this subparagraph, it may file a claim for refund of the tax paid under section 4940; or

(B) Complete and file its annual return, except for the line relating to excise taxes on investment income, by such date, and, in lieu of paying the tax on investment income imposed under section 4940, file a statement with its annual return which establishes that the organization has taken affirmative action by such date to terminate its private foundation status under section 507(b)(1)(A). Such statement must indicate the type of affirmative action taken and explain how such action will result in the termination of its private foundation status under section 507(b)(1)(A). Such affirmative action may include making application to the appropriate State court for approval of the distribution of all net assets pursuant to section 507(b)(1)(A) in the case of a charitable trust, or the passage of a resolution by the organization's governing body directing the distribution of all net assets pursuant to section 507(b)(1)(A) in the case of a not-for-profit corporation. A written commitment or letter of agreement by the trustee or governing body to one or more section 509(a)(1) distributees indicating an intent to distribute all of the organization's net assets to such distributees will also constitute appropriate affirmative action for purposes of this subdivision. An organization may take such affirmative action and may terminate its private foundation status under section 507(b)(1)(A) in reliance upon 26 CFR 13.12 (rev. as of Jan. 1, 1972) and upon the provisions of the notices of proposed rule making under sections 170(b)(1)(A), 507(b)(1), and 509. Thus, if a distributee organization meets the requirements of the provisions of the notices of proposed rulemaking under sections 170(b)(1)(A), 507, or 509 as a distributee under section 507(b)(1)(A), the distributor organization may terminate its private foundation status under section 507(b)(1)(A) in reliance upon such provisions prior to the expiration of the period described in subdivision (ii) of this subparagraph. If such organization, however, fails to terminate its private foundation status under section 507(b)(1)(A) within the period specified in subdivision (ii) of this subparagraph by failing to meet the requirements of either the notices of proposed rulemaking under section

170(b)(1)(A), 507(b)(1), or 509 or the final regulations published under these Code sections, the tax imposed under section 4940 shall be treated as if due from the due date for its annual return (determined without regard to any extension of time for filing its return).

(6) **Return required from organizations terminating private foundation status under section 507(b)(1)(A).** (i) An organization which terminates its private foundation status under section 507(b)(1)(A) is required to file a return under the provisions of section 6043(b), rather than under the provisions of section 6050.

(ii) An organization which terminates its private foundation status under section 507(b)(1)(A) is not required to comply with section 6104(d) for the taxable year in which such termination occurs. For purposes of this subdivision, the term "taxable year" shall include the period described in subparagraph (5)(ii) of this paragraph.

(7) **Distribution of net assets.** A private foundation will meet the requirement that it "distribute all of its net assets" within the meaning of section 507(b)(1)(A) only if it transfers all of its right, title, and interest in and to all of its net assets to one or more organizations referred to in section 507(b)(1)(A).

(8) **Effect of restrictions and conditions upon distributions of net assets—(i) In general.** In order to effectuate a transfer of "all of its right, title, and interest in and to all of its net assets" within the meaning of paragraph (a)(7) of this section, a transferor private foundation may not impose any material restriction or condition that prevents the transferee organization referred to in section 507(b)(1)(A) (herein sometimes referred to as the "public charity") from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes. Whether or not a particular condition or restriction imposed upon a transfer of assets is "material" (within the meaning of paragraph (a)(8) of this section) must be determined from all of the facts and circumstances of the transfer. Some of the more significant facts and circumstances to be considered in making such a determination are:

(A) Whether the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the owner in fee of the assets it receives from the private foundation;

(B) Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes;

(C) Whether the governing body of the public charity has the ultimate authority and control over such assets, and the income derived therefrom; and

(D) Whether, and to what extent, the governing body of the public charity is organized and operated so as to be independent from the transferor.

(ii) **Independent governing body.** As provided in paragraph (a)(8)(i)(D) of this section, one of the more significant facts and circumstances to be considered in making the determination whether a particular condition or restriction imposed upon a transfer of assets is "material" within the meaning of paragraph (a)(8) of this section is whether, and the extent to which, the governing body is organized and operated so as to be independent from the transferor. In turn, the determination as to such factor must be determined from all of the facts and circumstances. Some of the more significant facts and circumstances to be considered in making such a determination are:

(A) Whether, and to what extent, members of the governing body are comprised of persons selected by the transferor private foundation or disqualified persons with respect thereto, or are themselves such disqualified persons;

(B) Whether, and to what extent, members of the governing body are selected by public officials acting in their capacities as such; and

(C) How long a period of time each member of the governing body may serve as such. In the case of a transfer that is a community trust, the community trust shall meet paragraph (a)(8)(ii)(C) of this section if it meets the requirements of § 1.170A-9(e)(13)(iv) (other than § 1.170A-9(e)(13)(iv)(C) or (D)), relating to rules for governing body.

(iii) **Factors not adversely affecting determination.** The presence of some or all of the following factors will not be considered as preventing the transferee "from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes" (within the meaning of paragraph (a)(8)(i) of this section):

(A) Name. The fund is given a name or other designation which is the same as or similar to that of the transferor private foundation or otherwise memorializes the creator of the foundation or his family.

(B) Purpose. The income and assets of the fund are to be used for a designated purpose or for one or more particular section 509(a)(1), (2), or (3) organizations, and such use is consistent with the charitable, educational, or other basis for the exempt status of the public charity under section 501(c)(3).

(C) Administration. The transferred assets are administered in an identifiable or separate fund, some or all of the principal of which is not to be distributed for a specified period, if the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the legal and equitable owner of the fund and the governing body exercises ultimate and direct authority and control over such fund, as, for example, a fund to endow a chair at a university or a medical research fund at a hospital. In the case of a community trust, the transferred assets must be administered in or as a component part of the community trust within the meaning of § 1.170A–9(e)(11).

(D) Restrictions on disposition. The transferor private foundation transfers property the continued retention of which by the transferee is required by the transferor if such retention is important to the achievement of charitable or other similar purposes in the community because of the peculiar features of such property, as, for example, where a private foundation transfers a woodland preserve which is to be maintained by the public charity as an arboretum for the benefit of the community. Such a restriction does not include a restriction on the disposition of an investment asset or the distribution of income.

(iv) Adverse factors. The presence of any of the following factors will be considered as preventing the transferee "from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes" (within the meaning of paragraph (a)(8)(i) of this section):

(A) Distributions. (1) With respect to distributions made after April 19, 1977, the transferor private foundation, a disqualified person with respect thereto, or any person or committee designated by, or pursuant to the terms of an agreement with, such a person (hereinafter referred to as "donor"), reserves the right, directly or indirectly, to name (other than by designation in the instrument of transfer of particular section 509(a)(1), (2), or (3) organizations) the persons to which the transferee public charity must distribute, or to direct the timing of such distributions (other than by direction in the instrument of transfer that some or all of the principal, as opposed to specific assets, not be distributed for a specified period) as, for example, by a power of appointment. The Internal Revenue Service will examine carefully whether the seeking of advice by the transferee from, or the giving of advice by, any donor after the assets have been transferred to the transferee constitutes an indirect reservation of a right to direct such distributions. In any such case, the reservation of such a right will be considered to exist where the only criterion considered by the public charity in making a distribution of income or principal from a donor's fund is advice offered by the donor. Whether there is a reservation of such a right will be determined from all of the facts and circumstances, including, but not limited to, the facts contained in paragraph (a)(8)(iv)(A)(2) and (3) of this section.

(2) The presence of some or all of the following factors will indicate that the reservation of such a right does not exist:

(i) There has been an independent investigation by the staff of the public charity evaluating whether the donor's advice is consistent with specific charitable needs most deserving of support by the public charity (as determined by the public charity);

(ii) The public charity has promulgated guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity and the donor's advice is consistent with such guidelines;

(iii) The public charity has instituted an educational program publicizing to donors and other persons the guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity;

(iv) The public charity distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor; and

(v) The public charity's solicitations (written or oral) for funds specifically state that such public charity will not be bound by advice offered by the donor.

(3) The presence of some or all of the following factors will indicate the reservation of such a right does exist:

(i) The solicitations (written or oral) of funds by the public charity state or imply, or a pattern of

conduct on the part of the public charity creates an expectation, that the donor's advice will be followed;

(ii) The advice of a donor (whether or not restricted to a distribution of income or principal from the donor's trust or fund) is limited to distributions of amounts from the donor's fund, and the factors described in paragraph (a)(8)(iv)(A)(2) or (i) or (ii) of this section are not present;

(iii) Only the advice of the donor as to distributions of such donor's fund is solicited by the public charity and no procedure is provided for considering advice from persons other than the donor with respect to such fund; and

(iv) For the taxable year and all prior taxable years the public charity follows the advice of all donors with respect to their funds substantially all of the time.

(B) Other action or withholding of action. The terms of the transfer agreement, or any expressed or implied understanding, required the public charity to take or withhold action with respect to the transferred assets which is not designed to further one or more of the exempt purposes of the public charity, and such action or withholding of action would, if performed by the transferor private foundation with respect to such assets, have subjected the transferor to tax under chapter 42 (other than with respect to the minimum investment return requirement of section 4942(e)).

(C) Assumption of leases, etc. The public charity assumes leases, contractual obligations, or liabilities of the transferor private foundation, or takes the assets thereof subject to such liabilities (including obligations under commitments or pledges to donees of the transferor private foundation), for purposes inconsistent with the purposes or best interests of the public charity, other than the payment of the transferor's chapter 42 taxes incurred prior to the transfer to the public charity to the extent of the value of the assets transferred.

(D) Retention of investment assets. The transferee public charity is required by any restriction or agreement (other than a restriction or agreement imposed or required by law or regulatory authority), express or implied, to retain any securities or other investment assets transferred to it by the private foundation. In a case where such transferred assets consistently produce a low annual return of income, the Internal Revenue Service will examine carefully whether the transferee is required by any such restriction or agreement to retain such assets.

(E) Right of first refusal. An agreement is entered into in connection with the transfer of securities or other property which grants directly or indirectly to the transferor private foundation or any disqualified person with respect thereto a right of first refusal with respect to the transferred securities or other property when and if disposed of by the public charity, unless such securities or other property was acquired by the transferor private foundation subject to such right of first refusal prior to October 9, 1969.

(F) Relationships. An agreement is entered into between the transferor private foundation and the transferee public charity which establishes irrevocable relationships with respect to the maintenance or management of assets transferred to the public charity, such as continuing relationships with banks, brokerage firms, investment counselors, or other advisors with regard to the investments or other property transferred to the public charity (other than a relationship with a trustee, custodian, or agent for a community trust acting as such). The transfer of property to a public charity subject to contractual obligations which were established prior to November 11, 1976 between the transferor private foundation and persons other than disqualified persons with respect to such foundation will not be treated as prohibited under the preceding sentence, but only if such contractual obligations were not entered into pursuant to a plan to terminate the private foundation status of the transferor under section 507(b)(1)(A) and if the continuation of such contractual obligations is in the best interests of the public charity.

(G) Other conditions. Any other condition is imposed on action by the public charity which prevents it from exercising ultimate control over the assets received from the transferor private foundation for purposes consistent with its exempt purposes.

(v) Examples. The provisions of paragraph (a)(8) of this section may be illustrated by the following examples:

Example (1). The M Private Foundation transferred all of its net assets to the V Cancer Institute, a public charity described in section 170(b)(1)(A)(iii). Prior to the transfer, M's activities consisted of making grants to hospitals and universities to further research into the causes of cancer. Under the terms of the transfer, V is required to keep M's assets in a separate fund and use the income and principal to further cancer research. Although the assets may be used only for a limited purpose, this purpose is consistent with and in furtherance of V's exempt purposes, and does not prevent the

transfer from being a distribution for purposes of section 507(b)(1)(A).

Example (2). The N Private Foundation transferred all of its net assets to W University, a public charity described in section 170(b)(1)(A)(ii). Under the terms of the transfer, W is required to use the income and principal to endow a chair at the university to be known as the "John J. Doe Memorial Professorship", named after N's creator. Although the transferred assets are to be used for a specified purpose by W, this purpose is in furtherance of W's exempt educational purposes, and there are no conditions on investment or reinvestment of the principal or income. The use of the name of the foundation's creator for the chair is not a restriction which would prevent the transfer from being a distribution for purposes of section 507(b)(1)(A).

Example (3). The O Private Foundation transferred all of its net assets to X Bank as trustee for the P Community Trust, a community trust which is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, X is to hold the assets in trust for P and is directed to distribute the income annually to the Y Church, a public charity described in Section 170(b)(1)(A)(i). The distribution of income to Y Church is consistent with P's exempt purposes. If the trust created by this transfer otherwise meets the requirements of § 1.170A-9(e)(11) as a component part of P Community Trust, and assets transferred by O to X will be treated as distributed to one or more public charities within the meaning of section 507(b)(1)(A). The direction to distribute the income to Y Church meets the conditions of paragraph (a)(8)(iii)(B) of this section and will therefore not disqualify the transfer under section 507(b)(1)(A).

Example (4). The U Private Foundation transferred all of its net assets to Z Bank as trustee for the R Community Trust, a community trusl which is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, Z is to hold the assets in trust for R and distribute the income to those public charities described in section 170(b)(1)(A)(i) through (vi) that are designated by B, the creator of U. R's governing body has no authority during B's lifetime to vary B's direction. Under the terms of the transfer, it is intended that Z retain the transferred assets in their present form for a period of 20 years, or until the date of B's death if it occurs before the expiration of such period. Upon the death of B, R will have the power to distribute the income to such public charities as it selects and may dispose of the corpus as it sees fit.

Under paragraph (a)(8)(iv)(A) or (D) of this section, as a result of the restrictions imposed with respect to the transferred assets, there has been no distribution of all U's net assets within the meaning of section 507(b)(1)(A) at the time of the transfer. In addition, U has not transferred its net assets to a component part of R Community Trust, but rather to a separate trust described in § 1.170A-9(e)(14).

(vi) Transitional rule. If the governing instrument of the public charity (or an instrument of transfer) lacks the factors described in paragraph (a)(8)(i)(D) or (ii) of this section, but with respect to gifts or bequests acquired before January 1, 1982, the public charity changes its governing instrument (or instrument of transfer) by the later of November 11, 1977, or one year after the gift or bequest is acquired, in order to conform such instrument to such provisions, then such an instrument shall be treated as consistent with such provisions for taxable years beginning prior to the date of change. In addition, if prior to the later of such dates, the organization has instituted court proceedings in order to conform such an instrument, then it may apply (prior to the later of such dates) for an extension of the period to conform such instrument to such provisions. Such application shall be made to the Commissioner of Internal Revenue, Attention E:EO, Washington, D.C. 20224. The Commissioner, at the Commissioner's discretion, may grant such an extension, if in the Commissioner's opinion such a change will conform the instrument to such provisions, and the change will be made within a reasonable time.

(b) Operation as a public charity—(1) In general. Under section 507(b)(1)(B) an organization can terminate its private foundation status if the organization:

(i) Meets the requirements of section 509(a)(1), (2), or (3) by the end of the 12-month period (as extended by paragraph (c)(3)(i) of this section) beginning with its first taxable year which begins after December 31, 1969, or for a continuous period of 60 calendar months beginning with the first day of any taxable year which begins after December 31, 1969;

(ii) In compliance with section 507(b)(1)(B)(ii) and subparagraph (3) of this paragraph, properly notifies the district director before the commencement of such 12-month or 60-month period or before March 29, 1973 that it is terminating its private foundation status; and

(iii) Properly establishes immediately after the expiration of such 12-month or 60-month period that such organization has complied with the requirements of section 509(a)(1), (2), or (3) by the end of the 12-month period or during the 60-month period, as the case may be, in the manner described in subparagraph (4) of this paragraph.

(2) Relationship of section 507(b)(1)(B) to section 507(a), (c), and (g). Since section 507(a) does not apply to a termination described in section 507(b)(1)(B), a private foundation's notification that it is commencing a termination pursuant to section 507(b)(1)(B) will not be treated as a notification described in section 507(a) even if the private foundation does not successfully terminate its private foundation status pursuant to section 507(b)(1)(B). A private foundation which terminates its private foundation status under section 507(b)(1)(B) does not incur tax under section 507(c) and, therefore, no abatement of such tax under section 507(g) is required.

(3) Notification of termination. In order to comply with the requirements under section

507(b)(1)(B)(ii), an organization shall before the commencement of the 12-month or 60-month period under section 507(b)(1)(B)(i) (or before March 29, 1973) or, in the case of the 12-month period for a community trust, before May 11, 1977, notify the district director of its intention to terminate its private foundation status.

Such notification shall contain the following information:

(i) The name and address of the private foundation;

(ii) Its intention to terminate its private foundation status;

(iii) Whether the 12-month or 60-month period shall apply;

(iv) The Code section under which it seeks classification (section 509(a)(1), (2), or (3));

(v) If section 509(a)(1) is applicable, the clause of section 170(b)(1)(A) involved;

(vi) The date its regular taxable year begins; and

(vii) The date of commencement of the 12-month or 60-month period.

(4) **Establishment of termination.** In order to comply with the requirements under section 507(b)(1)(B)(iii), an organization shall within 90 days after the expiration of the 12-month or 60-month period, file such information with the district director as is necessary to make a determination as to the organization's status as an organization described under section 509(a)(1), (2), or (3) and the regulations thereunder. See paragraphs (c) and (d) of this section as to the information required to be submitted under this subparagraph.

(5) **Incomplete information; 12- and 60-month terminations.** The failure to supply, within the required time, all of the information required by subparagraph (3) or (4) of this paragraph is not alone sufficient to constitute a failure to satisfy the requirements of section 507(b)(1)(B). If the information which is submitted within the required time is incomplete and the organization supplies the necessary additional information at the request of the Commissioner within the additional time period allowed by him, the original submission will be considered timely.

(6) **Application of special rules and filing requirements.** An organization which has terminated its private foundation status under section 507(b)(1)(B) is not required to comply with the special rules set forth in section 508(a) and (b). Such organization is also not required to file a return under the provisions of section 6043(b) or 6050 by reason of termination of its private foundation status under the provisions of section 507(b)(1)(B).

(7) **Extension of time to assess deficiencies.** If a private foundation files a notification (described in subparagraph (3) of this paragraph) that it intends to begin a 60-month termination pursuant to section 507(b)(1)(B) and does not file a request for an advance ruling pursuant to paragraph (e) of this section, such private foundation may file with the notification described in subparagraph (3) of this paragraph a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the 60-month termination period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the 60-month period. Such consents, if filed, will ordinarily be accepted by the Commissioner. See paragraph (f)(3) of this section for an illustration of the procedure required to obtain a refund of the tax imposed by section 4940 in a case where such a consent is not in effect.

(c) **Twelve-month terminations—(1) Method of determining normal sources of support—(i) In general.** The 12-month termination provisions of section 507(b)(1)(B) permit a private foundation to terminate its private foundation status by changing its organizational structure, its operations, the sources of its support, or any combination thereof, in order to conform to the requirements of section 509(a)(1), (2), or (3) by the end of the 12-month period.

(ii) **Support requirements for 12-month termination under section 170(b)(1)(A)(vi).** A private foundation attempting to meet the requirements of section 509(a)(1) as an organization described in section 170(b)(1)(A)(vi) will be considered "normally" to receive a substantial part of its support from governmental units or direct or indirect contributions from the general public if it can establish that it has changed the sources of its support before the close of the 12-month period to those of an organization described in section 170(b)(1)(A)(vi) and it can reasonably be expected to maintain its publicly supported status for subsequent years. In order to establish these facts, an organization shall submit all information sufficient to make a determination under § 1.170A–9(e) as if such provisions applied, including a description of all organizational and operational changes which have occurred during the 12-month period. It

shall also submit detailed information with respect to its sources of support for the 12-month period, as well as for the four taxable years immediately preceding the 12-month period. In applying the tests contained in § 1.170A-9(e), however, data from periods preceding the 12-month period shall be disregarded except for purposes of determining whether the organization has effectively changed its sources of support and whether it can reasonably be expected to maintain such publicly supported status for subsequent years. Thus, for example, in applying the mathematical tests of § 1.170A-9(e) only data for the 12-month period may enter into the computation.

(iii) Support requirements for 12-month terminations under section 170(b)(1)(A)(iv). Section 170(b)(1)(A)(iv) describes an organization which "normally" receives a substantial part of its support (exclusive of income from related activities) from the United States or any State or political subdivision thereof, or from the general public, and which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of certain colleges or universities. For purposes of the 12-month termination period, the rule set forth in subdivision (ii) of this subparagraph with respect to section 170(b)(1)(A)(vi) organizations shall be applicable in determining whether an organization "normally" receives a substantial part of its support from the sources required under section 170(b)(1)(A)(iv).

(iv) Support requirements for 12-month terminations under section 509(a)(2). An organization attempting to terminate its private foundation status under section 507(b)(1)(B) by meeting the requirements of section 509(a)(2) by the end of the 12-month period will be considered as "normally" receiving its support in compliance with the one-third support requirements of section 509(a)(2) if:

(A) For the 12-month period under section 507(b)(1)(B), the organization receives more than one-third of its support from gifts, grants, contributions, membership fees, and gross receipts from related activities (as limited by section 509(a)(2)(A)(ii)) and not more than one-third of its support from items described in section 509(a)(2)(B), and

(B) The organization can establish that it can reasonably be expected to maintain its continued public support for subsequent years. In order to establish a reasonable expectation of continued public support, an organization shall submit a detailed statement describing its past and current operations, any organizational or operational changes and when such changes have occurred, and any changes in its foundation managers (as defined in section 4946(b)(1)). Duplicate copies of its governing instrument and bylaws, with an indication of any amendments made, and detailed information with respect to its sources of support for the 4 taxable years immediately preceding the 12-month period shall also be submitted as part of the evidence that the organization can reasonably be expected to maintain its publicly supported status.

(2) Organizational and operational tests—(i) Section 509(a)(3) organizations—(A) In general. An organization attempting to terminate its private foundation status under section 507(b)(1)(B) by meeting the requirements of section 509(a)(3) by the end of the 12-month period is required to meet the organizational and operational test of section 509(a)(3)(A), in addition to the requirements of section 509(a)(3)(B) and (C), by the end of the 12-month period beginning with its first taxable year which begins after December 31, 1969. An organization may qualify under section 509(a)(3)(A) even though its original governing instrument did not limit its purposes to those set forth in section 509(a)(3)(A) and even though it operated for some other purpose before the end of the 12-month period, if it has amended its governing instrument and changed its operations to conform to the requirements of section 509(a)(3) by the end of the 12-month period.

(B) Proof of changed status. In order to establish that an organization described in (A) of this subdivision will continue to be operated exclusively for the required purposes in years subsequent to the end of the 12-month period, such organization shall submit a detailed statement describing its past and current operations, any organizational or operational changes and when such changes have occurred, any changes in foundation managers (as defined in section 4946(b)(1)), and duplicate copies of its governing instrument and bylaws, with an indication of any amendments made. A detailed statement of the relationship between such organization and the specified organizations described in section 509(a)(1) or (2) (as required by section 509(a)(3)(A) and (B)) and all pertinent information to establish that the organization does not violate the control requirements of section 509(a)(3)(C) shall also be submitted.

(ii) Section 509(a)(1) organizations other than those described in section 170(b)(1)(A)(vi)—(A) In general. An organization attempting to terminate its private foundation status under section

507(b)(1)(B) by meeting the requirements of section 170(b)(1)(A)(i), (ii), (iii), (iv), or (v) by the end of the 12-month period is required to be operated as an organization described in clauses (i), (ii), (iii), (iv), or (v) of section 170(b)(1)(A) by the end of the 12-month period beginning with its first taxable year which begins after December 31, 1969.

(B) Proof of changed status. In order to establish that it will continue to be operated as an organization described in section 509(a)(1) in years subsequent to the end of the 12-month period, the organization shall submit a detailed statement describing its past and current operations, any organizational or operational changes and when such changes have occurred, and any changes in its foundation managers (as defined in section 4946(b)(1)). Duplicate copies of its governing instrument and bylaws, with an indication of any amendments made, and its financial statements for the 4-taxable years immediately preceding the 12-month period shall also be submitted as evidence that the organization can reasonably be expected to maintain its status as an organization described in section 170(b)(1)(A)(i), (ii), (iii), (iv), or (v).

(3) Extensions of the 12-month period. (i) For purposes of this section, an organization may accomplish a 12-month termination if it meets the requirements of section 507(b)(1)(B) and this paragraph for such a termination with respect to any of the following periods:

(A) The 12-month period beginning with the organization's first taxable year which begins after December 31, 1969;

(B) The period described in paragraph (a)(5)(ii) of this section; or

(C) Any period consisting of two or more taxable years beginning with the organization's first taxable year beginning after December 31, 1969, and ending with any taxable year ending before the end of the period described in paragraph (a)(5)(ii) of this section.

(ii) An organization will be considered as "normally" meeting the requirements of section 170(b)(1)(A)(iv) or (vi) or 509(a)(2), as the case may be, if it meets the requirements of such provision with respect to any period described in subdivision (i)(A), (B), or (C) of this subparagraph. Thus, for example, an organization on a calendar year basis which seeks to convert to a section 509(a)(2) organization under section 507(b)(1)(B) may meet the one-third support requirement based on the aggregate support received during a period described in subdivision (i)(A), (B), or (C) of this subparagraph, for purposes of subparagraph (1)(iv) of this paragraph.

(4) Status of organization subsequent to the 12-month period. For purposes of sections 507 through 509, an organization, the status of which as a private foundation is terminated under section 507(b)(1), shall (except as provided in paragraph (b)(6) of this section) be treated as an organization created on the day after the date of such termination. However, termination of private foundation status under the provisions of section 507(b)(1)(B) is based upon an organization's submission of information establishing compliance by the end of the 12-month period with the requirements of subparagraph (1) or (2) of this paragraph. Therefore, if in the 4 taxable years immediately following the end of the 12-month period, the sources of support or the methods of operation of the organization are materially different from the facts and circumstances presented during the 12-month period upon which the determination under section 507(b)(1)(B)(iii) was made (and such material difference adversely affects such determination), the organization will be deemed not to have satisfied the requirements of section 507(b)(1)(B). Under such circumstances, section 509(c) will not apply and the organization will continue to remain subject to the provisions of section 507. However, the status of grants and contributions under sections 170, 4942, and 4945 will not be affected until the Internal Revenue Service makes notice to the public (such as by publication in the Internal Revenue Bulletin) that the organization has been deleted from classification as an organization described in section 509(a)(1), (2), or (3) unless the donor (1) was in part responsible for, or was aware of, the act or failure to act that resulted in the organization's inability to satisfy the requirements of section 507(b)(1)(B), or (2) had knowledge that such organization would be deleted from classification as an organization described in section 509(a)(1), (2), or (3). Prior to the making of any grant or contribution which allegedly will not result in the grantee's loss of classification under section 509(a)(1), (2), or (3), a potential grantee organization may request a ruling whether such grant or contribution may be made without such loss of classification. A request for such ruling may be filed by the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner.

(d) Sixty-month terminations—(1) Method of determining normal sources of support. (i) In order to meet the requirement of section

507(b)(1)(B) for the 60-month termination period as a section 509(a)(1) or (2) organization, an organization must meet the requirements of section 509(a)(1) or (2), as the case may be, for a continuous period of at least 60 calendar months. In determining whether an organization seeking status under section 509(a)(1) as an organization described in section 170(b)(1)(A)(iv) or (vi) or under section 509(a)(2) "normally" meets the requirements set forth under such sections, support received in taxable years prior to the commencement of the 60-month period shall not be taken into consideration, except as otherwise provided in this section. Therefore, in such cases rules similar to the rules applicable to new organizations would apply.

(ii) For purposes of section 507(b)(1)(B), an organization will be considered to be a section 509(a)(1) organization described in section 170(b)(1)(A)(vi) for a continuous period of 60 calendar months only if the organization satisfies the provisions of § 1.170A–9(e) based upon aggregate data for such entire period, rather than for any shorter period set forth in § 1.170A–9(e). Except for the substitution of such 60-month period for the periods described in § 1.170A–9(e), all other provisions of such regulations pertinent to determining an organization's normal sources of support shall remain applicable.

(iii) For purposes of section 507(b)(1)(B), an organization will be considered to be a section 509(a)(2) organization only if such organization meets the support requirements set forth in section 509(a)(2)(A) and (B) for the continuous period of 60 calendar months prescribed under section 507(b)(1)(B), rather than for any shorter period set forth in the regulations under section 509(a)(2). Except for the substitution of such 60-month period for the periods described in the regulations under section 509(a)(2), all other provisions of such regulations pertinent to determining an organization's normal sources of support shall remain applicable.

(2) Organizational and operational tests. In order to meet the requirements of section 507(b)(1)(B) for the 60-month termination period as an organization described in section 170(b)(1)(A)(i), (ii), (iii), (iv), or (v) or section 509(a)(3), as the case may be, an organization must meet the requirements of the applicable provision for a continuous period of at least 60 calendar months. For purposes of section 507(b)(1)(B), an organization will be considered to be such an organization only if it satisfies the requirements of the applicable provision (including with respect to section 509(a)(3), the organizational and operational test set forth in subparagraph (A) thereof) at the commencement of such 60-month period and continuously thereafter during such period.

(e) Advance rulings for 60-month terminations—(1) In general. An organization which files the notification required by section 507(b)(1)(B)(ii) that it is commencing a 60-month termination may obtain an advance ruling from the Commissioner that it can be expected to satisfy the requirements of section 507(b)(1)(B)(i) during the 60-month period. Such an advance ruling may be issued if the organization can reasonably be expected to meet the requirements of section 507(b)(1)(B)(i) during the 60-month period. The issuance of a ruling will be discretionary with the Commissioner.

(2) Basic consideration. In determining whether an organization can reasonably be expected (within the meaning of subparagraph (1) of this paragraph) to meet the requirements of section 507(b)(1)(B)(i) for the 60-month period, the basic consideration is whether its organizational structure (taking into account any revisions made prior to the beginning of the 60-month period), proposed programs or activities, intended method of operation, and projected sources of support are such as to indicate that the organization is likely to satisfy the requirements of section 509(a)(1), (2), or (3) and paragraph (d) of this section during the 60-month period. In making such a determination, all pertinent facts and circumstances shall be considered.

(3) Reliance by grantors and contributors. For purposes of sections 170, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, grants or contributions to an organization which has obtained a ruling referred to in this paragraph will be treated as made to an organization described in section 509(a)(1), (2), or (3), as the case may be, until notice that such advance ruling is being revoked is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's failure to meet the requirements of section 509(a)(1), (2), or (3), or acquired knowledge that the Internal Revenue Service had given notice to such organization that its advance ruling would be revoked. Prior to the making of any grant or contribution which allegedly will not result in the grantee's failure to meet the requirements of section 509(a)(1), (2), or (3), a potential grantee organization may request a ruling whether such grant or contribution may be made without

such failure. A request for such ruling may be filed by the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination on the factors referred to in subparagraph (2) of this paragraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522.

(4) Reliance by organization. An organization obtaining an advance ruling pursuant to this paragraph cannot rely on such a ruling. Consequently, if the organization does not pay the tax imposed by section 4940 for any taxable year or years during the 60-month period, and it is subsequently determined that such tax is due for such year or years (because the organization did not in fact complete a successful termination pursuant to section 507(b)(1)(B) and was not treated as an organization described in section 509(a)(1), (2), or (3) for such year or years), the organization is liable for interest in accordance with section 6601 if any amount of tax under section 4940 has not been paid on or before the last date prescribed for payment. However, since any failure to pay such tax during the 60-month period (or prior to the revocation of such ruling) is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

(5) Extension of time to assess deficiencies. The advance ruling described in subparagraph (1) of this paragraph shall be issued only if such organization's request for an advance ruling is filed with a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the advance ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the 60-month period.

(f) Effect on grantors or contributors and on the organization itself—(1) Effect of satisfaction of requirements for termination—(i) Treatment during the termination period. In the event that an organization satisfies the requirements of section 507(b)(1)(B) for termination of its private foundation status by the end of the 12-month period or during the continuous 60-month period, such organization shall be treated for such entire 12-month or 60-month period in the same manner as an organization described in section 509(a)(1), (2), or (3).

(ii) Twelve-month terminations by fiscal year organizations. In the case of an organization which operates on a fiscal year basis and terminates its private foundation status by the end of the 12-month period beginning with its first taxable year which begins after December 31, 1969, such 12-month period shall, for purposes of this paragraph, be treated as including the period between January 1, 1970, and the last day of the taxable year immediately preceding its first taxable year which begins after December 31, 1969, so long as the requirements of section 507(b)(1)(B) and paragraph (c) of this section are met by the end of the 12-month period (including such additional period).

(2) Failure to meet termination requirements—(i) In general. Except as otherwise provided in subdivision (ii) of this subparagraph and paragraph (e) of this section, any organization which fails to satisfy the requirements of section 507(b)(1)(B) for termination of its private foundation status by the end of the 12-month period or during the continuous 60-month period shall be treated as a private foundation for the entire 12-month or 60-month period, for purposes of sections 507 through 509 and chapter 42, and grants or contributions to such an organization shall be treated as made to a private foundation for purposes of sections 170, 507(b)(1)(A), 4942, and 4945.

(ii) Certain 60-month terminations. Notwithstanding subdivision (i) of this subparagraph, if an organization fails to satisfy the requirements of section 509(a)(1), (2), or (3) for the continuous 60-month period but does satisfy the requirements of section 509(a)(1), (2), or (3), as the case may be, for any taxable year or years during such 60-month period, the organization shall be treated as a section 509(a)(1), (2), or (3) organization for such taxable year or years and grants or contributions made during such taxable year or years shall be treated as made to an organization described in section 509(a)(1), (2), or (3). In addition, sections 507 through 509 and chapter 42 shall not apply to such organization for any taxable year within such 60-month period for which it does meet such requirements. For purposes of determining whether an organization satisfies the requirements of section 509(a)(1), (2), or (3) for any taxable year in the 60-month period, the organization shall be treated as if it were a new organization with its first taxable year beginning on the date of the commencement of the 60-month period. Thus, for

example, if an organization were attempting to terminate its private foundation status under section 507(b)(1)(B) by meeting the requirements of section 170(b)(1)(A)(vi), the rules under § 1.170A–9(e) relating to the initial determination of status of a new organization would apply.

(iii) Aggregate tax benefit. For purposes of section 507(d), the organization's aggregate tax benefit resulting from the organization's section 501(c)(3) status shall continue to be computed from the date from which such computation would have been made, but for the notice filed under section 507(b)(1)(B)(ii), except that any taxable year within such 60-month period for which such organization meets the requirements of section 509(a)(1), (2), or (3) shall be excluded from such computations.

(iv) Excess business holdings. See section 4943 and the regulations thereunder for rules relating to decreases in a private foundation's holdings in a business enterprise which are caused by the foundation's failure to terminate its private foundation status after giving the notification for termination under section 507(b)(1)(B)(ii).

(3) Example. The provisions of this paragraph may be illustrated by the following example:

Example. Y, a calendar year private foundation, notifies the district director that it intends to terminate its private foundation status by converting into a publicly supported organization described in section 170(b)(1)(A)(vi) and that its 60-month termination period will commence on January 1, 1974. Y does not obtain a ruling described in paragraph (e) of this section. Based upon its support for 1974 Y does not qualify as a publicly supported organization within the meaning of § 1.170A–9(e) and this paragraph. Consequently, in order to avoid the risks of penalties and interest if Y fails to terminate within the 60-month period, Y files its return as a private foundation and pays the tax imposed by section 4940. Similarly, based upon its support for the period 1974 through 1975, fails to qualify as such a publicly supported organization and files its return and pays the tax imposed by section 4940 for both 1975 and 1976. Since a consent (described in paragraph (b)(7) of this section) which would prevent the period of limitation from expiring is not in effect, in order to be able to file a claim for refund, Y and the district director agree to extend the period of limitation for all taxes imposed under chapter 42. However, based upon its support for the period 1974 through 1976 Y does qualify as a publicly supported organization, and therefore shall not be treated as a private foundation for either 1977 or 1978 even if it fails to terminate within the 60-month period. However, based upon the aggregate data for the entire 60-month period (1974 through 1978), Y does qualify as an organization described in section 170(b)(1)(A)(vi). Consequently, pursuant to this paragraph, Y is treated as if it had been a publicly supported organization for the entire 60-month period. Y files claim for refund for the taxes paid under section 4940 for the years 1974, 1975, and 1976, and such taxes are refunded.

(g) Special transitional rules for organizations operating as public charities. Section 4940 imposes a tax upon private foundations with respect to the carrying on of activities for each taxable year. For purposes of section 4940, an organization which terminates its private foundation status under section 507(b)(1)(B) by the end of the period described in paragraph (a)(5)(ii) of this section will not be considered as carrying on activities within the meaning of section 4940 during such period. Such organization will therefore not be subject to the tax imposed under section 4940 for such period. Consequently, in the case of an organization seeking to terminate its private foundation status under section 507(b)(1)(B) if the period described in paragraph (a)(5)(ii) of this section has not expired prior to the due date for the organization's annual return required to be filed under section 6033 or 6012 (determined with regard to any extension of time for filing the return) for its first taxable year which begins after December 31, 1969 (or any other taxable year ending before the expiration of the period described in paragraph (a)(5)(ii) of this paragraph) and if the organization has not terminated its private foundation status under section 507(b)(1)(B) by such date, then notwithstanding the provisions of paragraph (f) of this section, the organization must take either of the following courses of action:

(1) Complete and file its annual return including the line relating to excise taxes on investment income, by such date, and pay the tax on investment income imposed under section 4940 at the time it files its annual return. If such organization subsequently terminates its private foundation status under section 507(b)(1)(B) within a period specified in paragraph (c)(3)(i) of this section, it may file a claim for refund of the tax paid under section 4940; or

(2) Complete and file its annual return, except for the line relating to excise taxes on investment income, by such date, and in lieu of paying the tax on investment income imposed under section 4940, file a statement with its annual return which establishes that the organization has taken affirmative action by such date to terminate its private foundation status under section 507(b)(1)(B). Such statement must indicate the type of affirmative action taken and explain how such action will result in the termination of its private foundation status under section 507(b)(1)(B). Such affirmative action may include making application to the appropriate State court for approval to amend the provisions of the organization's trust instrument to limit payments to specified section 509(a)(1) or (2) beneficiaries pursuant to section 509(a)(3) in the case of a charitable trust; commencing a fund-

raising drive among the general public in the case of an organization seeking to become a section 170(b)(1)(A)(vi) or 509(a)(2) organization; or the passage of a resolution by the organization's governing body or the filing of an amendment to the organization's articles of incorporation permitting a change in the operations of the organization to enable it to conform to the provisions of section 509(a)(1), (2), or (3) in the case of a not-for-profit corporation. An organization may take such affirmative action and may terminate its private foundation status under section 507(b)(1)(B) in reliance upon 26 CFR 13.12 (rev. as of Jan. 1, 1972) and upon the provisions of the notices of proposed rulemaking under sections 170(b)(1)(A), 507(b)(1), and 509. Thus, if an organization meets the requirement of the provisions of the notice of proposed rulemaking as a section 509(a)(3) organization, such organization may terminate its private foundation status under section 507(b)(1)(B) in reliance upon such provisions prior to the expiration of the period described in paragraph (a)(5)(ii) of this section. If such organization, however, fails to terminate its private foundation status under section 507(b)(1)(B) within the period specified in paragraph (a)(5)(ii) of this section by failing to meet the requirements of either the notices of proposed rulemaking under section 170(b)(1)(A), 507(b)(1), or 509 or the final regulations published under these Code sections, the tax imposed under section 4940 shall be treated as if due from the due date for its annual return (determined without regard to any extension of time, for filing its return).

[T.D. 7248, 38 FR 861, Jan. 5, 1973; 38 FR 3598, Feb. 8, 1973; 38 FR 4259, Feb. 12, 1973, as amended by T.D. 7290, 38 FR 31833, Nov. 19, 1973; T.D. 7440, 41 FR 50654, Nov. 17, 1976; 41 FR 52454, Nov. 30, 1976; T.D. 7465, 42 FR 4437, Jan. 25, 1977; T.D. 7784, 47 FR 37889, July 23, 1981]

§ 1.507-3 Special rules; transferee foundations.

(a) General rule. (1) For purposes of Part II, Subchapter F, Chapter 1 of the Code, in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, the transferee organization shall not be treated as a newly created organization. Thus, in the case of a significant disposition of assets to one or more private foundations within the meaning of paragraph (c) of this section, the transferee organization shall not be treated as a newly created organization. A transferee organization to which this paragraph applies shall be treated as possessing those attributes and characteristics of the transferor organization which are described in subparagraphs (2), (3), and (4) of this paragraph.

(2)(i) A transferee organization to which this paragraph applies shall succeed to the aggregate tax benefit of the transferor organization in an amount determined as follows: Such amount shall be an amount equal to the amount of such aggregate tax benefit multiplied by a fraction the numerator of which is the fair market value of the assets (less encumbrances) transferred to such transferee and the denominator of which is the fair market value of the assets of the transferor (less encumbrances) immediately before the transfer. Fair market value shall be determined as of the time of the transfer.

(ii) Notwithstanding subdivision (i) of this subparagraph, a transferee organization which is not effectively controlled (within the meaning of § 1.482-1(a)(3)), directly or indirectly, by the same person or persons who effectively control the transferor organization shall not succeed to an aggregate tax benefit in excess of the fair market value of the assets transferred at the time of the transfer.

(iii) This subparagraph may be illustrated by the following examples:

Example (1). Pursuant to a transfer described in section 507(b)(2), F, a private foundation, transfers to G, a private foundation, all of its assets, which have a fair market value of $400,000. Immediately before the transfer F's aggregate tax benefit was $200,000, and G's aggregate tax benefit was $300,000. After the transfer G's aggregate tax benefit is $500,000 ($200,000 + $300,000).

Example (2). Pursuant to a transfer described in section 507(b)(2), M, a private foundation, transfers all of its assets, which immediately prior to the transfer have a fair market value of $100,000. The assets were transferred to the following organizations at the following fair market values (determined at the time of transfer) $40,000 to N, a private foundation, $30,000 to O, a private foundation, and $30,000 to P, an organization described in section 170(b)(1)(A)(vi). Immediately before the transfer M's aggregate tax benefit was $50,000. Therefore, N succeeds to M's aggregate tax benefit to the extent of $20,000 ($50,000 × $40,000/$100,000) and O succeeds to M's aggregate tax benefit to the extent of $15,000 ($50,000 × $30,000/$100,000). The remaining $15,000 of M's aggregate tax benefit is retained by M as M has not terminated under section 507.

Example (3). Assume the same facts as in Example (2) except that the transfers were made as follows: M transferred $30,000 to N on January 1, 1972, $40,000 to P on July 1, 1972, and $30,000 to O on December 31, 1972. Further, assume that the fair market value of the assets and the aggregate tax benefit do not change during 1972 and that O is not effectively controlled (directly or indirectly) by the same person or persons who effectively control M. N succeeds to M's aggregate tax benefit to the extent of $15,000 ($50,000 × $30,000/$100,000). However, since $40,000 of the remaining $70,000 ($100,000–

$30,000) of assets of M was transferred to P on July 1, 1972, immediately before the transfer to O, the fair market value of the assets held by M is $30,000 ($70,000–$40,000). On the other hand, because P is not a private foundation, M's aggregate tax benefit immediately before the transfer to O remains $35,000 ($50,000–$15,000). Therefore, before applying subdivision (ii) of this subparagraph, O would succeed to $35,000 ($35,000 × $30,000/$30,000) of M's aggregate tax benefit. However, applying subdivision (ii) of this subparagraph since M transferred only $30,000 to O, O shall succeed to only $30,000 of M's aggregate tax benefit. The remaining $5,000 ($35,000–$30,000) of M's aggregate tax benefit is retained by M as M has not terminated under section 507.

(3) For purposes of section 507(d)(2), in the event of a transfer of assets described in section 507(b)(2), any person who is a "substantial contributor" (within the meaning of section 507(d)(2)) with respect to the transferor foundation shall be treated as a "substantial contributor" with respect to the transferee foundation, regardless of whether such person meets the $5,000-two percent test with respect to the transferee organization at any time. If a private foundation makes a transfer described in section 507(b)(2) to two or more transferee private foundations, any person who is a "substantial contributor" with respect to the transferor foundation prior to such transfer shall be considered a "substantial contributor" with respect to each transferee private foundation.

(4) If a private foundation incurs liability for one or more of the taxes imposed under chapter 42 (or any penalty resulting therefrom) prior to, or as a result of, making a transfer of assets described in section 507(b)(2) to one or more private foundations, in any case where transferee liability applies each transferee foundation shall be treated as receiving the transferred assets subject to such liability to the extent that the transferor foundation does not satisfy such liability.

(5) Except as provided in subparagraph (9) of this paragraph, a private foundation is required to meet the distribution requirements of section 4942 for any taxable year in which it makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation. Such transfer shall itself be counted toward satisfaction of such requirements to the extent the amount transferred meets the requirements of section 4942(g). However, where the transferor has disposed of all of its assets, the recordkeeping requirements of section 4942(g)(3)(B) shall not apply during any period in which it has no assets. Such requirements are applicable for any taxable year other than a taxable year during which the transferor has no assets.

(6) For purposes of section 4943(c)(4), (5), and (6), whenever a private foundation makes a section 507(b)(2) transfer of all or part of its net assets to another private foundation, the applicable period of time described in section 4943(c)(4), (5), or (6) shall include both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets.

(7) Except as provided in subparagraph (9) of this paragraph, where the transferor has disposed of all of its assets, during any period in which the transferor has no assets, section 4945(d)(4) and (h) shall not apply to the transferee or the transferor with respect to any "expenditure responsibility" grants made by the transferor. However, the exception contained in this subparagraph shall not apply with respect to any information reporting requirements imposed by section 4945 and the regulations thereunder for any year in which any such transfer is made.

(8)(i) Except as provided in subdivision (ii) of this subparagraph or subparagraph (6) or (9) of this paragraph or whenever a private foundation makes a transfer of assets described in section 507(b)(2) to one or more private foundations, the transferee foundation:

(a) Will not be treated as being in existence prior to January 1, 1970, with respect to any transferred assets;

(b) Will not be treated as holding the transferred assets prior to January 1, 1970; and

(c) Will not be treated as having engaged in, or become subject to, any transaction, lease, contract, or other obligation with respect to the transferred assets prior to January 1, 1970.

(ii) Notwithstanding subdivision (i) of this subparagraph, the provisions enumerated in (a) through (g) of this subdivision shall apply to the transferee foundation with respect to the assets transferred to the same extent and in the same manner that they would have applied to the transferor foundation had the transfer described in section 507(b)(2) not been effected:

(a) Section 4940(c)(4)(B) and the regulations thereunder with respect to basis of property,

(b) Section 4942(f)(4) and the regulations thereunder with respect to distributions of income,

(c) Section 101(*l*)(2) of the Tax Reform Act of 1969 (83 Stat. 533), as amended by sections 1301 and 1309 of the Tax Reform Act of 1976 (90 Stat. 1713, 1729), with respect to the provisions of section 4941,

(d) Section 101(*l*)(3)(A) of the Tax Reform Act of 1969 (83 Stat. 534) with respect to the provisions of section 4942, but only if the transferor qualified for the application of such section immediately before the transfer, and at least 85 percent of the fair market value of the net assets of the transferee immediately after the transfer was received pursuant to the transfer,

(e) Section 101(*l*)(3)(B) through (E) of the Tax Reform Act of 1969 (83 Stat. 534) with respect to the provisions of section 4942,

(f) Section 101(*l*)(5) of the Tax Reform Act of 1969 (83 Stat. 535) with respect to the provisions of section 4945, and

(g) Section 101(*l*)(6) of the Tax Reform Act of 1969 (83 Stat. 535) with respect to the provisions of section 508(e).

(9)(i) If a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (within the meaning of § 1.482–1(a)(3)), directly or indirectly, by the same person or persons which effectively controlled the transferor private foundation, for purposes of chapter 42 (section 4940 et seq.) and part II of subchapter F of chapter 1 of the Code (sections 507 through 509) such a transferee private foundation shall be treated as if it were the transferor. However, where proportionality is appropriate, such a transferee private foundation shall be treated as if it were the transferor in the proportion which the fair market value of the assets (less encumbrances) transferred to such transferee bears to the fair market value of the assets (less encumbrances) of the transferor immediately before the transfer.

(ii) Subdivision (i) of this subparagraph shall not apply to the requirements under sections 6033, 6056, and 6104 which must be complied with by the transferor private foundation, nor to the requirement under section 6043 that the transferor file a return with respect to its liquidation, dissolution, or termination.

(iii) This subparagraph may be illustrated by the following examples:

Example (1). The trustees of X charitable trust, a private foundation, form the Y charitable corporation, also a private foundation, in order to facilitate the conduct of their activities. The trustees of X are also the directors of Y. Y has the same charitable purposes as X. All of the assets of X are transferred to Y, and Y continues to carry on X's charitable activities. Under such circumstances, Y shall be treated as if it were X for the purposes of subdivision (i) of this subparagraph. Thus, for example, Y will be permitted to take advantage of any special rules or savings provisions with respect to chapter 42 to the same extent as X could have if X had continued in existence.

Example (2). A and B are the trustees of the P charitable trust, a private foundation, and are the only substantial contributors to P. On July 1, 1973, in order to facilitate accomplishment of diverse charitable purposes, A and B create and control the R Foundation, the S Foundation and the T Foundation and transfer the net assets of P to R, S, and T. As of the end of 1973, P has an outstanding grant to Foundation W and has been required to exercise expenditure responsibility with respect to this grant under sections 4945(d)(4) and (h). Under these circumstances, R, S, and T shall each be treated as if they are P in the proportion the fair market value of the assets transferred to each bears to the fair market value of the assets of P immediately before the transfer. Since R, S, and T are treated as P, absent a specific provision for exercising expenditure responsibility with respect to the grant to W, each of them is required to exercise expenditure responsibility with respect to such grant. If, as a part of the transfer to R, P assigned, and R assumed, P's duties with respect to the expenditure responsibility grant to W, only R would be required to exercise expenditure responsibility with respect to the grant to W. Since R, S, and T are treated as P rather than as recipients of "expenditure responsibility" grants, there are no expenditure responsibility requirements which must be exercised under sections 4945(d)(4) and (h) with respect to the transfers of assets to R, S, and T.

(10) For certain rules relating to filing requirements where a private foundation has transferred all its net assets, see § 1.507–1(b)(9).

(b) Status of transferee organization under section 507(b)(2). Since a transfer of assets pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization to an organization not described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or 4947 is a taxable expenditure under section 4945(d)(5), in order for such a transfer of assets not to be a taxable expenditure, it must be to an organization described in section 501(c)(3) (other than an organization described in section 509(a)(4)) or treated as described in section 501(c)(3) under section 4947. See § 53.4945–6(c)(3) of this chapter. Consequently, unless such a transferee is an organization described in section 509(a)(1), (2), or (3), the transferee is a private foundation and the rules of section 507(b)(2) and paragraph (a) of this section apply. On the other hand, if such a transfer of assets is made to a transferee organization which is not described in either section 501(c)(3) (other than an organization described in section 509(a)(4)) or 4947, and in order to correct the making of a taxable expenditure, such assets are transferred to a private foundation, section 507(b)(2) and paragraph (a) of this section shall apply as if the transfer of assets had been made directly to such private foundation.

(c) Section 507(b)(2) transfers. (1) A transfer of assets is described in section 507(b)(2) if it is made by a private foundation to another private

foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization. This shall include any organization or reorganization described in subchapter C of chapter 1. For purposes of section 507(b)(2), the terms "other adjustment, organization, or reorganization" shall include any partial liquidation or any other significant disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. For purposes of this paragraph, a distribution out of current income shall include any distribution described in section 4942(h)(1)(A) and (B).

(2) The term "significant disposition of assets to one or more private foundations" shall include any disposition for a taxable year where the aggregate of:

(i) The dispositions to one or more private foundations for the taxable year, and

(ii) Where any disposition to one or more private foundations for the taxable year is part of a series of related dispositions made during prior taxable years, the total of the related dispositions made during such prior taxable years, is 25 percent or more of the fair market value of the net assets of the foundation at the beginning of the taxable year (in the case of subdivision (i) of this subparagraph) or at the beginning of the first taxable year in which any of the series of related dispositions was made (in the case of subdivision (ii) of this subparagraph). A "significant disposition of assets" may occur in a single taxable year (as in subdivision (i) of this subparagraph) or over the course of two or more taxable years (as in subdivision (ii) of this subparagraph). The determination whether a significant disposition has occurred through a series of related distributions (within the meaning of subdivision (ii) of this subparagraph) will be made on the basis of all the facts and circumstances of the particular case. However, if one or more persons who are disqualified persons (within the meaning of section 4946) with respect to the transferor private foundation are also disqualified persons with respect to any of the transferee private foundations, such fact shall be evidence that the transfer is part of a series of related dispositions (within the meaning of subdivision (ii) of this subparagraph). In the case of a series of related dispositions described in subdivision (ii) of this subparagraph, each transferee private foundation shall (on any date) be subject to the provisions of section 507(b)(2) (with respect to all such dispositions made to it on or before such date) to the extent described in paragraphs (a) and (b) of this section.

(3) A private foundation which fails to meet the requirements of section 507(b)(1)(A) for a taxable year may be required to file a return under section 6043(b) by reason of a transfer of assets to one or more sections 509(a)(1), (2), or (3) organizations. Hence, such filing does not necessarily mean that a section 507(b)(2) transfer has occurred. See § 1.6043-3(f)(1).

(4) This paragraph applies to any section 507(b)(2) transfer made by a private foundation referred to in section 170(b)(1)(E)(i), (ii), or (iii).

(5) The provisions of this paragraph may be illustrated by the following examples:

Example (1). M is a private foundation on the calendar year basis. It has net assets worth $100,000 as of January 1, 1971. In 1971, in addition to distributions out of current income, M transfers $10,000 to N, $10,000 to O, and $10,000 to P. N, O, and P are all private foundations. Under subparagraph (2)(i) of this paragraph, M has made a significant disposition of its assets in 1971 since M has disposed of more than 25 percent of its net assets (with respect to the fair market value of such assets as of January 1, 1971). M has therefore made section 507(b)(2) transfers within the meaning of this paragraph, and section 507(b)(2) applies to the transfers made to N, O, and P.

Example (2). U, a tax-exempt private foundation on the calendar year basis, has net assets worth $100,000 as of January 1, 1971. As part of a series of related dispositions in 1971 and 1972, U transfers in 1971, in addition to distributions out of current income, $10,000 to private foundation X and $10,000 to private foundation Y, and in 1972, in addition to distributions out of current income, U transfers $10,000 to private foundation Z. Under subparagraph (2)(ii) of this paragraph, U is treated as having made a series of related dispositions in 1971 and 1972. The aggregate of the 1972 disposition (under subparagraph (2)(i) of this paragraph) and the series of related dispositions (under subparagraph (2)(ii) of this paragraph) is $30,000, which is more than 25 percent of the fair market value of U's net assets as of the beginning of 1971 ($100,000), the first year in which any such disposition was made. Thus, U has made a significant disposition of its assets and has made transfers described in section 507(b)(2). The provisions of paragraphs (a) and (b) of this section apply to each of the transferees as of the date on which it received assets from U.

(d) Inapplicability of section 507(a) to section 507(b)(2) transfers. Unless a private foundation voluntarily gives notice pursuant to section 507(a)(1), a transfer of assets described in section 507(b)(2) will not constitute a termination of the transferor's private foundation status under section 507(a)(1). Such transfer must, nevertheless, satisfy the requirements of any pertinent provisions of chapter 42. See subparagraphs (5) through (7) of paragraph (a) of this section. However, if such transfer constitutes an act or failure to act which is described in section 507(a)(2)(A), then such transfer will be subject to the provisions of section 507(a)(2) rather than section 507(b)(2). For example, X, a private nonoperating foundation,

transfers all of its net assets to Y, a private operating foundation, in 1971. X does not file the notice referred to in section 507(a)(1) and the transfer does not constitute either a willful and flagrant act (or failure to act), or one of a series of willful repeated acts (or failures to act), giving rise to liability for tax under chapter 42. Under these circumstances, the transfer is described in section 507(b)(2) and the provisions of paragraph (a) of this section apply with respect to Y. The private foundation status of X has not been terminated under section 507(a).

(e) **Transfers to certain section 509(a)(1), (2), or (3) organizations.** If a private foundation transfers all or part of its assets to one or more organizations described in section 509(a)(1), (2), or (3) and, within a period of 3 years from the date of such transfers, one or more of the transferee organizations lose their section 509(a)(1), (2), or (3) status and become private foundations, then for purposes of this section, a transfer of assets within the meaning of paragraph (c) of this section to such an organization which becomes a private foundation will be treated as a transfer described in section 507(b)(2), and the provisions of paragraph (a) of this section shall be treated as applying to such a transferee organization from the date on which any such transfer was made to it.

(f) **Certain transfers made during section 507(b)(1)(B) terminations.** If—

(1) During the course of the 12-month or 60-month period described in section 507(b)(1)(B), a private foundation makes one or more transfers to one or more private foundations;

(2) Such transfers are described in § 1.507–3(c)(1); and

(3) Even though the transferor foundation thereafter meets the requirements of section 507(b)(1)(B),

then for purposes of this section, the provisions of § 1.507–2(e) shall not apply with respect to such transfers, and such transfers will be treated as transfers described in section 507(b)(2) and § 1.507–3 rather than as transfers from an organization described in section 509(a)(1), (2), or (3).

[T.D. 7233, 37 FR 28158, Dec. 21, 1972; 38 FR 3189, Feb. 2, 1973, as amended by T.D. 7678, 44 FR 12415, Feb. 26, 1980]

§ 1.507–4 Imposition of tax.

(a) **General rule.** Section 507(c) imposes on each organization the private foundation status of which is terminated under section 507(a) a tax equal to the lower of:

(1) The amount which such organization substantiates by adequate records (or other corroborating evidence which may be required by the Commissioner) as the aggregate tax benefit (as defined in section 507(d)) resulting from the section 501(c)(3) status of such organization, or

(2) The value of the net assets of such organization.

(b) **Transfers not subject to section 507(c).** Private foundations which make transfers described in section 507(b)(1)(A) or (2) are not subject to the tax imposed under section 507(c) with respect to such transfers unless the provisions of section 507(a) become applicable. See §§ 1.507–1(b), 1.507–2(a)(6) and 1.507–3(d).

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–5 Aggregate tax benefit; in general.

(a) **General rule.** For purposes of section 507(c)(1), the aggregate tax benefit resulting from the section 501(c)(3) status of any private foundation is the sum of:

(1) The aggregate increases in tax under chapters 1, 11, and 12 (or the corresponding provisions of prior law) which would have been imposed with respect to all substantial contributors to the foundation if deductions for all contributions made by such contributors to the foundation after February 28, 1913, had been disallowed,

(2) The aggregate increases in tax under chapter 1 (or the corresponding provisions of prior law) which would have been imposed with respect to the income of the private foundation for taxable years beginning after December 31, 1912, if (i) it had not been exempt from tax under section 501(a) (or the corresponding provisions of prior law), and (ii) in the case of a trust, deductions under section 642(c) (or the corresponding provisions of prior law) had been limited to 20 percent of the taxable income of the trust (computed without the benefit of section 642(c) but with the benefit of section 170(b)(1)(A)),

(3) The amount succeeded to from transferors under § 1.507–3(a) and section 507(b)(2), and

(4) Interest on the increases in tax determined under subparagraphs (1), (2), and (3) of this paragraph from the first date on which each such increase would have been due and payable to the

date on which the organization ceases to be a private foundation.

(b) Contributions. In computing the amount of the aggregate increases in tax under subparagraph (1) of this paragraph, all deductions attributable to a particular contribution shall be included. For example, if a substantial contributor has taken deductions under sections 170 and 2522 (or the corresponding provisions of prior law) with respect to the same contribution, the amount of each deduction shall be included in the computations under section 507(d)(1)(A). Accordingly, the aggregate tax benefit may exceed the fair market value of the property transferred.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–6 Substantial contributor defined.

(a) Definition—(1) In general. Except as provided in subparagraph (2) of this paragraph, the term "substantial contributor" means, with respect to a private foundation, any person (within the meaning of section 7701(a)(1)), whether or not exempt from taxation under section 501(a), who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the private foundation before the close of the taxable year of the private foundation in which a contribution or bequest is received by the foundation from such person. In the case of a trust, the term "substantial contributor" also means the creator of the trust. Such term does not include a governmental unit described in section 170(c)(1).

(2) Special rules. For purposes of sections 170(b)(1)(E)(iii), 507(d)(1), 508(d), 509(a)(1) and (3), and chapter 42, the term "substantial contributor" shall not include an organization which is described in section 509(a)(1), (2), or (3) or any other organization which is wholly owned by such section 509(a)(1), (2), or (3) organization. Furthermore, taking section 4941 (relating to taxes on self-dealing) in context, it would unduly restrict the activities of private foundations if the term "substantial contributor" were to include any section 501(c)(3) organizations. It was not intended, for example, that a large grant for charitable purposes from one private foundation to another would forever preclude the latter from making any grants to, or otherwise dealing with, the former. Accordingly, for purposes of section 4941 only, the term "substantial contributor" shall not only include any organization which is described in section 501(c)(3) (other than an organization described in section 509(a)(4)).

(b) Determination of substantial contributor—(1) In general. In determining under paragraph (a) of this section whether the aggregate of contributions and bequests from a person exceeds 2 percent of the total contributions and bequests received by a private foundation, both the total of such amounts received by the private foundation, and the aggregate of such amounts contributed and bequeathed by such person, shall be determined as of the last day of each taxable year commencing with the first taxable year ending after October 9, 1969. Generally, under section 507(d)(2) and this section, except for purposes of valuation under section 507(d)(2)(B)(i), all contributions and bequests made before October 9, 1969, are deemed to have been made on October 9, 1969. For purposes of section 509(a)(2) and the support test described in § 1.509(a)–3(c), contributions and bequests before October 9, 1969, will be taken into account in the year when actually made. For example, in the case of a contribution or bequest of $6,000 in 1967, such contribution or bequest shall be treated as made by a substantial contributor in 1967 for purposes of section 509(a)(2) and § 1.509(a)–3(c) if such person met the $5,000—2 percent test as of December 31, 1967, and December 31, 1969 (in the case of a calendar year accounting period). Although the determination of the percentage of total contributions and bequests represented by a given donor's contributions and bequests is not made until the end of the foundation's taxable year, a donor is a substantial contributor as of the first date when the foundation received from him an amount sufficient to make him a substantial contributor. Except as otherwise provided in this subparagraph, such amount is treated for all purposes as made by a substantial contributor. Thus, the total contributions and bequests received by the private foundation from all persons, and the aggregate contributions and bequests made by a particular person, are to be determined as of December 31, 1969 (in the case of a calendar year organization which was in existence on that date), and the amounts included in each respective total would be all contributions and bequests received by the organization on or before that date, and all contributions and bequests made by the person on or before that date. Thereafter, a similar determination is to be made with respect to such private foundation as of the end of each of its succeeding taxable years. Status as a substantial contributor, however, will date from the time when the donor first met the $5,000 and 2 percent test. Once a person is a

substantial contributor with respect to a private foundation, he remains a substantial contributor even though he might not be so classified if a determination were first made at some later date. For instance, even though the aggregate contributions and bequests of a person become less than 2 percent of the total received by a private foundation (for example, because of subsequent contributions and bequests by other persons), such person remains a substantial contributor with respect to the foundation.

(2) Examples. The provisions of paragraph (a) of this section and this paragraph (b) may be illustrated by the following examples:

Example (1). On January 1, 1968, A, an individual, gave $4,500 to M, a private foundation on a calendar year basis. On June 1, 1969, A gave M the further sum of $1,500. Throughout its existence, through December 31, 1969, M has received $250,000 in contributions and bequests from all sources. As of June 1, 1969, A is a substantial contributor to M for purposes of section 509(a)(2).

Example (2). On September 9, 1966, B, an individual, gave $3,500 to N, a private foundation on a calendar year basis. On March 15, 1970, B gave N the further sum of $3,500. Throughout its existence, through December 31, 1970, N has received $200,000 in contributions and bequests from all sources. B is a substantial contributor to N as of March 15, 1970, since that is the first date on which his contributions met the 2 percent-$5,000 test.

Example (3). On July 21, 1964, X, a corporation, gave $2,000 to O, a private foundation on a calendar year basis. As of December 31, 1969, O had received $150,000 from all sources. On September 17, 1970, X gave O the further sum of $3,100. Through September 17, 1970, O had received $245,000 from all sources as total contributions and bequests. Between September 17, 1970, and December 31, 1970, however, O received $50,000 in contributions and bequests from others. X is not a substantial contributor to O, since X's contributions to O were not more than 2 percent of the total contributions and bequests received by O by December 31, 1970, the end of O's taxable year, even though X's contributions met that test at one point during the year.

Example (4). On September 16, 1970, C, an individual, gave $10,000 to P, a private foundation on a calendar year basis. Throughout its existence, and through December 31, 1970, the close of its taxable year, P had received a total of $100,000 in contributions and bequests. On January 3, 1971, P received a bequest of $1 million. C is a substantial contributor to P since be was a substantial contributor as of September 16, 1970, and therefore remains one even though he no longer meets the 2-percent test on a later date after the end of the taxable year of the foundation in which he first became a substantial contributor.

(c) Special rules—(1) Contributions defined. The term "contribution" shall, for purposes of section 507(d)(2), have the same meaning as such term has under section 170(c) and also include bequests, legacies, devises, and transfers within the meaning of section 2055 or 2106(a)(2). Thus, for purposes of section 507(d)(2), any payment of money or transfer of property without adequate consideration shall be considered a "contribution". Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the qualification of all or any part of such payment or transfer as a contribution under section 170(c) shall determine whether and to what extent such payment or transfer constitutes a "contribution" under section 507(d)(2).

(2) Valuation of contributions and bequests. Each contribution or bequest to a private foundation shall be valued at fair market value when actually received by the private foundation.

(3) Contributions and bequests by a spouse. An individual shall be considered, for purposes of this section, to have made all contributions and bequests made by his spouse during the period of their marriage. Thus, for example, where W contributed $500,000 to P, a private foundation, in 1941 and that amount exceeded 2 percent of the total contributions received by P as of the end of P's first taxable year ending after October 9, 1969, H (W's spouse at the time of the 1941 gift) is considered to have made such contribution (even if W died prior to October 9, 1969, or their marriage was otherwise terminated prior to such date). Similarly, any bequest or devise shall be treated as having been made by the decedent's surviving spouse.

[T.D. 7241, 37 FR 28743, Dec. 29, 1972; 38 FR 24206, Sept. 6, 1973]

§ 1.507–7 Value of assets.

(a) In general. For purposes of section 507(c), the value of the net assets shall be determined at whichever time such value is higher:

(1) The first day on which action is taken by the organization which culminates in its ceasing to be a private foundation, or

(2) The date on which it ceases to be a private foundation.

(b) Valuation dates. (1) In the case of a termination under section 507(a)(1), the date referred to in paragraph (a)(1) of this section shall be the date on which the terminating foundation gives the notification described in section 507(a)(1).

(2) In the case of a termination under section 507(a)(2), the date referred to in paragraph (a)(1) of this section shall be the date of occurrence of the willful and flagrant act (or failure to act) or the first of the series of willful repeated acts (or failures to act) giving rise to liability for tax under

chapter 42 and the imposition of tax under section 507(a)(2).

(c) Fair market value. For purposes of this section, fair market value shall be determined pursuant to the provisions of § 53.4942(a)–2(c)(4) of this chapter.

(d) Net assets. For purposes of section 507 and the regulations thereunder, the term "net assets" shall mean the gross assets of a private foundation reduced by all liabilities of the foundation, including appropriate estimated and contingent liabilities. Thus, a determination of net assets may reflect reductions for any liability or contingent liability for tax imposed upon the private foundation under chapter 42 with respect to acts or failures to act prior to termination, for any liability or contingent liability for failures to correct such acts or failures to act, or for any liability or estimated or contingent liability with respect to expenses associated with winding up the organization. If a private foundation's determination of net assets reflects any reduction for any estimated or contingent liability, such private foundation must establish, to the satisfaction of the Commissioner, the reasonableness of such reduction. If the amount of net assets reflects a reduction for any estimated or contingent liability, at the earlier of the final determination of the contingency or the termination of a reasonable time, any excess of the amount by which the gross assets was reduced over the amount of the liability shall be treated in the same manner as if such excess had been considered part of the net assets.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–8 Liability in case of transfers.

For purposes of determining liability for the tax imposed under section 507(c) in the case of assets transferred by the private foundation, such tax shall be deemed to have been imposed on the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation. If an organization's private foundation status is terminated under section 507(a)(2), the first day on which action is taken which culminates in its ceasing to be a private foundation (within the meaning of section 507(f)) shall be the date described in § 1.507–7(b)(2). If an organization terminates its private foundation status under section 507(a)(1), the first day on which action is taken which culminates in its ceasing to be a private foundation (within the meaning of section 507(f)) shall be the date described in § 1.507–7(b)(1).

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.507–9 Abatement of taxes.

(a) General rule. The Commissioner may at his discretion abate the unpaid portion of the assessment of any tax imposed by section 507(c), or any liability in respect thereof, if:

(1) The private foundation distributes all of its net assets to one or more organizations described in section 170(b)(1)(A) (other than in clauses (vii) or (viii)) each of which has been in existence and so described for a continuous period of at least 60 calendar months, or

(2) Effective assurance is given to the Commissioner in accordance with paragraphs (b) and (c) of this section that the assets of the organization which are dedicated to charitable purposes will, in fact, be used for charitable purposes.

The provisions of § 1.507–2(a)(2), (3), and (7) shall apply to distributions under subparagraph (1) of this paragraph. Since section 507(g) provides only for the abatement of tax imposed under section 507(c), no tax imposed under any provision of chapter 42 shall be abated under section 507(g). Where the taxpayer files a petition with the Tax Court with respect to a notice of deficiency regarding any tax under section 507(c), such tax shall be treated as having been assessed for the purposes of abatement of such tax under section 507(g) and the regulations thereunder.

(b) State proceedings. (1) The Commissioner may at his discretion abate the unpaid portion of the assessment of any tax imposed by section 507(c), or any liability in respect thereof, under the procedures outlined in subparagraphs (2) and (3) of this paragraph. Such tax may not be abated by the Commissioner unless he determines that corrective action as defined in paragraph (c) of this section has been taken. The Commissioner may not abate by reason of section 507(g) any amount of such tax which has already been collected since only the unpaid portion thereof can be abated.

(2) The appropriate State officer shall have 1 year from the date of notification prescribed in section 6104(c) that a notice of deficiency of tax imposed under section 507(c) has been issued with respect to a foundation, to advise the Commissioner that corrective action has been initiated pursuant to State law as may be ordered or approved by a court of competent jurisdiction. Corrective action may be initiated either by the appropriate State officer or by an organization described in section 509(a)(1), (2), or (3) which is a beneficiary of the private foundation and has enforceable

rights against such foundation under State law. Copies of all pleadings and other documents filed with the court at the initial stages of the proceedings shall be attached to the notification made by the State officer to the Commissioner. Prior to notification by the appropriate State officer that corrective action has been initiated, the Commissioner shall follow those procedures which would apply with respect to the assessment and collection of the tax imposed under section 507(c) without regard to section 507(g)(2). Subsequent to notification by the appropriate State officer that corrective action has been initiated, the Commissioner shall suspend action with respect to the assessment or collection of tax imposed under section 507(c) until notified of the final determination of such corrective action, as long as any such resulting delay does not jeopardize the collection of such tax and does not cause collection to be barred by operation of law or any rule of law. In any case where collection of such tax is about to be barred by operation of section 6502 and the Commissioner has not been advised of the final determination of corrective action, the Commissioner should make every effort to obtain appropriate agreements with the foundation subject to such tax to extend the period of limitations under section 6502(a)(2). Where such agreements are obtained, action with respect to the assessment and collection of such tax may be suspended to the extent not inconsistent with this subparagraph.

(3) Upon receipt of certification from the appropriate State officer that action has been ordered or approved by a court of competent jurisdiction, the Commissioner may abate the unpaid portion of the assessment of tax imposed by section 507(c), or any liability in respect thereof, if in his judgment such action is corrective action within the meaning of paragraph (c) of this section. In the event that such action is not corrective action, the Commissioner may in his discretion again suspend action on the assessment and collection of such tax until corrective action is obtained, or if in his judgment corrective action cannot be obtained, he may resume the assessment and collection of such tax.

(c) **Corrective action.** The term "corrective action" referred to in paragraph (b) of this section means vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42 and insure that the assets of such private foundation are preserved for such charitable or other purposes specified in section 501(c)(3). Except where assets of the terminated private foundation are transferred to an organization described in section 509(a)(1) through (4) the State is required to take such action to assure that the provisions of section 508(e)(1)(A) and (B) are applicable to the terminated foundation (or any transferee) with respect to such assets as if such organization were a private foundation. Thus, the governing instrument of such organization must include provisions with respect to such assets—

(1) Requiring its income therefrom for each taxable year to be distributed at such time and in such manner as not to subject such organization to tax under section 4942 (as if the organization were a private foundation),

(2) Prohibiting such organization from engaging in any act of self-dealing (as defined in section 4941(d) as if the organization were a private foundation),

(3) Prohibiting such organization from retaining any excess business holdings (as defined in section 4943(c) as if the organization were a private foundation),

(4) Prohibiting such organization from making any investments in such manner as to subject such organization to tax under section 4944 (as if the organization were a private foundation), and

(5) Prohibiting such organization from making any taxable expenditures (as defined in section 4945(d) as if the organization were a private foundation). Consequently, in cases where the preceding sentence applies, although the private foundation status of an organization is terminated for tax purposes, it is contemplated that its status under State law would remain unchanged, because the tax under section 507(c) has been abated solely because the Commissioner has been given effective assurance that there is vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42. Therefore, in such a case while chapter 42 will not apply to acts occurring subsequent to termination which previously would have resulted in the imposition of tax under chapter 42, it is contemplated that there will be vigorous enforcement of State laws (including laws made applicable by the provisions in the governing instrument) with respect to such acts. Notwithstanding the preceding three sentences, no amendment to the organization's governing instrument is necessary where there are provisions of State law which have the effect of requiring a terminated private foundation to which the rules of subparagraphs (1) through (5) of this paragraph apply to be subject to such rules whether or not there are such provisions in such terminated private foundation's governing instrument.

[T.D. 7233, 37 FR 28161, Dec. 21, 1972]

§ 1.508-1 Notices.

(a) **New organizations must notify the Commissioner that they are applying for recognition of section 501(c)(3) status—(1) In general.** Except as provided in subparagraph (3) of this paragraph, an organization that is organized after October 9, 1969, will not be treated as described in section 501(c)(3)—

(i) Unless such organization has given the Commissioner notice in the manner prescribed in subparagraph (2) of this paragraph; or

(ii) For any period before the giving of such notice, unless such notice is given in the manner and within the time prescribed in subparagraph (2) of this paragraph.

No organization shall be exempt from taxation under section 501(a) by reason of being described in section 501(c)(3) whenever such organization is not treated as described in section 501(c)(3) by reason of section 508(a) and this paragraph. See section 508(d)(2)(B) and § 1.508-2(b) regarding the deductibility of charitable contributions to an organization during the period such organization is not exempt under section 501(a) as an organization described in section 501(c)(3) by reason of failing to file a notice under section 508(a) and this subparagraph. See also § 1.508-2(b)(1)(viii) regarding the deductibility of charitable contributions to trusts described in section 4947(a)(1).

(2) **Filing of notice.** (i) For purposes of subparagraph (1) of this paragraph, except as provided in subparagraph (3) of this paragraph, an organization seeking exemption under section 501(c)(3) must file the notice described in section 508(a) within 15 months from the end of the month in which the organization was organized, or before March 22, 1973, whichever comes later. Such notice is filed by submitting a properly completed and executed Form 1023, exemption application. Notice should be filed with the district director. A request for extension of time for the filing of such notice should be submitted to such district director. Such request may be granted if it demonstrates that additional time is required.

(ii) Although the information required by Form 1023 must be submitted to satisfy the notice required by this section, the failure to supply, within the required time, all of the information required to complete such form is not alone sufficient to deny exemption from the date of organization to the date such complete information is submitted by the organization. If the information which is submitted within the required time is incomplete, and the organization supplies the necessary additional information at the request of the Commissioner within the additional time period allowed by him, the original notice will be considered timely.

(iii) For purposes of subdivision (i) of this subparagraph and paragraph (b)(2)(i) of this section, an organization shall be considered "organized" on the date it becomes an organization described in section 501(c)(3) (determined without regard to section 508(a)).

(iv) Since a trust described in section 4947(a)(2) is not an organization described in section 501(c)(3), it is not required to file a notice described in section 508(a).

(v) For the treatment of community trusts, and the trusts or funds comprising them, under section 508, see the special rules under § 1.170A-9(e).

(vi) A foreign organization shall, for purposes of section 508, be treated in the same manner as a domestic organization, except that section 508 shall not apply to a foreign organization which is described in section 4948(b).

(3) **Exceptions from notice.** (i) Subparagraphs (1) and (2) of this paragraph are inapplicable to the following organizations:

(a) Churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group;

(b) Any organization which is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000 (as described in subdivision (ii) of this subparagraph);

(c) Subordinate organizations (other than private foundations) covered by a group exemption letter;

(d) Solely for purposes of sections 507, 508(d)(1), 508(d)(2)(A) and 508(d)(3), 508(e), 509 and chapter 42, a trust described in section 4947(a)(1). (However, a trust described in section 501(c)(3) which was organized after October 9, 1969, shall be exempt under section 501(a) by reason of being described in section 501(c)(3) only if it files such notice); and

(e) Any other class of organization that the Commissioner from time to time excludes from the requirement of filing notice under section 508(a).

(ii) For purposes of subdivision (i)(b) of this subparagraph and paragraph (b)(7)(ii) of this sec-

tion, the gross receipts (as defined in subdivision (iii) of this subparagraph) of an organization are normally not more than $5,000 if—

(a) During the first taxable year of the organization the organization has received gross receipts of $7,500 or less;

(b) During its first 2 taxable years the aggregate gross receipts received by the organization are $12,000 or less; and

(c) In the case of an organization which has been in existence for at least 3 taxable years, the aggregate gross receipts received by the organization during the immediately preceding 2 taxable years, plus the current year are $15,000 or less.

If an organization fails to meet the requirements of (a), (b), or (c) of this subdivision, then with respect to the organization, such organization shall be required to file the notices described in section 508(a) and (b) within 90 days after the end of the period described in (a), (b), or (c) of this subdivision or before March 22, 1973, whichever is later, in lieu of the period prescribed in subparagraph (2)(i) of this paragraph. Thus, for example, if an organization meets the $7,500 requirement of (a) of this subdivision for its first taxable year, but fails to meet the $12,000 requirement of (b) of this subdivision for the period ending with its second taxable year, then such organization shall meet the notification requirements of section 508(a)(1) and 508(b) and subparagraph (2)(i) of this paragraph if it files such notification within 90 days after the close of its second taxable year. If an organization which has been in existence at least 3 taxable years meets the requirements of (a), (b), and (c) with respect to all prior taxable years, but fails to meet the requirements of (c) of this subdivision with respect to the current taxable year, then even if the organization fails to make such notification within 90 days after the close of the current taxable year, section 508(a)(1) and 508(b) shall not apply with respect to its prior years. In such a case, the organization shall not be treated as described in section 501(c)(3) for a period beginning with such current taxable year and ending when such notice is given under section 508(a)(2).

(iii) For a definition of "gross receipts" for purposes of subdivision (i)(b) of this subparagraph and paragraph (b)(7)(ii) of this section, see § 1.6033–2(g)(4).

(4) Voluntary filings by new organizations excepted from filing notice. Any organization excepted from the requirement of filing notice under section 508(a) will be exempt from taxation under section 501(c)(3) if it meets the requirements of that section, whether or not it files such notice. However, in order to establish its exemption with the Internal Revenue Service and receive a ruling or determination letter recognizing its exempt status, an organization excepted from the notice requirement by reason of subparagraph (3) of this paragraph should file proof of its exemption in the manner prescribed in § 1.501(a)–1.

(b) Presumption that old and new organizations are private foundations—(1) In general. Except as provided in subparagraph (7) of this paragraph, any organization (including an organization in existence on October 9, 1969) which is described in section 501(c)(3), and which does not notify the Commissioner within the time and in the manner prescribed in subparagraph (2) that it is not a private foundation, will be presumed to be a private foundation.

(2) Filing of notice. (i) Except as provided in subparagraph (7) of this paragraph, an organization must file the notice described in section 508(b) and subparagraph (1) of this paragraph within 15 months from the end of the month in which such organization was organized, or before March 22, 1973, whichever comes later. See paragraph (a)(2)(iii) of this section, for rules pertaining to when an organization is "organized".

(ii) Any organization filing notice under this paragraph that has received a ruling or determination letter from the Internal Revenue Service dated on or before July 13, 1970, recognizing its exemption from taxation under section 501(c)(3) (or the corresponding provisions of prior law), shall file the notice described in section 508(b) by submitting a properly completed and executed Form 4653, Notification Concerning Foundation Status.

(iii) The financial schedule on Form 4653 need be completed only if the organization is, or thinks it might be, described in section 170(b)(1)(A)(iv) or (vi) or section 509(a)(2).

(iv) Any organization filing notice under this paragraph that has not received a ruling or determination letter from the Internal Revenue Service dated on or before July 13, 1970, recognizing its exemption from taxation under section 501(c)(3) (or the corresponding provisions of prior law), shall file its notice by submitting a properly completed and executed Form 1023 and providing information that it is not a private foundation. The organization shall also submit all information required by the regulations under section 170 or 509 (whichever is applicable) necessary to establish recognition of its classification as an organization

described in section 509(a)(1), (2), (3), or (4). A Form 1023 submitted prior to July 14, 1970, will satisfy this requirement if the organization submits an additional statement that it is not a private foundation together with all pertinent additional information required. Any statement filed under this subdivision shall be accompanied by a written declaration by the principal officer, manager or authorized trustee that there is a reasonable basis in law and in fact for the statement that the organization so filing is not a private foundation, and that to the best of the knowledge and belief of such officer, manager or trustee, the information submitted is complete and correct.

(v) The notice filed under subdivision (ii) of this subparagraph should be filed in accordance with the instructions applicable to Form 4653. The notice required by subdivision (iv) of this subparagraph should be filed with the district director. An extension of time for the filing of such notice may be granted by the Director of the Internal Revenue Service Center or district director upon timely request by the organization to such person, if the organization demonstrates that additional time is required.

(3) Effect of notice upon the filing organization. (i) The notice filed under this paragraph may not be relied upon by the organization so filing unless and until the Internal Revenue Service notifies the organization that it is an organization described in paragraph (1), (2), (3), or (4), of section 509(a). For purposes of the preceding sentence, an organization that has filed notice under section 508(b), and has previously received a ruling that it is an organization described in section 170(b)(1)(A) (other than clauses (vii) and (viii) thereof), will be considered to have been notified by the Internal Revenue Service that it is an organization described in paragraph (1) of section 509(a) if (a) the facts and circumstances forming the basis for the issuance of such ruling have not substantially changed, and (b) the ruling issued under that section has not been revoked expressly or by a subsequent change of the law or regulations under which the ruling was issued.

(ii) If an organization has filed a notice under section 508(b) stating that it is not a private foundation and designating only one paragraph of section 509(a) under which it claims recognition of its classification (such as an organization described in section 509(a)(2)), and if it has received a ruling or determination letter which recognizes that it is not a private foundation but which fails to designate the paragraph under section 509(a) in which it is described, then such organization will be treated as described under the paragraph designated by it, until such ruling or determination letter is modified or revoked. The rule in the preceding sentence shall not apply to an organization which indicated that it does not know its status under section 509(a) or which claimed recognition of its status under more than one paragraph of section 509(a).

(4) Effect of notice upon grantors or contributors to the filing organization. In the case of grants, contributions, or distributions made prior to—

(i) In the case of community trusts, 6 months after the date on which corrective and clarifying regulations designated as § 1.170A–9(e)(10) become final;

(ii) In the case of medical research organizations, 6 months after the date on which corrective and clarifying regulations designated as § 1.170A–9(b)(2), become final, and

(iii) In all other cases, January 1, 1976, any organization which has properly filed the notice described in section 508(b) prior to March 22, 1973 will not be treated as a private foundation for purposes of making any determination under the internal revenue laws with respect to a grantor, contributor or distributor (as for example, a private foundation distributing all of its net assets pursuant to a section 507(b)(1)(A) termination) thereto, unless the organization is controlled directly or indirectly by such grantor, contributor or distributor, if by the 30th day after the day on which such notice is filed, the organization has not been notified by the Commissioner that the notice filed by such organization has failed to establish that such organization is not a private foundation. See subparagraph (6) of this paragraph for the effect of an adverse notice by the Internal Revenue Service. For purposes of this subparagraph, an organization which has properly filed notice described in section 508(b) prior to March 22, 1973, and which has claimed recognition of its status under only one paragraph of section 509(a) in such notice, will be treated only for purposes of grantors, contributors or distributors as having the classification claimed in the notice if the provisions of this subparagraph are otherwise satisfied.

(5) Statement that old and new organizations are operating foundations. (i) Any organization (including an organization in existence on October 9, 1969) which is described in section 501(c)(3) may submit a statement, in the form and manner provided for notice in subparagraph (2) of this

paragraph, that it is an operating foundation (as defined in section 4942(j)(3)) and include in such statement:

(a) Necessary supporting information as required by the regulations under section 4942(j)(3) to confirm such determination (including a statement identifying the clause of section 4942(j)(3)(B) that is applicable); and

(b) A written declaration by the principal officer, manager, or authorized trustee that there is a reasonable basis in law and in fact that the organization so filing is an operating foundation, and that to the best of the knowledge and belief of such officer, manager or trustee, the information submitted is complete and correct.

(ii) The statement filed under this subparagraph may not be relied upon by the organization so filing unless and until the Internal Revenue Service notifies the organization that it is an operating foundation described in section 4942(j)(3).

(iii) In the case of grants, contributions, or distributions made prior to March 22, 1973, any organization which has properly filed the statement described in this subparagraph prior to such date will be treated as an operating foundation for purposes of making any determination under the internal revenue laws with respect to a grantor, contributor, or distributor thereto, unless the organization is controlled directly or indirectly by such grantor, contributor, or distributor, if by the 30th day after the day on which such statement is filed, the organization has not been notified by the Commissioner or his delegate that its statement has failed to establish that such organization is an operating foundation. See subparagraph (6) of this paragraph for the effect of an adverse notice by the Internal Revenue Service.

(6) Effect of notice by Internal Revenue Service concerning organization's notice or statement. Subparagraph (4) and subdivision (iii) of subparagraph (5) of this paragraph shall have no effect:

(i) With respect to a grantor, contributor, or distributor to any organization for any period after the date on which the Internal Revenue Service makes notice to the public (such as by publication in the Internal Revenue Bulletin) that a grantor, contributor, or distributor to such organization can no longer rely upon the notice or statement submitted by such organization; and

(ii) Upon any grant, contribution, or distribution made to an organization on or after the date on which a grantor, contributor, or distributor acquired knowledge that the Internal Revenue Service has given notice to such organization that its notice or statement has failed to establish that such organization either is not a private foundation, or is an operating foundation, as the case may be.

(7) Exceptions from notice. Subparagraphs (1) and (2) of this paragraph are inapplicable to the following organizations:

(i) Churches, interchurch organizations of local units of a church, conventions or associations of churches, or integrated auxiliaries of a church, such as a men's or women's organization, religious school, mission society, or youth group;

(ii) Any organization which is not a private foundation (as defined in section 509(a)) and the gross receipts of which in each taxable year are normally not more than $5,000 (as determined under paragraph (a)(3)(ii) of this section);

(iii) Subordinate organizations (other than private foundations) covered by a group exemption letter but only if the parent or supervisory organization submits a notice covering the subordinates;

(iv) Trusts described in section 4947(a)(1); and

(v) Any other class of organization that the Commissioner from time to time excludes from the notification requirements of section 508(b).

(8) Voluntary filings by organizations excepted from filing notice. Any organization excepted from the requirement of filing notice under section 508(b) by reason of subdivisions (i), (ii), and (v) of subparagraph (7) of this paragraph may receive the benefits of subparagraph (4) of this paragraph by filing such notice.

[T.D. 7232, 37 FR 28289, Dec. 22, 1972, as amended by T.D. 7258, 38 FR 4258, Feb. 12, 1973; T.D. 7300, 38 FR 35304, Dec. 27, 1973; T.D. 7342, 40 FR 1237, Jan. 7, 1975; T.D. 7395, 41 FR 1063, Jan. 6, 1976]

§ 1.508–2 Disallowance of certain charitable, etc., deductions.

(a) Gift or bequest to organizations subject to section 507(c) tax—(1) General rule. No gift or bequest made to an organization upon which the tax provided by section 507(c) has been imposed shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made:

(i) By any person after notification has been made by the organization under section 507(a)(1)

or after notification has been made by the Commissioner under section 507(a)(2)(B), or

(ii) By a substantial contributor (as defined in section 507(d)(2)) in his taxable year which includes the first day on which action is taken by such organization which culminates in the imposition of tax under section 507(c) and any subsequent taxable year.

For purposes of subdivision (ii) of this subparagraph, the first day on which action is taken by an organization which culminates in the imposition of tax under section 507(c) shall be determined under the rules set forth in § 1.507–7(b)(1) and (2).

(2) Exception. Subparagraph (1) of this paragraph shall not apply if the entire amount of the unpaid portion of the tax imposed by section 507(c) is abated by the Commissioner under section 507(g).

(b) Gift or bequest to taxable private foundation, section 4947 trust, etc.—(1) General rule. (i) Except as provided in subparagraph (2) of this paragraph, no gift or bequest made to an organization shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made:

(a) To a private foundation or a trust described in section 4947(a)(2) in a taxable year for which it fails to meet the requirements of section 508(e) (determined without regard to section 508(e)(2)(B) and (C)), or

(b) To any organization in a period for which it is not treated as an organization described in section 501(c)(3) by reason of section 508(a).

(ii) For purposes of subdivision (i)(a) of this subparagraph the term "taxable year" refers to the taxable year of the donee or beneficiary organization. In the event a bequest is made to a private foundation or trust described in section 4947(a)(2) which is not in existence at the date of the testator's death (but which is created under the terms of the testator's will), the term "taxable year" shall mean the first taxable year of the private foundation or trust.

(iii) For purposes of subdivision (i)(a) of this subparagraph, an organization does not fail to meet the requirements of section 508(e) for a taxable year, unless it fails to meet such requirements for the entire year. Therefore, even if a donee organization fails to meet the requirements of section 508(e) on the date it receives a grant from a donor, the donor's grant will not be disallowed by operation of section 508(d)(2)(A) and subdivision (i)(a) of this subparagraph, if the organization meets the requirements of section 508(e) (determined without regard to section 508(e)(2)(B) or (C)) by the end of its taxable year.

(iv) No deduction will be disallowed under section 508(d)(2)(A) with respect to a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 if during the taxable year in question, the private foundation or trust described in section 4947(a)(2) has instituted a judicial proceeding which is necessary to reform its governing instrument or other instrument in order to meet the requirements of section 508(e)(1). This subdivision shall not apply unless within a reasonable time such judicial proceedings succeed in so reforming such instrument.

(v) No deduction will be disallowed under section 508(d)(2)(A) and subdivision (i)(a) of this subparagraph for any taxable year beginning before January 1, 1972, with respect to a private foundation or trust described in section 4947 organized before January 1, 1970. See also § 1.508–3(g) regarding transitional rules for extending compliance with section 508(e)(1).

(vi)(a) In the case of a contribution or bequest to a trust described in section 4947(a)(2) other than to a trust to which subdivision (vii) of this subparagraph applies, no deduction shall be disallowed by reason of section 508(d)(2)(A) on the grounds that such trust's governing instrument contains no provisions with respect to section 4942. Similarly, if for a taxable year such trust is also a trust described in section 4947(b)(3), no deduction for such year shall be so disallowed on the grounds that the governing instrument contains no provision with respect to section 4943 or 4944.

(b) This subdivision may be illustrated by the following example:

Example. H executes a will on January 1, 1977, establishing a charitable remainder trust (as described in section 664) with income payable to W, his wife, for life, remainder to X university, an organization described in section 170(b)(1)(A)(ii). The will provides that the trust is prohibited from engaging in activities which would subject itself, its foundation manager or a disqualified person to taxes under section 4941 or 4945 of the Code. The will is silent as to sections 4942, 4943, and 4944. H dies February 12, 1978. Section 508(d)(2)(A) will not operate to disallow any deduction to H's estate under section 2055 with respect to such trust.

(vii)(a) In the case of a trust described in section 4947(a)(2) which by its terms will become a trust described in section 4947(a)(1) and the governing instrument of which is executed after March 22, 1973, the governing instrument shall not meet the requirements of section 508(e)(1) if it

does not contain provisions to the effect that the trust must comply with the provisions of section 4942, or sections 4942, 4943, and 4944 (as the case may be) to the extent such section or sections shall become applicable to such trust.

(b) This subdivision may be illustrated by the following example:

Example. H executes a will on January 1, 1977, establishing a charitable remainder trust (as described in section 664) with income payable to W, his wife, for life, remainder in trust in perpetuity for the benefit of an organization described in section 170(c). By its terms the trust will become a trust described in section 4947(a)(1), and will become a private foundation. The will provides that the trust is prohibited from engaging in activities which would subject itself, its foundation manager or a disqualified person to taxes under sections 4941 or 4945 of the Code. The will is silent as to sections 4942, 4943, and 4944. H dies February 12, 1978. Unless the trust's governing instrument is amended prior to the end of the trust's first taxable year, or judicial proceedings have been instituted under subdivision (iv) of this subparagraph, section 508(d)(2)(A) will operate to disallow any deduction to H's estate under section 2055 with respect to such trust.

(viii) Since a charitable trust described in section 4947(a)(1) is not required to file a notice under section 508(a), section 508(d)(2)(B) and subdivision (i)(b) of this subparagraph are not applicable to such a trust.

(2) Transitional rules. Any deduction which would otherwise be allowable under section 642(c)(2), 2106(a)(2), or 2055 shall not be disallowed under section 508(d)(2)(A) if such deduction is attributable to:

(i) Property passing under the terms of a will executed on or before October 9, 1969,

(a) If the decedent dies after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise,

(b) If the decedent dies after October 9, 1969, and at no time after that date had the right to change the portions of the will which pertains to the passing of property to, or for the use of, an organization described in section 170(c)(2)(B) or 2055(a), or

(c) If no dispositive provision of the will is amended by the decedent, by codicil or otherwise, before October 9, 1972, and the decedent is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to amend the will by codicil or otherwise, or

(ii) Property transferred in trust on or before October 9, 1969,

(a) If the grantor dies after October 9, 1969, but before October 9, 1972, without having amended, after October 9, 1969, any dispositive provision of the instrument governing the disposition of the property,

(b) If the property transferred was an irrevocable interest to, or for the use of, an organization described in section 170(c)(2)(B) or 2055(a),

(c) In the case of a deduction under section 2106(a)(2) or 2055; if no dispositive provision of the instrument governing the disposition of the property is amended by the grantor before October 9, 1972, and the grantor is on October 9, 1972, and at all times thereafter under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to change the disposition of the property, or

(d) In the case of a deduction under section 642(c)(2)(A), if the grantor is at all times after October 9, 1969, and up to, and including, the last day of the taxable year for which the deduction under such section is claimed, under a mental disability (as defined in § 1.642(c)–2(b)(3)(ii)) to change the terms of the trust.

See also § 1.508–3(g) regarding the extension of time for compliance with section 508(e), § 1.664–1(f)(3)(ii) and (g) regarding the special transitional rules for charitable remainder annuity and unitrusts described in section 664 which were created prior to December 31, 1972, and § 20.2055–2(e)(4) of this chapter regarding the rules for determining if the dispositive provisions have been amended.

[T.D. 7232, 37 FR 28291, Dec. 22, 1972]

§ 1.508–3 Governing instruments.

(a) General rule. A private foundation shall not be exempt from taxation under section 501(a) for a taxable year unless by the end of such taxable year its governing instrument includes provisions the effects of which are:

(1) To require distributions at such times and in such manner as not to subject the foundation to tax under section 4942, and

(2) To prohibit the foundation from engaging in any act of self-dealing (as defined in section 4941(d)), from retaining any excess business holdings (as defined in section 4943(c)), from making any investments in such manner as to subject the foundation to tax under section 4944, and from making any taxable expenditures (as defined in section 4945(d)).

(b) Effect and nature of governing instrument—(1) In general. Except as provided in paragraph (d) of this section, the provisions of a foundation's governing instrument must require or prohibit, as the case may be, the foundation to act or refrain from acting so that the foundation, and any foundation managers or other disqualified persons with respect thereto, shall not be liable for any of the taxes imposed by sections 4941, 4942, 4943, 4944, and 4945 of the Code or, in the case of a split-interest trust described in section 4947(a)(2), any of the taxes imposed by those sections of chapter 42 made applicable under section 4947. Specific reference to these sections of the Code will generally be required to be included in the governing instrument, unless equivalent language is used which is deemed by the Commissioner to have the same full force and effect. However, a governing instrument which contains only language sufficient to satisfy the requirements of the organizational test under § 1.501(c)(3)-1(b) will not be considered as meeting the requirements of this subparagraph, regardless of the interpretation placed on such language as a matter of law by a State court in a particular jurisdiction, unless the requirements of paragraph (d) of this section are satisfied.

(2) Corpus. A governing instrument does not meet the requirements of paragraph (a)(1) of this section if it expressly prohibits the distribution of capital or corpus.

(3) Savings provisions. For purposes of sections 508(d)(2)(A) and (e), a governing instrument need not include any provision which is inconsistent with section 101(*l*), (2), (3), (4), or (5) of the Tax Reform Act of 1969 (83 Stat. 533), as amended by sections 1301 and 1309 of the Tax Reform Act of 1976 (90 Stat. 1713, 1729), with respect to the organization. Accordingly, a governing instrument complying with the requirements of subparagraph (1) of this paragraph may incorporate any savings provision contained in section 101(*l*), (2), (3), (4), or (5) of the Tax Reform Act of 1969, as amended by sections 1301 and 1309 of the Tax Reform Act of 1976, as a specific exception to the general provisions of paragraph (a) of this section. In addition, in the absence of any express provisions to the contrary, the exceptions contained in such savings provisions will generally be regarded as contained in a governing instrument meeting the requirements of subparagraph (1) of this paragraph.

(4) Excess holdings. For purposes of paragraph (a)(2) of this section, the prohibition against "retaining any excess business holdings (as defined in section 4943(c))" shall be deemed only to prohibit the foundation from retaining any excess business holdings when such holdings would subject the foundation to tax under section 4943(a).

(5) Revoked ruling on status. In the case of an organization which—

(i) Has been classified as an organization described in section 509(a)(1), (2), (3), or (4), and

(ii) Subsequently receives a ruling or determination letter stating that it is no longer described in section 509(a)(1), (2), (3), or (4), but is a private foundation within the meaning of section 509,

such organization shall have 1 year from the date of receipt of such ruling or determination letter, or the final ruling or determination letter if a protest is filed to an earlier one, to meet the requirements of section 508(e). Section 508(d)(2)(A) shall not be applicable with respect to gifts and bequests made during this 1-year period if such requirements are met within the 1-year period.

(6) Judicial proceeding. For purposes of paragraphs (a), (b)(5), (d)(2), and (e)(3) of this section, an organization shall be deemed to have met the requirements of section 508(e) within a year, if a judicial proceeding which is necessary to reform its governing instrument or other instrument is instituted within the year and within a reasonable time the organization, in fact, meets the requirements of section 508(e). For purposes only of paragraphs (b)(5), (d)(2), and (e)(3) of this section, if an organization organized before January 1, 1970, institutes such a judicial proceeding within such 1-year period, section 508(e)(2)(C) shall be applied as if such proceeding had been instituted prior to January 1, 1972.

(c) Meaning of governing instrument. For purposes of section 508(e), the term "governing instrument" shall have the same meaning as the term "articles of organization" under § 1.501(c)(3)-1(b)(2). The bylaws of an organization shall not constitute its governing instrument for purposes of section 508(e).

(d) Effect of State law—(1) In general. A private foundation's governing instrument shall be deemed to conform with the requirements of paragraph (a) of this section if valid provisions of State law have been enacted which:

(i) Require it to act or refrain from acting so as not to subject the foundation to the taxes imposed by section 4941 (relating to taxes on self-dealing), 4942 (relating to taxes on failure to distribute income), 4943 (relating to taxes on excess business holdings), 4944 (relating to taxes on investments

which jeopardize charitable purpose), and 4945 (relating to taxable expenditures); or

(ii) Treat the required provisions as contained in the foundation's governing instrument.

(2) **Validity.** (i) Any provision of State law described in subparagraph (1) of this paragraph shall be presumed valid as enacted, and in the absence of State provisions to the contrary, to apply with respect to any foundation that does not specifically disclaim coverage under State law (either by notification to the appropriate State official or by commencement of judicial proceedings) except as provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) If such provision is declared invalid or inapplicable with respect to a class of foundations by the highest appellate court of the State or by the Supreme Court of the United States, the foundations covered by the determination must meet the requirements of section 508(e) within 1 year from the date on which the time for perfecting an application for review by the Supreme Court expires. If such application is filed, the requirements of section 508(e) must be met within a year from the date on which the Supreme Court disposes of the case, whether by denial of the application for review or decision on the merits.

(iii) In addition, if such provision of State law is declared invalid or inapplicable with respect to a class of foundations by any court of competent jurisdiction which decision is not reviewed by a court referred to in subdivision (ii) of this subparagraph, and the Commissioner makes notice to the general public (such as by publication in the Internal Revenue Bulletin) that such provision has been so declared invalid or inapplicable, then all foundations in such State must meet the requirements of section 508(e), without reliance upon such statute to the extent declared invalid or inapplicable by such decision, within 1 year from the date such notice is made public.

(iv) This subparagraph shall not apply to any foundation that is subject to a final judgment entered by a court of competent jurisdiction, holding the law invalid or inapplicable with respect to such foundation. See paragraph (b)(6) of this section for the effect of certain judicial proceedings that are brought within 1 year.

(3) **Conflicting instrument.** For taxable years beginning after March 22, 1973 in order for a private foundation or trust described in section 4947(a)(2) to receive the benefit of coverage under any State statute which makes applicable the requirements of section 508(e)(1)(A) and (B), where the statute by its terms does not apply to a governing instrument which contains a mandatory direction conflicting with any of such requirements, such organization must indicate on its annual return required to be filed under section 6033 (or section 6012 in the case of a trust described in section 4947(a)) that its governing instrument contains no mandatory directions which conflict with the requirements of section 508(e)(1)(A) or (B), as incorporated by the State statute. General language in a governing instrument empowering the trustee to make investments without being limited to those investments authorized by law will not be regarded as a mandatory conflicting direction.

(4) **Exclusion from statute.** (i) For any taxable year beginning after March 22, 1973 in the case of a private foundation or trust described in section 4947(a)(2) subject to a State statute which makes applicable the requirements of section 508(e)(1)(A) and (B) to the governing instruments of such organizations, other than those which take action to be excluded therefrom (such as by filing a notice of exclusion or by instituting appropriate judicial proceedings), an organization will receive the benefit of such State statute only if it indicates on its annual return required to be filed under section 6033 (or section 6012 in the case of a trust described in section 4947(a)) that it has not so taken action to be excluded.

(ii) This paragraph permits certain organizations that are subject to the provisions of such a State law, to avoid changing their governing instruments in order to meet the requirements of section 508(e)(1). Since an organization which avoids the application of a provision or provisions of State law, such as by filing a notice of exclusion, is not entitled to the benefits of this paragraph, such an organization must meet the requirements of section 508(e)(1) without regard to this paragraph and except as provided in section 508(e)(2)(C) or paragraph (g)(1)(iii) of this section must change its governing instrument to the extent inconsistent with section 508(e)(1).

(5) **Treatment of prevailing conflicting clause.** If provisions of State law are inapplicable to a clause in a governing instrument which is contrary to the provisions of section 508(e)(1), the requirements of section 508(e)(2)(C) and paragraph (g)(1)(iii) of this section are not satisfied by a provision of State law which purports to eliminate the need for litigation under such circumstances. Therefore, except as otherwise provided in this section unless the governing instrument is changed or litigation is commenced pursuant to section

508(e)(2)(B) by an organization organized before January 1, 1970, or pursuant to paragraph (g)(1)(ii) of this section, to amend the nonconforming provision to meet the requirements of section 508(e)(1)(A) and (B), then pursuant to section 508(e), such organization will not be exempt from taxation.

(6) Retroactive application to grants or bequests. If valid provisions of such a State law apply retroactively to a taxable year within which an organization has received a grant or request, section 508(d)(2)(A) shall not apply so as to disallow such grant or bequest, but only if such valid provisions of State law are enacted within 2 years of such grant or bequest.

(e) Effect of section 508(e) upon section 4947 trusts—(1) Section 4947(a)(1) trusts. A charitable trust described in section 4947(a)(1) (unless also described in a paragraph of section 509(a)) is subject to all the provisions of paragraph (a) of this section.

(2) Section 4947(a)(2) trusts. A split-interest trust described in section 4947(a)(2), as long as it is so described, is subject to the provisions of paragraph (a)(2) of this section, except to the extent that section 4947 makes any such provisions inapplicable to certain trusts and certain amounts in trust. The governing instrument of a trust described in section 4947(a)(2) may except amounts described in section 4947(a)(2)(A), (B), and (C) from the requirements of paragraph (a)(2) of this section. In the case of a trust having amounts transferred to it both before May 27, 1969, and after May 26, 1969, its governing instrument may except from the provisions of paragraph (a)(2) of this section only those segregated amounts excluded from the application of section 4947(a)(2) by reason of section 4947(a)(2)(C) and the regulations thereunder. Also, the governing instrument of such a trust may exclude the application of sections 4943 and 4944 for any period during which such trust is described in section 4947(b)(3)(A) or (B). See § 53.4947–1(c) of this chapter for rules relating to the applicability of section 4947 to split-interest trusts and § 1.508–2(b)(1)(vi) and (vii) for rules relating to the deductibility of grants or bequests to such trusts.

(3) A section 4947(a)(2) trust becoming a section 4947(a)(1) trust. If the governing instrument of a trust described in section 4947(a)(2) meets the applicable requirements of paragraph (a)(2) of this section and such trust ceases to be so described and becomes instead a trust described in section 4947(a)(1), then such governing instrument must meet, prior to the end of 12 months from the date such trust first becomes described in section 4947(a)(1) (except as otherwise provided in this section) all the requirements of paragraph (a) of this section in order to comply with section 508(e).

(f) Special rules for existing private foundations. (1) Pursuant to section 508(e)(2), section 508(e)(1) and paragraph (a) of this section shall not apply in the case of any organization whose governing instrument was executed before January 1, 1970:

(i) To any taxable year beginning before January 1, 1972;

(ii) To any period after December 31, 1971, during the pendency of any judicial proceeding begun before January 1, 1972, by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument in order to meet the requirements of section 508(e)(1); and

(iii) To any period after the termination of any judicial proceeding described in subdivision (ii) of this subparagraph during which its governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1).

(2) For purposes of subparagraph (1) of this paragraph, and § 1.508–2(b)(1)(vi)(a), a governing instrument will not be treated as executed before the applicable date, if, after such date the dispositive provisions of the instrument are amended (determined under rules similar to the rules set forth in § 20.2055–2(e)(4) of this chapter).

(3) For purposes of subparagraph (1)(ii) and (iii) of this paragraph, a private foundation will be treated as meeting the requirements of section 508(e)(2)(B) and (C) if it has commenced a necessary and timely proceeding in an appropriate court of original jurisdiction and such court has ruled that the foundation's governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1). Such foundation is not required to commence proceedings in any court of appellate jurisdiction in order to comply with section 508(e)(2)(C). See also § 1.508–2(b)(2).

(g) Extension of time for compliance with section 508(e). (1) Except as provided in subparagraph (2) of this paragraph, section 508(e)(1) shall not apply to any private foundation (regardless of when organized) with respect—

(i) To any taxable year beginning before the transitional date,

(ii) To any period on or after the transitional date during the pendency of any judicial proceeding begun before the transitional date by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument in order to meet the requirements of section 508(e)(1), and

(iii) To any period after the termination of any judicial proceeding described in subdivision (ii) of this subparagraph during which its governing instrument or any other instrument does not permit it to meet the requirements of section 508(e)(1).

(2) Subparagraph (1) of this paragraph shall apply only to gifts or bequests referred to in section 508(d)(2)(A) that are made before the transitional date.

(3) For purposes of this paragraph the term "transitional dates" means the earlier of the following dates:

(i) In the case of a medical research organization, May 21, 1976 or in the case of a community trust February 10, 1977, or

(ii) The 91st day after the date an organization receives a final ruling or determination letter that it is a private foundation under section 509(a).
[T.D. 7232, 37 FR 28292, Dec. 22, 1972, as amended by T.D. 7440, 41 FR 50656, Nov. 17, 1976; T.D. 7678, 45 FR 12415, Feb. 26, 1980]

§ 1.508–4 Effective date.

Except as otherwise provided, §§ 1.508–1 through 1.508–3 shall take effect on January 1, 1970.
[T.D. 7232, 37 FR 28294, Dec. 22, 1972]

§ 1.509(a)–1 Definition of private foundation.

In general. Section 509(a) defines the term "private foundation" to mean any domestic or foreign organization described in section 501(c)(3) other than an organization described in section 509(a)(1), (2), (3), or (4). Organizations which fall into the categories excluded from the definition of "private foundation" are generally those which either have broad public support or actively function in a supporting relationship to such organizations. Organizations which test for public safety are also excluded.
[T.D. 7212, 37 FR 21907, Oct. 17, 1972]

§ 1.509(a)–2 Exclusion for certain organizations described in section 170(b)(1)(A).

(a) General rule. Organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)) are excluded from the definition of "private foundation" by section 509(a)(1). For the requirements to be met by organizations described in section 170(b)(1)(A)(i) through (vi), see § 1.170A–9 (a) through (e) and paragraph (b) of this section. For purposes of this section, the parenthetical language "other than in clauses (vii) and (viii)" used in section 509(a)(1) means "other than an organization which is described only in clause (vii) or (viii)." For purposes of this section, an organization may qualify as a section 509(a)(1) organization regardless of the fact that it does not satisfy section 170(c)(2) because:

(1) Its funds are not used within the United States or its possessions, or

(2) It was created or organized other than in, or under the law of, the United States, any State or territory, the District of Columbia, or any possession of the United States.

(b) Medical research organizations. In order to qualify under section 509(a)(1) as a medical research organization described in section 170(b)(1)(A)(iii), an organization must meet the requirements of section 170(b)(1)(A)(iii) and § 1.170A–9(c)(2), except that, solely for purposes of classification as a section 509(a)(1) organization, such organization need not be committed to spend every contribution for medical research before January 1 of the fifth calendar year which begins after the date such contribution is made.
[T.D. 7212, 37 FR 21907, Oct. 17, 1972]

§ 1.509(a)–3 Broadly, publicly supported organizations.

(a) In general—(1) General rule. Section 509(a)(2) excludes certain types of broadly, publicly supported organizations from private foundation status. An organization will be excluded under section 509(a)(2) if it meets the one-third support test under section 509(a)(2)(A) and the not-more-than-one-third support test under section 509(a)(2)(B).

(2) One-third support test. An organization will meet the one-third support test if it normally (within the meaning of paragraph (c), (d), or (e) of this section) receives more than one-third of its

support in each taxable year from any combination of:

(i) Gifts, grants, contributions, or membership fees, and

(ii) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business (within the meaning of section 513), subject to certain limitations described in paragraph (b) of this section,

from permitted sources. For purposes of this section, governmental units, organizations described in section 509(a)(1) and persons other than disqualified persons with respect to the organization shall be referred to as permitted sources. For purposes of this section, the amount of support received from the sources described in subdivisions (i) and (ii) of this subparagraph (subject to the limitations referred to in this subparagraph) will be referred to as the numerator of the one-third support total amount of support received (as defined in section 509(d)) will be referred to as the denominator of the one-third support fraction. For purposes of section 509(a)(2), paragraph (f) of this section distinguishes gifts and contributions from gross receipts; paragraph (g) of this section distinguishes grants from gross receipts; paragraph (h) of this section defines membership fees; paragraph (i) of this section defines "any bureau or similar agency of a governmental unit"; paragraph (j) of this section describes the treatment of certain indirect forms of support; paragraph (k) of this section describes the method of accounting for support; paragraph (*l*) of this section describes the treatment of gross receipts from section 513(a)(1), (2), or (3) activities; and paragraph (m) of this section distinguishes gross receipts from gross investment income.

(3) Not-more-than-one-third support test—(i) In general. An organization will meet the not-more-than-one-third support test under section 509(a)(2)(B) if it normally (within the meaning of paragraph (c), (d), or (e) of this section) receives not more than one-third of its support in each taxable year from the sum of its gross investment income (as defined in section 509(e)) and the excess (if any) of the amount of its unrelated business taxable income (as defined in section 512) derived from trades or businesses which were acquired by the organization after June 30, 1975, over the amount of tax imposed on such income by section 511. For purposes of this section the amount of support received from items described in section 509(a)(2)(B) will be referred to as the numerator of the not-more-than-one-third support fraction, and the total amount of support (as defined in section 509(d)) will be referred to as the denominator of the not-more-than-one-third support fraction. For purposes of section 509(a)(2), paragraph (m) of this section distinguishes gross receipts from gross investment income.

(ii) Trade or business. For purposes of section 509(a)(2)(B)(ii), a trade or business acquired after June 30, 1975, by an organization shall include, in addition to other trades or businesses:

(A) A trade or business acquired after such date from, or as a result of the liquidation of, an organization's subsidiary which is described in section 502 whether or not the subsidiary was held on June 30, 1975,

(B) A new trade or business commenced by an organization after such date.

(iii) Allocation of deductions between businesses acquired before, and businesses acquired after, June 30, 1975. Deductions which are allowable under section 512 but are not directly connected to a particular trade or business, such as deductions referred to in paragraphs (10) and (12) of section 512(b), shall be allocated in the proportion that the unrelated trade or business taxable income derived from trades or businesses acquired after June 30, 1975, bears to the organization's total unrelated business taxable income, both amounts being determined without regard to such deductions.

(iv) Allocation of tax. The tax imposed by section 511 shall be allocated in the same proportion as in paragraph (a)(3)(iii) of this section.

(4) Purposes. The one-third support test and the not-more-than-one-third support test are designed to insure that an organization which is excluded from private foundation status under section 509(a)(2) is responsive to the general public, rather than to the private interests of a limited number of donors or other persons.

(b) Limitation on gross receipts—(1) General rule. In computing the amount of support received from gross receipts under section 509(a)(2)(A)(ii) for purposes of the one-third support test of section 509(a)(2)(A), gross receipts from related activities received from any person, or from any bureau or similar agency of a governmental unit, are includible in any taxable year only to the extent that such receipts do not exceed the greater of $5,000 or 1 percent of the organization's support in such taxable year.

(2) **Examples.** The application of this paragraph may be illustrated by the examples set forth below. For purposes of these examples, the term "general public" is defined as persons other than disqualified persons and other than persons from whom the foundation receives gross receipts in excess of the greater of $5,000 or 1 percent of its support in any taxable year, and the term "gross receipts" is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

Example (1). For the taxable year 1970, X, an organization described in section 501(c)(3), received support of $10,000 from the following sources:

Bureau M (a governmental bureau from which X received gross receipts for services rendered)	$25,000
Bureau N (a governmental bureau from which X received gross receipts for services rendered)	25,000
General public (gross receipts for services rendered)	20,000
Gross investment income	15,000
Contributions from individual substantial contributors (defined as disqualified persons under section 4946(a)(2))	15,000
Total support	100,000

Since the $25,000 received from each bureau amounts to more than the greater of $5,000 or 1 percent of X's support for 1970 (1% of $100,000=$1,000) under section 509(a)(2)(A)(ii), each amount is includible in the numerator of the one-third support fraction only to the extent of $5,000. Thus, for the taxable year 1970, X received support from sources which are taken into account in meeting the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau M	$5,000
Bureau N	5,000
General public	20,000
Total	30,000

Therefore, in making the computations required under paragraph (c), (d), or (e) of this section, only $30,000 is includible in the aggregate numerator and $100,000 is includible in the aggregate denominator of the support fraction.

Example (2). For the taxable year 1970, Y, an organization described in section 501(c)(3), received support of $600,000 from the following sources:

Bureau O (gross receipts for services rendered)	$10,000
Bureau P (gross receipts for services rendered)	10,000
General public (gross receipts for services rendered)	150,000
General public (contributions)	40,000
Gross investment income	150,000
Contributions from substantial contributors	240,000
Total support	600,000

Since the $10,000 received from each bureau amounts to more than the greater of $5,000 or 1 percent of Y's support for 1970 (1% of $600,000=$6,000), each amount is includible in the numerator of the one-third support fraction only to the extent of $6,000. Thus, for the taxable year 1970, Y received support from sources required to meet the one-third support test of section 509(a)(2)(A) computed as follows:

Bureau O	$6,000
Bureau P	6,000
General public (gross receipts)	150,000
General public (contributions)	40,000
Total	202,000

Therefore, in making the computations required under paragraph (c), (d), or (e) of this section, $202,000 is includible in the aggregate numerator and $600,000 is includible in the aggregate denominator of the support fraction.

(c) **"Normally"—(1) In general—(i) Definition.** The support tests set forth in section 509(a)(2) are to be computed on the basis of the nature of the organization's "normal" sources of support. An organization will be considered as "normally" receiving one-third of its support from any combination of gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in paragraph (b) of this section) and not more than one-third of its support from items described in section 509(a)(2)(B) for its current taxable year and the taxable year immediately succeeding its current year, if, for the 4 taxable years immediately preceding the current taxable year, the aggregate amount of the support received during the applicable period from gifts, grants, contributions, membership fees, and gross receipts from permitted sources (subject to the limitations described in paragraph (b) of this section) is more than one-third, and the aggregate amount of the support received from items described in section 509(a)(2)(B) is not more than one-third of the total support of the organization for such 4-year period.

(ii) **Exception for material changes in sources of support.** If for the current taxable year there are substantial and material changes in an organization's sources of support other than changes arising from unusual grants excluded under subparagraph (3) of this paragraph, then in applying subdivision (i) of this subparagraph, neither the 4-year computation period, applicable to such year as an immediately succeeding taxable year, not the 4-year computation period, applicable to such year as a current taxable year shall apply, and in lieu of such computation periods there shall be applied a computation period consisting of the taxable year of substantial and material changes and the 4 taxable years immediately preceding such year. Thus, for example, if there are substantial and material changes in an organization's sources of support for taxable year 1976, then even though such organization meets the requirements of subdivision (i) of this subparagraph based on a computation period of taxable years 1971 through 1974 or 1972 through 1975, such an organization will not meet the requirements of section 509(a)(2)

unless it meets the requirements of subdivision (i) of this subparagraph for a computation period of the taxable years 1972 through 1976. See example (3) in subparagraph (6) of this paragraph for an illustration of this subdivision. An example of a substantial and material change is the receipt of an unusually large contribution or bequest which does not qualify as an unusual grant under subparagraph (3) of this paragraph. See subparagraph (5)(ii) of this paragraph as to the procedure for obtaining a ruling whether an unusually large grant may be excluded as an unusual grant.

(iii) Status of grantors and contributors. (a) If as a result of subdivision (ii) of this subparagraph, an organization is not able to meet the requirements of either the one-third support test described in paragraph (a)(2) of this section or the not-more-than-one-third support test described in paragraph (a)(3) of this section for its current taxable year, its status (with respect to a grantor or contributor under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522) will not be affected until notice of change of status under section 509(a)(2) is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or was aware of, the substantial and material change referred to in subdivision (ii) of this subparagraph, or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as section 509(a)(2) organization.

(b) A grantor or contributor other than one of the organization's founders, creators, or foundation managers (within the meaning of section 4946(b)) will not be considered to be responsible for, or aware of, the substantial and material change referred to in subdivision (ii) of this subparagraph if such grantor or contributor has made such grant or contribution in reliance upon a written statement by the grantee organization that such grant or contribution will not result in the loss of such organization's classification as not a private foundation under section 509(a). Such statement must be signed by a responsible officer of the grantee organization and must set forth sufficient information, including a summary of the pertinent financial data for the 4 preceding years, to assure a reasonably prudent man that his grant or contribution will not result in the loss of the grantee organization's classification as not a private foundation under section 509(a). If a reasonable doubt exists as to the effect of such grant or contribution, or if the grantor or contributor is one of the organization's founders, creators, or foundation managers, the procedure set forth in subparagraph (5)(ii) of this paragraph may be followed by the grantee organization for the protection of the grantor or contributor.

(iv) Special rule for new organizations. If an organization has been in existence for at least 1 taxable year consisting of at least 8 months, but for fewer than 5 taxable years, the number of years for which the organization has been in existence immediately preceding each current taxable year being tested will be substituted for the 4-year period described in subdivision (i) of this subparagraph to determine whether the organization "normally" meets the requirements of paragraph (a) of this section. However, if subdivision (ii) of this subparagraph applies, then the period consisting of the number of years for which the organization has been in existence (up to and including the current year) will be substituted for the 4-year period described in subdivision (i) of this subparagraph. An organization which has been in existence for at least 1 taxable year, consisting of 8 or more months, may be issued a ruling or determination letter if it "normally" meets the requirements of paragraph (a) of this section for the number of years described in this subdivision. Such an organization may apply for a ruling or determination letter under the provisions of this paragraph, rather than under the provisions of paragraph (d) of this section. The issuance of a ruling or determination letter will be discretionary with the Commissioner. See paragraph (e)(4) of this section as to the initial determination of the status of a newly created organization. This subdivision shall not apply to those organizations receiving an extended advance ruling under paragraph (d)(4) of this section.

(2) Terminations under section 507(b)(1)(B). For the special rules applicable to the term "normally" as applied to private foundations which elect to terminate their private foundation status pursuant to the 12-month or 60-month procedure provided in section 507(b)(1)(B), see the regulations under such section.

(3) Exclusion of unusual grants. For purposes of applying the 4-year aggregation test for support set forth in subparagraph (1) of this paragraph, one or more contributions (including contributions made prior to Jan. 1, 1970) may be excluded from the numerator of the one-third support fraction and from the denominator of both the one-third support and not-more-than-one-third support fractions only if such a contribution meets the requirements of this subparagraph. The exclusion pro-

vided by this subparagraph is generally intended to apply to substantial contributions and bequests from disinterested parties, which contributions or bequests:

(i) Are attracted by reason of the publicly supported nature of the organization;

(ii) Are unusual or unexpected with respect to the amount thereof; and

(iii) Would by reason of their size, adversely affect the status of the organization as normally meeting the one-third support test for any of the applicable periods described in paragraph (c), (d), or (e) of this section.

In the case of a grant (as defined in paragraph (g) of this section) which meets the requirements of this subparagraph, if the terms of the granting instrument (whether executed before or after 1969) require that the funds be paid to the recipient organization over a period of years, the amount received by the organization each year pursuant to the terms of such grant may be excluded for such year. However, no item described in section 509(a)(2)(B) may be excluded under this subparagraph. The provisions of this subparagraph shall apply to exclude unusual grants made during any of the applicable periods described in paragraph (c), (d), or (e) of this section. See subparagraph (5)(ii) of this paragraph as to reliance by a grantee organization upon an unusual grant ruling under this subparagraph.

(4) Determining factor. In determining whether a particular contribution may be excluded under subparagraph (3) of this paragraph, all pertinent facts and circumstances will be taken into consideration. No single factor will necessarily be determinative. Among the factors to be considered are:

(i) Whether the contribution was made by any person (or persons standing in a relationship to such person which is described in section 4946(a)(1)(C) through (G)) who created the organization, previously contributed a substantial part of its support or endowment, or stood in a position of authority, such as a foundation manager (within the meaning of section 4946(b)), with respect to the organization. A contribution made by a person other than those persons described in this subdivision will ordinarily be given more favorable consideration than a contribution made by a person described in this subdivision.

(ii) Whether the contribution was a bequest or an inter vivos transfer. A bequest will ordinarily be given more favorable consideration than an inter vivos transfer.

(iii) Whether the contribution was in the form of cash, readily marketable securities, or assets which further the exempt purposes of the organization, such as a gift of a painting to a museum.

(iv) Except in the case of a new organization, whether, prior to the receipt of the particular contribution, the organization (a) has carried on an actual program of public solicitation and exempt activities and (b) has been able to attract a significant amount of public support.

(v) Whether the organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution. In this connection, continued reliance on unusual grants to fund an organization's current operating expenses (as opposed to providing new endowment funds) may be evidence that the organization cannot reasonably be expected to attract future support from the general public.

(vi) Whether, prior to the year in which the particular contribution was received, the organization met the one-third support test described in subparagraph (1) of this paragraph without the benefit of any exclusions of unusual grants pursuant to subparagraph (3) of this paragraph.

(vii) Whether neither the contributor nor any person standing in a relationship to such contributor which is described in section 4946(a)(1)(C) through (G) continues directly or indirectly to exercise control over the organization;

(viii) Whether the organization has a representative governing body as described in § 1.509(a)–3(d)(3)(i); and

(ix) Whether material restrictions or conditions (within the meaning of § 1.507–2(a)(8)) have been imposed by the transferor upon the transferee in connection with such transfer.

(5) Grantors and contributors. (i) As to the status of grants and contributions which result in substantial and material changes in the organization (as described in subparagraph (1)(ii) of this paragraph) and which fail to meet the requirements for exclusion under subparagraph (3) of this paragraph, see the rules prescribed in subparagraph (1)(iii) of this paragraph.

(ii) Prior to the making of any grant or contribution which will allegedly meet the requirements for exclusion under subparagraph (3) of this paragraph, a potential grantee organization may request a ruling whether such grant or contribution may be so excluded. Requests for such ruling

may be filed by the grantee organization with the district director. The issuance of such ruling will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination of the applicability of subparagraph (3) of this paragraph, including all information relating to the factors described in subparagraph (4) of this paragraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of subparagraph (3) of this paragraph.

(6) Examples. The application of the principles set forth in this paragraph is illustrated by the examples set forth below. For purposes of these examples, the term "general public" is defined as persons other than disqualified persons and other than persons from whom the foundation received gross receipts in excess of the greater of $5,000 or 1 percent of its support in any taxable year, the term "gross investment income" is as defined in section 509(e), and the term "gross receipts" is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

Example (1). For the years 1970 through 1973, X, an organization exempt under section 501(c)(3) which makes scholarship grants to needy students of a particular city, received support from the following sources:

1970	
Gross receipts (general public)	$35,000
Contributions (substantial contributors)	36,000
Gross investment income	29,000
Total support	100,000
1971	
Gross receipts (general public)	34,000
Contributions (substantial contributors)	35,000
Gross investment income	31,000
Total support	100,000
1972	
Gross receipts (general public)	35,000
Contributions (substantial contributors)	30,000
Gross investment income	35,000
Total support	100,000
1973	
Gross receipts (general public)	30,000
Contributions (substantial contributors)	39,000
Gross investment income	31,000
Total support	100,000

In applying section 509(a)(2) to the taxable year 1974 on the basis of subparagraph (1)(i) of this paragraph, the total amount of support from gross receipts from the general public ($134,000) for the period 1970 through 1973 was more than one-third, and the total amount of support from gross investment income ($126,000) was less than one-third, of its total support for the same period ($400,000). For the taxable years 1974 and 1975, X is therefore considered "normally" to receive more than one-third of its support from the public sources described in section 509(a)(2)(A) and less than one-third of its support from items described in section 509(a)(2)(B) since due to the pattern of X's support, there are no substantial and material changes in the sources of the organization's support in these years. The fact that X received less than one-third of its support from section 509(a)(2)(A) sources in 1973 and more than one-third of its support from items described in section 509(a)(2)(B) in 1972 does not affect its status since it met the "normally" test over a 4-year period.

Example (2). Assume the same facts as in example (1) except that in 1973 X also received an unexpected bequest of $50,000 from A, an elderly widow who was interested in encouraging the work of X, but had no other relationship to it. Solely by reason of the bequest, A became a disqualified person. X used the bequest to create five new scholarships. Its operations otherwise remained the same. Under these circumstances X could not meet the 4-year support test since the total amount received from gross receipts from the general public ($134,000) would not be more than one-third of its total support for the 4-year period ($450,000). Since A is a disqualified person, her bequest cannot be included in the numerator of the one-third support test under section 509(a)(2)(A). However, based on the factors set forth in subparagraph (4) of this paragraph, A's bequest may be excluded as an unusual grant under subparagraph (3) of this paragraph. Therefore, X will be considered to have met the support test for the taxable years 1974 and 1975.

Example (3). In 1970, Y, an organization described in section 501(c)(3), was created by A, the holder of all the common stock in M corporation, B, A's wife, and C, A's business associate. Each of the three creators made small cash contributions to Y to enable it to begin operations. The purpose of Y was to sponsor and equip athletic teams for underprivileged children in the community. Between 1970 and 1973, Y was able to raise small amounts of contributions through fund raising drives and selling admission to some of the sponsored sporting events. For its first year of operations, it was determined that Y was excluded from the definition of "private foundation" under the provisions of section 509(a)(2). A made small contributions to Y from time to time. At all times, the operations of Y were carried out on a small scale, usually being restricted to the sponsorship of two to four baseball teams of underprivileged children. In 1974, M recapitalized and created a first and second class of 6 percent nonvoting preferred stock, most of which was held by A and B. A then contributed 49 percent of his common stock in M to Y. A, B, and C continued to be active participants in the affairs of Y from its creation through 1974. A's contribution of M's common stock was substantial and constituted 90 percent of Y's total support for 1974. Although Y could satisfy the one-third support test on the basis of the four taxable years prior to 1974, a combination of the facts and circumstances described in subparagraph (4) of this paragraph preclude A's contribution of M's common stock in 1974 from being excluded as an unusual grant under subparagraph (3) of this paragraph. A's contribution in 1974 constituted a substantial and material change in Y's sources of support within the meaning of subparagraph (1)(ii) of this paragraph and on the basis of the 5-year period prescribed in subparagraph (1)(ii) of this paragraph (1970 to 1974), Y would not be considered as "normally" meeting the one-third support test described in paragraph (a)(2) of this section for the taxable years 1974 (the current taxable year) and 1975 (the immediately succeeding taxable year).

Example (4). M, an organization described in section 501(c)(3), was organized in 1971 to promote the appreciation of ballet in a particular region of the United States. Its principal activities will consist of erecting a theater for the performance

of ballet and the organization and operation of a ballet company. The governing body of M consists of 9 prominent unrelated citizens residing in the region who have either an expertise in ballet or a strong interest in encouraging appreciation of the art form. In order to provide sufficient capital for M to commence its activities, X, a private foundation, makes a grant of $500,000 in cash to M. Although A, the creator of X, is one of the nine members of M's governing body, was one of M's original founders, and continues to lend his prestige to M's activities and fund raising efforts, A does not, directly or indirectly, exercise any control over M. By the close of its first taxable year, M has also received a significant amount of support from a number of smaller contributions and pledges from other members of the general public. Upon the opening of its first season of ballet performances, M expects to charge admission to the general public. Under the above circumstances, the grant by X to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2). Although A was a founder and member of the governing body of M, X's grant may be excluded.

Example (5). Assume the same facts as example (4). In 1974, during M's third season of operations, B, a widow, passed away and bequeathed $4 million to M. During 1971 through 1973, B had made small contributions to M, none exceeding $10,000 in any year. During 1971 through 1974, M had received approximately $550,000 from receipts for admissions and contributions from the general public. At the time of B's death, no person standing in a relationship to B described in section 4946(a)(1)(C) through (G) was a member of M's governing body. B's bequest was in the form of cash and readily marketable securities. The only condition placed upon the bequest was that it be used by M to advance the art of ballet. Under the above circumstances, the bequest of B to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2).

Example (6). O is a research organization described in section 501(c)(3). O was created by A in 1971 for the purpose of carrying on economic studies primarily through persons receiving grants from O and engaging in the sale of economic publications. O's five-member governing body consists of A, A's sons, B, and C, and two unrelated economists. In 1971, A made a contribution to O of $100,000 to help establish the organization. During 1971 through 1974 A made annual contributions to O averaging $20,000 a year. During the same period, O received annual contributions from members of the general public averaging $15,000 per year and receipts from the sale of its publications averaging $50,000 per year. In 1974, B made an inter vivos contribution to O of $600,000 in cash and readily marketable securities. Under the above circumstances, B's contribution cannot be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether O meets the one-third support test.

Example (7). P is an educational organization described in section 501(c)(3). P was created in 1971. The governing body of P has 9 members, consisting of A, a prominent civic leader and 8 other unrelated civic leaders and educators in the community, who also participated in the creation of P. During 1971 through 1974, the principal source of income for P has been receipts from the sale of its educational periodicals. These sales have amounted to $200,000 for this period. Small contributions amounting to $50,000 have also been received during the same period from members of the governing body, including A, as well as other members of the general public. In 1974 A contributed $750,000 of the nonvoting stock of Y, a closely held corporation. A retained a substantial portion of the voting stock of Y. By a majority vote, the governing body decided to retain the Y stock for a period of at least 5 years. Under the above circumstances, A's contribution of the Y stock cannot be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether P meets the one-third support test.

(d) Advance rulings to newly created organizations—(1) In general. A ruling or determination letter that an organization is described in section 509(a)(2) will not be issued to a newly created organization prior to the close of its first taxable year consisting of at least 8 months. However, such organization may request a ruling or determination letter that it will be treated as a section 509(a)(2) organization for its first 2 taxable years (or its first 3 taxable years, if its first taxable year consists of less than 8 months). For purposes of this section such 2- or 3-year period, whichever is applicable, shall be referred to as the advance ruling period. Such an advance ruling or determination letter may be issued if the organization can reasonably be expected to meet the requirements of paragraph (a) of this section during the advance ruling period. The issuance of a ruling or determination letter will be discretionary with the Commissioner.

(2) Basic consideration. In determining whether an organization "can reasonably be expected" (within the meaning of subparagraph (1) of this paragraph) to meet the one-third support test under section 509(a)(2)(A) and the not-more-than-one-third support test under section 509(a)(2)(B) described in paragraph (a) of this section for its advance ruling period or extended advance ruling period as provided in subparagraph (4) of this paragraph, if applicable, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units which is necessary to meet such tests. While the factors which are relevant to this determination, and the weight accorded to each of them, may differ from case to case, depending on the nature and functions of the organization, a favorable determination will not be made where the facts indicate that an organization is likely during its advance or extended advance ruling period to receive less than one-third of its support from permitted sources (subject to the limitations of paragraph (b) of this section) or to receive more than one-third of its support from items described in section 509(a)(2)(B).

(3) Factors taken into account. All pertinent facts and circumstances shall be taken into account under subparagraph (2) of this paragraph in determining whether the organizational structure,

programs or activities, and method of operation of an organization are such as to enable it to meet the tests under section 509(a)(2) for its advance or extended advance ruling period. Some of the pertinent factors are:

(i) Whether the organization has or will have a governing body which is comprised of public officials, or individuals chosen by public officials acting in their capacity as such, of persons having special knowledge in the particular field or discipline in which the organization is operating, of community leaders, such as elected officials, clergymen, and educators, or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership. This characteristic does not exist if the membership of the organization's governing body is such as to indicate that it represents the personal or private interests of disqualified persons, rather than the interests of the community or the general public.

(ii) Whether a substantial portion of the organization's initial funding is to be provided by the general public, by public charities, or by government grants, rather than by a limited number of grantors or contributors who are disqualified persons with respect to the organization. The fact that the organization plans to limit its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons will be taken into consideration in determining whether those persons providing the initial support for the organization are representative of the general public. On the other hand, the subsequent sources of funding which the organization can reasonably expect to receive after it has become established and fully operational will also be taken into account.

(iii) Whether a substantial proportion of the organization's initial funds are placed, or will remain, in an endowment, and whether the investment of such funds is unlikely to result in more than one-third of its total support being received from items described in section 509(a)(2)(B).

(iv) In the case of an organization which carries on fund-raising activities, whether the organization has developed a concrete plan for solicitation of funds from the general public on a community or area-wide basis; whether any steps have been taken to implement such plan; whether any firm commitments of financial or other support have been made to the organization by civic, religious, charitable, or similar groups within the community; and whether the organization has made any commitments to, or established any working relationships with, those organizations or classes of persons intended as the future recipients of its funds.

(v) In the case of an organization which carries on community services, such as slum clearance and employment opportunities, whether the organization has a concrete program to carry out its work in the community; whether any steps have been taken to implement that program; whether it will receive any part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant or contribution; and whether it has enlisted the sponsorship or support of other civic or community leaders involved in community service programs similar to those of the organization.

(vi) In the case of an organization which carries on educational or other exempt activities for, or on behalf of, members, whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community, area, profession, or field of special interest (depending on the size of the area and the nature of the organization's activities); whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross-section of the public rather than to restrict membership to a limited number of persons; and whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations.

(vii) In the case of an organization which provides goods, services, or facilities, whether the organization is or will be required to make its services, facilities, performances, or products available (regardless of whether a fee is charged) to the general public, public charities, or governmental units, rather than to a limited number of persons or organizations; whether the organization will avoid executing contracts to perform services for a limited number of firms or governmental agencies or bureaus; and whether the service to be provided is one which can be expected to meet a special or general need among a substantial portion of the general public.

(4) Extension of advance ruling period. (i) The advance ruling period described in subparagraph (1) of this paragraph shall be extended for a period of 3 taxable years after the close of the unextended

advance ruling period if the organization so requests, but only if such organization's request accompanies its request for an advance ruling and is filed with a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the extended advance ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the extended advance ruling period. An organization's extended advance ruling period is 5 taxable years if its first taxable year consists of at least 8 months, or is 6 taxable years if its first taxable year is less than 8 months.

(ii) Notwithstanding subdivision (i) of this subparagraph, an organization which has received or applied for an advance ruling prior to October 16, 1972, may file its request for the 3-year extension within 90 days from such date, but only if it files the consents required in this section.

(iii) See paragraph (e)(4)(i)(d) of this section for the effect upon the initial determination of status of an organization which receives an advance ruling for an extended advance ruling period.

(e) **Status of newly created organizations—(1) Advance or extended advance ruling.** This subparagraph shall apply to a newly created organization which has received a ruling or determination letter under paragraph (d) of this section that it be treated as a section 509(a)(2) organization for its advance or extended advance ruling period. So long as such an organization's ruling or determination letter has not been terminated by the Commissioner before the expiration of the advance or extended advance ruling period, then whether or not such organization has satisfied the requirements of paragraph (a) of this section during such advance or extended advance ruling period, such an organization will be treated as an organization described in section 509(a)(2) in accordance with subparagraphs (2) and (3) of this paragraph, both for purposes of the organization and any grantor or contributor to such organization.

(2) **Reliance period.** Except as provided in subparagraphs (1) and (3) of this paragraph, an organization described in subparagraph (1) of this paragraph will be treated as an organization described in section 509(a)(2) for all purposes other than section 507(d) and 4940 for the period beginning with its inception and ending 90 days after its advance or extended advance ruling period. Such period will be extended until a final determination is made of such an organization's status only if the organization submits, within the 90-day period, information needed to determine whether it meets the requirements of paragraph (a) of this section for its advance or extended advance ruling period (even if such organization fails to meet the requirements of such paragraph (a)). However, since this subparagraph does not apply to section 4940, if it is subsequently determined that the organization was a private foundation from its inception, then the tax imposed by section 4940 shall be due without regard to the advance ruling or determination letter. Consequently, if any amount of tax under section 4940 in such a case is not paid on or before the last date prescribed for payment, the organization is liable for interest in accordance with section 6601. However, since any failure to pay such tax during the period referred to in this subparagraph is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

(3) **Grantors or contributors.** If a ruling or determination letter is terminated by the Commissioner prior to the expiration of the period described in subparagraph (2) of this paragraph, for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 the status of grants or contributions with respect to grantors or contributors to such organizations will not be affected until notice of change of status of such organization is made to the public (such as by publication of the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's loss of classification under section 509(a)(2) or acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from such classification. See, however, § 1.509(a)–3(c)(5)(ii) for the procedures to be followed to protect the grantor or contributor from being considered responsible for, or aware of, the act or failure to act resulting in the grantee's loss of classification under section 509(a)(2).

(4) **Initial determination of status—(i) New organizations.** (a) The initial determination of status of a newly created organization is the first determination (other than by issuance of an advance ruling or determination letter under paragraph (d) of this section) that the organization will be considered as "normally" meeting the requirements of paragraph (a) of this section for a period beginning with its first taxable year.

(b) In the case of a new organization whose first taxable year is at least 8 months, except as provid-

ed for in subdivision (i)(d) of this subparagraph, the initial determination of status shall be based on a computation period of either the first taxable year or the first and second taxable years.

(c) In the case of a new organization whose first taxable year is less than 8 taxable months, except as provided for in subdivision (i)(d) of this subparagraph, the initial determination of status shall be based on a computation period of either the first and second taxable years or the first, second and third taxable years.

(d) In the case of an organization which has received a ruling or determination letter for an extended advance ruling period under paragraph (d)(4) of this section, the initial determination of status shall be based on a computation period of all of the taxable years in the extended advance ruling period. However, where the ruling or determination letter for an extended advance ruling period under paragraph (d)(4) of this section is terminated by the Commissioner prior to the expiration of the period described in subparagraph (2) of this paragraph, the initial determination of status shall be based on a computation period of the period provided for in (b) or (c) of this subdivision or, if greater, the number of years to which the advance ruling applies.

(e) An initial determination that an organization will be considered as "normally" meeting the requirements of paragraph (a) of this section shall be effective for each taxable year in the computation period plus (except as provided by paragraph (c)(1)(ii) of this section relating to material changes in sources of support) the two taxable years immediately succeeding the computation period. Therefore, in the case of an organization referred to in (b) of this subdivision to which paragraph (c)(1)(ii) of this section does not apply, with respect to its first, second, and third taxable years, such an organization shall be described in section 509(a)(2) if it meets the requirements of paragraph (a) of this section for either its first taxable year or for its first and second taxable years on an aggregate basis. In addition, if it meets the requirements of paragraph (a) of this section for its first and second taxable years it shall be described in section 509(a)(2) for its fourth taxable year. Once an organization is considered as "normally" meeting the requirements of paragraph (a) for a period specified under this subdivision, paragraph (c)(1)(i), (ii), or (iv) of this section shall apply.

(f) The provisions of this subdivision may be illustrated by the following examples:

Example (1). X, a calendar year organization described in section 501(c)(3), is created in February 1972 for the purpose of displaying African art. The support X received from the public in 1972 satisfies the one-third support and not-more-than-one-third support tests described in section 509(a)(2) for its first taxable year, 1972. X may therefore get an initial determination that it meets the requirements of paragraph (a) of this section for its first taxable year beginning in February 1972 and ending on December 31, 1972. This determination will be effective for taxable years 1972, 1973, and 1974.

Example (2). Assume the same facts as in example (1) except that X also receives a substantial contribution from one individual in 1972 which is not excluded from the denominator of the one-third support fraction described in section 509(a)(2) by reason of the unusual grant provision of subparagraph (c)(3) of this section. Because of this substantial contribution, X fails to satisfy the one-third support test over its first taxable year, 1972. However, the support received from the public over X's first and second taxable years in the aggregate satisfies the one-third support and not-more-than-one-third support tests. X may therefore get an initial determination that it meets the requirements of paragraph (a) of this section for its first and second taxable years in the aggregate beginning in February 1972 and ending on December 31, 1973. This determination will be effective for taxable years 1972, 1973, 1974, and 1975.

Example (3). Y, a calendar year organization described in section 501(c)(3), is created in July 1972 for the encouragement of the musical arts. Y requests and receives an extended advance ruling period of five full taxable years plus its initial short taxable year of 6 months under subparagraph (d)(4) of this section. The extended advance ruling period begins in July 1972 and ends on December 31, 1977. The support received from the public over Y's first through sixth taxable years in the aggregate will satisfy the one-third support and not-more-than-one-third support tests described in section 509(a)(2). Therefore, Y in 1978 may get an initial determination that it meets the requirements of paragraph (a) of this section in the aggregate over all the taxable years in its extended advance ruling period beginning in July 1972 and ending on December 31, 1977. This determination will be effective for taxable years 1972 through 1979.

Example (4). Assume the same facts as in example (3) except that the ruling for the extended advance ruling period is terminated prospectively at the end of 1975, so that Y may not rely upon such ruling for 1976 or any succeeding year. The support received from the public over Y's first through fourth taxable years (1972 through 1975) will not satisfy the one-third support and not-more-than-one-third support tests described in section 509(a)(2). Because the ruling was terminated, the computation period for Y's initial determination of status is the period 1972 through 1975. Since Y has not met the requirements of paragraph (a) of this section for such computation period, Y is not described in section 509(a)(2) for purposes of its initial determination of status. If Y is not described in section 509(a)(1), (3), or (4), then Y is a private foundation. As of 1976, Y shall be treated as a private foundation for all purposes (except as provided in subparagraph (3) of this paragraph with respect to grantors and contributors), and as of July 1972 for purposes of the tax imposed by section 4940 and for purposes of section 507(d) (relating to aggregate tax benefit).

(ii) **Advance rulings.** Unless a newly created organization has obtained a ruling or determination letter under paragraph (d) of this section that it be treated as a section 509(a)(2) organization for its advance or extended advance ruling period, it can not rely upon the possibility it will meet the

requirements of paragraph (a) of this section for a taxable year which begins before the close of either applicable computation period provided for in subdivision (i)(b) or (c) of this subparagraph. Therefore, an organization which has not obtained such a ruling or determination letter, in order to avoid the risks associated with subsequently being determined to be a private foundation, may comply with the rules applicable to private foundations, and may pay, for example, the tax imposed by section 4940. In that event, if the organization subsequently meets the requirements of paragraph (a) for either applicable computation period, it shall be treated as a section 509(a)(2) organization from its inception, and, therefore, any tax imposed under chapter 42 shall be refunded and section 509(b) shall not apply.

(iii) Penalties. If a newly created organization fails to obtain a ruling or determination letter under paragraph (d) of this section, and fails to meet the requirements of paragraph (a) of this section for the first applicable computation period provided for in subdivision (i)(b) or (c) of this subparagraph, see section 6651 for penalty for failure to file return and pay tax.

(iv) Examples. This subparagraph may be illustrated by the following examples:

Example (1). On January 1, 1972, A contributes $100,000 to X, an organization described in section 501(c)(3) which he created on such date. X is not described in section 509(a)(1), (3), or (4). X's governing instrument does not contain the provisions referred to in section 508(e). Therefore, A is not entitled to a deduction under section 170 for the $100,000 contribution by reason of section 508(d)(2)(A) unless X is described in section 509(a)(2). If X meets the requirements of section 509(a)(2) for 1972 and 1973 on an aggregate basis, then whether or not X met the requirements of section 509(a)(2) for 1972 based on the support received in 1972, X would not have to meet the governing instrument requirements of section 508(e), and section 508(d)(2)(A) would not prevent A from claiming the deduction under section 170 for 1972. If X fails to meet the requirements of section 509(a)(2) for both 1972 and, on an aggregate basis, 1972 and 1973, X would lose its exempt status under section 508(e) for both 1972 and 1973, and A would be barred by section 508(d)(2)(A) from claiming a deduction for the $100,000 contribution to X.

Example (2). Assume the same facts as in example (1) except that X's governing instrument contains provisions which meet the requirements of section 508(e) in the event X is a private foundation, but do not apply to X in the event X is not a private foundation. Whether or not X meets the requirements of section 509(a)(2) for 1972 based on the support received in 1972 or 1972 and 1973 on an aggregate basis, since X meets the requirements of section 508(e), section 508(d)(2)(A) would not bar A from claiming a deduction under section 170 for 1972 for the contribution to X.

(f) Gifts and contributions distinguished from gross receipts—(1) In general. In determining whether an organization normally receives more than one-third of its support from permitted sources, all "gifts" and "contributions" (within the meaning of section 509(a)(2)(A)(i)) received from permitted sources, are includible in the numerator of the support fraction in each taxable year. However, "gross receipts" (within the meaning of section 509(a)(2)(A)(ii)) from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, are includible in the numerator of the support fraction in any taxable year only to the extent that such gross receipts do not exceed the limitation with respect to the greater of $5,000 or 1 percent of support which is describing paragraph (b) of this section. The terms "gifts" and "contributions" shall, for purposes of section 509(a)(2), have the same meaning as such terms have under section 170(c) and also include bequests, legacies, devises, and transfers within the meaning of section 2055 or 2106(a)(2). Thus, for purposes of section 509(a)(2)(A), any payment of money or transfer of property without adequate consideration shall be considered a "gift" or "contribution." Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the status of the payment or transfer under section 170(c) shall determine whether and to what extent such payment or transfer constitutes a "gift" or "contribution" under section 509(a)(2)(A)(i) as distinguished from "gross receipts" from related activities under section 509(a)(2)(A)(ii).

(2) Valuation of property. For purposes of section 509(a)(2), the amount includible in computing support with respect to gifts, grants or contributions of property or use of such property shall be the fair market or rental value of such property at the date of such gift or contribution.

(3) Example. The provisions of this paragraph may be illustrated by the following example:

Example. P is a local agricultural club described in section 501(c)(3). In order to encourage interest and proficiency by young people in farming and raising livestock, it makes awards at its annual fair for outstanding specimens of produce and livestock. Most of these awards are cash or other property donated by local businessmen. When the awards are made, the donors are given recognition for their donations by being identified as the donor of the award. The recognition given to donors is merely incidental to the making of the award to worthy youngsters. For these reasons, the donations will constitute "contributions" for purposes of section 509(a)(2)(A)(i). The amount includible in computing support with respect to such contributions is equal to the cash contributed or the fair market value of other property on the dates contributed.

(g) Grants distinguished from gross receipts—(1) In general. In determining whether an orga-

nization normally receives more than one-third of its support from public sources, all "grants" (within the meaning of section 509(a)(2)(A)(i)) received from permitted sources are includible in full in the numerator of the support fraction in each taxable year. However, "gross receipts" (within the meaning of section 509(a)(2)(A)(ii)) from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business, are includible in the numerator of the support fraction in any taxable year only to the extent that such gross receipts do not exceed the limitation with respect to the greater of $5,000 or 1 percent of support which is described in paragraph (b) of this section. A grant is normally made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes. It may contain certain terms and conditions imposed by the grantor to insure that the grantee's programs or activities are conducted in a manner compatible with the grantor's own programs and policies and beneficial to the public. The grantee may also perform a service or produce a work product which incidentally benefits the grantor. Because of the imposition of terms and conditions, the frequent similarity of public purposes of grantor and grantee, and the possibility of benefit resulting to the grantor, amounts received as grants "for" the carrying on of exempt activities are sometimes difficult to distinguish from amounts received as gross receipts "from" the carrying on of exempt activities. The fact that the agreement, pursuant to which payment is made, is designated a "contract" or a "grant" is not controlling for purposes of classifying the payment under section 509(a)(2).

(2) **Distinguishing factors.** For purposes of section 509(a)(2)(A)(ii), in distinguishing the term "gross receipts" from the term "grants," the term "gross receipts" means amounts received from an activity which is not an unrelated trade or business, if a specific service, facility, or product is provided to serve the direct and immediate needs of the payor, rather than primarily to confer a direct benefit upon the general public. In general, payments made primarily to enable the payor to realize or receive some economic or physical benefit as a result of the service, facility, or product obtained will be treated as "gross receipts" with respect to the payee. The fact that a profitmaking organization would, primarily for its own economic or physical betterment, contract with a nonprofit organization for the rendition of a comparable service, facility or product from such organization constitutes evidence that any payments received by the nonprofit payee organization (whether from a governmental unit, a nonprofit or a profitmaking organization) for such services, facilities or products are primarily for the economic or physical benefit of the payor and would therefore be considered "gross receipts," rather than "grants" with respect to the payee organization. For example, if a nonprofit hospital described in section 170(b)(1)(A)(iii) engages an exempt research and development organization to develop a more economical system of preparing food for its own patients and personnel, and it can be established that a hospital operated for profit might engage the services of such an organization to perform a similar benefit for its economic betterment, such fact would constitute evidence that the payments received by the research and development organization constitute "gross receipts," rather than "grants." Research leading to the development of tangible products for the use or benefit of the payor will generally be treated as a service provided to serve the direct and immediate needs of the payor, while basic research or studies carried on in the physical or social sciences will generally be treated as primarily to confer a direct benefit upon the general public.

(3) **Examples.** The application of this paragraph may be illustrated by the following examples:

Example (1). M, a nonprofit research organization described in section 501(c)(3), engages in some contract research. It receives funds from the government to develop a specific electronic device needed to perfect articles of space equipment. The initiative for the project came solely from the government. Furthermore, the government could have contracted with profitmaking research organizations which carry on similar activities. The funds received from the government for this project are gross receipts and do not constitute "grants" within the meaning of section 509(a)(2)(A)(i). M provided a specific product at the government's request and thus was serving the direct and immediate needs of the payor within the meaning of subparagraph (2) of this paragraph.

Example (2). N is a nonprofit educational organization described in section 501(c)(3). Its principal activity is to operate institutes to train employees of various industries in the principles of management and administration. The government pays N to set up a special institute for certain government employees and to train them over a 2-year period. Management training is also provided by profitmaking organizations. The funds received are included as "gross receipts." The particular services rendered were to serve the direct and immediate needs of the government in the training of its employees within the meaning of subparagraph (2) of this paragraph.

Example (3). The Office of Economic Opportunity makes a community action program grant to O, an organization described in section 509(a)(1). O serves as a "delegate agency" of OEO for purposes of financing a local community action program. As part of this program, O signs an agreement with X, an educational and charitable organization described in section 501(c)(3), to carry out a housing program for the benefit of poor families. Pursuant to this agreement, O pays X out of the funds provided by OEO to build or rehabilitate low

income housing and to provide advisory services to other nonprofit organizations in order for them to meet similar housing objectives, all on a nonprofit basis. Payments made from O to X constitute "grants" for purposes of section 509(a)(2)(A) because such program is carried on primarily for the direct benefit of the community.

Example (4). P is an educational institute described in section 501(c)(3). It carries on studies and seminars to assist institutions of higher learning. It receives funds from the government to research and develop a program of black studies for institutions of higher learning. The performance of such a service confers a direct benefit upon the public. Because such program is carried on primarily for the direct benefit of the public, the funds are considered a "grant."

Example (5). Q is an organization described in section 501(c)(3) which carries on medical research. Its efforts have primarily been directed toward cancer research. Q sought funds from the government for a particular project being contemplated in connection with its work. In order to encourage its activities, the government gives Q the sum of $25,000. The research project sponsored by government funds is primarily to provide direct benefit to the general public, rather than to serve the direct and immediate needs of the government. The funds are therefore considered a "grant."

Example (6). R is a public service organization described in section 501(c)(3) and composed of State and local officials involved in public works activities. The Bureau of Solid Waste, Management of the Department of Health, Education, and Welfare paid R to study the feasibility of a particular system for disposal of solid waste. Upon completion of the study, R was required to prepare a final report setting forth its findings and conclusions. Although R is providing the Bureau of Solid Waste Management with a final report, such report is the result of basic research and study in the physical sciences and is primarily to provide direct benefit to the general public by serving to further the general functions of government, rather than a direct and immediate governmental need. The funds paid to R are therefore a "grant" within the meaning of section 509(a)(2).

Example (7). R is the public service organization referred to in example (6). W, a municipality described in section 170(c)(1), decides to construct a sewage disposal plant. W pays R to study a number of possible locations for such plant and to make recommendations to W, based upon a number of factors, as to the best location. W instructed R that in making its recommendation, primary consideration should be given to minimizing the costs of the project to W. Since the study commissioned by W was primarily directed toward producing an economic benefit to W in the form of minimizing the costs of its project, the services rendered are treated as serving W's direct and immediate needs and are includible as "gross receipts" by R.

Example (8). S is an organization described in section 501(c)(3). It was organized and is operated to further African development and strengthen understanding between the United States and Africa. To further these purposes, S receives funds from the Agency for International Development and the Department of State under which S is required to carry out the following programs: Selection, transportation, orientation, counseling, and language training of African students admitted to American institutions of higher learning; payment of tuition, other fees, and maintenance of such students; and operation of schools and vocational training programs in underdeveloped countries for residents of those countries. Since the programs carried on by S are primarily to provide direct benefit to the general public, all of the funds received by S from the Federal agencies are considered "grants" within the meaning of section 509(a)(2).

(h) Definition of membership fees—(1) General rule. For purposes of section 509(a)(2), the fact that a membership organization provides services, admissions, facilities, or merchandise to its members as part of its overall activities will not, in itself, result in the classification of fees received from members as "gross receipts" rather than "membership fees." If an organization uses membership fees as a means of selling admissions, merchandise, services, or the use of facilities to members of the general public who have no common goal or interest (other than the desire to purchase such admissions, merchandise, services, or use of facilities), then the income received from such fees shall not constitute "membership fees" under section 509(a)(2)(A)(i), but shall, if from a related activity, constitute "gross receipts" under section 509(a)(2)(A)(ii). On the other hand, to the extent the basic purpose for making the payment is to provide support for the organization rather than to purchase admissions, merchandise, services, or the use of facilities, the income received from such payment shall constitute "membership fees."

(2) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). M is a symphony society described in section 501(c)(3). Its primary purpose is to support the local symphony orchestra. The organization has three classes of membership. Contributing members pay annual dues of $10, sustaining members pay $25, and honorary members pay $100. The dues are placed in a maintenance fund which is used to provide financial assistance in underwriting the orchestra's annual deficit. Members have the privilege of purchasing subscriptions to the concerts before they go on sale to the general public, but must pay the same price as any other member of the public. They also are entitled to attend a number of rehearsals each season without charge. Under these circumstances, M's receipts from the members constitute "membership fees" for purposes of section 509(a)(2)(A)(i).

Example (2). N is a theater association described in section 501(c)(3). Its purpose is to support a repertory company in the community in order to make live theatrical performances available to the public. The organization sponsors six plays each year. Members of the organization are entitled to a season subscription to the plays. The fee paid as dues approximates the retail price of the six plays, less a 10-percent discount. Tickets to each performance are also sold directly to the general public. The organization also holds a series of lectures on the theater which members may attend. Under these circumstances, the fees paid by members as dues will be considered "gross receipts" from a related activity. Although the fees are designated as membership fees, they are actually admissions to a series of plays.

(i) "Bureau" defined—(1) In general. The term "any bureau or similar agency of a governmental unit" (within the meaning of section 509(a)(2)(A)(ii)), refers to a specialized operating unit of the executive, judicial, or legislative branch

of government where business is conducted under certain rules and regulations. Since the term "bureau" refers to a unit functioning at the operating, as distinct from the policymaking, level of government, it is normally descriptive of a subdivision of a department of government. The term "bureau," for purposes of section 509(a)(2)(A)(ii), would therefore not usually include those levels of government which are basically policymaking or administrative, such as the office of the Secretary or Assistant Secretary of a department, but would consist of the highest operational level under such policymaking or administrative levels. Each subdivision of a larger unit within the Federal Government, which is headed by a Presidential appointee holding a position at or above Level V of the Executive Schedule under 5 U.S.C. 5316, will normally be considered an administrative or policymaking, rather than an operating, unit. Amounts received from a unit functioning at the policymaking or administrative level of government will be treated as received from one bureau or similar agency of such unit. Units of a governmental agency above the operating level shall be aggregated and considered a separate bureau for this purpose. Thus, an organization receiving gross receipts from both a policymaking or administrative unit and an operational unit of a department will be treated as receiving gross receipts from two "bureaus" within the meaning of section 509(a)(2)(A)(ii). For purposes of this subparagraph, the Departments of Air Force, Army, and Navy are separate departments and each is considered as having its own policymaking, administrative, and operating units.

(2) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). The Bureau of Health Insurance is considered a "bureau" within the meaning of section 509(a)(2)(A)(ii). It is a part of the Department of Health, Education, and Welfare, whose Secretary performs a policymaking function, and is under the Social Security Administration, which is basically an administrative unit. The Bureau of Health Insurance is in the first operating level within the Social Security Administration. Similarly, the National Cancer Institute would be considered a "bureau," as it is an operating part of the National Institutes of Health within the Department of Health, Education, and Welfare.

Example (2). The Bureau for Africa and the Bureau for Latin America are considered "bureaus" within the meaning of section 509(a)(2)(A)(ii). Both are separate operating units under the administrator of the Agency for International Development, a policymaking official. If an organization received gross receipts from both of these bureaus, the amount of gross receipts received from each would be subject to the greater of $5,000 or 1 percent limitation under section 509(a)(2)(A)(ii).

Example (3). The Bureau of International Affairs of the Civil Aeronautics Board is considered a "bureau" within the meaning of section 509(a)(2)(A)(ii). It is an operating unit under the administrative office of the Executive Director. The subdivisions of the Bureau of International Affairs are Geographic Areas and Project Development Staff. If an organization received gross receipts from these subdivisions, the total gross receipts from these subdivisions would be considered gross receipts from the same "bureau," the Bureau of International Affairs, and would be subject to the greater of $5,000 or 1 percent limitation under section 509(a)(2)(A)(ii).

Example (4). The Department of Mental Health, a State agency which is an operational part of State X's Department of Public Health, is considered a "bureau." The Department of Public Health is basically an administrative agency and the Department of Mental Health is at the first operational level within it.

Example (5). The Aeronautical Systems Division of the Air Force Systems Command, and other units on the same level, are considered separate "bureaus" with the meaning of section 509(a)(2)(A)(ii). They are part of the Department of the Air Force which is a separate department for this purpose, as are the Army and Navy. The Secretary and the Under Secretary of the Air Force perform the policymaking function, the Chief of Staff and the Air Force Systems Command are basically administrative, having a comprehensive complement of staff functions to provide administration for the various divisions. The Aeronautical Systems Division and other units on the same level are thus the first operating level, as evidenced by the fact that they are the units that let contracts and perform the various operating functions.

Example (6). The Division of Space Nuclear Systems, the Division of Biology and Medicine, and other units on the same level within the Atomic Energy Commission are each separate "bureaus" within the meaning of section 509(a)(2)(A)(ii). The Commissioners (which make up the Commission) are the policymakers. The general manager and the various assistant general managers perform the administrative function. The various divisions perform the operating function as evidenced by the fact that each has separate programs to pursue and contracts specifically for these various programs.

(j) Grants from public charities—(1) General rule. For purposes of the one-third support test in section 509(a)(2)(A), grants (as defined in paragraph (g) of this section) received from an organization described in section 509(a)(1) (hereinafter referred to in this subparagraph as a "public charity") are generally includible in full in computing the numerator of the recipient's support fraction of the taxable year in question. It is sometimes necessary to determine whether the recipient of a grant from a public charity has received such support from the public charity as a grant, or whether the recipient has in fact received such support as an indirect contribution from a donor to the public charity. If the amount received is considered a grant from the public charity, it is fully includible in the numerator of the support fraction under section 509(a)(2)(A). However, if the amount received is considered to be an indirect contribution from one of the public charity's donors which has passed through the public charity to the recipient organization, such amount will retain its character as a contribution from such donor and, if, for example, the donor is a substan-

tial contributor (as defined in section 507(d)(2)) with respect to the ultimate recipient, such amount shall be excluded from the numerator of the support fraction under section 509(a)(2). If a public charity makes both an indirect contribution from its donor and an additional grant to the ultimate recipient, the indirect contribution shall be treated as made first.

(2) Indirect contributions. For purposes of subparagraph (1) of this paragraph, an indirect contribution is one which is expressly or impliedly earmarked by the donor as being for, or for the benefit of, a particular recipient (rather than for a particular purpose).

(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). M, a national foundation for the encouragement of the musical arts, is an organization described in section 170(b)(1)(A)(vi). A gives M a donation of $5,000 without imposing any restrictions or conditions upon the gift. M subsequently makes a $5,000 grant to X, an organization devoted to giving public performances of chamber music. Since the grant to X is treated as being received from M, it is fully includible in the numerator of X's support fraction for the taxable year of receipt.

Example (2). Assume M is the same organization described in example (1). B gives M a donation of $10,000, but requires that M spend the money for the purpose of supporting organizations devoted to the advancement of contemporary American music. M has complete discretion as to the organizations of the type described to which it will make a grant. M decides to make grants of $5,000 each to Y and Z, both being organizations described in section 501(c)(3) and devoted to furthering contemporary American music. Since the grants to Y and Z are treated as being received from M, Y and Z may each include one of the $5,000 grants in the numerator of its support fraction for purposes of section 509(a)(2)(A). Although the donation to M was conditioned upon the use of the funds for a particular purpose, M was free to select the ultimate recipient.

Example (3). N is a national foundation for the encouragement of art and is an organization described in section 170(b)(1)(A)(vi). Grants to N are permitted to be earmarked for particular purposes. O, which is an art workshop devoted to training young artists and claiming status under section 509(a)(2), persuades C, a private foundation, to make a grant of $25,000 to N. C is a disqualified person with respect to O. C made the grant to N with the understanding that N would be bound to make a grant to O in the sum of $25,000, in addition to a matching grant of N's funds to O in the sum of $25,000. Only the $25,000 received directly from N is considered a grant from N. The other $25,000 is deemed an indirect contribution from C to O and is to be excluded from the numerator of O's support fraction.

(k) Method of accounting. For purposes of section 509(a)(2), an organization's support will be determined solely on the cash receipts and disbursement method of accounting described in section 446(c)(1). For example, if a grantor makes a grant to an organization payable over a term of years, such grant will be includible in the support fraction of the grantee organization only when and to the extent amounts payable under the grant are received by the grantee.

(*l*) Gross receipts from section 513(a)(1), (2), or (3) activities. For purposes of section 509(a)(2)(A)(ii), gross receipts from activities described in section 513(a)(1), (2), or (3) will be considered gross receipts from activities which are not unrelated trade or business.

(m) Gross receipts distinguished from gross investment income. (1) For purposes of section 509(a)(2), where the charitable purpose of an organization described in section 501(c)(3) is accomplished through the furnishing of facilities for a rental fee or loans to a particular class of persons, such as aged, sick, or needy persons, the support received from such persons will be considered "gross receipts" (within the meaning of section 509(d)(2)) from an activity which is not an unrelated trade or business, rather than "gross investment income." However, if such organization also furnishes facilities or loans to persons who are not members of such class and such furnishing does not contribute importantly to the accomplishment of such organization's exempt purposes (aside from the need of such organization for income or funds or the use it makes of the profits derived), the support received from such furnishing will be considered "rents" or "interest" and therefore will be treated as "gross investment income" within the meaning of section 509(d)(4), unless such income is included in computing the tax imposed by section 511.

(2) The provisions of this paragraph may be illustrated by the following example:

Example. X, an organization described in section 501(c)(3), is organized and operated to provide living facilities for needy widows of deceased servicemen. X charges such widows a small rental fee for the use of such facilities. Since X is accomplishing its exempt purpose through the rental of such facilities, the support received from the widows is considered "gross receipts" within the meaning of section 509(d)(2). However, if X rents part of its facilities to persons having no relationship to X's exempt purpose, the support received from such rental will be considered "gross investment income" within the meaning of section 509(d)(4), unless such income is included in computing the tax imposed by section 511.

[T.D. 7212, 37 FR 21907, Oct. 17, 1972, as amended by T.D. 7784, 46 FR 37889, July 23, 1981]

§ 1.509(a)–4 Supporting organizations.

(a) In general. (1) Section 509(a)(3) excludes from the definition of "private foundation" those organizations which meet the requirements of subparagraphs (A), (B), and (C) thereof.

(2) Section 509(a)(3)(A) provides that a section 509(a)(3) organization must be organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2). Section 509(a)(3)(A) describes the nature of the support or benefit which a section 509(a)(3) organization must provide to one or more section 509(a)(1) or (2) organizations. For purposes of section 509(a)(3)(A), paragraph (b) of this section generally describes the organizational and operational tests; paragraph (c) of this section describes permissible purposes under the organizational test; paragraph (d) of this section describes the requirement of supporting or benefiting one or more "specified" publicly supported organizations; and paragraph (e) of this section describes permissible beneficiaries and activities under the operational test.

(3) Section 509(a)(3)(B) provides that a section 509(a)(3) organization must be operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2). Section 509(a)(3)(B) and paragraph (f) of this section describe the nature of the relationship which must exist between the section 509(a)(3) and section 509(a)(1) or (2) organizations. For purposes of section 509(a)(3)(B), paragraph (g) of this section defines "operated, supervised, or controlled by"; paragraph (h) of this section defines "supervised or controlled in connection with;" and paragraph (i) of this section defines "operated in connection with."

(4) Section 509(a)(3)(C) provides that a section 509(a)(3) organization must not be controlled directly or indirectly by disqualified persons (other than foundation managers or organizations described in section 509(a)(1) or (2)). Section 509(a)(3)(C) and paragraph (j) of this section prescribe a limitation on the control over the section 509(a)(3) organization.

(5) For purposes of this section, the term "supporting organization" means either an organization described in section 509(a)(3) or an organization seeking section 509(a)(3) status, depending upon its context. For purposes of this section, the term "publicly supported organization" means an organization described in section 509(a)(1) or (2).

(b) Organizational and operational tests. (1) Under subparagraph (A) of section 509(a)(3), in order to qualify as a supporting organization, an organization must be both organized and operated exclusively "for the benefit of, to perform the functions of, or to carry out the purposes of" (hereinafter referred to in this section as being organized and operated "to support or benefit") one or more specified publicly supported organizations. If an organization fails to meet either the organizational or the operational test, it cannot qualify as a supporting organization.

(2) In the case of supporting organizations created prior to January 1, 1970, the organizational and operational tests shall apply as of January 1, 1970. Therefore, even though the original articles of organization did not limit its purposes to those required under section 509(a)(3)(A) and even though it operated before January 1, 1970, for some purpose other than those required under section 509(a)(3)(A), an organization will satisfy the organizational and operational tests if, on January 1, 1970, and at all times thereafter, it is so constituted as to comply with these tests. For the special rules pertaining to the application of the organizational and operational tests to organizations terminating their private foundation status under the 12-month or 60-month termination period provided under section 507(b)(1)(B) by becoming "public" under section 509(a)(3), see the regulations under section 507(b).

(c) Organizational test—(1) In general. An organization is organized exclusively for one or more of the purposes specified in section 509(a)(3)(A) only if its articles of organization (as defined in § 1.501(c)(3)–1(b)(2)):

(i) Limit the purposes of such organization to one or more of the purposes set forth in section 509(a)(3)(A);

(ii) Do not expressly empower the organization to engage in activities which are not in furtherance of the purposes referred to in subdivision (i) of this subparagraph;

(iii) State the specified publicly supported organizations on whose behalf such organization is to be operated (within the meaning of paragraph (d) of this section); and

(iv) Do not expressly empower the organization to operate to support or benefit any organization other than the specified publicly supported organizations referred to in subdivision (iii) of this subparagraph.

(2) **Purposes.** In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes set forth in section 509(a)(3)(A). Therefore, an organization which, by the terms of its articles, is formed "for the benefit of" one or

more specified publicly supported organizations shall, if it otherwise meets the other requirements of this paragraph, be considered to have met the organizational test. Similarly, articles which state that an organization is formed "to perform the publishing functions" of a specified university are sufficient to comply with the organizational test. An organization which is "operated, supervised, or controlled by" (within the meaning of paragraph (g) of this section) or "supervised or controlled in connection with" (within the meaning of paragraph (h) of this section) one or more sections 509(a)(1) or (2) organizations to carry out the purposes of such organizations, will be considered as meeting the requirements of this paragraph if the purposes set forth in its articles are similar to, but no broader than, the purposes set forth in the articles of its controlling section 509(a)(1) or (2) organizations. If, however, the organization by which it is operated, supervised, or controlled is a publicly supported section 501(c)(4), (5), or (6) organization (deemed to be a section 509(a)(2) organization for purposes of section 509(a)(3) under the provisions of section 509(a)), the supporting organization will be considered as meeting the requirements of this paragraph if its articles require it to carry on charitable, etc., activities within the meaning of section 170(c)(2).

(3) Limitations. An organization is not organized exclusively for the purposes set forth in section 509(a)(3)(A) if its articles expressly permit it to operate to support or benefit any organization other than those specified publicly supported organizations referred to in subparagraph (1)(iii) of this paragraph. Thus, for example, an organization will not meet the organizational test under section 509(a)(3)(A) if its articles expressly empower it to pay over any part of its income to, or perform any service for, any organization other than those publicly supported organizations specified in its articles (within the meaning of paragraph (d) of this section). The fact that the actual operations of such organization have been exclusively for the benefit of the specified publicly supported organizations shall not be sufficient to permit it to meet the organizational test.

(d) Specified organizations—(1) In general. In order to meet the requirements of section 509(a)(3)(A), an organization must be organized and operated exclusively to support or benefit one or more "specified" publicly supported organizations. The manner in which the publicly supported organizations must be "specified" in the articles for purposes of section 509(a)(3)(A) will depend upon whether the supporting organization is "operated, supervised, or controlled by" or "supervised or controlled in connection with" (within the meaning of paragraphs (g) and (h) of this section) such organizations or whether it is "operated in connection with" (within the meaning of paragraph (i) of this section) such organizations.

(2) Nondesignated publicly supported organizations; requirements. (i) Except as provided in subdivision (iv) of this subparagraph, in order to meet the requirements of subparagraph (1) of this paragraph, the articles of the supporting organization must designate each of the "specified" organizations by name unless:

(a) The supporting organization is operated, supervised, or controlled by (within the meaning of paragraph (g) of this section), or is supervised or controlled in connection with (within the meaning of paragraph (h) of this section) one or more publicly supported organizations; and

(b) The articles of organization of the supporting organization require that it be operated to support or benefit one or more beneficiary organizations which are designated by class or purpose and which include:

(1) The publicly supported organizations referred to in (a) of this subdivision (without designating such organizations by name); or

(2) Publicly supported organizations which are closely related in purpose or function to those publicly supported organizations referred to in subdivision (i)(a) or this subparagraph (without designating such organization by name).

(ii) If a supporting organization is described in subdivision (i)(a) of this subparagraph, it will not be considered as failing to meet the requirements of subparagraph (1) of this paragraph that the publicly supported organizations be specified merely because its articles of organization permit the conditions described in subparagraphs (3)(i), (ii), and (iii) and (4)(i)(a) and (b) of this paragraph.

(iii) This subparagraph may be illustrated by the following examples:

Example (1). X is an organization described in section 501(c)(3) which operates for the benefit of institutions of higher learning in the State of Y. X is controlled by these institutions (within the meaning of paragraph (g) of this section) and such institutions are all section 509(a)(1) organizations. X's articles will meet the organizational test if they require X to operate for the benefit of institutions of higher learning or educational organizations in the State of Y (without naming each institution). X's articles would also meet the organizational test if they provided for the giving of scholarships to enable students to attend institutions of higher learning but only in the State of Y.

Example (2). M is an organization described in section 501(c)(3) which was organized and operated by representatives of N church to run a home for the aged. M is controlled (within the meaning of paragraph (g) of this section) by N church, a section 509(a)(1) organization. The care of the sick and the aged are longstanding temporal functions and purposes of organized religion. By operating a home for the aged, M is operating to support or benefit N church in carrying out one of its temporal purposes. Thus M's articles will meet the organizational test if they require M to care for the aged since M is operating to support one of N church's purposes (without designating N church by name).

(iv) A supporting organization will meet the requirements of subparagraph (1) of this paragraph even though its articles do not designate each of the "specified" organizations by name if:

(a) There has been an historic and continuing relationship between the supporting organization and the section 509(a)(1) or (2) organizations, and

(b) By reason of such relationship, there has developed a substantial identity of interests between such organizations.

(3) Nondesignated publicly supported organizations; scope of rule. If the requirements of subparagraph (2)(i)(a) of this paragraph are met, a supporting organization will not be considered as failing the test of being organized for the benefit of "specified" organizations solely because its articles:

(i) Permit the substitution of one publicly supported organization within a designated class for another publicly supported organization either in the same or a different class designated in the articles;

(ii) Permit the supporting organization to operate for the benefit of new or additional publicly supported organizations of the same or a different class designated in the articles; or

(iii) Permit the supporting organization to vary the amount of its support among different publicly supported organizations within the class or classes of organizations designated by the articles.

For example, X is an organization which operates for the benefit of private colleges in the State of Y. If X is controlled by these colleges (within the meaning of paragraph (g) of this section) and such colleges are all section 509(a)(1) organizations, X's articles will meet the organization test even if they permit X to operate for the benefit of any new colleges created in State Y in addition to the existing colleges or in lieu of one which has ceased to operate, or if they permit X to vary its support by paying more to one college than to another in a particular year.

(4) Designated publicly supported organizations. (i) If an organization is organized and operated to support one or more publicly supported organizations and it is "operated in connection with" such organization or organizations, then, except as provided in subparagraph (2)(iv) of this paragraph, its articles of organization must, for purposes of satisfying the organizational test under section 509(a)(3)(A), designate the "specified" organizations by name. Under the circumstances described in this subparagraph, a supporting organization which has one or more "specified" organizations designated by name in its articles, will not be considered as failing the test of being organized for the benefit of "specified" organizations solely because its articles:

(a) Permit a publicly supported organization which is designated by class or purpose, rather than by name, to be substituted for the publicly supported organization or organizations designated by name in the articles, but only if such substitution is conditioned upon the occurrence of an event which is beyond the control of the supporting organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the publicly supported organization or organizations designated in the articles;

(b) Permit the supporting organization to operate for the benefit of a beneficiary organization which is not a publicly supported organization, but only if such supporting organization is currently operating for the benefit of a publicly supported organization and the possibility of its operating for the benefit of other than a publicly supported organization is a remote contingency; or

(c) Permit the supporting organization to vary the amount of its support between different designated organizations, so long as it meets the requirements of the integral part test set forth in paragraph (i)(3) of this section with respect to at least one beneficiary organization.

(ii) If the beneficiary organization referred to in subdivision (i)(b) of this subparagraph is not a publicly supported organization, the supporting organization will not then meet the operational test of paragraph (e)(1) of this section. Therefore, if a supporting organization substituted in accordance with such subdivision (i)(b) a beneficiary other than a publicly supported organization and operated in support of such beneficiary organization, the supporting organization would not be described in section 509(a)(3).

(iii) This subparagraph may be illustrated by the following example:

Example. X is a charitable trust described in section 4947(a)(1) organized in 1968. Under the terms of its trust instrument, X's trustees are required to pay over all of X's annual income to M University Medical School for urological research. If M University Medical School is unable or unwilling to devote these funds to urological research, the trustees are required to pay all of such income to N University Medical School. However if N University Medical School is also unable or unwilling to devote these funds to urological research, X's trustees are directed to choose a similar organization willing to apply X's funds for urological research. From 1968 to 1973, X pays all of its net income to M University Medical School pursuant to the terms of the trust. M and N are publicly supported organizations. Although the contingent remainderman may not be a publicly supported organization, the possibility that X may operate for the benefit of other than a publicly supported organization is, in 1973, a remote possibility, and X will be considered as operating for the benefit of a "specified" publicly supported organization under subdivision (i)(b) of this subparagraph. However, if, at some future date, X actually substituted a nonpublicly supported organization as beneficiary, X would fail the requirements of the operational test set forth in paragraph (e)(1) of this section.

(e) Operational test—(1) Permissible beneficiaries. A supporting organization will be regarded as "operated exclusively" to support one or more specified publicly supported organizations (hereinafter referred to as the "operational test") only if it engages solely in activities which support or benefit the specified publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization. A supporting organization may also, for example, make a payment indirectly through another unrelated organization to a member of a charitable class benefited by the specified publicly supported organization, but only if such a payment constitutes a grant to an individual rather than a grant to an organization. In determining whether a grant is indirectly to an individual rather than to an organization the same standard shall be applied as in § 53.4945–4(a)(4) of this chapter. Similarly, an organization will be regarded as "operated exclusively" to support or benefit one or more specified publicly supported organizations even if it supports or benefits an organization, other than a private foundation, which is described in section 501(c)(3) and is operated, supervised, or controlled directly by or in connection with such publicly supported organizations, or which is described in section 511(a)(2)(B). However, an organization will not be regarded as operated exclusively if any part of its activities is in furtherance of a purpose other than supporting or benefiting one or more specified publicly supported organizations.

(2) Permissible activities. A supporting organization is not required to pay over its income to the publicly supported organizations in order to meet the operational test. It may satisfy the test by using its income to carry on an independent activity or program which supports or benefits the specified publicly supported organizations. All such support must, however, be limited to permissible beneficiaries in accordance with subparagraph (1) of this paragraph. The supporting organization may also engage in fund raising activities, such as solicitations, fund raising dinners, and unrelated trade or business to raise funds for the publicly supported organizations, or for the permissible beneficiaries.

(3) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). M is a separately incorporated alumni association of X University and is an organization described in section 501(c)(3). X University is designated in M's articles as the sole beneficiary of its support. M uses all of its dues and income to support its own program of educational activities for alumni, faculty, and students of X University and to encourage alumni to maintain a close relationship with the university and to make contributions to it. M does not distribute any of its income directly to X for the latter's general purposes. M pays no part of its funds to, or for the benefit of, any organization other than X. Under these circumstances, M is considered as operated exclusively to perform the functions and carry out the purpose of X. Although it does not pay over any of its funds to X, it carries on a program which both supports and benefits X.

Example (2). N is a separately incorporated religious and educational organization described in section 501(c)(3). It was formed and is operated by Y Church to provide religious training for the members of the church. While it does not maintain a regular faculty, N conducts a Sunday school, weekly adult education lectures on religious subjects, and other similar activities for the benefit of the church members. All of its funds are disbursed in furtherance of such activities and no part of its funds is paid to, or for the benefit of, any organization other than Y Church. N is considered as operated exclusively to perform the educational functions of Y Church and to carry out its religious purposes by providing various forms of religious instruction.

Example (3). P is an organization described in section 501(c)(3). Its primary activity is providing financial assistance to S, a publicly supported organization which aids underdeveloped nations in Central America. P's articles of organization designate S as the principal recipient of P's assistance. However, P also makes a small annual general purpose grant to T, a private foundation engaged in work similar to that carried on by S. T performs a particular function that assists in the overall aid program carried on by S. Even though P is operating primarily for the benefit of S, a specified publicly supported organization, it is not considered as operated exclusively for the purposes set forth in section 509(a)(3)(A). The grant to T, a private foundation, prevents it from complying with the operational test under section 509(a)(3)(A).

Example (4). Assume the same facts as example (3), except that T is a section 501(c)(3) organization other than a private foundation and is operated in connection with S. Under these circumstances, P will be considered as operated exclusively to support S within the meaning of section 509(a)(3)(A).

Example (5). Assume the same facts as example (3) except that instead of the annual general purpose grant made to T,

each grant made by P to T is specifically earmarked for the training of social workers and teachers, designated by name, from Central America. Under these circumstances, P's grants to T would be treated as grants to the individual social workers and teachers under section 4945(d)(3) and § 53.4945–4(a)(4), rather than as grants to T under section 4945(d)(4). These social workers and teachers are part of the charitable class benefitted by S. P would thus be considered as operating exclusively to support S within the meaning of section 509(a)(3)(A).

(f) Nature of relationship required between organizations—(1) In general. Section 509(a)(3)(B) describes the nature of the relationship required between a section 501(c)(3) organization and one or more publicly supported organizations in order for such section 501(c)(3) organization to qualify under the provisions of section 509(a)(3). To meet the requirements of section 509(a)(3), an organization must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations. If an organization does not stand in one of such relationships (as provided in this paragraph) to one or more publicly supported organizations, it is not an organization described in section 509(a)(3).

(2) Types of relationships. Section 509(a)(3)(B) sets forth three different types of relationships, one of which must be met in order to meet the requirements of subparagraph (1) of this paragraph. Thus, a supporting organization may be:

(i) Operated, supervised, or controlled by,

(ii) Supervised or controlled in connection with, or

(iii) Operated in connection with, one or more publicly supported organizations.

(3) Requirements of relationships. Although more than one type of relationship may exist in any one case, any relationship described in section 509(a)(3)(B) must insure that:

(i) The supporting organization will be responsive to the needs of demands of one or more publicly supported organizations; and

(ii) The supporting organization will constitute an integral part of, or maintain a significant involvement in, the operations of one or more publicly supported organizations.

(4) General description of relationships. In the case of supporting organizations which are "operated, supervised, or controlled by" one or more publicly supported organizations, the distinguishing feature of this type of relationship is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization, as described in paragraph (g) of this section. In the case of supporting organizations which are "supervised or controlled in connection with" one or more publicly supported organizations, the distinguishing feature is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors, as described in paragraph (h) of this section. In the case of a supporting organization which is "operated in connection with" one or more publicly supported organizations, the distinguishing feature is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization, as described in paragraph (i) of this section.

(g) Meaning of "operated, supervised, or controlled by". (1)(i) Each of the items "operated by," "supervised by," and "controlled by," as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization. This relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.

(ii) A supporting organization may be "operated, supervised, or controlled by" one or more publicly supported organizations within the meaning of section 509(a)(3)(B) even though its governing body is not comprised of representatives of the specified publicly supported organizations for whose benefit it is operated within the meaning of section 509(a)(3)(A). A supporting organization may be "operated, supervised, or controlled by" one or more publicly supported organizations (within the meaning of section 509(a)(3)(B)) and be operated "for the benefit of" one or more different publicly supported organizations (within the meaning of section 509(a)(3)(A)) only if it can be demonstrated that the purposes of the former organizations are carried out by benefitting the latter organizations.

(2) The provisions of this paragraph may be illustrated by the following examples:

Example (1). X is a university press which is organized and operated as a nonstock educational corporation to perform the

publishing and printing for M University, a publicly supported organization. Control of X is vested in a Board of Governors appointed by the Board of Trustees of M University upon the recommendation of the president of the university. X is considered to be operated, supervised, or controlled by M University within the meaning of section 509(a)(3)(B).

Example (2). Y Council was organized under the joint sponsorship of seven independent publicly supported organizations, each of which is dedicated to the advancement of knowledge in a particular field of social science. The sponsoring organizations organized Y Council as a means of pooling their ideas and resources for the attainment of common objectives, including the conducting of scholarly studies and formal discussions in various fields of social science. Under Y Council's by-laws, each of the seven sponsoring organizations elects three members to Y's board of trustees for 3-year terms. Y's board also includes the president of Y Council and eight other individuals elected at large by the board. Pursuant to policies established or approved by the board, Y Council engages in research, planning, and evaluation in the social sciences and sponsors or arranges conferences, seminars, and similar programs for scholars and social scientists. It carries out these activities through its own full-time professional staff, through a part-time committee of scholars, and through grant recipients. Under the above circumstances, Y Council is subject to a substantial degree of direction by the sponsoring publicly supported organizations. It is therefore considered to be operated, supervised, or controlled by such sponsoring organizations within the meaning of section 509(a)(3)(B).

Example (3). Z is a charitable trust created by A in 1972. It has three trustees, all of whom are appointed by M University, a publicly supported organization. The trust was organized and is operated to pay over all of its net income for medical research to N, O, and P, each of which is specified in the trust, is a hospital described in section 509(a)(1), and is located in the same city as M. Members of M's biology department are permitted to use the research facilities of N, O, and P. Under subparagraph (1)(ii) of this paragraph, Z is considered to be operated, supervised, or controlled by M within the meaning of section 509(a)(3)(B), even though it is operated for the benefit of N, O, and P within the meaning of section 509(a)(3)(A).

(h) Meaning of "supervised or controlled in connection with". (1) In order for a supporting organization to be "supervised or controlled in connection with" one or more publicly supported organizations, there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. Therefore, in order to meet such requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.

(2) A supporting organization will not be considered to be "supervised or controlled in connection with" one or more publicly supported organizations if such organization merely makes payments (mandatory or discretionary) to one or more named publicly supported organizations, even if the obligation to make payments to the named beneficiaries is enforceable under State law by such beneficiaries and the supporting organization's governing instrument contains provisions whose effect is described in section 508(e)(1)(A) and (B). Such arrangements do not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organizations to constitute supervision or control in connection with such organizations.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, a philanthropist, founded X school for orphan boys (a publicly supported organization). At the same time A founded X school, he also established Y trust into which he transferred all of the operating assets of the school, together with a substantial endowment for it. Under the provisions of the trust instrument, the same persons who control and manage the school also control and manage the trust. The sole function of Y trust is to hold legal title to X school's operating and endowment assets, to invest the endowment assets and to apply the income from the endowment to the benefit of the school in accordance with direction from the school's governing body. Under these circumstances, Y trust is organized and operated "for the benefit of" X school and is "supervised or controlled in connection with" such organization within the meaning of section 509(a)(3). The fact that the same persons control both X and Y insures Y's responsiveness to X's needs.

Example (2). In 1972, B, a philanthropist, created P, a charitable trust for the benefit of Z, a symphony orchestra described in section 509(a)(2). B transferred 100 shares of common stock to P. Under the terms of the trust instrument, the trustees (none of whom is under the control of B) were required to pay over all of the income produced by the trust assets to Z. The governing instrument of P contains certain provisions whose effect is described in section 508(e)(1)(A) and (B). Under applicable State law, Z can enforce the provisions of the trust instrument and compel payment to Z in a court of equity. There is no relationship between the trustees of P and the governing body of Z. Under these circumstances P is not supervised or controlled in connection with a publicly supported organization. Because of the lack of any common supervision or control by the trustees of P and the governing body of Z, P is not supervised or controlled in connection with Z within the meaning of section 509(a)(3)(B).

Example (3). T is a charitable trust described in section 501(c)(3) and created under the will of D. Prior to his death, D was a leader and very active in C church, a publicly supported organization. D created T to perpetuate his interest in, and assistance to, C. The sole purpose of T was to provide financial support for C and its related institutions. All of the original named trustees of T are members of C, are leaders in C, and hold important offices in one or more of C's related institutions. Successor trustees of T are by the terms of the charitable trust instrument to be chosen by the remaining trustees and are also to be members of C. All of the original trustees have represented that any successor trustee will be a leader in C and will hold an important office in one or more of C's related institutions. By reason of the foregoing relationship T and its trustees are responsive to the needs and requirements of C and its related institutions. Under these circumstances, T trust is organized and operated "for the benefit of" C and is "supervised or controlled in connection with" C and its related institutions within the meaning of section 509(a)(3)(B).

(i) Meaning of "operated in connection with"—(1) General rule. (i) Except as provided in subdivisions (ii) and (iii) of this subparagraph and subparagraph (4) of this paragraph, a supporting organization will be considered as being operated in connection with one or more publicly supported organizations only if it meets the "responsiveness test" which is defined in subparagraph (2) of this paragraph and the "integral part test" which is defined in subparagraph (3) of this paragraph.

(ii) In the case of an organization which was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as a historic and continuing relationship between organizations, may be taken into account, in addition to the factors described in subparagraph (2) of this paragraph, to establish compliance with the responsiveness test.

(iii) If—

(a) A supporting organization can establish that it has met the integral part test set forth in subparagraph (3)(iii) of this paragraph for any 5-year period, and

(b) Such organization cannot meet the requirements of such test for its current taxable year solely because the amount received by one or more of the publicly supported beneficiary organizations from such supporting organization is no longer sufficient, with respect to such beneficiary organizations, to satisfy subparagraph (3)(iii) of this paragraph, and

(c) There has been a historic and continuing relationship of support between such organizations between the end of such 5-year period and the taxable year in question,

then such supporting organization will be considered as meeting the requirements of the integral part test in subparagraph (3)(iii) of this paragraph for such taxable year.

(2) Responsiveness test. (i) For purposes of this paragraph, a supporting organization will be considered to meet the "responsiveness test" if the organization is responsive to the needs or demands of the publicly supported organizations within the meaning of this subparagraph. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii)(a) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;

(b) One or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or

(c) The officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the publicly supported organizations; and

(d) By reason of (a), (b), or (c) of this subdivision, the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization.

(iii)(a) The supporting organization is a charitable trust under State law;

(b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and

(c) The beneficiary organization has the power to enforce the trust and compel an accounting under State law.

(3) Integral part test; general rule. (i) For purposes of this paragraph, a supporting organization will be considered to meet the "integral part test" if it maintains a significant involvement in the operations of one or more publicly supported organizations and such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. In order to meet this test, either subdivision (ii) or subdivision (iii) of this subparagraph must be satisfied.

(ii) The activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.

(iii)(a) The supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations is sufficient to insure the attentiveness of

such organizations to the operations of the supporting organization. In addition, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations which meet the attentiveness requirement of this subdivision with respect to such supporting organization. Except as provided in (b) of this subdivision, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness. In applying the preceding sentence, if such supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the department or school shall be substituted for the total support of the beneficiary organization.

(b) Even where the amount of support received by a publicly supported beneficiary organization does not represent a sufficient part of the beneficiary organization's total support, the amount of support received from a supporting organization may be sufficient to meet the requirements of this subdivision if it can be demonstrated that in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. This may be the case where either the supporting organization or the beneficiary organization earmarks the support received from the supporting organization for a particular program or activity, even if such program or activity is not the beneficiary organization's primary program or activity so long as such program or activity is a substantial one.

(c) This subdivision may be illustrated by the following examples:

Example (1). X, an organization described in section 501(c)(3), pays over all of its annual net income to Y, a museum described in section 509(a)(2). X meets the responsiveness test described in subparagraph (2) of this paragraph. In recent years, Y has earmarked the income received from X to underwrite the cost of carrying on a chamber music series consisting of 12 performances a year which are performed for the general public free of charge at its premises. Because of the expense involved in carrying on these recitals, Y is dependent upon the income from X for their continuation. Under these circumstances, X will be treated as providing Y with a sufficient portion of Y's total support to assure Y's attentiveness to X's operations, even though the chamber music series is not the primary part of Y's activities.

Example (2). M, an organization described in section 501(c)(3), pays over all of its annual net income to the Law School of N University, a publicly supported organization. M meets the responsiveness test described in subparagraph (2) of this paragraph. M has earmarked the income paid over to N's Law School to endow a chair in its Department of International Law. Without M's continued support, N might not continue to maintain this chair. Under these circumstances, M will be treated as providing N with a sufficient portion of N's total support to assure N's attentiveness to M's operations.

(d) All pertinent factors, including the number of beneficiaries, the length and nature of the relationship between the beneficiary and supporting organization and the purpose to which the funds are put (as illustrated by subdivision (iii)(b) and (c) of this subparagraph), will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization. Normally the attentiveness of a beneficiary organization is motivated by reason of the amounts received from the supporting organization. Thus, the more substantial the amount involved, in terms of a percentage of the publicly supported organization's total support the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to insure the attentiveness of the beneficiary organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the beneficiary organization is of almost equal importance. An example of acceptable evidence of actual attentiveness is the imposition of a requirement that the supporting organization furnish reports at least annually for taxable years beginning after December 31, 1971, to the beneficiary organization to assist such beneficiary organization in insuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return (taking appreciation into account) and has not engaged in any activity which would give rise to liability for a tax imposed under sections 4941, 4943, 4944, and 4945 if such organization were a private foundation. The imposition of such requirement within 120 days after October 16, 1972, will be deemed to have retroactive effect to January 1, 1970, for purposes of determining whether a supporting organization has met the requirements of this subdivision for its first two taxable years beginning after December 31, 1969. The imposition of such requirement is, however, merely one of the factors in determining whether a supporting organization is complying with this subdivision and the absence of such requirement will not preclude an organization from classification as a supporting organization based on other factors.

(e) However, where none of the beneficiary organizations is dependent upon the supporting organization for a sufficient amount of the benefi-

ciary organization's support within the meaning of this subdivision, the requirements of this subparagraph will not be satisfied, even though such beneficiary organizations have enforceable rights against such organization under State law.

(4) Integral part test; transitional rule. (i) A trust (whether or not exempt from taxation under section 501(a)) which on November 20, 1970, has met and continues to meet the requirements of subdivisions (ii) through (vi) of this subparagraph shall be treated as meeting the requirements of the integral part test (whether or not it meets the requirements of subparagraph (3)(ii) or (iii) of this paragraph) if for taxable years beginning after October 16, 1972, the trustee of such trust makes annual written reports to all of the beneficiary publicly supported organizations with respect to such trust setting forth a description of the assets of the trust, including a detailed list of the assets and the income produced by such assets. A trust organization which meets the requirements of this subparagraph may request a ruling that it is described in section 509(a)(3) in such manner as the Commissioner may prescribe.

(ii) All the unexpired interests in the trust are devoted to one or more purposes described in section 170(c)(1) or (2)(B) and a deduction was allowed with respect to such interests under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), 2522, or corresponding provisions of prior law (or would have been allowed such a deduction if the trust had not been created before 1913).

(iii) The trust was created prior to November 20, 1970, and did not receive any grant, contribution, bequest or other transfer on or after such date. For purpose of this subdivision, a split-interest trust described in section 4947(a)(2) which was created prior to November 20, 1970, which was irrevocable on such date, and which becomes a charitable trust described in section 4947(a)(1) after such date shall be treated as having been created prior to such date;

(iv) The trust is required by its governing instrument to distribute all of its net income currently to a designated publicly supported beneficiary organization. Where more than one publicly supported beneficiary organization is designated in the governing instrument of a trust, all of the net income must be distributable and must be distributed currently to each of such beneficiary organizations in fixed shares pursuant to such governing instrument. For purposes of this subdivision, the governing instrument of a charitable trust shall be treated as requiring distribution to a designated beneficiary organization where the trust instrument describes the charitable purpose of the trust so completely that such description can apply to only one existing beneficiary organization and is of sufficient particularity as to vest in such organization rights against the trust enforceable in a court possessing equitable powers;

(v) The trustee of the trust does not have discretion to vary either the beneficiaries or the amounts payable to the beneficiaries. For purposes of this subdivision, a trustee shall not be treated as having such discretion where the trustee has discretion to make payments of principal to the single section 509(a)(1) or (2) organization that is currently entitled to receive all of the trust's income or where the trust instrument provides that the trustee may cease making income payments to a particular charitable beneficiary in the event of certain specific occurrences, such as the loss of exemption under section 501(c)(3) or classification under section 509(a)(1) or (2) by the beneficiary or the failure of the beneficiary to carry out its charitable purpose properly;

(vi) None of the trustees would be disqualified persons within the meaning of section 4946(a) (other than foundation managers under 4946(a)(1)(B)) with respect to the trust if such trust were treated as a private foundation.

(5) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). N is a nonprofit publishing organization described in section 501(c)(3). It does all of the publishing and printing for the churches of a particular denomination (which are publicly supported organizations). Control of the organization is vested in a five-man Board of Directors, which includes one church official and four lay members of the congregations of that denomination. N does no other printing or publishing. It publishes all of the churches' religious as well as secular tracts and materials. Under these circumstances, N is considered as being "operated in connection with" a number of publicly supported organizations. Publishing religious literature is an integral part of the churches' activities; it is carried on by N on behalf of the churches, and there is sufficient direction of N's activities by the churches to insure responsiveness by N to their needs.

Example (2). O, an alumni association described in section 501(c)(3), was formed to promote a spirit of loyalty among graduates of Y University, a publicly supported organization, and to effect united action in promoting the general welfare of the university. A special committee of Y's governing board meets with O and makes recommendations as to the allocation of O's program of gifts and scholarships to the university and its students. O also provides certain functions which would otherwise be part of Y's functions, such as maintaining records of alumni. O publishes a bulletin to keep alumni aware of the activities of the university. Under these circumstances O is considered to be operated in connection with Y within the meaning of section 509(a)(3)(B).

Example (3). P is a trust created under the will of A for the purpose of furthering musical education. As a means of accomplishing its purposes P founded X, a school of music described in section 509(a)(1). The trust instrument is thereafter amended to name X specifically as the beneficiary of the trust. X can enforce its equitable rights as trust beneficiary under State law. Members of the governing body of X form a minority of the foundation managers of P. For many years the organizations have been operated in close association with each other. P provides the principal endowment fund for the operation of X. In addition, while the governing body of X concerns itself with artistic policies, the foundation managers of P handle the budgetary concerns of X. X's annual budget is prepared with the assistance of P's foundation managers and is approved by P. Under these circumstances, P is considered to be operated in connection with X within the meaning of section 509(a)(3)(B).

Example (4). Q is a charitable trust described in section 501(c)(3) and created under the will of C. Prior to his death, C built H Hospital and deeded it to I University for use as a training and clinical facility for I's medical school. Both H and I are publicly supported organizations. C created Q to perpetuate his interest in, and assistance to, H Hospital. The sole purpose of Q was to provide financial support for H, the beneficiary organization named in C's will. H can enforce its equitable rights as trust beneficiary under State law. After the death of C, Q continued to provide substantial support for H. It was primarily responsible for the erecting of a new hospital building, as well as the construction of other facilities for the hospital. In addition, each medical department of H indicates during the year what its greatest needs are. Once these requests are approved by the medical director of I University's Medical School, they are presented to Q, and subject to the amount of Q's income (all of which is applied to H), these requests are honored and the new equipment of facility is supplied through Q's funds. The governing body of Q and those of H and I are completely independent. However, based on the above facts, Q is responsive to the needs of H, Q maintains a substantial involvement in the conduct of H, and H is substantially dependent upon the receipt of support from Q. Accordingly, Q is operated in connection with one or more section 509(a)(1) organizations within the meaning of section 509(a)(3)(B).

Example (5). R is a charitable trust created under the will of B, who died in 1971. Its purpose is to hold assets as an endowment for S, a hospital, T, a university, and U, a national medical research organization (all being publicly supported organizations and specifically named in the trust instrument), and to distribute all of the income each year in equal shares among the three named beneficiaries. S, T, and U have certain enforceable rights against R under State law, including the right to compel an accounting. Except for making these annual payments, the trustees of R have no further contacts or relationships with S, T, or U. The payments by R to such organizations do not comprise a sufficient amount of support to meet the requirements of subparagraph (3) of this paragraph for any of these organizations. Although R meets the responsiveness test described in subparagraph (2) of this paragraph, it does not meet the integral part test described in subparagraph (3) of this paragraph. R is not, therefore, considered as operated in connection with one or more publicly supported organizations within the meaning of section 509(a)(3)(B). However, if B had died prior to November 20, 1970, R could, upon meeting all of the requirements of subparagraph (4) of this paragraph, be considered as operated in connection with one or more of publicly supported organizations within the meaning of section 509(a)(3)(B).

Example (6). S is a charitable trust described in section 501(c)(3). S was created under the will of C in 1910 for the purpose of providing aged and indigent women with care and shelter. Prior to his death in 1910, C helped to create T, a home for aged women, through a substantial inter vivos contribution. Although T is not specifically named in C's will, the trustees of S (who are completely independent of T) have paid over all of S's income to T in furtherance of the trust's purposes since the death of C. S establishes that between 1910 and 1955, the amount of support received by T from S was sufficient support to satisfy the provisions of § 1.509(a)–4(i)(3)(iii). In 1956, T merged with U, a home for aged and indigent men, and V, a nursing home. S continued to pay all its income to W, the organization resulting from the merger of T, U, and V. However, as a result of the merger and certain changes in the methods of financing the operations, the payments made by S after 1955 no longer were sufficient to satisfy the integral part test of § 1.509(a)–4(i)(3)(iii). W qualifies as an organization described in section 509(a)(2). For the taxable year 1971, S meets the responsiveness test under § 1.509(a)–4(i)(2)(ii). Although W is not a named beneficiary under S's governing instrument, pursuant to § 1.509(a)–4(i)(1)(ii) the historic and continuing relationship between the organizations will be taken into account to establish compliance with the responsiveness test. Furthermore, pursuant to § 1.509(a)–4(i)(1)(iii), under the facts set forth above, the integral part test under § 1.509(a)–4(i)(3)(iii) will be considered as being satisfied for the taxable year 1971. Thus S will be considered as "operated in connection with" W for the taxable year 1971.

(j) **Control by disqualified persons—(1) In general.** Under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered "controlled," for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operation or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more

disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

(2) **Proof of independent control.** Notwithstanding subparagraph (1) of this paragraph, an organization shall be permitted to establish to the satisfaction of the Commissioner that disqualified persons do not directly or indirectly control it. For example, in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization will not disqualify the organization under section 509(a)(3)(C) if a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.

(k) **Organizations operated in conjunction with certain section 501(c)(4), (5), or (6) organizations.** (1) For purposes of section 509(a)(3), an organization which is operated in conjunction with an organization described in section 501(c)(4), (5), or (6) (such as a social welfare organization, labor or agricultural organization, business league, or real estate board) shall, if it otherwise meets the requirements of section 509(a)(3), be considered an organization described in section 509(a)(3) if such section 501(c)(4), (5), or (6) organization would be described in section 509(a)(2) if it were an organization described in section 501(c)(3). The section 501(c)(4), (5), or (6) organization, which the supporting organization is operating in conjunction with, must therefore meet the one-third tests of a publicly supported organization set forth in section 509(a)(2).

(2) This paragraph may be illustrated by the following example:

Example. X medical association, described in section 501(c)(6), is supported by membership dues and funds resulting from the performance of its exempt activities. This support, which is entirely from permitted sources, constitutes more than one-third of X's support. X does not normally receive more than one-third of its support from items described in section 509(a)(2)(B). X organized and operated an endowment fund for the sole purpose of furthering medical education. The fund is an organization described in section 501(c)(3). Since more than one-third of X's support is derived from membership dues and from funds resulting from the performance of exempt purposes (all of which are from permitted sources) and not more than one-third of its support is from items described in section 509(a)(2)(B), it would be a publicly supported organization described in section 509(a)(2) if it were described in section 501(c)(3) rather than section 501(c)(6). Accordingly, if the fund otherwise meets the requirements of section 509(a)(3) with respect to X, it will be considered an organization described in section 509(a)(3).

[T.D. 7212, 37 FR 21916, Oct. 17, 1972, as amended by T.D. 7784, 46 FR 37890, July 23, 1981]

§ 1.509(a)–5 Special rules of attribution.

(a) **Retained character of gross investment income.** (1) For purposes of determining whether an organization meets the not-more-than-one-third support test set forth in section 509(a)(2)(B), amounts received by such organization from:

(i) An organization which seeks to be described in section 509(a)(3) by reason of its support of such organization; or

(ii) A charitable trust, corporation, fund, or association described in section 501(c)(3) (including a charitable trust described in section 4947(a)(1)) or a split interest trust described in section 4947(a)(2), which is required by its governing instrument or otherwise to distribute, or which normally does distribute, at least 25 percent of its adjusted net income (within the meaning of section 4942(f)) to such organization, and such distribution normally comprises at least 5 percent of such distributee organization's adjusted net income,

will retain their character as gross investment income (rather than gifts or contributions) to the extent that such amounts are characterized as gross investment income in the possession of the distributing organization described in subdivision (i) or (ii) of this subparagraph or, if the distributing organization is a split interest trust described in section 4947(a)(2), to the extent that such amounts would be characterized as gross investment income attributable to transfers in trust after May 26, 1969, if such trust were a private foundation. For purposes of this section, all income which is characterized as gross investment income in the possession of the distributing organization

shall be deemed to be distributed first by such organization and shall retain its character as such in the possession of the recipient of amounts described in this paragraph. If an organization described in subdivision (i) or (ii) of this subparagraph makes distributions to more than one organization, the amount of gross investment income deemed distributed shall be prorated among the distributees.

(2) For purposes of subparagraph (1) of this paragraph, amounts paid by an organization to provide goods, services, or facilities for the direct benefit of an organization seeking section 509(a)(2) status (rather than for the direct benefit of the general public) shall be treated in the same manner as amounts received by the latter organization. Such amounts will be treated as gross investment income to the extent that such amounts are characterized as gross investment income in the possession of the organization spending such amounts. For example, X is an organization described in subparagraph (1)(i) of this paragraph. It uses part of its funds to provide Y, an organization seeking section 509(a)(2) status, with certain services which Y would otherwise be required to purchase on its own. To the extent that the funds used by X to provide such services for Y are characterized as gross investment income in the possession of X, such funds will be treated as gross investment income received by Y.

(3) An organization seeking section 509(a)(2) status shall file a separate statement with its return required by section 6033, setting forth all amounts received from organizations described in paragraph (a)(1)(i) or (ii) of this section.

(b) Relationships created for avoidance purposes. (1) If a relationship between an organization seeking section 509(a)(3) status and an organization seeking section 509(a)(2) status:

(i) Is established or availed of after October 9, 1969, and

(ii) One of the purposes of establishing or utilizing such relationship is to avoid classification as a private foundation with respect to either organization, the character and amount of support received by the section 509(a)(3) organization will be attributed to the section 509(a)(2) organization for purposes of determining whether the latter meets the one-third support test and the not-more-than-one-third support test under section 509(a)(2). If a relationship described in this subparagraph is established or utilized by an organization seeking section 509(a)(3) status and two or more organizations seeking section 509(a)(2) status, the amount of support received by the former organization will be prorated among the latter organizations and the character of each class of support (as defined in section 509(d)) will be attributed pro rata to each such organization. The provisions of this paragraph and of paragraph (a) of this section are not mutually exclusive.

(2) In determining whether a relationship between one or more organizations seeking section 509(a)(2) status (hereinafter referred to as "beneficiary organizations") and an organization seeking section 509(a)(3) status (hereinafter referred to as the "supporting organization") has been established or availed of to avoid classification as a private foundation (within the meaning of subparagraph (1) of this paragraph), all pertinent facts and circumstances, including the following, shall be taken into account as evidence that a relationship was not established or availed of to avoid classification as a private foundation:

(i) The supporting organization is operated to support or benefit several specified beneficiary organizations.

(ii) The beneficiary organization has a substantial number of dues-paying members (in relation to the public it serves and the nature of its activities) and such members have an effective voice in the management of both the supporting and beneficiary organizations.

(iii) The beneficiary organization is composed of several membership organizations, each of which has a substantial number of members (in relation to the public it serves and the nature of its activities), and such membership organizations have an effective voice in the management of the supporting and beneficiary organizations.

(iv) The beneficiary organization receives a substantial amount of support from the general public, public charities, or governmental grants.

(v) The supporting organization uses its funds to carry on a meaningful program of activities to support or benefit the beneficiary organization and such use would, if such supporting organization were a private foundation, be sufficient to avoid the imposition of any tax upon such organization under section 4942.

(vi) The supporting organization is not able to exercise substantial control or influence over the beneficiary organization by reason of the former's receiving support or holding assets which are disproportionately large in comparison with the support received or the assets held by the latter.

(vii) Different persons manage the operations of the beneficiary and supporting organizations and each organization performs a different function.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). M, an organization described in section 509(a)(2), is a council composed of 10 learned societies. Each member society has a large membership of scholars interested in a particular academic area. In 1970 M established N, an organization seeking section 509(a)(3) status, for the purpose of carrying on research and study projects of interest to the member societies. The principal source of funds for N's activities is from foundation and government grants and contracts. The principal source of funds for M's activities after the creation of N is membership dues. M continued to maintain a wide variety of activities for its members, such as publishing periodicals and carrying on seminars and conferences. N is subject to complete control by the governing body of M. Under these circumstances, the relationship between these organizations is not one which is described in subparagraph (1) of this paragraph.

Example (2). Q is a local medical research organization described in section 509(a)(2). Its fixed assets are negligible and it carries on research activities on a limited scale. It also makes a limited number of grants to scientists and doctors who are engaged in medical research of interest to Q. It receives support through small government grants and a few research contracts from private foundations. R is an organization described in section 501(c)(3). As of January 1, 1970, R was classified as a private foundation under section 509. It has a substantial endowment which it uses to make grants to various charitable and scientific organizations described in section 501(c)(3). During 1970, R agrees to subsidize the research activities of Q. R amends its governing instrument to provide specifically that all of R's support will be used for research activities which are approved and supervised by Q. R also amends its bylaws to permit a minority of Q's board of directors to be members of R's governing body. R then gives timely notification under section 507(b)(1)(B)(ii) that R is terminating its private foundation status by meeting the requirements of section 509(a)(3) by the end of the 12-month period described in section 507(b)(1)(B)(i). For purposes of determining whether R has met the requirements of section 509(a)(3) by the end of the 12-month period, as well as determining Q's status under section 509(a)(2), the character and amount of support received by R will be attributed to Q.

(c) Effect on organizations claiming section 509(a)(3) status. If an organization claiming section 509(a)(2) status fails to meet either the one-third support test or the not-more-than-one-third support test under section 509(a)(2) by reason of the application of the provisions of paragraph (a) or (b) of this section, and such organization is one of the specified organizations (within the meaning of section 509(a)(3)(A)) for whose support or benefit an organization claiming section 509(a)(3) status is operated, the organization claiming section 509(a)(3) status will not be considered to be operated exclusively to support or benefit one or more section 509(a)(1) or (2) organizations.

[T.D. 7212, 37 FR 21922, Oct. 17, 1972, as amended by T.D. 7290, 38 FR 31834, Nov. 19, 1973; T.D. 7784, 46 FR 37890, July 23, 1981]

§ 1.509(a)–6 Classification under section 509(a).

If an organization is described in section 509(a)(1) and also in another paragraph of section 509(a), it will be treated as described in section 509(a)(1). For purposes of this section, the parenthetical language "other than in clauses (vii) and (viii)" used in section 509(a)(1) shall be construed to mean "other than an organization which is described only in clause (vii) or (viii)". For example, X is an organization which is described in section 170(b)(1)(A)(vi), but could also meet the description of section 170(b)(1)(A)(viii) as an organization described in section 509(a)(2). For purposes of the one-third support test in section 509(a)(2)(A), contributions from X to other organizations will be treated as support from an organization described in section 170(b)(1)(A)(vi) rather than from an organization described in section 170(b)(1)(A)(viii).

[T.D. 7212, 37 FR 21923, Oct. 17, 1972]

§ 1.509(a)–7 Reliance by grantors and contributors to section 509(a)(1), (2), and (3) organizations.

(a) General rule. Once an organization has received a final ruling or determination letter classifying it as an organization described in section 509(a)(1), (2), or (3), the treatment of grants and contributions and the status of grantors and contributors to such organization under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 will not be affected by reason of a subsequent revocation by the service of the organization's classification as described in section 509(a)(1), (2), or (3) until the date on which notice of change of status is made to the public (such as by publication in the Internal Revenue Bulletin) or another applicable date, if any, specified in such public notice. In appropriate cases, however, the treatment of grants and contributions and the status of grantors and contributors to an organization described in section 509(a)(1), (2), or (3) may be affected pending verification of the continued classification of such organization under section 509(a)(1), (2), or (3). Notice to this affect will be made in a public announcement by the service. In such cases the effect of grants and contributions made after the date of the announcement will depend upon the statutory qualification of the organization as an organization described in section 509(a)(1), (2), or (3).

(b) Exceptions. (1) Paragraph (a) of this section shall not apply if the grantor or contributor:

(i) Had knowledge of the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a)(1), (2), or (3), or

(ii) Was in part responsible for, or was aware of, the act, the failure to act, or the substantial and material change on the part of the organization which gave rise to the revocation of the ruling or determination letter classifying the organization as an organization described in section 509(a)(1), (2), or (3).

(2) Paragraph (a) of this section shall not apply where a different rule is otherwise expressly provided in the regulations under sections 170(b)(1)(A), 507(b)(1)(B), or 509.

[T.D. 7212, 37 FR 21923, Oct. 17, 1972]

§ 1.509(b)-1 Continuation of private foundation status.

(a) In general. If an organization is a private foundation (within the meaning of section 509(a)) on October 9, 1969, or becomes a private foundation on any subsequent date, such organization shall be treated as a private foundation for all periods after October 9, 1969, or after such subsequent date, unless its status as such is terminated under section 507. Therefore, if an organization was described in section 501(c)(3) and was a private foundation within the meaning of section 509(a) on October 9, 1969, it shall be treated as a private foundation for all periods thereafter, even though it may also satisfy the requirements of an organization described in some other paragraph of section 501(c). For example, if on October 9, 1969, an organization was described in section 501(c)(3), but because of its activities, it could also have qualified as an organization described in section 501(c)(4), such organization will continue to be treated as a private foundation, if it was a private foundation within the meaning of section 509(a) on October 9, 1969.

(b) Taxable private foundations. If an organization is a private foundation on October 9, 1969, and it is determined that it is not exempt under section 501(a) as an organization described in section 501(c)(3) as of any date after October 9, 1969, such organization, even though it may operate thereafter as a taxable entity, will continue to be treated as a private foundation unless its status as such is terminated under section 507. For example, X organization is a private foundation on October 9, 1969. It is subsequently determined that, as of July 1, 1972, X is no longer exempt under section 501(a) as an organization described in section 501(c)(3) because, for example, it has not conformed its governing instrument pursuant to section 508(e). X will continue to be treated as a private foundation after July 1, 1972, unless its status as such is terminated under section 507. However, if an organization is not exempt under section 501(a) as an organization described in section 501(c)(3) on October 9, 1969, then it will not be treated as a private foundation within the meaning of section 509(a) by reason of section 509(b), unless it becomes a private foundation on a subsequent date.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(c)-1 Status of organization after termination of private foundation status.

(a) In general. For purposes of Part II of Subchapter F of this chapter, an organization whose status as a private foundation is terminated under section 507 shall be treated as an organization created on the day after the date of such termination. An organization whose private foundation status has been terminated under the provisions of section 507(a) will, if it continues to operate, be treated as a new organization and must, if it desires to be classified under section 501(c)(3), give notification that it is applying for recognition of section 501(c)(3) status pursuant to the provisions of section 508(a).

(b) Effect upon section 507(d)(1). If the private foundation status of an organization has been terminated under section 507(b)(1)(B) and the regulations thereunder, and:

(1) Such organization does not continue at all times thereafter to meet the requirements of section 509(a)(1), (2), or (3) (and is therefore no longer excluded from the definition of a private foundation); and

(2) The status of such organization as a private foundation is thereafter terminated under section 507(a),

then the tax imposed under section 507(c)(1) upon the aggregate tax benefit (described in section 507(d)(1)) resulting from section 501(c)(3) status shall be computed only upon the aggregate tax benefit resulting after the date on which the organization again becomes a private foundation under subparagraph (1) of this paragraph.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(d)–1 Definition of support

For purposes of section 509(a)(2), the term "support" does not include amounts received in repayment of the principal of a loan or other indebtedness. See, however, section 509(e) as to amounts received as interest on a loan or other indebtedness.

[T.D. 7212, 37 FR 21924, Oct. 17, 1972]

§ 1.509(e)–1 Definition of gross investment income.

For the distinction between gross receipts and gross investment income, see § 1.509(a)–3(m).

[T.D. 7212, 37 FR 21925, Oct. 17, 1972]

Taxation of Business Income of Certain Exempt Organizations

§ 1.511–1 Imposition and rates of tax.

Section 511(a) imposes a tax upon the unrelated business taxable income of certain organizations otherwise exempt from Federal income tax. Under section 511(a)(1), organizations described in section 511(a)(2)(A) and in paragraph (a) of § 1.511–2 and organizations described in section 511(a)(2)(B) are subject to normal tax and surtax at the corporate rates provided by section 11. Under section 511(b)(1), trusts described in section 511(b)(2) are subject to tax at the individual rates prescribed in section 1(d) of the Code as amended by the Tax Reform Act of 1969 (section 1 for taxable years ending before Jan. 1, 1971). The deduction for personal exemption provided in section 642(b) in the case of a trust taxable under subchapter J, chapter 1 of the Code, is not allowed in computing unrelated business taxable income.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9421, May 25, 1971]

§ 1.511–2 Organizations subject to tax.

(a) Organizations other than trusts and title holding companies. (1)(i) The taxes imposed by section 511(a)(1) apply in the case of any organization (other than a trust described in section 511(b)(2) or an organization described in section 501(c)(1)) which is exempt from taxation under section 501(a) (except as provided in sections 507 through 515). For special rules concerning corporations described in section 501(c)(2), see paragraph (c) of this section.

(ii) In the case of an organization described in section 501(c)(4), (7), (8), (9), (10), (11), (12), (13), (14)(A), (15), (16), or (18), the taxes imposed by section 511(a)(1) apply only for taxable years beginning after December 31, 1969. In the case of an organization described in section 501(c)(14)(B) or (C), the taxes imposed by section 511(a)(1) apply only for taxable years beginning after February 2, 1966.

(2) The taxes imposed by section 511(a) apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof or by any agency or instrumentality of any one or more governments or political subdivisions. Such taxes also apply in the case of any corporation wholly owned by one or more such colleges or universities. As here used, the word "government" includes any foreign government (to the extent not contrary to any treaty obligation of the United States) and all domestic governments (the United States and any of its Territories or possessions, any State, and the District of Columbia). Elementary and secondary schools operated by such governments are not subject to the tax on unrelated business income.

(3)(i) For taxable years beginning before January 1, 1970, churches and associations or conventions of churches are exempt from the taxes imposed by section 511. The exemption is applicable only to an organization which itself is a church or an association or convention of churches. Subject to the provisions of subdivision (ii) of this subparagraph, religious organizations, including religious orders, if not themselves churches or associations or conventions of churches, and all other organizations which are organized or operated under church auspices, are subject to the tax imposed by section 511, whether or not they engage in religious, educational, or charitable activities approved by a church.

(ii) The term "church" includes a religious order or a religious organization if such order or organization (a) is an integral part of a church, and (b) is engaged in carrying out the functions of a church, whether as a civil law corporation or otherwise. In determining whether a religious order or organization is an integral part of a church, consideration will be given to the degree to which it is connected with, and controlled by, such church. A religious order or organization shall be considered to be engaged in carrying out the functions of a church if its duties include the

ministration of sacerdotal functions and the conduct of religious worship. If a religious order or organization is not an integral part of a church, or if such an order or organization is not authorized to carry out the functions of a church (ministration of sacerdotal functions and conduct of religious worship) then it is subject to the tax imposed by section 511 whether or not it engages in religious, educational, or charitable activities approved by a church. What constitutes the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of a particular religious body constituting a church. If a religious order or organization can fully meet the requirements stated in this subdivision, exemption from the tax imposed by section 511 will apply to all its activities, including those which it conducts through a separate corporation (other than a corporation described in section 501(c)(2)) or other separate entity which it wholly owns and which is not operated for the primary purpose of carrying on a trade or business for profit. Such exemption from tax will also apply to activities conducted through a separate corporation (other than a corporation described in section 501(c)(2)) or other separate entity which is wholly owned by more than one religious order or organization, if all such orders or organizations fully meet the requirements stated in this subdivision and if such corporation or other entity is not operated for the primary purpose of carrying on a trade or business for profit.

(iii) For taxable years beginning after December 31, 1969, churches and conventions or associations of churches are subject to the taxes imposed by section 511, unless otherwise entitled to the benefit of the transitional rules of section 512(b)(14) and § 1.512(b)–1(i).

(b) Trusts—(1) In general. The taxes imposed by section 511(b) apply in the case of any trust which is exempt from taxation under section 501(a) (except as provided in sections 507 through 515), and which, if it were not for such exemption, would be subject to the provisions of subchapter J, Chapter 1, of the Code. An organization which is considered as "trustee" of a stock bonus, pension, or profit-sharing plan described in section 401(a), a supplemental unemployment benefit trust described in section 501(c)(17), or a pension plan described in section 501(c)(18) (regardless of the form of such organization) is subject to the taxes imposed by section 511(b)(1) on its unrelated business income. However, if such an organization conducts a business which is a separate taxable entity on the basis of all the facts and circumstances, for example, an association taxable as a corporation, the business will be taxable as a feeder organization described in section 502.

(2) Effective dates. In the case of a trust described in section 501(c)(3), the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1953. In the case of a trust described in section 401(a), the taxes imposed by section 511(b) apply for taxable years beginning after June 30, 1954. In the case of a trust described in section 501(c)(17), the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1959. In the case of any other trust described in subparagraph (1) of this paragraph, the taxes imposed by section 511(b) apply for taxable years beginning after December 31, 1969.

(c) Title holding companies—(1) In general. If a corporation described in section 501(c)(2) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and if such corporation and such organization file a consolidated income tax return for such taxable year, then such corporation shall be treated, for purposes of the tax imposed by section 511(a), as being organized and operated for the same purposes as such organization, as well as for its title-holding purpose. Therefore, if an item of income of the section 501(c)(2) corporation is derived from a source which is related to the exempt function of the exempt organization to which such income is payable and with which such corporation files a consolidated return, such item is, together with all deductions directly connected therewith, excluded from the determination of unrelated business taxable income under section 512 and shall not be subject to the tax imposed by section 511(a). If, however, such item of income is derived from a source which is not so related, then such item, less all deductions directly connected therewith, is, subject to the modifications provided in section 512(b), unrelated business taxable income subject to the tax imposed by section 511(a).

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The income of X, a section 501(c)(2) corporation, is required to be distributed to exempt organization A. During the taxable year X realizes net income of $900,000 from source M and $100,000 from source N. Source M is related to A's exempt function, while source N is not so related. X and A file a consolidated return for such taxable year. X has net

unrelated business income of $100,000, subject to the modifications in section 512(b).

(3) Cross reference. For rules relating generally to the filing of consolidated returns by certain organizations exempt from taxation under section 501(a), see section 1504(e) of the Code and § 1.1502-100.

(4) Effective dates. Subparagraphs (1) through (3) of this paragraph apply with respect to taxable years beginning after December 31, 1969. For taxable years beginning before January 1, 1970, a corporation described in section 501(c)(2) and otherwise exempt from taxation under section 501(a) is taxable upon its unrelated business taxable income only if such income is payable either—

(i) To a church or convention or association of churches, or

(ii) To any organization subject, for taxable years beginning before January 1, 1970, to the tax imposed by section 511(a)(1).

(d) The fact that any class of organizations exempt from taxation under section 501(a) is subject to the unrelated business income tax under section 511 and this section does not in any way enlarge the permissible scope of business activities of such class for purposes of the continued qualification of such class under section 501(a).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6971, 33 FR 12899, Sept. 12, 1968; T.D. 7183, 37 FR 7884, April 21, 1972; T.D. 7632, 44 FR 42681, July 20, 1979]

§ 1.511-3 Provisions generally applicable to the tax on unrelated business income.

(a) Assessment and collections. Since the taxes imposed by section 511 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 511. Organizations subject to the tax imposed by section 511(a)(1) are subject to the same provisions, including penalties, as are provided in the case of the income tax of other corporations. In the case of a trust subject to the tax imposed by section 511(b)(1), the fiduciaries for such trust are subject to the same provisions, including penalties, as are applicable to fiduciaries in the case of the income tax of other trusts. See section 6151, et seq., and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) Returns. For requirements of filing annual returns with respect to unrelated business taxable income by organizations subject to the tax on such income, see section 6012, paragraph (e) of § 1.6012-2, and paragraph (a)(5) of § 1.6012-3.

(c) Taxable years, method of accounting, etc. The taxable year (fiscal year or calendar year, as the case may be) of an organization shall be determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing unrelated business taxable income, the determination of the taxable year for which an item of income or expense is taken into account shall be made under the provisions of sections 441, 446, 451, and 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon unrelated business taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 511, unless such method is changed in accordance with the provisions of § 1.166-1. A taxpayer which has not previously selected a method for treating bad debts may, in its first return under section 511, exercise the option granted in § 1.166-1.

(d) Foreign tax credit. See section 515 for provisions applicable to the credit for foreign taxes provided in section 901.

§ 1.511-4 Minimum tax for tax preferences.

The tax imposed by section 56 applies to an organization subject to tax under section 511 with respect to items of tax preference which enter into the computation of unrelated business taxable income. For this purpose, only those items of income and those deductions entering into the determination of the tax imposed by this section are considered in the determination of the items of tax preference under section 57. For rules relating to the minimum tax for tax preferences, see sections 56 through 58 and the regulations thereunder.

[T.D. 7564, 43 FR 40494, Sept. 12, 1978]

§ 1.512(a)-1 Definition.

(a) In general. Except as otherwise provided in § 1.512(a)-3, § 1.512(a)-4, or paragraph (f) of this section, section 512(a)(1) defines "unrelated

business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain modifications referred to in § 1.512(b)–1. To be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business. Except as provided in paragraph (d)(2) of this section, to be "directly connected with" the conduct of unrelated business for purposes of section 512, an item of deduction must have proximate and primary relationship to the carrying on of that business. In the case of an organization which derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. For the treatment of amounts of income or loss of common trust funds, see § 1.584–2(c)(3).

(b) Expenses attributable solely to unrelated business activities. Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and therefore qualify for deduction to the extent that they meet the requirements of section 162, section 167, or other relevant provisions of the Code, connected with the conduct of that activity and are deductible in computing unrelated business activities are directly connected with the conduct of that activity and are deductible in computing unrelated business taxable income if they otherwise qualify for deduction under the requirements of section 162. Similarly, depreciation of a building used entirely in the conduct of unrelated business activities would be an allowable deduction to the extent otherwise permitted by section 167.

(c) Dual use of facilities or personnel. Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead), shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant provisions of the Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of $20,000 a year. X derives gross income from the conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his time during the year to the unrelated business activity. For purposes of computing X's unrelated business taxable income, a deduction of $2,000 (10 percent of $20,000), would be allowable for the salary paid to its president.

(d) Exploitation of exempt activities—(1) In general. In certain cases, gross income is derived from an unrelated trade or business activity which exploits an exempt activity. One example of such exploitation is the sale of advertising in a periodical of an exempt organization which contains editorial material related to the accomplishment of the organization's exempt purpose. Except as specified in subparagraph (2) of this paragraph and paragraph (f) of this section, in such cases, expenses, depreciation and similar items attributable to the conduct of the exempt activities are not deductible in computing unrelated business taxable income. Since such items are incident to an activity which is carried on in furtherance of the exempt purpose of the organization, they do not possess the necessary proximate and primary relationship to the unrelated trade or business activity and are therefore not directly connected with that business activity.

(2) Allowable deductions. Where an unrelated trade or business activity is of a kind carried on for profit by taxable organizations and where the exempt activity exploited by the business is a type of activity normally conducted by taxable organizations in pursuance of such business, expenses, depreciation, and similar items which are attributable to the exempt activity qualify as directly connected with the carrying on of the unrelated trade or business activity to the extent that:

(i) The aggregate of such items exceeds the income (if any) derived from or attributable to the exempt activity; and

(ii) The allocation of such excess to the unrelated trade or business activity does not result in

a loss from such unrelated trade or business activity.

Under the rule of the preceding sentence, expenses, depreciation and similar items paid or incurred in the performance of an exempt activity must be allocated first to the exempt activity to the extent of the income derived from or attributable to the performance of that activity. Furthermore, such items are in no event allocable to the unrelated trade or business activity exploiting such exempt activity to the extent that their deduction would result in a loss carryover or carryback with respect to that trade or business activity. Similarly, they may not be taken into account in computing unrelated business taxable income attributable to any unrelated trade or business activity not exploiting the same exempt activity. See paragraph (f) of this section for the application of these rules to periodicals published by exempt organizations.

(e) Example. Paragraphs (a) through (d) of this section are illustrated by the following example:

Example. W is an exempt business league with a large membership. Under an arrangement with an advertising agency W regularly mails brochures, pamphlets and other advertising materials to its members, charging the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of the purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from an unrelated trade or business activity. In computing W's unrelated business taxable income, the expenses attributable solely to the conduct of the business, or allocable to such business under the rule of paragraph (c) of this section, are allowable as deductions in accordance with the provisions of section 162. Such deductions include the costs of handling and mailing, the salaries of personnel used full-time in the unrelated business activity and an allocable portion of the salaries of personnel used both to carry on exempt activities and to conduct the unrelated business activity. However, costs of developing W's membership and carrying on its exempt activities are not deductible. Those costs are necessary to the maintenance of the intangible asset exploited in the unrelated business activity—W's membership—but are incurred primarily in connection with W's fundamental purpose as an exempt organization. As a consequence, they do not have proximate and primary relationship to the conduct of the unrelated business activity and do not qualify as directly connected with it.

(f) Determination of unrelated business taxable income derived from sale of advertising in exempt organization periodicals—(1) In general. Under section 513 (relating to the definition of unrelated trade or business) and § 1.513-1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business activity involving the exploitation of an exempt activity; namely, the circulation and readership of the periodical developed through the production and distribution of the readership content of the periodical. Paragraph (d) of this section provides for the allowance of deductions attributable to the production and distribution of the readership content of the periodical. Thus, subject to the limitations of paragraph (d)(2) of this section, where the circulation and readership of an exempt organization periodical are utilized in connection with the sale of advertising in the periodical, expenses, depreciation, and similar items of deductions attributable to the production and distribution of the editorial or readership content of the periodical shall qualify as items of deductions directly connected with the unrelated advertising activity. Subparagraphs (2) through (6) of this paragraph provide rules for determining the amount of unrelated business taxable income attributable to the sale of advertising in exempt organization periodicals. Subparagraph (7) of this paragraph provides rules for determining when the unrelated business taxable income of two or more exempt organization periodicals may be determined on a consolidated basis.

(2) Computation of unrelated business taxable income attributable to sale of advertising—(i) Excess advertising costs. If the direct advertising costs of an exempt organization periodical (determined under subparagraph (6)(ii) of this paragraph) exceed gross advertising income (determined under subparagraph (3)(ii) of this paragraph), such excess shall be allowable as a deduction in determining unrelated business taxable income from any unrelated trade or business activity carried on by the organization.

(ii) Excess advertising income. If the gross advertising income of an exempt organization periodical exceeds direct advertising costs, paragraph (d)(2) of this section provides that items of deduction attributable to the production and distribution of the readership content of an exempt organization periodical shall qualify as items of deduction directly connected with unrelated advertising activity in computing the amount of unrelated business taxable income derived from the advertising activity to the extent that such items exceed the income derived from or attributable to such production and distribution, but only to the extent that such items do not result in a loss from such advertising activity. Furthermore, such items of deduction shall not qualify as directly connected with such advertising activity to the extent that their deduction would result in a loss carryback or carryover with respect to such advertising activity. Similarly, such items of deduction shall not be taken into account in computing unrelated business taxable income attributable to any unrelated

trade or business activity other than such advertising activity. Thus—

(a) If the circulation income of the periodical (determined under subparagraph (3)(iii) of this paragraph) equals or exceeds the readership costs of such periodical (determined under subparagraph (6)(iii) of this paragraph), the unrelated business taxable income attributable to the periodical is the excess of the gross advertising income of the periodical over direct advertising costs; but

(b) If the readership costs of an exempt organization periodical exceed the circulation income of the periodical, the unrelated business taxable income is the excess, if any, of the total income attributable to the periodical (determined under subparagraph (3) of this paragraph) over the total periodical costs (as defined in subparagraph (6)(i) of this paragraph).

See subparagraph (7) of this paragraph for rules relating to the consolidation of two or more periodicals.

(iii) Examples. The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the production and distribution of the readership content of the periodical is related to the organization's exempt purpose.

Example (1). X, an exempt trade association, publishes a single periodical which carries advertising. During 1971, X realizes a total of $40,000 from the sale of advertising in the periodical (gross advertising income) and $60,000 from the sales of the periodical to members and nonmembers (circulation income). The total periodical costs are $90,000 of which $50,000 is directly connected with the sale and publication of advertising (direct advertising costs) and $40,000 is attributable to the production and distribution of the readership content (readership costs). Since the direct advertising costs of the periodical ($50,000) exceed gross advertising income ($40,000), pursuant to subdivision (i) of this subparagraph, the unrelated business taxable income attributable to advertising is determined solely on the basis of the income and deductions directly connected with the production and sale of the advertising:

Gross advertising revenue	$40,000
Direct advertising costs	(50,000)
Loss attributable to advertising	(10,000)

X has realized a loss of $10,000 from its advertising activity. This loss is an allowable deduction in computing X's unrelated business taxable income derived from any other unrelated trade or business activity.

Example (2). Assume the facts as stated in example (1), except that the circulation income of X periodical is $100,000 instead of $60,000, and that of the total periodical costs, $25,000 are direct advertising costs, and $65,000 are readership costs. Since the circulation income ($100,000) exceeds the total readership costs ($65,000), pursuant to subdivision (ii)(a) of this subparagraph the unrelated business taxable income attributable to the advertising activity is $15,000, the excess of gross advertising income ($40,000) over direct advertising costs ($25,000).

Example (3). Assume the facts as stated in example (1), except that of the total periodical costs, $20,000 are direct advertising costs and $70,000 are readership costs. Since the readership costs of the periodical ($70,000), exceed the circulation income ($60,000), pursuant to subdivision (ii)(b) of this subparagraph the unrelated business taxable income attributable to advertising is the excess of the total income attributable to the periodical over the total periodical costs. Thus, X has unrelated business taxable income attributable to the advertising activity of $10,000 ($100,000 total income attributable to the periodical less $90,000 total periodical costs).

Example (4). Assume the facts as stated in example (1), except that the total periodical costs are $120,000 of which $30,000 are direct advertising costs and $90,000 are readership costs. Since the readership costs of the periodical ($90,000), exceed the circulation income ($60,000), pursuant to subdivision (ii)(b) of this subparagraph the unrelated business taxable income attributable to advertising is the excess, if any, of the total income attributable to the periodical over the total periodical costs. Since the total income of the periodical ($100,000) does not exceed the total periodical costs ($120,000), X has not derived any unrelated business taxable income from the advertising activity. Further, only $70,000 of the $90,000 of readership costs may be deducted in computing unrelated business taxable income since as provided in subdivision (ii) of this subparagraph, such costs may be deducted, to the extent they exceed circulation income, only to the extent they do not result in a loss from the advertising activity. Thus, there is no loss from such activity, and no amount may be deducted on this account in computing X's unrelated trade or business income derived from any other unrelated trade or business activity.

(3) Income attributable to exempt organization periodicals—(i) In general. For purposes of this paragraph the total income attributable to an exempt organization periodical is the sum of its gross advertising income and its circulation income.

(ii) Gross advertising income. The term "gross advertising income" means all amounts derived from the unrelated advertising activities of an exempt organization periodical (or for purposes of this paragraph in the case of a taxable organization, all amounts derived from the advertising activities of the taxable organization).

(iii) Circulation income. The term "circulation income" means the income attributable to the production, distribution or circulation of a periodical (other than gross advertising income) including all amounts realized from or attributable to the sale or distribution of the readership content of the periodical, such as amounts realized from charges made for reprinting or republishing articles and special items in the periodical and amounts realized from sales of back issues. Where the right to receive an exempt organization periodical is associated with membership or similar status in such organization for which dues, fees or other charges are received (hereinafter referred to as "membership receipts"), circulation income includes the portion of such membership receipts allocable to

the periodical (hereinafter referred to as "allocable membership receipts"). Allocable membership receipts is the amount which would have been charged and paid if—

(a) The periodical was that of a taxable organization.

(b) The periodical was published for profit, and

(c) The member was an unrelated party dealing with the taxable organization at arm's length.

See subparagraph (4) of this paragraph for a discussion of the factors to be considered in determining allocable membership receipts of an exempt organization periodical under the standard described in the preceding sentence.

(4) Allocable membership receipts. The allocable membership receipts of an exempt organization periodical shall be determined in accordance with the following rules:

(i) Subscription price charged to nonmembers. If 20 percent or more of the total circulation of a periodical consist of sales to nonmembers, the subscription price charged to such nonmembers shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(ii) Subscription price to nonmembers. If paragraph (f)(4)(i) of this section does not apply and if the membership dues from 20 percent or more of the members of an exempt organization are less than those received from the other members because the former members do not receive the periodical, the amount of the reduction in membership dues for a member not receiving the periodical shall determine the price of the periodical for purposes of allocating membership receipts to the periodical.

(iii) Pro rata allocation of membership receipts. Since it may generally be assumed that membership receipts and gross advertising income are equally available for all the exempt activities (including the periodical) of the organization, the share of membership receipts allocated to the periodical, where paragraphs (f)(4)(i) and (ii) of this section do not apply, shall be an amount equal to the organization's membership receipts multiplied by a fraction the numerator of which is the total periodical costs and the denominator of which is such costs plus the cost of other exempt activities of the organization. For example, assume that an exempt organization has total periodical costs of $30,000 and other exempt costs of $70,000. Further assume that the membership receipts of the organization are $60,000 and that paragraphs (f)(4)(i) and (ii) of this section do not apply. Under these circumstances $18,000 ($60,000 times $30,000/$100,000) is allocated to the periodical's circulation income.

(5) Examples. The rules set forth in paragraph (f)(4) of this section may be illustrated by the following examples. For purposes of these examples it is assumed that the exempt organization periodical contains advertising, and that the production and distribution of the readership content of the periodical is related to the organization's exempt purpose.

Example (1). U is an exempt scientific organization with 10,000 members who pay annual dues of $15 per year. One of U's activities is the publication of a monthly periodical which is distributed to all of its members. U also distributes 5,000 additional copies of its periodical to nonmember subscribers at a cost of $10 per year. Pursuant to paragraph (f)(4)(i) of this section, since the nonmember circulation of U's periodical represents 33⅓ percent of its total circulation the subscription price charged to nonmembers will be used to determine the portion of U's membership receipts allocable to the periodical. Thus, U's allocable membership receipts will be $100,000 ($10 times 10,000 members), and U's total circulation income for the periodical will be $150,000 ($100,000 from members plus $50,000 from sales to nonmembers).

Example (2). Assume the facts as stated in example (1), except that U sells only 500 copies of its periodical to nonmembers, at a price of $10 per year. Assume further that U's members may elect not to receive the periodical, in which case their annual dues are reduced from $15 per year to $6 per year, and that only 3,000 members elect to receive the periodical and pay the full dues of $15 per year. U's stated subscription price to members of $9 consistently results in an excess of total income (including gross advertising income) attributable to the periodical over total costs of the periodical. Since the 500 copies of the periodical distributed to nonmembers represents only 14 percent of the 3,500 copies distributed, pursuant to paragraph (f)(4)(i) of this section, the $10 subscription price charged to nonmembers will not be used in determining the portion of membership receipts allocable to the periodical. On the other hand, since 70 percent of the members elect not to receive the periodical and pay $9 less per year in dues, pursuant to paragraph (f)(4)(ii) of this section, such $9 price will be used in determining the subscription price charged to members. Thus, the allocable membership receipts will be $9 per member, or $27,000 ($9 times 3,000 copies) and U's total circulation income will be $32,000 ($27,000 plus $5,000).

Example (3). (a) W, an exempt trade association, has 800 members who pay annual dues of $50 per year. W publishes a monthly journal the editorial content and advertising of which are directed to the business interests of its own members. The journal is distributed to all of W's members and no receipts are derived from nonmembers.

(b) W has total receipts of $100,000 of which $40,000 ($50 × 800) are membership receipts and $60,000 are gross advertising income. W's total costs for the journal and other exempt activities is $100,000. W has total periodical costs of $76,000 of which $41,000 are direct advertising costs and $35,000 are readership costs.

(c) Paragraph (f)(4)(i) of this section will not apply since no copies are available to nonmembers. Therefore, the allocation of membership receipts shall be made in accordance with

paragraph (f)(4)(iii) of this section. Based upon pro rata allocation of membership receipts (40,000) by a fraction the numerator of which is total periodical costs ($76,000) and the denominator of which is the total costs of the journal and the other exempt activities ($100,000), $30,400 ($76,000/$100,000 times $40,000) of membership receipts is circulation income.

(6) **Deductions attributable to exempt organization periodicals**—(i) **In general.** For purposes of this paragraph the term "total periodical costs" means the total deductions attributable to the periodical. For purposes of this paragraph the total periodical costs of an exempt organization periodical are the sum of the direct advertising costs of the periodical (determined under subdivision (ii) of this subparagraph) and the readership costs of the periodical (determined under subdivision (iii) of this subparagraph). Items of deduction properly attributable to exempt activities other than the publication of an exempt organization periodical may not be allocated to such periodical. Where items are attributable both to an exempt organization periodical and to other activities of an exempt organization, the allocation of such items must be made on a reasonable basis which fairly reflects the portion of such item properly attributable to each such activity. The method of allocation will vary with the nature of the item, but once adopted, a reasonable method of allocation with respect to an item must be used consistently. Thus, for example, salaries may generally be allocated among various activities on the basis of the time devoted to each activity; occupancy costs such as rent, heat and electricity may be allocated on the basis of the portion of space devoted to each activity; and depreciation may be allocated on the basis of space occupied and the portion of the particular asset utilized in each activity. Allocations based on dollar receipts from various exempt activities will generally not be reasonable since such receipts are usually not an accurate reflection of the costs associated with activities carried on by exempt organizations.

(ii) **Direct advertising costs.** (a) The direct advertising costs of an exempt organization periodical include all expenses, depreciation, and similar items of deduction which are directly connected with the sale and publication of advertising as determined in accordance with paragraphs (a), (b), and (c) of this section. These items are allowable as deductions in the computation of unrelated business income of the organization for the taxable year to the extent they meet the requirements of section 162, section 167, or other relevant provisions of the Code. The items allowable as deductions under this subdivision do not include any items of deduction attributable to the production or distribution of the readership content of the periodical.

(b) The items allowable as deductions under this subdivision would include agency commissions and other direct selling costs, such as transportation and travel expenses, office salaries, promotion and research expenses, and direct office overhead directly connected with the sale of advertising lineage in the periodical. Also included would be other items of deduction commonly classified as advertising costs under standard account classification, such as art work and copy preparation, telephone, telegraph, postage, and similar costs directly connected with advertising.

(c) In addition to the items of deduction normally included in standard account classifications relating to advertising costs, it is also necessary to ascertain the portion of mechanical and distribution costs attributable to advertising lineage. For this purpose, the general account classifications of items includible in mechanical and distribution costs ordinarily employed in business-paper and consumer publication accounting provide a guide for the computation. Thus, the mechanical and distribution costs in such cases would include the portion of the costs and other expenses of composition, presswork, binding, mailing (including paper and wrappers used for mailing), and the bulk postage attributable to the advertising lineage of the publication. The portion of mechanical and distribution costs attributable to advertising lineage of the periodical will be determined on the basis of the ratio of advertising lineage to total lineage of the periodical, and the application of that ratio to the total mechanical and distribution costs of the periodical, where records are not kept in such a manner as to reflect more accurately the allocation of mechanical and distributions costs to advertising lineage of the periodical, and where there is no factor in the character of the periodical to indicate that such an allocation would be unreasonable.

(iii) **Readership costs.** The "readership costs" of an exempt organization periodical include expenses, depreciation or similar items which are directly connected with the production and distribution of the readership content of the periodical and which would otherwise be allowable as deductions in determining unrelated business taxable income under section 512 and the regulations thereunder if such production and distribution constituted an unrelated trade or business activity. Thus, readership costs include all the items of deduction attributable to an exempt organization periodical which are not allocated to direct adver-

tising costs under subdivision (ii) of this subparagraph, including the portion of such items attributable to the readership content of the periodical, as opposed to the advertising content, and the portion of mechanical and distribution costs which is not attributable to advertising lineage in the periodical.

(7) Consolidation—(i) In general. Where an exempt organization subject to unrelated business income tax under section 511 publishes two or more periodicals for the production of income, it may treat the gross income from all (but not less than all) of such periodicals and the items of deduction directly connected with such periodicals (including readership costs of such periodicals), on a consolidated basis as if such periodicals were one periodical in determining the amount of unrelated business taxable income derived from the sale of advertising in such periodical. Such treatment must, however, be followed consistently and once adopted shall be binding unless the consent of the Commissioner is obtained as provided in sections 446(e) and § 1.446–1(e).

(ii) Production of income. For purposes of this subparagraph, an exempt organization periodical is "published for the production of income" if—

(a) The organization generally receives gross advertising income from the periodical equal to at least 25 percent of the readership costs of such periodical, and

(b) The publication of such periodical is an activity engaged in for profit.

For purposes of the preceding sentence, the determination whether the publication of a periodical is an activity engaged in for profit is to be made by reference to objective standards taking into account all the facts and circumstances involved in each case. The facts and circumstances must indicate that the organization carries on the activity with the objective that the publication of the periodical will result in economic profit (without regard to tax consequences), although not necessarily in a particular year. Thus, an exempt organization periodical may be treated as having been published with such an objective even though in a particular year its total periodical costs exceed its total income. Similarly, if an exempt organization begins publishing a new periodical, the fact that the total periodical costs exceed the total income for the startup years because of a lack of advertising sales does not mean that the periodical was published without an objective of economic profit. The organization may establish that the activity was carried on with such an objective. This might be established by showing, for example, that there is a reasonable expectation that the total income, by reason of an increase in advertising sales, will exceed costs within a reasonable time. See § 1.183–2 for additional factors bearing on this determination.

(iii) **Example.** This subparagraph may be illustrated by the following example:

Example. Y, an exempt trade association, publishes three periodicals which it distributes to its members: a weekly newsletter, a monthly magazine, and quarterly journal. Both the monthly magazine and the quarterly journal contain advertising which accounts for gross advertising income equal to more than 25 percent of their respective readership costs. Similarly, the total income attributable to each such periodical has exceeded the total deductions attributable to each such periodical for substantially all the years they have been published. The newsletter carries no advertising and its annual subscription price is not intended to cover the cost of publication. The newsletter is a service of Y distributed to all of its members in an effort to keep them informed of changes occurring in the business world and is not engaged in for profit. Under these circumstances, Y may consolidate the income and deductions from the monthly and quarterly journals in computing its unrelated business taxable income, but may not consolidate the income and deductions attributable to the publication of the newsletter with the income and deductions of its other periodicals since the newsletter is not published for the production of income.

(g) Foreign organizations—(1) In general. The unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists of:

(i) The organization's unrelated business taxable income which is derived from sources within the United States but which is not effectively connected with the conduct of a trade or business within the United States, plus

(ii) The organization's unrelated business taxable income effectively connected with the conduct of a trade or business within the United States (whether or not such income is derived from sources within the United States).

To determine whether income realized by a foreign organization is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, see part 1, subchapter N, chapter 1 of the Code (section 861 and following) and the regulations thereunder.

(2) Effective dates. Subparagraph (1) of this paragraph applies to taxable years beginning after December 31, 1969. For taxable years beginning on or before December 31, 1969, the unrelated business taxable income of a foreign organization exempt from taxation under section 501(a) consists

of the organization's unrelated business taxable income which—

(i) For taxable years beginning after December 31, 1966, is effectively connected with the conduct of a trade or business within the United States, whether or not such income is derived from sources within the United States;

(ii) For taxable years beginning on or before December 31, 1966, is derived from sources within the United States.

(h) Effective date. Paragraphs (a) through (f) of this section are applicable with respect to taxable years beginning after December 12, 1967. However, if a taxpayer wishes to rely on the rules stated therein for taxable years beginning before December 13, 1967, he may do so.

[T.D. 6939, 32 FR 17660, Dec. 12, 1967, as amended by T.D. 7183, 37 FR 7885, Apr. 21, 1972; T.D. 7392, 40 FR 58638, Dec. 18, 1975; T.D. 7438, 41 FR 44392, Oct. 8, 1976; T.D. 7935, 49 FR 1694, Jan. 13, 1984]

§ 1.512(a)–2 Definition applicable to taxable years beginning before December 13, 1967.

(a) In general. The unrelated business taxable income which is subject to the tax imposed by section 511 is the gross income, derived by any organization to which section 511 applies, from any unrelated trade or business regularly carried on by it, less the deductions allowed by chapter 1 of the Code which are directly connected with the carrying on of such trade or business, subject to certain exceptions, additions, and limitations referred to below. In the case of an organization which regularly carries on two or more unrelated businesses, its unrelated business taxable income is the aggregate of its gross income from all such unrelated businesses, less the aggregate of the deductions allowed with respect to all such unrelated businesses. For provisions generally applicable to the unrelated business tax, see § 1.511–3, and for rules applicable to the determination of the adjusted basis of property, see paragraph (a)(2) of § 1.514(a)–1.

(b) Effective date. Except as provided in paragraph (f) of § 1.512(a)–1, this section is applicable with respect to taxable years beginning before December 13, 1967.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17660, Dec. 12, 1967]

§ 1.512(a)–3 [Reserved]

§ 1.512(a)–4 Special rules applicable to war veterans organizations.

(a) In general. For taxable years beginning after December 31, 1969, this section provides special rules for the determination of the unrelated business taxable income of an organization described in section 501(c)(19). In general, the rules contained in sections 511 through 514 which are applicable to any organization listed in section 501(c) apply in determining the unrelated business taxable income of an organization described in section 501(c)(19). However, that amount which is paid by members to the organization for the purpose described in paragraph (b)(1) of this section, if set aside from other organizational monies and accounts in an insurance set aside, may be excluded from the unrelated business taxable income of the organization. The insurance set aside shall be used exclusively for providing insurance benefits, for the purposes specified in section 170(c)(4) of the Code, for the reasonable costs of administering the insurance program that are directly related to such set aside, or for the reasonable costs of distributing funds for section 170(c)(4) purposes. If an amount so set aside is used for any purposes other than those described in the preceding sentence, it shall be included in unrelated business taxable income without regard to any modifications provided by section 512(b), in the taxable year in which it is withdrawn from such set aside. Amounts will be considered to have been withdrawn from an insurance set aside if they are used in any manner inconsistent with providing insurance benefits, paying the reasonable costs of administering the insurance program for section 170(c)(4) purposes and for costs of distributing funds for section 170(c)(4) purposes. An example of a use of funds which would be considered a withdrawal would be the use of such funds as security for a loan.

(b) Insurance set aside—(1) Purpose of payments by members. Payments by members (including commissions on such payments earned by the set aside as agent for an insurance company) into an insurance set aside must be for the sole purpose of obtaining life, sick, accident or health insurance benefits from the organization or for the reasonable costs of administration of the insurance program, except that such purpose is not violated when excess funds from an experience gain are utilized for those purposes specified in section 170(c)(4) or the reasonable costs of distributing funds for such purposes. Funds for any other

purpose may not be set aside in the insurance set aside.

(2) Income from set aside. In addition to the payments by members described in paragraph (b)(1) of this section, only income from amounts in the insurance set aside (including commissions earned as agent for an insurance company) may be so set aside. Moreover unless such income is used for providing insurance benefits, for those purposes specified in section 170(c)(4), or for reasonable costs of administration, such income must be set aside within the period described in paragraph (b)(3) of this section in order to avoid being included as an item of unrelated business taxable income under section 512(a)(4).

(3) Time within which income must be set aside. Income from amounts in the insurance set aside generally must be set aside in the taxable year in which it would be includible in gross income but for this section. However, income set aside on or before the date prescribed for filing the organization's return of unrelated business taxable income (whether or not it had such income) for the taxable year (including any extension of time) may, at the election of the organization, be treated as having been set aside in such taxable year.

(4) Computation of income from set aside. Income from amounts in the insurance set aside shall consist solely of items of investment income from, and other gains derived from dealings in, property in the set aside. The deductions allowed against such items of income or other gains are those amounts which are related to the production of such income or other gains. Only the amounts of income or other gain which are in excess of such deductions may be set aside in the insurance set aside.

(5) Requirements for set aside. An amount is not properly set aside if the organization commingles it with any amount which is not to be set aside. However, adequate records describing the amount set aside and indicating that it is to be used for the designated purpose are sufficient. Amounts that are set aside need not be permanently committed to such use either under state law or by contract. Thus, for example, it is not necessary that the organization place these funds in an irrevocable trust. Although set aside income may be accumulated, any accumulation which is unreasonable in amount or duration is evidence that the income was not accumulated for the purposes set forth. For purposes of the preceding sentence, accumulations which are reasonably necessary for the purpose of providing life, sick, health, or accident insurance benefits on the basis of recognized mortality or morbidity tables and assumed rates of interest under an actuarially acceptable method would not be unreasonable even though such accumulations are quite large and the time between the receipt by the organization of such amounts and the date of payment of the benefits is quite long. For example, an accumulation of income for 20 years or longer which is determined to be reasonably necessary to pay life insurance benefits to members, their dependents or designated beneficiaries, generally would not be an unreasonable accumulation. Income which has been set aside may be invested, pending the action contemplated by the set aside, without being regarded as having been used for other purposes.

[T.D. 7438, 41 FR 44393, Oct. 8, 1976]

§ 1.512(a)–5T Questions and answers relating to the unrelated business taxable income of organizations described in paragraphs (9), (17) or (20) of section 501(c) (temporary).

Q–1: What does section 512(a)(3), as amended by the Tax Reform Act of 1984 (Act), provide with respect to organizations described in paragraphs (9), (17) or (20) of section 501(c)?

A–1: In general, section 512(a)(3), as amended by section 511 of the Act, extends the rules for determining the unrelated business income tax of voluntary employees' beneficiary associations (VEBAs) to supplemental unemployment compensation benefit trusts (SUBs) and group legal service organizations (GLSOs). The section also restricts the amount of income that may be set aside by such organizations for exempt purposes.

Q–2: What is the effective date of the amendments to section 512(a)(3)?

A–2: The amendments to section 512(a)(3) will apply to income earned by VEBAs, SUBs or GLSOs after December 31, 1985, in the taxable years of such organizations ending after such date. For purposes of applying section 512(a)(3) to the first taxable year of such an organization ending after December 31, 1985, the income of the VEBA, SUB or GLSO earned after December 31, 1985, will be determined by allocating the total income earned for such taxable year on the basis of the calendar year 1985 and 1986 months in such taxable year. However, if a VEBA, SUB or GLSO is part of a plan that is maintained pursuant to one or more collective bargaining agreements (a) between employee representatives and one or more employers, and (b) which are in effect on July 1, 1985 (or ratified on or before that date),

the amendments do not apply to income earned in a taxable year of a VEBA, SUB or GLSO beginning before the termination of the last of the collective bargaining agreements pursuant to which the plan is maintained (determined without regard to any extension of the contract agreed to after July 1, 1985). For purposes of the preceding sentence, any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added under section 511 of the Tax Reform Act 1984 (i.e., requirements under section 419, 419A, 512(a)(3)(E), and 4976) shall not be treated as a termination of such collective bargaining agreements.

Q–3: What amount of income may a VEBA, SUB or GLSO set aside for exempt purposes?

A–3: (a) Pursuant to section 512(a)(3)(E)(i), the amounts set aside in a VEBA, SUB, or GLSO (including a VEBA, SUB, or GLSO that is part of a 10 or more employer plan, as defined in section 419A(f)(6)(B)) as of the close of a taxable year of such VEBA, SUB, or GLSO to provide for the payment of life, sick, accident, or other benefits may not be taken into account for purposes of determining "exempt function income" to the extent that such amounts exceed the qualified asset account limit, determined under sections 419A(c) and 419A(f)(7), for such taxable year of the VEBA, SUB, or GLSO. In calculating the qualified asset account limit for this purpose, a reserve for post-retirement medical benefits under section 419A(c)(2)(A) is not to be taken into account.

(b) The exempt function income of a VEBA, SUB, or GLSO for a taxable year of such an organization, under section 512(a)(3)(B), includes: (1) Certain amounts paid by members of the VEBA, SUB, or GLSO within the meaning of the first sentence of section 512(a)(3)(B) ("member contributions"); and (2) other income of the VEBA, SUB, or GLSO (including earnings on member contributions) that is set aside for the payment of life, sick, accident, or other benefits to the extent that the total amount set aside in the VEBA, SUB or GLSO as of the close of the taxable year for any purpose (including member contributions and other income set aside in the VEBA, SUB, or GLSO as of the close of the year) does not exceed the qualified asset account limit for such taxable year of the organization. For purposes of section 512(c)(3)(B), member contributions include both employee contributions and employer contributions to the VEBA, SUB, or GLSO. In calculating the total amount set aside in a VEBA, SUB, or GLSO as of the close of a taxable year, certain assets with useful lives extending substantially beyond the end of the taxable year (e.g., buildings, and licenses) are not to be taken into account to the extent they are used in the provision of life, sick, accident, or other benefits. For example, cash and securities (and similar investments) held by a VEBA, SUB or GLSO are not disregarded in calculating the total amount set aside for this purpose because they are used to pay welfare benefits, rather than merely used in the provision of such benefits. Accordingly, the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such an organization generally will equal the lesser of two amounts: the income of the VEBA, SUB, or GLSO for the taxable year (excluding member contributions); or, the excess of the total amount set aside as of the close of the taxable year (including member contributions, and excluding certain assets with a useful life extending substantially beyond the end of the taxable year to the extent they are used in the provision of welfare benefits) over the qualified asset account limit (calculated without regard to the otherwise permitted reserve for post-retirement medical benefits) for the taxable year. See § 1.419A-2T for special rules relating to collectively bargained welfare benefit funds.

(c) The income of a VEBA, SUB, or GLSO for any taxable year includes gain realized by the organization on the sale or disposition of any asset during such year. The gain realized by a VEBA, SUB, or GLSO on the sale or disposition of an asset is equal to the amount realized by the organization over the basis of such asset (in the hands of the organization), reduced by any qualified direct costs attributable to such asset (under paragraphs (b), (c), and (d) of Q&A–6 of § 1.419–1T).

Q–4: What transition rules apply to "existing reserves for post-retirement medical or life insurance benefits"?

A–4: (a) Section 512(a)(3)(E)(iii)(I) provides that income that is either directly or indirectly attributable to "existing reserves for post-retirement medical or life insurance benefits" will not be treated as unrelated business taxable income. An "existing reserve for post-retirement medical or life insurance benefits" (as defined in section 512(a)(3)(E)(iii)(II)) is the total amount of assets actually set aside in a VEBA, SUB, or GLSO on July 18, 1984 (calculated in the manner set forth in Q&A-3 of the regulation, and adjusted under paragraph (c) of Q&A–11 of § 1.419–1T), reduced by employer contributions to the fund on or before such date to the extent such contributions are not deductible for the taxable year of the employer containing July 18, 1984, and for any prior taxable

year of the employer, for purposes of providing such post-retirement benefits. For purposes of the preceding sentence only, an amount that was not actually set aside on July 18, 1984, will be treated as having been actually set aside on such date if (1) such amount was incurred by the employer (without regard to section 461(h)) as of the close of the last taxable year of the VEBA, SUB, or GLSO ending before July 18, 1984, and (2) such amount was actually contributed to the VEBA, SUB, or GLSO within 8½ months following the close of such taxable year.

(b) In addition, section 512(a)(3)(E)(iii)(I) applies to existing reserves for such post-retirement benefits only to the extent that such "existing reserves" do not exceed the amount that could be accumulated under the principles set forth in Revenue Rulings 69-382, 1969-2, C.B. 28; 69-478, 1969-2 C.B. 29; and 73-599, 1973-2 C.B. 40. Thus, amounts attributable to such excess "existing reserves" are not within this transition rule even though they were actually set aside on July 18, 1984.

(c) All post-retirement medical or life insurance benefits (or other benefits to the extent paid with amounts set aside to provide post-retirement medical or life insurance benefits) provided after July 18, 1984 (whether or not the employer has maintained a reserve or fund for such benefits) are to be charged, first, against the "existing reserves" within this transition rule (including amounts attributable to "existing reserves" within this transition rule) for post-retirement medical benefits or for post-retirement life insurance benefits (as the case may be) and, second, against all other amounts. For this purpose, the qualified direct cost of an asset with a useful life extending substantially beyond the end of the taxable year (as determined under Q&A-6 of § 1.419-1T) will be treated as a benefit provided and thus charged against the "existing reserve" based on the extent to which such asset is used in the provision of post-retirement medical benefits or post-retirement life insurance benefits (as the case may be). All plans of an employer providing post-retirement medical benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III), and all plans of an employer providing post-retirement life insurance benefits are to be treated as one plan for purposes of section 512(a)(3)(E)(iii)(III).

(d) In calculating the unrelated business taxable income of a VEBA, SUB, or GLSO for a taxable year of such organization, the total income of the VEBA, SUB, or GLSO for the taxable year is reduced by the income attributable to "existing reserves" within the transition rule before such income is compared to the excess of the total amount set aside as of the close of the taxable year over the qualified asset account limit for the taxable year. Thus, for example, assume that the total income of a VEBA for a taxable year is $1,000, and that the excess of the total amount of the VEBA set aside as of the close of the taxable year over the applicable qualified asset account limit is $600. Assume also that of the $1,000 of total income, $500 is attributable to "existing reserves" within the transition rule of section 512(a)(3)(E)(iii)(I). The unrelated business income of this VEBA for the taxable year is equal to the lesser of the following two amounts: (1) the total income of the VEBA for the taxable year ($1,000), reduced to the extent that such income is attributable to "existing reserves" within the transition rule ($500); or (2) the excess of the total amount set aside as of the close of the taxable year over the applicable qualified asset account limit ($600). Thus, the unrelated business income of this VEBA for the taxable year is $500.

[T.D. 8073, 51 FR 4332, Feb. 4, 1986; 51 FR 7262, March 3, 1986; 51 FR 11303, April 2, 1986]

§ 1.512(b)–1 Modifications.

Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case. For example, if a payment termed "rent" by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or joint venturer, such payment is not within the modification for rents. The modifications provided in section 512(b) are as follows:

(a) **Dividends, interest, and annuities.** Dividends, interest, and annuities, and the deductions directly connected therewith, shall be excluded in computing unrelated business taxable income. However, for taxable years beginning after December 31, 1969, certain dividends, interest, and annuities derived from and certain deductions in connection with debt-financed property (as defined in section 514(b)), and certain interest and annuities derived from and certain deductions in connection with controlled organizations (as defined in paragraph (*l*) of this section) shall be included in computing unrelated business taxable income.

(b) **Royalties.** Royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income. However, for

taxable years beginning after December 31, 1969, certain royalties from and certain deductions in connection with either, debt-financed property (as defined in section 514(b)) or controlled organizations (as defined in paragraph (*l*) of this section) shall be included in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded. To the extent not treated as a loan under section 636, payments in discharge of mineral production payments shall be treated in the same manner as royalty payments for the purpose of computing unrelated business taxable income. To the extent treated as a loan under section 636, the amount of any payment in discharge of a production payment which is the equivalent of interest shall be treated as interest for purposes of section 512(b)(1) and paragraph (a) of this section.

(c) Rents—(1) Taxable years beginning before January 1, 1970. For taxable years beginning before January 1, 1970, rents from real property (including personal property leased with the real property) and the deductions directly connected therewith shall be excluded in computing unrelated business taxable income, except that certain rents from, and certain deductions in connection with, a business lease (as defined in section 514(f)) shall be included in computing unrelated business taxable income. See subparagraph (5) of this paragraph for rules governing amounts received for the rendering of services.

(2) Taxable years beginning after December 31, 1969—(i) In general. For taxable years beginning after December 31, 1969, except as provided in subdivision (iii) of this subparagraph, rents from property described in subdivision (ii) of this subparagraph, and the deductions directly connected therewith, shall be excluded in computing unrelated business taxable income. However, notwithstanding subdivision (ii) of this subparagraph, certain rents from and certain deductions in connection with either debt-financed property (as defined in section 514(b)) or property rented to controlled organizations (as defined in paragraph (*l*) of this section) shall be included in computing unrelated business taxable income.

(ii) Excluded rents. The rents which are excluded from unrelated business income under section 512(b)(3)(A) and this paragraph are—

(a) Real property. All rents from real property; and

(b) Personal property. All rents from personal property leased with real property if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time personal property are an incidental amount service by the lessee.

For purposes of the preceding sentence, rents attributable to personal property generally are not an incidental amount of the total rents if such rents exceed 10 percent of the total rents from all the property leased. For example, if the rents attributable to the personal property leased are determined to be $3,000 per year, and the total rents from all property leased are $10,000 per year, then such $3,000 amount is not to be excluded from the computation of unrelated business taxable income by operation of section 512(b)(3)(A)(ii) and this paragraph, since such amount is not an incidental portion of the total rents.

(iii) Exception. Subdivision (ii) of this subparagraph shall not apply, if either—

(a) Excess personal property rents. More than 50 percent of the total rents are attributable to personal property, determined at the time such personal property is first placed in service by the lessee; or

(b) Net profits. The determination of the amount of such rents depends in whole or in part on the income or profits derived by any person from the property leased, other than an amount based on a fixed percentage or percentages of the gross receipts or sales. For purposes of the preceding sentence, the rules contained in paragraph (b)(3) and (6) (other than paragraph (b)(6)(ii)) of § 1.856–4 shall apply.

(iv) Illustration. This subparagraph may be illustrated by the following example:

Example. A, an exempt organization, owns a printing factory which consists of a building housing two printing presses and other equipment necessary for printing. On January 1, 1971, A rents the building and the printing equipment to B for $10,000 a year. The lease states that $9,000 of such rent is for the building and $1,000 for the printing equipment. However, it is determined that notwithstanding the terms of the lease $4,000, or 40 percent ($4,000/$10,000), of the rent is actually attributable to the printing equipment. During 1971, A has $3,000 of deductions, all of which are properly allocable to the land and building. Under these circumstances, A shall not take into account in computing its unrelated business taxable income the $6,000 of rent attributable to the building and the $3,000 of deductions directly connected with such rent. How-

ever, the $4,000 of rent attributable to the printing equipment is not excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3)(A)(ii) or this paragraph since such rent represents more than an incidental portion of the total rents.

(3) Definitions and special rules. For purposes of subparagraph (2) of this paragraph—

(i) Real property defined. The term "real property" means all real property, including any property described in sections 1245(a)(3)(C) and 1250(c) and the regulations thereunder.

(ii) Personal property defined. The term "personal property" means all personal property, including any property described in section 1245(a)(3)(B) and the regulations thereunder.

(iii) Multiple leases. If separate leases are entered into with respect to real and personal property, and such properties have an integrated use (*e.g.*, one or more leases for real property and another lease or leases for personal property to be used upon such real property), all such leases shall be considered as one lease.

(iv) Placed in service. Property is "placed in service" by the lessee when it is first subject to his use in accordance with the terms of the lease. For example, property subject to a lease entered into on November 1, 1971, for a term commencing on January 1, 1972, shall be considered as placed in service on January 1, 1972, regardless of when the property is first actually used by the lessee.

(v) Changes in rent charged or personal property rented. If—

(a) By reason of the placing of additional or substitute personal property in service, there is an increase of 100 percent or more in the rent attributable to all the personal property leased, or

(b) There is a modification of the lease by which there is a change in the rent charged (whether or not there is a change in the amount of personal property rented), the rent attributable to personal property shall be recomputed to determine whether the exclusion under subparagraph (2)(ii)(b) of this paragraph or the exception under subparagraph (2)(iii)(a) of this paragraph applies. Any change in the treatment of rents, attributable to a recomputation under this subdivision, shall be effective only with respect to rents for the period beginning with the event which occasioned the recomputation.

(4) Examples. Subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example (1). On January 1, 1971, A, an exempt organization, executes two leases with B. One is for the rental of a computer, with a stated annual rent of $750. The other is for the rental of office space in which to use the computer, at a stated annual rent of $7,250. The total annual rent under both leases for 1971 is $8,000. At the time the computer is first placed in service, however, taking both leases into consideration, it is determined that notwithstanding the terms of the leases $3,000, or 37.5 percent ($3,000/$8,000), of the rent is actually attributable to the computer. Therefore, for 1971, only the $5,000 ($8,000–$3,000) attributable to the rental of the office space is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example (2). Assume the facts as stated in example (1). Assume further that the leases to which the computer and office space are subject in example (1) provide that the rent may be increased or decreased, depending upon the prevailing rental value for similar computers and office space. On January 1, 1972, the total annual rent is increased in the computer lease to $2,000, and in the office space lease to $9,000. For 1972, it is determined that notwithstanding the terms of the leases $6,000, or 54.5 percent ($6,000/$11,000), of the total rent is actually attributable to the computer as of that time. Even though the rent attributable to personal property now exceeds 50 percent of the total rent, the rent attributable to real property will continue to be excluded, since there was no modification of the terms of the leases and since the increase in the rent was not attributable to the placing of new personal property in service. See subparagraph (3)(v) of this paragraph. Thus, for 1972 the $5,000 of rent attributable to the office space continues to be excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example (3). Assume the facts as stated in example (1), except that on January 1, 1973, B rents a second computer from A, which is placed in service on that date. The total rent is increased to $2,000 for the computer lease and to $10,000 for the office space lease. It is determined at the time the second computer is first placed in service that notwithstanding the terms of the leases $7,000 of the rent is actually attributable to the computers. Since the rent attributable to personal property has increased by more than 100 percent ($4,000/$3,000=133 percent), a redetermination must be made pursuant to subparagraph (3)(v)(a) of this paragraph. As a result, 58.3 percent ($7,000/$12,000) of the total rent is determined to be attributable to personal property. Accordingly, since more than 50 percent of the total rent A receives is attributable to the personal property leased, none of the rents are excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3).

Example (4). Assume the facts as stated in example (3), except that on June 30, 1975, the lease between B and A is modified. The total rent for the computer lease is reduced to $1,500 and the total rent for the office space lease is reduced to $7,500. Pursuant to subdivision (3)(v)(b) of this paragraph, a redetermination is made as of June 30, 1975. As of the modification date, it is determined that notwithstanding the terms of the leases, the rent actually attributable to the computers is $4,000, or 44.4 percent ($4,000/$9,000), of the total rent. Since less than 50 percent of the total rent is now attributable to personal property, the rent attributable to real property ($5,000), for periods after June 30, 1975, is excluded from the computation of A's unrelated business taxable income by operation of section 512(b)(3). However, the rent attributable to personal property ($4,000) is not excluded from unrelated business taxable income for such periods by operation of section 512(b)(3), since it represents more than an incidental portion of the total rent.

(5) **Rendering of services.** For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use of occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

(d)(1) **Gains and losses from the sale, etc. of property.** There shall also be excluded from the computation of unrelated business taxable income gains or losses from the sale, exchange, or other disposition of property other than (i) stock in trade or other property of a kind which would properly be included in the inventory of the organization if on hand at the close of the taxable year, or (ii) property held primarily for sale to customers in the ordinary course of the trade or business. This exclusion does not apply with respect to the cutting of timber which is considered, upon the application of section 631(a), as a sale or exchange of such timber. In addition, for taxable years beginning after December 31, 1969, this exclusion does not apply to the gain derived from the sale or other disposition of debt-financed property (as defined in section 514(b)). Otherwise, the exclusion under section 512(b)(5) applies with respect to gains and losses from involuntary conversions, casualties, etc.

(2) There shall be excluded from the computation of unrelated business taxable income any gain from the lapse or termination after December 31, 1975, of options to buy or sell securities (as that term is defined in section 1236(c)). An option is considered terminated when the organization's obligation under the option ceases by any means other than by reason of the exercise or lapse of such option. If the exclusion is otherwise available it will apply whether or not the organization owns the securities upon which the option is written, that is, whether or not the option is "covered." However, income from the lapse or termination of an option is excludable only if the option is written in connection with the organization's investment activities. Thus, for example, if the securities upon which the options are written are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business, the income from the lapse or termination will not be excludable under the provisions of this paragraph. Similarly, if an organization is engaged in the trade or business of writing options (whether or not such options are covered) the exclusion will not be available.

(e) **Net operating losses.** (1) The net operating loss deduction provided in section 172 shall be allowed in computing unrelated business taxable income. However, the net operating loss carryback or carryover (from a taxable year for which the taxpayer is subject to the provisions of section 511) shall be determined under section 172 without taking into account any amount of income or deduction which is not included under section 511 in computing unrelated business taxable income. For example, a loss attributable to an unrelated trade or business shall not be diminished by reason of the receipt of dividend income.

(2) For the purpose of computing the net operating loss deduction provided by section 172, any prior taxable year for which an organization was not subject to the provisions of section 511, or a corresponding provision of prior law, shall not be taken into account. Thus, if the organization was not subject to the provisions of section 511 or Supplement U of the Internal Revenue Code of 1939 for a preceding taxable year, the net operating loss is not a carryback to such preceding taxable year, and the net operating loss carryover to succeeding taxable years is not reduced by the taxable income for such preceding taxable year.

(3) A net operating loss carryback or carryover shall be allowed only from a taxable year for which the taxpayer is subject to the provisions of section 511, or a corresponding provision of prior law.

(4) In determining the span of years for which a net operating loss may be carried for purposes of section 172, taxable years in which an organization was not subject to the provisions of section 511 or a corresponding provision of prior law shall be taken into account. Thus, for example, if an organization is subject to the provisions of section 511 for the taxable year 1955 and has a net

operating loss for that year, the last taxable year to which any part thereof may be carried over is the year 1960 regardless of whether the organization is subject to the provisions of section 511 in any of the intervening taxable years.

(f) Research. (1) Income derived from research for the United States or any of its agencies or instrumentalities or a State or political subdivision thereof, and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(2) In the case of a college, university, or hospital, all income derived from research performed for any person and all deductions directly connected with such income, shall be excluded in computing unrelated business taxable income.

(3) In the case of an organization operated primarily for the purpose of carrying on fundamental research (as distinguished from applied research) the results of which are freely available to the general public, all income derived from research performed for any person and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income.

(4) For the purpose of §§ 1.512(a)–1, 1.512(a)–2, and this section, the term "research" does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc. The term "fundamental research" does not include research carried on for the primary purpose of commercial or industrial application.

(g) Charitable, etc., contributions. (1) In computing the unrelated business taxable income of an organization described in section 511(a)(2) the deduction from gross income allowed by section 170 (relating to charitable contributions and gifts) shall be allowed, whether or not the contribution is directly connected with the carrying on of the trade or business. Section 512(b)(10) provides that this deduction shall not exceed 5 percent of the organization's unrelated business taxable income computed without regard to that deduction. The provisions of section 170(b)(2) are not applicable to contributions by the organizations described in section 511(a)(2).

(2) In computing the unrelated business taxable income of a trust described in section 511(b)(2), the deduction allowed by section 170 (relating to charitable contributions and gifts) shall be allowed whether or not the contribution is directly connected with the carrying on of the trade or business. The deduction is limited as provided in section 170(b)(1)(A) and (B), except that the amounts so allowed are determined on the basis of unrelated business taxable income computed without regard to this deduction (rather than on the basis of adjusted gross income). For purposes of this deduction, a distribution by a trust described in section 511(b)(2) made pursuant to the trust instrument to a beneficiary described in section 170 shall be treated in the same manner as gifts or contributions.

(3) The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction, not in excess of 5 percent of its unrelated business taxable income, for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

(h) Specific deduction—(1) In general. In computing unrelated business taxable income a specific deduction from gross income of $1,000 is allowed. However, for taxable years beginning after December 31, 1969, such specific deduction is not allowed in computing the net operating loss under section 172 and paragraph (6) of section 512(b).

(2) Special rule for a diocese, province of a religious order, or a convention or association of churches. (i) In the case of a diocese, province of a religious order, or a convention or association of churches, there shall be allowed with respect to each parish, individual church, district, or other local unit a specific deduction equal to the lower of $1,000 or the gross income derived from an unrelated trade or business regularly conducted by such local unit. However, a diocese, province of a religious order, or a convention or association of churches shall not be entitled to a specific deduction for a local unit which, for a taxable year, files a separate return. In the case of a local unit which, for a taxable year, files a separate return, such local unit may claim a specific deduction equal to the lower of $1,000 or the gross income derived from any unrelated trade or business which it regularly conducts.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. X is an association of churches on the calendar year basis. X is divided into local units A, B, C, and D. During 1973, A, B, C, and D derive gross income of, respectively, $1,200, $800, $1,500, and $700 from unrelated businesses which they regularly conduct. Furthermore, for such taxable year, D files a separate return. X may claim a specific deduction of $1,000 with respect to A, $800 with respect to B, and $1,000 with respect to C. X may not claim a specific deduction with respect to D. D, however, may claim a specific deduction of $700 on its return.

(i) **Transitional period for churches.** (1)(i) In the case of an unrelated trade or business (as defined in section 513) carried on before May 27, 1969, by a church or convention or association of churches (as defined in § 1.511–2(a)(3)(ii)), or by the predecessor of a church or convention or association of churches which predecessor was itself a church or convention or association of churches, all gross income derived from such unrelated trade or business and all deductions directly connected with the carrying on of such unrelated trade or business shall be excluded from the determination of unrelated business taxable income under section 512(a) for all taxable years beginning before January 1, 1976. Notwithstanding the preceding sentence, in the case of income from debt-financed property (and the deductions attributable thereto), as defined in section 514, of a church or convention or association of churches or by the predecessor of a church or convention or association of churches, the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b) shall apply for taxable years beginning after December 31, 1969.

(ii) The provisions of subdivision (i) may be illustrated by the following example:

Example. X, a church as defined in § 1.511–2(a)(3)(ii), realizes gross income from an unrelated business (as defined in section 513) of $100,000 for calendar year 1972. X's predecessor church, Y, began conducting such unrelated business in January 1, 1968. Of the $100,000 realized for calendar year 1972, $40,000 is attributable to debt-financed property (as defined in section 514). Since the unrelated business was conducted by Y prior to May 27, 1969, and since X's taxable year begins before January 1, 1976, that amount of the income realized from such business (and all deductions directly connected therewith) which is not attributable to debt-financed property shall be excluded from the determination of unrelated business taxable income under section 512(a). Therefore, of the $100,000 realized, $60,000 ($100,000 less $40,000 attributable to debt-financed property), and all deductions directly connected therewith shall be excluded from the determination of such unrelated business taxable income for purposes of imposition of the tax under section 511(a). The remaining $40,000 and the deductions attributable thereto shall be subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(2) This paragraph shall not apply in the case of income from property, or deductions directly connected with such income, if title to the property is held by a corporation described in section 501(c)(2) for a church or convention or association of churches. Thus, if such income is derived from an unrelated trade or business, the corporation shall be liable for tax imposed by section 511(a) on such income.

(j) **Special rule for certain unrelated trades or businesses carried on by a religious order or by an educational institution maintained by such order.** (1) Except as provided in subparagraph (2) of this paragraph, gross income realized by a religious order (or an educational organization described in section 170(b)(1)(A)(ii) maintained by such order) from an unrelated trade or business, together with all deductions directly connected therewith, shall be excluded from the determination of unrelated business taxable income under section 512(a), if—

(i) The trade or business has been operated by such order or by such institution since before May 27, 1959,

(ii) The trade or business consists of providing services under a license issued by a Federal regulatory agency,

(iii) More than 90 percent of the net income from the business is, for each taxable year for which gross income from such business is so excluded by reason of section 512(b)(15) and this paragraph, devoted to religious, charitable, or educational purposes, and

(iv) It is established to the satisfaction of an officer no lower than the Regional Commissioner that the rates or other charges for such services are fully competitive with rates or other charges charged for such services by persons not exempt from taxation. Rates or other charges for such services shall be considered as fully competitive with rates or other charges charged for such services by persons not exempt from taxation if the rates charged by such unrelated trade or business are neither materially higher nor materially lower than the rates charged by similar businesses operating in the same general area.

(2) The provisions of this paragraph shall not apply with respect to income from debt-financed property (as defined in section 514) and the deductions attributable thereto. For taxable years beginning after December 31, 1969, such income and deductions are subject to the provisions of paragraphs (a) through (e) of section 514 and paragraph (4) of section 512(b).

(k) **Income and deductions from debt-financed property.** For taxable years beginning after December 31, 1969, in the case of debt-financed

property (as defined in section 514(b)), there shall be included in the unrelated business taxable income of an exempt organization, as an item of gross income derived from an unrelated trade or business, the amount of unrelated debt-financed income determined under section 514(a)(1) and § 1.514(a)–1(a), and there shall be allowed, as a deduction with respect to such income, the amount determined under section 514(a)(2) and § 1.514(a)–1(b).

***(l)* Interest, annuities, royalties, and rents from controlled organizations—(1) In general.** For taxable years beginning after December 31, 1969, if an exempt organization (hereinafter referred to as the "controlling organization") has control (as defined in subparagraph (4) of this paragraph) of another organization (hereinafter referred to as the "controlled organization"), the controlling organization shall include as an item of gross income in computing its unrelated business taxable income, the amount of interest, annuities, royalties, and rents derived from the controlled organization determined under subparagraph (2) or (3) of this paragraph. The preceding sentence shall apply whether or not the activity conducted by the controlling organization to derive such amounts represents a trade or business or is regularly carried on. Thus, amounts received by a controlling organization from the rental of its real property to a controlled organization may be included in the unrelated business taxable income of the controlling organization, even though the rental of such property is not an activity regularly carried on by the controlling organization.

(2) Exempt controlled organization—(i) In general. If the controlled organization is exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the unrelated business taxable income of the controlled organization bears to whichever of the following amounts is the greater—

(a) The taxable income of the controlled organization, computed as though the controlled organization were not exempt from taxation under section 501(a), or

(b) The unrelated business taxable income of the controlled organization, both determined without regard to any amounts paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions directly connected with amounts included in gross income under the preceding sentence.

(ii) Examples. This subparagraph may be illustrated by the following examples:

Example (1). A, an exempt scientific organization described in section 501(c)(3), owns all the stock of B, another exempt scientific organization described in section 501(c)(3). During 1971, A rents space for a laboratory to B for $15,000 a year. A's total deductions for 1971 with respect to the leased property are $3,000: $1,000 for maintenance and $2,000 for depreciation. If B were not an exempt organization, its total taxable income would be $300,000, disregarding rent paid to A. B's unrelated business taxable income, disregarding rent paid to A, is $100,000. Under these circumstances, $4,000 of the rent paid by B will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

B's unrelated business taxable income (disregarding rent paid to A)	$100,000
B's taxable income (computed as though B were not exempt and disregarding rent paid to A)	300,000
Ratio ($100,000/$300,000)	⅓
Total rent	15,000
Total deductions	3,000
Rental income treated as gross income from an unrelated trade or business (⅓ of $15,000)	5,000
Less deductions directly connected with such income (⅓ of $3,000)	1,000
Net rental income included by A in computing its unrelated business taxable income	$4,000

Example (2). Assume the facts as stated in example (1), except that B's taxable income is $90,000 (computed as though B were not an exempt organization, and disregarding rents paid to A). B's unrelated business taxable income ($100,000) is therefore greater than its taxable income ($90,000). Thus, the ratio used to determine the portion of rent received by A which is to be taken into account is one since both the numerator and denominator of such ratio is B's unrelated business taxable income. Consequently, all the rent received by A from B ($15,000), and all the deductions directly connected therewith ($3,000), are included by A in computing its unrelated business taxable income.

(3) Nonexempt controlled organization—(i) In general. If the controlled organization is not exempt from taxation under section 501(a), the amount referred to in subparagraph (1) of this paragraph is an amount which bears the same ratio to the interest, annuities, royalties, and rents received by the controlling organization from the controlled organization as the "excess taxable income" (as defined in subdivision (ii) of this subparagraph) of the controlled organization bears to whichever of the following amounts is the greater—

(a) The taxable income of the controlled organization, or

(b) The excess taxable income of the controlled organization,

both determined without regard to any amount paid directly or indirectly to the controlling organization. The controlling organization shall be allowed all deductions which are directly connected with amounts included in gross income under the preceding sentence.

(ii) Excess taxable income. For purposes of this paragraph, the term "excess taxable income" means the excess of the controlled organization's taxable income over the amount of such taxable income which, if derived directly by the controlling organization, would not be unrelated business taxable income.

(iii) Examples. This subparagraph may be illustrated by the following examples:

Example (1). A, an exempt university described in section 501(c)(3), owns all the stock of M, a nonexempt organization. During 1971, M leases a factory and a dormitory from A for a total annual rent of $100,000. During the taxable year, M has $500,000 of taxable income, disregarding the rent paid to A: $150,000 from a dormitory for students of A university, and $350,000 from the operation of a factory which is a business unrelated to A's exempt purpose. A's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. Under these circumstances, $56,000 of the rent paid by M will be included by A as net rental income in determining its unrelated business taxable income, computed as follows:

M's taxable income (disregarding rent paid to A)	$500,000
Less taxable income from dormitory	150,000
Excess taxable income	$350,000
Ratio ($350,000/$500,000)	7/10
Total rent paid to A	$100,000
Total deductions ($4,000 + $16,000)	20,000
Rental income treated as gross income from an unrelated trade or business (7/10 of $100,000)	70,000
Less deductions directly connected with such income (7/10 of $20,000)	14,000
Net rental income included by A in computing its unrelated business taxable income	$56,000

Example (2). Assume the facts as stated in example (1), except that M's taxable income (disregarding rent paid to A) is $300,000, consisting of $350,000 from the operation of the factory and a $50,000 loss from the operation of the dormitory. Thus, M's "excess taxable income" is also $300,000, since none of M's taxable income would be excluded from the computation of A's unrelated business taxable income if received directly by A. The ratio of M's "excess taxable income" to its taxable income is therefore one ($300,000/$300,000). Thus, all the rent received by A from M ($100,000), and all the deductions directly connected therewith ($20,000), are included in the computation of A's unrelated business taxable income.

(4) Control—(i) In general. For purposes of this paragraph—

(a) Stock corporation. In the case of an organization which is a stock corporation, the term "control" means ownership by an exempt organization of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation.

(b) Nonstock organization. In the case of a nonstock organization, the term "control" means that at least 80 percent of the directors or trustees of such organization are either representatives of or directly or indirectly controlled by an exempt organization. A trustee or director is a representative of an exempt organization if he is a trustee, director, agent, or employee of such exempt organization. A trustee or director is controlled by an exempt organization if such organization has the power to remove such trustee or director and designate a new trustee or director.

(ii) Gain or loss of control. If control of an organization (as defined in subdivision (i) of this subparagraph) is acquired or relinquished during the taxable year, only the interest, annuities, royalties, and rents paid or accrued to the controlling organization in accordance with its method of accounting for that portion of the taxable year it has control shall be subject to the tax on unrelated business income.

(5) Amounts taxable under other provisions of the Code—(i) In general. Except as provided in subdivision (ii) of this subparagraph, section 512(b)(13) and this paragraph do not apply to amounts which are included in the computation of unrelated business taxable income by operation of any other provision of the Code. However, amounts which are not included in unrelated business taxable income by operation of section 512(a)(1), or which are excluded by operation of section 512(b)(1), (2), or (3), may be included in unrelated business taxable income by operation of section 512(b)(13) and this paragraph.

(ii) Debt-financed property. Rents deprived from the lease of debt-financed property by a controlling organization to a controlled organization are subject to the rules contained in section 512(b)(13) and this paragraph. Thus, if a controlling organization leases debt-financed property to a controlled organization, the amount of rents includible in the controlling organization's unrelated business taxable income shall first be determined under section 512(b)(13) and this paragraph, and only the portion of such rents not taken into account by operation of section 512(b)(13) are taken into account by operation of section 514. See example (3) of § 1.514(b)-1(b)(3).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6939, 32 FR 17661, Dec. 12, 1967; T.D. 7177, 37 FR 7089, April 8, 1972; T.D. 7183, 37 FR 7885, April 21, 1972; T.D. 7229, 37 FR 28142, Dec. 21, 1972; T.D. 7261, 38 FR 5466, March 1, 1973; 38 FR 6387, March 9, 1973; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.512(c)–1 Special rules applicable to partnerships; in general.

In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in § 1.512(b)–1. For example, if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business taxable income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.513–1 Definition of unrelated trade or business.

(a) In general. As used in section 512 the term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less the deductions and subject to the modifications provided in section 512. Section 513 specifies with certain exceptions that the phrase "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). (For certain exceptions from this definition, see paragraph (e) of this section. For a special definition of "unrelated trade or business" applicable to certain trusts, see section 513(b).) Therefore, unless one of the specific exceptions of section 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if: (1) It is income from trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

(b) Trade or business. The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business

merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

(c) **Regularly carried on—(1) General principles.** In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

(2) **Application of principles in certain cases—(i) Normal time span of activities.** Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business. For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

(ii) **Intermittent activities; in general.** In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or "primarily for the convenience" of such persons within the meaning of section 513(a)(2) (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

(iii) **Intermittent activities; special rule in certain cases of infrequent conduct.** Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

(d) Substantially related—(1) In general. Gross income derives from "unrelated trade or business," within the meaning of section 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.

(2) Type of relationship required. Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

(3) Size and extent of activities. In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.

(4) Application of principles—(i) Income from performance of exempt functions. Gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business. The following examples illustrate the application of this principle:

Example (1). M, an organization described in section 501(c)(3), operates a school for training children in the performing arts, such as acting, singing, and dancing. It presents performances by its students and derives gross income from admission charges for the performances. The students' participation in performances before audiences is an essential part of their training. Since the income realized from the performances derives from activities which contribute importantly to the accomplishment of M's exempt purposes, it does not constitute gross income from unrelated trade or business. (For specific exclusion applicable in certain cases of contributed services, see section 513(a)(1) and paragraph (e)(1) of this section.)

Example (2). N is a trade union qualified for exemption under section 501(c)(5). To improve the trade skills of its members, N conducts refresher training courses and supplies handbooks and technical manuals. N receives payments from its members for these services and materials. However, the development and improvement of the skills of its members is one of the purposes for which exemption is granted N; and the activities described contribute importantly to that purpose. Therefore, the income derived from these activities does not constitute gross income from unrelated trade or business.

Example (3). O is an industry trade association qualified for exemption under section 501(c)(6). It presents a trade show in which members of its industry join in an exhibition of industry products. O derives income from charges made to exhibitors for exhibit space and admission fees charged patrons or viewers of the show. The show is not a sales facility for individual exhibitors; its purpose is the promotion and stimulation of interest in, and demand for, the industry's products in general, and it is conducted in a manner reasonably calculated to achieve that purpose. The stimulation of demand for the industry's products in general is one of the purposes for which exemption is granted O. Consequently, the activities productive of O's gross income from the show—that is, the promotion, organization and conduct of the exhibition—contribute importantly to the achievement of an exempt purpose, and the income does not constitute gross income from unrelated trade or business. See also section 513(d) and regulations thereunder regarding sales activity.

(ii) Disposition of product of exempt functions. Ordinarily, gross income from the sale of products which result from the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business if the product is sold in substantially the same state it is in on completion of the exempt functions. Thus, in the case of an organization described in section 501(c)(3) and engaged in a program of rehabilita-

tion of handicapped persons, income from sale of articles made by such persons as a part of their rehabilitation training would not be gross income from conduct of unrelated trade or business. The income in such case would be from sale of products, the production of which contributed importantly to the accomplishment of purposes for which exemption is granted the organization—namely, rehabilitation of the handicapped. On the other hand, if a product resulting from an exempt function is utilized or exploited in further business endeavor beyond that reasonably appropriate or necessary for disposition in the state it is in upon completion of exempt functions, the gross income derived therefrom would be from conduct of unrelated trade or business. Thus, in the case of an experimental dairy herd maintained for scientific purposes by a research organization described in section 501(c)(3), income from sale of milk and cream produced in the ordinary course of operation of the project would not be gross income from conduct of unrelated trade or business. On the other hand, if the organization were to utilize the milk and cream in the further manufacture of food items such as ice cream, pastries, etc., the gross income from the sale of such products would be from the conduct of unrelated trade or business unless the manufacturing activities themselves contribute importantly to the accomplishment of an exempt purpose of the organization.

(iii) **Dual use of assets or facilities.** In certain cases, an asset or facility necessary to the conduct of exempt functions may also be employed in a commercial endeavor. In such cases, the mere fact of the use of the asset or facility in exempt functions does not, by itself, make the income from the commercial endeavor gross income from related trade or business. The test, instead, is whether the activities productive of the income in question contribute importantly to the accomplishment of exempt purposes. Assume, for example, that a museum exempt under section 501(c)(3) has a theater auditorium which is specially designed and equipped for showing of educational films in connection with its program of public education in the arts and sciences. The theater is a principal feature of the museum and is in continuous operation during the hours the museum is open to the public. If the organization were to operate the theater as an ordinary motion picture theater for public entertainment during the evening hours when the museum was closed, gross income from such operation would be gross income from conduct of unrelated trade or business.

(iv) **Exploitation of exempt functions.** In certain cases, activities carried on by an organization in the performance of exempt functions may generate good will or other intangibles which are capable of being exploited in commercial endeavors. Where an organization exploits such an intangible in commercial activities, the mere fact that the resultant income depends in part upon an exempt function of the organization does not make it gross income from related trade or business. In such cases, unless the commercial activities themselves contribute importantly to the accomplishment of an exempt purpose, the income which they produce is gross income from the conduct of unrelated trade or business. The application of this subdivision is illustrated in the following examples:

Example (1). U, an exempt scientific organization, enjoys an excellent reputation in the field of biological research. It exploits this reputation regularly by selling endorsements of various items of laboratory equipment to manufacturers. The endorsing of laboratory equipment does not contribute importantly to the accomplishment of any purpose for which exemption is granted U. Accordingly, the income derived from the sale of endorsements is gross income from unrelated trade or business.

Example (2). V, an exempt university, has a regular faculty and a regularly enrolled student body. During the school year, V sponsors the appearance of professional theater companies and symphony orchestras which present drama and musical performances for the students and faculty members. Members of the general public are also admitted. V advertises these performances and supervises advance ticket sales at various places, including such university facilities as the cafeteria and the university bookstore. V derives gross income from the conduct of the performances. However, while the presentation of the performances makes use of an intangible generated by V's exempt educational functions—the presence of the student body and faculty—the presentation of such drama and music events contributes importantly to the overall educational and cultural function of the university. Therefore, the income which V receives does not constitute gross income from the conduct of unrelated trade or business.

Example (3). W is an exempt business league with a large membership. Under an arrangement with an advertising agency, W regularly mails brochures, pamphlets and other commercial advertising materials to its members, for which service W charges the agency an agreed amount per enclosure. The distribution of the advertising materials does not contribute importantly to the accomplishment of any purpose for which W is granted exemption. Accordingly, the payments made to W by the advertising agency constitute gross income from unrelated trade or business.

Example (4). X, an exempt organization for the advancement of public interest in classical music, owns a radio station and operates it in a manner which contributes importantly to the accomplishment of the purposes for which the organization is granted exemption. However, in the course of the operation of the station the organization derives gross income from the regular sale of advertising time and services to commercial advertisers in the manner of an ordinary commercial station. Neither the sale of such time nor the performance of such services contributes importantly to the accomplishment of any purpose for which the organization is granted exemption. Notwithstanding the fact that the production of the advertising

income depends upon the existence of the listening audience resulting from performance of exempt functions, such income is gross income from unrelated trade or business.

Example (5). Y, an exempt university, provides facilities, instruction and faculty supervision for a campus newspaper operated by its students. In addition to news items and editorial commentary, the newspaper publishes paid advertising. The solicitation, sale, and publication of the advertising are conducted by students, under the supervision and instruction of the university. Although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. Hence, none of the income derived from publication of the newspaper constitutes gross income from unrelated trade or business. The same result would follow even though the newspaper is published by a separately incorporated section 501(c)(3) organization, qualified under the university rules for recognition of student activities, and even though such organization utilizes its own facilities and is independent of faculty supervision, but carries out its educational purposes by means of student instruction of other students in the editorial and advertising activities and student participation in those activities.

Example (6). Z is an association exempt under section 501(c)(6), formed to advance the interests of a particular profession and drawing its membership from the members of that profession. Z publishes a monthly journal containing articles and other editorial material which contribute importantly to the accomplishment of purposes for which exemption is granted the organization. Income from the sale of subscriptions to members and others in accordance with the organization's exempt purposes, therefore, does not constitute gross income from unrelated trade or business. In connection with the publication of the journal, Z also derives income from the regular sale of space and services for general consumer advertising, including advertising of such products as soft drinks, automobiles, articles of apparel, and home appliances. Neither the publication of such advertisements nor the performance of services for such commercial advertisers contributes importantly to the accomplishment of any purpose for which exemption is granted. Therefore, notwithstanding the fact that the production of income from advertising utilizes the circulation developed and maintained in performance of exempt functions, such income is gross income from unrelated trade or business.

Example (7). The facts are as described in the preceding example, except that the advertising in Z's journal promotes only products which are within the general area of professional interest of its members. Following a practice common among taxable magazines which publish advertising, Z requires its advertising to comply with certain general standards of taste, fairness, and accuracy; but within those limits the form, content, and manner of presentation of the advertising messages are governed by the basic objective of the advertisers to promote the sale of the advertised products. While the advertisements contain certain information, the informational function of the advertising is incidental to the controlling aim of stimulating demand for the advertised products and differs in no essential respect from the informational function of any commercial advertising. Like taxable publishers of advertising, Z accepts advertising only from those who are willing to pay its prescribed rates. Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and in its method. Accordingly, Z's publication of advertising does not contribute importantly to the accomplishment of its exempt purposes; and the income which it derives from advertising constitutes gross income from unrelated trade or business.

(e) **Exceptions.** Section 513(a) specifically states that the term "unrelated trade or business" does not include—

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees; or, any trade or business carried on by a local association of employees described in section 501(c)(4) organized before May 27, 1969, which consists of the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the first part of the second exception, relating to an organization described in section 501(c)(3) or a governmental college or university described in section 511(a)(2)(B), would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The latter part of the second exception, dealing with certain sales by local employee associations, will not apply to sales of these items at locations other than the usual place of employment of the employees; therefore sales at such other locations will continue to be treated as unrelated trade or business. The third exception applies to so-called "thrift shops" operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, et cetera, to be sold to the general public with the proceeds going to the exempt organization.

(f) Special rule respecting publishing businesses prior to 1970. For a special rule for taxable years beginning before January 1, 1970, with respect to publishing businesses carried on by an organization, see section 513(c) of the Code prior to its amendment by section 121(c) of the Tax Reform Act of 1969 (83 Stat. 542).

(g) Effective date. This section is applicable with respect to taxable years beginning after December 12, 1967. However, if a taxpayer wishes to rely on the rules stated in this section for taxable years beginning before December 13, 1967, it may do so.

[T.D. 6939, 32 FR 17657, Dec. 12, 1967; 32 FR 17890, Dec. 14, 1967; 32 FR 17938, Dec. 15, 1967; T.D. 7107, 36 FR 6421, April 3, 1971; T.D. 7392, 40 FR 58642, Dec. 18, 1975; T.D. 7896, 48 FR 23817, May 27, 1983]

§ 1.513–2 Definition of unrelated trade or business applicable to taxable years beginning before December 13, 1967.

(a) In general. (1) As used in section 512(a), the term "unrelated business taxable income" includes only income from an unrelated trade or business regularly carried on, and the term "trade or business" has the same meaning as it has in section 162.

(2) The income of an exempt organization is subject to the tax on unrelated business income only if two conditions are present with respect to such income. The first condition is that the income must be from a trade or business which is regularly carried on by the organization. The second condition is that the trade or business must not be substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501, or in the case of an organization described in section 511(a)(2)(B) (governmental colleges, etc.) to the exercise or performance of any purpose or function described in section 501(c)(3). Whether or not an organization is subject to the tax imposed by section 511 shall be determined by the application of these tests to the particular circumstances involved in each individual case. For certain exceptions from the term "unrelated trade or business," see paragraph (b) of this section.

(3) A trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. An activity may be regularly carried on even though its performance is infrequent or seasonal.

(4) Ordinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption. For example, the operation of a wheat farm is substantially related to the exempt activity of an agricultural college if the wheat farm is operated as a part of the educational program of the college, and is not operated on a scale disproportionately large when compared with the educational program of the college. Similarly, a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university, but is considered an unrelated trade or business if operated in substantially the same manner as a commercial radio station or publishing house. A trade or business not otherwise related does not become substantially related to an organization's exempt purpose merely because incidental use is made of the trade or business in order to further the exempt purpose. For example, the manufacture and sale of a product by an exempt college would not become substantially related merely because students as part of their educational program perform clerical or bookkeeping functions in the business. In some cases, the business may be substantially related because it is a necessary part of the exempt activity. For example, in the case of an organization described in section 501(c)(3) and engaged in the rehabilitation of handicapped persons, the business of selling articles made by such persons as a part of their rehabilitation training would not be considered an unrelated business since such business is a necessary part of the rehabilitation program.

(5) If an organization receives a payment pursuant to a contract or agreement under which such organization is to perform research which constitutes an unrelated trade or business, the entire amount of such payment is income from an unrelated trade or business. See, however, section 512(b), (7), (8), and (9), relating to the exclusion from unrelated business taxable income of income

derived from research for the United States, or any State, and of income derived from research performed for any person by a college, university, hospital, or organization operated primarily for the purpose of carrying on fundamental research the results of which are freely available to the general public.

(b) Exceptions. Section 513(a) specifically states that the term "unrelated trade or business" does not include—

(1) Any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) Any trade or business carried on by an organization described in section 501(c)(3) or by a governmental college or university described in section 511(a)(2)(B), primarily for the convenience of its members, students, patients, officers, or employees; or

(3) Any trade or business which consists of selling merchandise, substantially all of which has been received by the organization as gifts or contributions.

An example of the operation of the first of the exceptions mentioned above would be an exempt orphanage operating a retail store and selling to the general public, where substantially all the work in carrying on such business is performed for the organization by volunteers without compensation. An example of the second exception would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students. The third exception applies to so-called "thrift shops" operated by a tax-exempt organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization.

(c) Special rules respecting publishing businesses. For a special rule with respect to publishing businesses carried on by an organization, see section 513(c) of the Code prior to its amendment by section 121(c) of the Tax Reform Act of 1969 (83 Stat. 542).

(d) Effective date. Except as provided in paragraph (g) of § 1.513–1, this section is applicable with respect to taxable years beginning before December 13, 1967.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6525, 26 FR 190, Jan. 11, 1961; T.D. 6939, 32 FR 17657, Dec. 12, 1967; T.D. 7392, 40 FR 58643, Dec. 18, 1975; 40 FR 60053, Dec. 31, 1975]

§ 1.513–3 Qualified convention and trade show activity.

(a) Introduction—(1) In general. Section 513(d) and § 1.513–3(b) provide that convention and trade show activities carried on by a qualifying organization in connection with a qualified convention or trade show will not be treated as unrelated trade or business. Consequently, income from qualified convention and trade shown activities, derived by a qualifying organization that sponsors the qualified convention or trade show, will not be subject to the tax imposed by section 511. Section 1.513–3(c) defines qualifying organizations and qualified conventions or trade shows. Section 1.513–3(d) concerns the treatment of income derived from certain activities, including rental of exhibition space at a qualified convention or trade show where sales activity is permitted, and the treatment of supplier exhibits at qualified conventions and trade shows.

(2) Effective date. This section is effective for taxable years beginning after October 4, 1976.

(b) Qualified activities not unrelated. A convention or trade show activity, as defined in section 513(d)(3)(A) and § 1.513–3(c)(4), will not be considered unrelated trade or business if it is conducted by a qualifying organization described in section 513(d)(3)(C) and § 1.513–3(c)(1), in conjunction with a qualified convention or trade show, as defined in section 513(d)(3)(B) and § 1.513–3(c)(2), sponsored by the qualifying organization. Such an activity is a qualified convention or trade show activity. A convention or trade show activity which is conducted by an organization described in section 501(c)(5) or (6), but which otherwise is not so qualified under this section, will be considered unrelated trade or business.

(c) Definitions—(1) Qualifying organization. Under section 513(d)(3)(C), a qualifying organization is one which—

(i) Is described in either section 501(c)(5) or (6), and

(ii) Regularly conducts as one of its substantial exempt purposes a qualified convention or trade show.

(2) Qualified convention or trade show. For purposes of this section, the term "qualified convention or trade show" means a show that meets the following requirements:

(i) It is conducted by a qualifying organization described in section 513(d)(3)(C);

(ii) At least one purpose of the sponsoring organization in conducting the show is the education of its members, or the promotion and stimulation of interest in, and demand for, the products or services of the industry (or segment thereof) of the members of the qualifying organization; and

(iii) The show is designed to achieve that purpose through the character of a significant portion of the exhibits or the character of conferences and seminars held at a convention or meeting.

(3) **Show.** For purposes of this section, the term "show" includes an international, national, state, regional, or local convention, annual meeting or show.

(4) **Convention and trade show activity.** For purposes of this section, convention and trade show activity means any activity of a kind traditionally carried on at shows. It includes, but is not limited to—

(i) Activities designed to attract to the show members of the sponsoring organization, members of an industry in general, and members of the public, to view industry products or services and to stimulate interest in, and demand for such products or services;

(ii) Activities designed to educate persons in the industry about new products or services or about new rules and regulations affecting the industry; and

(iii) Incidental activities, such as furnishing refreshments, of a kind traditionally carried on at such shows.

(d) **Certain activities—(1) Rental of exhibition space.** The rental of display space to exhibitors (including exhibitors who are suppliers) at a qualified trade show or at a qualified convention and trade show will not be considered unrelated trade or business even though the exhibitors who rent the space are permitted to sell or solicit orders.

(2) **Suppliers defined.** For purposes of subparagraph (1), a supplier's exhibit is one in which the exhibitor displays goods or services that are supplied to, rather than by, the members of the qualifying organization in the conduct of such members' own trades or businesses.

(e) **Example.** The provisions of this section may be illustrated by the following examples:

Example 1. X, an organization described in section 501(c)(6), was formed to promote the construction industry. Its membership is made up of manufacturers of heavy construction machinery many of whom own, rent, or lease one or more digital computers produced by various computer manufacturers. X is a qualifying organization under section 513(d)(3)(C) that regularly holds an annual meeting. At this meeting a national industry sales campaign and methods of consumer financing for heavy construction machinery are discussed. In addition, new construction machinery developed for use in the industry is on display with representatives of the various manufacturers present to promote their machinery. Both members and nonmembers attend this portion of the conference. In addition, manufacturers of computers are present to educate X's members. While this aspect of the conference is a supplier exhibit (as defined in paragraph (d) of this section), income earned from such activity by X will not constitute unrelated business taxable income to X because the activity is conducted as part of a qualified trade show described in § 1.513-3(c).

Example 2. Assume the same facts as in Example 1, but the only goods or services displayed are those of suppliers, the computer manufacturers. Selling and order taking are permitted. No member exhibits are maintained. Standing alone, this supplier exhibit (as defined in paragraph (d)(2) of this section) would constitute a supplier show and not a qualified convention or trade show. In this situation, however, the rental of exhibition space to suppliers is not unrelated trade or business. It is conducted by a qualifying organization in conjunction with a qualified convention or trade show. The show (the annual meeting) is a qualified convention or trade show because one of its purposes is the promotion and stimulation of interest in, and demand for, the products or services of the industry through the character of the annual meeting.

Example 3. Y is an organization described in section 501(c)(6). The organization conducts an annual show at which its members exhibit their products and services in order to promote public interest in the line of business. Potential customers are invited to the show, and sales and order taking are permitted. The organization secures the exhibition facility, undertakes the planning and direction of the show, and maintains exhibits designed to promote the line of business in general. The show is a qualified convention or trade show described in paragraph (c)(2) of this section. The provision of exhibition space to individual members is a qualified trade show activity, and is not unrelated trade or business.

Example 4. Z is an organization described in section 501(c)(6) that sponsors an annual show. As the sole activity at the show, suppliers to the members of Z exhibit their products and services for the purpose of stimulating the sale of their products. Selling and order taking are permitted. The show is a supplier show and does not meet the definition of a qualified convention show as it does not satisfy any of the three alternative bases for qualification. First, the show does not stimulate interest in the members' products through the character of product exhibits as the only products exhibited are those of suppliers rather than members. Second, the show does not stimulate interest in members' products through conferences or seminars as no such conferences are held at the show. Third, the show does not meet the definition of a qualified show on the basis of educational activities as the exhibition of suppliers' products is designed primarily to stimulate interest in, and sale of, suppliers' products. Thus, the organization's provision of exhibition space is not a qualified convention or trade show activity. Income derived from rentals of exhibition space to suppliers will be unrelated business taxable income under section 512.

[T.D. 7896, 48 FR 23817, May 27, 1983]

§ 1.513–5 Certain bingo games not unrelated trade or business

(a) In general. Under section 513(f), and subject to the limitations in paragraph (C) of this section, in the case of an organization subject to the tax imposed by section 511, the term "unrelated trade or business" does not include any trade or business that consists of conducting bingo games (as defined in paragraph (d) of this section).

(b) Exception. The provisions of this section shall not apply with respect to any bingo game otherwise excluded from the term "unrelated trade or business" by reason of section 513(a)(1) and § 1.513–1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

(c) Limitations—(1) Bingo games must be legal. Paragraph (a) of this section shall not apply with respect to any bingo game conducted in violation of State or local law.

(2) No commercial competition. Paragraph (a) of this section shall not apply with respect to any bingo game conducted in a jurisdiction in which bingo games are ordinarily carried out on a commercial basis. Bingo games are "ordinarily carried out on a commercial basis" within a jurisdiction if they are regularly carried on (within the meaning of § 1.513–1(c)) by for-profit organizations in any part of that jurisdiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether bingo games may be conducted by for-profit organizations, or if State law limits or confines the conduct of bingo games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether bingo games are ordinarily carried out on a commercial basis.

(3) Examples. The application of this paragraph is illustrated by the examples that follow. In each example, it is assumed that the bingo games referred to are operated by individuals who are compensated for their services. Accordingly, none of the bingo games would be excluded from the term "unrelated trade or business" under section 513(a)(1).

Example (1). Church Z, a tax-exempt organization, conducts weekly bingo games in State O. State and local laws in State O expressly provide that bingo games may be conducted by tax-exempt organizations. Bingo games are not conducted in State O by any for-profit businesses. Since Z's bingo games are not conducted in violation of State or local law and are not the type of activity ordinarily carried out on a commercial basis in State O, Z's bingo games do not constitute unrelated trade or business.

Example (2). Rescue Squad X, a tax-exempt organization, conducts weekly bingo games in State M. State M has a statutory provision that prohibits all forms of gambling including bingo games. However, that law generally is not enforced by State officials against local charitable organizations such as X that conduct bingo games to raise funds. Since bingo games are illegal under State law, X's bingo games constitute unrelated trade or business regardless of the degree to which the State law is enforced.

Example (3). Veteran's organizations Y and X, both tax-exempt organizations, are organized under the laws of State N. State N has a statutory provision that permits bingo games to be conducted by tax-exempt organizations. In addition, State N permits bingo games to be conducted by for-profit organizations in city S, a resort community located in county R. Several for-profit organizations conduct nightly bingo games in city S. Y conducts weekly bingo games in city S. X conducts weekly bingo games in county R. Since State law confines the conduct of bingo games by for-profit organizations to city S, and since bingo games are regularly carried on there by those organizations, Y's bingo games conducted in city S constitute unrelated trade or business. However, X's bingo games conducted in county R outside of city S do not constitute unrelated trade or business.

(d) Bingo game defined. A bingo game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in this section, the term "bingo game" means any game of bingo of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. The term "bingo game" does not refer to any game of chance (including, but not limited to, keno games, dice games, card games, and lotteries) other than the type of game described in this paragraph.

(e) Effective date. Section 513(f) and this section apply to taxable years beginning after December 31, 1969.

[T.D. 7699, 45 FR 33970, May 21, 1980]

§ 1.513-6 Certain hospital services not unrelated trade or business.

(a) In general. Under section 513(e), the furnishing of a service listed in section 501(e)(1)(A) by a hospital to one or more other hospitals will not constitute unrelated trade or business if—

(1) The service is provided solely to hospitals that have facilities to serve not more than 100 inpatients,

(2) The service would, if performed by the recipient hospital, constitute an activity consistent with that hospital's exempt purposes, and

(3) The service is provided at a fee not in excess of actual cost, including straight line depreciation and a reasonable rate of return on the capital goods used to provide the service. For purposes of this section, a rate of return on capital goods will be considered "reasonable" provided that it does not exceed, on an annual basis, the percentage described below which is based on the average of the rates of interest on special issues of public debt obligations issued to the Federal Hospital Insurance Trust Fund for each of the months included in the taxable year of the hospital during which the capital goods are used in providing the service. Determinations as to the cost of services and the applicable rate of return should be made as prescribed by 42 U.S.C. 1395x(v)(1) (A) and (B) and the regulations thereunder (permitting a health care facility to be reimbursed under the Medicare program for the "reasonable cost of (its) services," including, in the case of certain proprietary facilities, a "reasonable return on equity capital"). For taxable years beginning on or before May 14, 1986, the rate of return shall be one and one-half times the average of the rates of interest on public debt obligations described above which were in effect on or before April 20, 1983.

(b) Hospital defined. As used in this section the word "hospital" means a hospital described in section 170(b)(1)(A)(iii).

(c) Example. The provisions of this section are illustrated by the following example:

Example. A large metropolitan hospital provides various services to other hospitals. The hospital furnishes a purchasing service to hospitals N and O, a data processing service to hospitals R and S, and a food service to hospitals X and Y. All the hospitals are described in section 170(b)(1)(A)(iii). All the hospitals have facilities to serve not more than 100 inpatients except hospital N. The services are furnished at cost to all hospitals except that hospital R is charged a fee in excess of cost for its use of the data processing service. The purchasing service constitutes unrelated trade or business because it is not provided solely to hospitals having facilities to serve not more than 100 inpatients.

The data processing service constitutes unrelated trade or business because it is provided at a fee in excess of cost. The food service satisfies all three requirements of paragraph (a) of this section and does not constitute unrelated trade or business.

(d Effective date. Section 513(e) and this section apply to taxable years beginning after December 31, 1953.

[T.D. 8075, 51 FR 5322, Feb. 13, 1986; 51 FR 8490, March 12, 1986]

§ 1.514(a)–1 Unrelated debt-financed income and deductions.

(a) Income includible in gross income:

(1) Percentage of income taken into account— (i) In general. For taxable years beginning after December 31, 1969, there shall be included with respect to each debt-financed property (as defined in section 514 and § 1.514(b)–1) as an item of gross income derived from an unrelated trade or business the amount of unrelated debt-financed income (as defined in subdivision (ii) of this subparagraph). See paragraph (a)(5) of § 1.514(c)–1 for special rules regarding indebtedness incurred before June 28, 1966, applicable for taxable years beginning before January 1, 1972, and for special rules applicable to churches or conventions or associations of churches.

(ii) Unrelated debt-financed income. The "unrelated debt-financed income" with respect to each debt-financed property is an amount which is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of such property as—

(a) The average acquisition indebtedness (as defined in subparagraph (3) of this paragraph) with respect to the property is of

(b) The average adjusted basis of such property (as defined in subparagraph (2) of this paragraph).

(iii) Debt/basis percentage. The percentage determined under subdivision (ii) of this subparagraph is hereinafter referred to as the "debt/basis percentage".

(iv) Example. Subdivisions (i), (ii), and (iii) of this subparagraph are illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt trade association, owns an office building which in 1971 produces $10,000 of gross rental income. The average adjusted basis of the building for 1971 is $100,000, and the average acquisition indebtedness with respect to the building for 1971 is $50,000. Accordingly, the debt/basis percentage for 1971 is 50 percent (the ratio of $50,000 to $100,000). Therefore, the unrelated debt-financed income with respect to the building for 1971 is $5,000 (50 percent of $10,000).

(v) Gain from sale or other disposition. If debt-financed property is sold or otherwise dis-

posed of, there shall be included in computing unrelated business taxable income an amount with respect to such gain (or loss) which is the same percentage (but not in excess of 100 percent) of the total gain (or loss) derived from such sale or other disposition as—

(a) The highest acquisition indebtedness with respect to such property during the 12-month period, preceding the date of disposition, is of

(b) The average adjusted basis of such property.

The tax on the amount of gain (or loss) included in unrelated business taxable income pursuant to the preceding sentence shall be determined in accordance with the rules set forth in Subchapter P, Chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

(2) Average adjusted basis—(i) In general. The "average adjusted basis" of debt-financed property is the average amount of the adjusted basis of such property during that portion of the taxable year it is held by the organization. This amount is the average of:

(a) The adjusted basis of such property as of the first day during the taxable year that the organization holds the property, and

(b) The adjusted basis of such property as of the last day during the taxable year that the organization holds the property.

See section 1011 and the regulations thereunder for determination of the adjusted basis of property.

(ii) Adjustments for prior taxable years. For purposes of subdivision (i) of this subparagraph, the determination of the average adjusted basis of debt-financed property is not affected by the fact that the organization was exempt from taxation for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. For example, adjustment must be made for depreciation for all prior taxable years whether or not the organization was exempt from taxation for any such years. Similarly, the fact that only a portion of the depreciation allowance may be taken into account in computing the percentage of deductions allowable under section 514(a)(2) does not affect the amount of the adjustment for depreciation which is used in determining average adjusted basis.

(iii) Cross reference. For the determination of the basis of debt-financed property acquired in a complete or partial liquidation of a corporation in exchange for its stock, see § 1.514(d)–1.

(iv) Example. This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. On July 10, 1970, X, an exempt educational organization, purchased an office building for $510,000, using $300,000 of borrowed funds. During 1970 the only adjustment to basis is $20,000 for depreciation. As of December 31, 1970, the adjusted basis of the building is $490,000 and the indebtedness is still $300,000. X files its return on a calendar year basis. Under these circumstances, the debt/basis percentage for 1970 is 60 percent, calculated in the following manner:

	Basis
As of July 10, 1970 (acquisition date)........	$510,000
As of December 31, 1970..................	490,000
Total	1,000,000

Average Adjusted basis:

$1,000,000÷2=$500,000

Debt/basis percentage:

Average acquisition indebtedness ($300,000)/Average adjusted basis ($500,000)=60 percent

For an illustration of the determination of the debt/basis percentage as changes in the acquisition indebtedness occur, see example (1) of subparagraph (3)(iii) of this paragraph.

(3) Average acquisition indebtedness—(i) In general. The "average acquisition indebtedness" with respect to debt-financed property is the average amount of the outstanding principal indebtedness during that portion of the taxable year the property is held by the organization.

(ii) Computation. The average acquisition indebtedness is computed by determining the amount of the outstanding principal indebtedness on the first day in each calendar month during the taxable year that the organization holds the property, adding these amounts together, and then dividing this sum by the total number of months during the taxable year that the organization held such property. A fractional part of a month shall be treated as a full month in computing average acquisition indebtedness.

(iii) Examples. The application of this subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property is debt-financed property.

Example (1). Assume the facts as stated in the example in subparagraph (2)(iv) of this paragraph, except that beginning July 20, 1970, the organization makes payments of $21,000 a month ($20,000 of which is attributable to principal and $1,000 to interest). In this situation, the average acquisition indebtedness for 1970 is $250,000. Thus, the debt/basis percentage for 1970 is 50 percent, calculated in the following manner:

Month:	*Indebtedness on the first day in each calendar month that the property is held*
July	$300,000
August	280,000
September	260,000
October	240,000
November	220,000
December	200,000
Total	1,500,000

Average acquisition indebtedness:

$1,500,000÷6 months=$250,000

Debt/basis percentage:

Average acquisition indebtedness ($250,000)/Average adjusted basis ($500,000)=50 percent

Example (2). Y, an exempt organization, owns stock in a corporation which it does not control. At the beginning of the year, Y has an outstanding principal indebtedness with respect to such stock of $12,000. Such indebtedness is paid off at the rate of $2,000 per month beginning January 30, so that it is retired at the end of 6 months. The average acquisition indebtedness for the taxable year is $3,500, calculated in the following manner:

Month:	*Indebtedness on the first day in each calendar month that the property is held*
January	$12,000
February	10,000
March	8,000
April	6,000
May	4,000
June	2,000
July thru December	0
Total	42,000

Average acquisition indebtedness:

$42,000÷6 months=$3,500

(4) Indeterminate price—(i) In general. If an exempt organization acquires (or improves) property for an indeterminate price, the initial acquisition indebtedness and the unadjusted basis shall be determined in accordance with subdivisions (ii) and (iii) of this paragraph, unless the organization has obtained the consent of the Commissioner to use another method to compute such amounts.

(ii) Unadjusted basis. For purposes of this subparagraph, the unadjusted basis of property (or of an improvement) is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement). The average adjusted basis of such property shall be determined in accordance with paragraph (a)(2) of this section.

(iii) Initial acquisition indebtedness. For purposes of this subparagraph, the initial acquisition indebtedness is the fair market value of the property (or improvement) on the date of acquisition (or the date of completion of the improvement) less any down payment or other initial payment applied to the principal indebtedness. The average acquisition indebtedness with respect to such property shall be computed in accordance with paragraph (a)(3) of this section.

(iv) Example. The application of this subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. On January 1, 1971, X, an exempt trade association, acquires an office building for a down payment of $310,000 and an agreement to pay 10 percent of the income generated by the building for 10 years. Neither the sales price nor the amount which X is obligated to pay in the future is certain. The fair market value of the building on the date of acquisition is $600,000. The depreciation allowance for 1971 is $40,000. Unless X obtains the consent of the Commissioner to use another method, the unadjusted basis of the property is $600,000 (the fair market value of the property on the date of acquisition), and the initial acquisition indebtedness is $290,000 (fair market value of $600,000 less initial payment of $310,000). Under these circumstances, the average adjusted basis of the property for 1971 is $580,000, calculated as follows:

[Initial fair market value+(initial fair market value less depreciation)]÷2=[$600,000+($600,000–$40,000)]÷2=$580,000.

If no payment other than the initial payment is made in 1971, the average acquisition indebtedness for 1971 is $290,000. Thus, the debt/basis percentage for 1971 is 50 percent, calculated as follows:

Average acquisition indebtedness÷average adjusted basis=$290,000÷$580,000=50 percent

(b) Deductions—(1) Percentage of deductions taken into account. Except as provided in subparagraphs (4) and (5) of this paragraph, there shall be allowed as a deduction with respect to each debt-financed property an amount determined by applying the debt/basis percentage to the sum of the deductions allowable under subparagraph (2) of this paragraph.

(2) Deductions allowable. The deductions allowable are those items allowed as deductions by chapter 1 of the Code which are directly connected with the debt-financed property or the income therefrom (including the dividends received deductions allowed by sections 243, 244, and 245), except that—

(i) The allowable deductions are subject to the modifications provided by section 512(b) on com-

putation of the unrelated business taxable income, and

(ii) If the debt-financed property is of a character which is subject to the allowance for depreciation provided in section 167, such allowance shall be computed only by use of the straight-line method of depreciation.

(3) Directly connected with. To be "directly connected with" debt-financed property or the income therefrom, an item of deduction must have proximate and primary relationship to such property or the income therefrom. Expenses, depreciation, and similar items attributable solely to such property are proximately and primarily related to such property or the income therefrom, and therefore qualify for deduction, to the extent they meet the requirements of subparagraph (2) of this paragraph. Thus, for example, if the straight-line depreciation allowance for an office building is $10,000 a year, an organization would be allowed a deduction for depreciation of $10,000 if the entire building were debt-financed property. However, if only one-half of the building were treated as debt-financed property, then the depreciation allowed as a deduction would be $5,000. (See example (2) of § 1.514(b)–1(b)(1)(iii).)

(4) Capital losses—(i) In general. If the sale or exchange of debt-financed property results in a capital loss, the amount of such loss taken into account in the taxable year in which the loss arises shall be computed in accordance with paragraph (a)(1)(v) of this section. If, however, any portion of such capital loss not taken into account in such year may be carried back or carried over to another taxable year, the debt/basis percentage is not applied to determine what portion of such capital loss may be taken as a deduction in the year to which such capital loss is carried.

(ii) Example. This subparagraph is illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. X, an exempt educational organization, owns securities which are capital assets and which it has held for more than 6 months. In 1972 X sells the securities at a loss of $20,000. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the securities is 40 percent. Thus, X has sustained a capital loss of $8,000 (40 percent of $20,000) with respect to the sale of the securities. For 1972 and the preceding three taxable years X has no other capital transactions. Under these circumstances, the $8,000 of capital loss may be carried over to the succeeding 5 taxable years without further application of the debt/basis percentage.

(5) Net operating loss—(i) In general. If, after applying the debt/basis percentage to the income derived from debt-financed property and the deductions directly connected with such income, such deductions exceed such income, the organization has sustained a net operating loss for the taxable year. This amount may be carried back or carried over to other taxable years in accordance with section 512(b)(6). However, the debt/basis percentage shall not be applied in such other years to determine the amounts that may be taken as a deduction in those years.

(ii) Example. This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that the property is debt-financed property.

Example. During 1974, Y, an exempt organization, receives $20,000 of rent from a building which it owns. Y has no other unrelated business taxable income for 1974. For 1974 the deductions directly connected with this building are property taxes of $5,000, interest of $5,000 on the acquisition indebtedness, and salary of $15,000 to the manager of the building. The debt/basis percentage for 1974 with respect to the building is 50 percent. Under these circumstances, Y shall take into account in computing its unrelated business taxable income for 1974, $10,000 of income (50 percent of $20,000) and $12,500 (50 percent of $25,000) of the deductions directly connected with such income. Thus, for 1974 Y has sustained a net operating loss of $2,500 ($10,000 of income less $12,500 of deductions) which may be carried back or carried over to other taxable years without further application of the debt/basis percentage.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7229, 37 FR 28143, Dec. 21, 1972]

§ 1.514(a)–2 Business lease rents and deductions for taxable years beginning before January 1, 1970.

(a) Effective date. This section applies to taxable years beginning before January 1, 1970.

(b) In general—(1) Rents includible in gross income. There shall be included with respect to each business lease, as an item of gross income derived from an unrelated trade or business, an amount which is the same percentage (but not in excess of 100 percent) of the total rents derived during the taxable year under such lease as—

(i) The amount of the business lease indebtedness at the close of the taxable year of the lessor tax-exempt organization, with respect to the premises covered by such lease, is of

(ii) The adjusted basis of such premises at the close of such taxable year.

For definition of business lease as a lease for a term of more than 5 years, and for rules for determining the computation of such 5-year term in certain specific situations, see § 1.514(f)–1. For definition of business lease indebtedness and

allocation of business lease indebtedness where only a portion of the property is subject to a business lease, see § 1.514(g)–1.

(2) **Determination of basis.** For purposes of the unrelated business income tax the basis (unadjusted) of property is determined under section 1012, and the adjusted basis of property is determined under section 1011. The determination of the adjusted basis of property is not affected by the fact that the organization was exempt from tax for prior taxable years. Proper adjustment must be made under section 1011 for the entire period since the acquisition of the property. Thus adjustment must be made for depreciation for all taxable years whether or not the organization was exempt from tax for any of such years. Similarly, for taxable years during which the organization is subject to the tax on unrelated business taxable income the fact that only a portion of the deduction for depreciation is taken into account under paragraph (c)(1) of this section does not affect the amount of the adjustment for depreciation.

(3) **Examples.** The application of this paragraph may be illustrated by the following examples, in each of which it is assumed that the taxpayer makes its returns under section 511 on the basis of the calendar year, and that the lease is not substantially related to the purpose for which the organization is granted exemption from tax.

Example (1). Assume that a tax-exempt educational organization purchased property in 1952 for $600,000, using borrowed funds, and leased the building for a period of 20 years. Assume further that the adjusted basis of such building at the close of 1954 is $500,000 and that, at the close of 1954, $200,000 of the indebtedness incurred to acquire the property remains outstanding. Since the amount of the outstanding indebtedness is two-fifths of the adjusted basis of the building at the close of 1954, two-fifths of the gross rental received from the building during 1954 shall be included as an item of gross income in computing unrelated business taxable income. If, at the close of a subsequent taxable year, the outstanding indebtedness is $100,000 and the adjusted basis of the building is $400,000, one-fourth of the gross rental for such taxable year shall be included as an item of gross income in computing unrelated business taxable income for such taxable year.

Example (2). Assume that a tax-exempt organization owns a four-story building, that in 1954 it borrows $100,000 which it uses to improve the whole building, and that it thereafter in 1954 rents the first and second floors of the building under six-year leases at rentals of $4,000 a year. The third and fourth floors of the building are leased on a yearly basis during 1954. Assume, also, that the adjusted basis of the real property at the end of 1954 (after reflecting the expenditures for improving the building) is $200,000, allocable equally to each of the four stories. Under these facts, only one-half of the real property is subject to a business lease since only one-half is rented under a lease for more than 5 years. See § 1.514(f)–1. The percentage of the rent under such lease which is taken into account is determined by the ratio which the allocable part of the business lease indebtedness bears to the allocable part of the adjusted basis of the real property, that is, the ratio which one-half of the $100,000 of business lease indebtedness outstanding at the close of 1954, or $50,000, bears to one-half of the adjusted basis of the business lease premises at the close of 1954, or $100,000. The percentage of rent which is business lease income for 1954 is, therefore, one-half (the ratio of $50,000 to $100,000) of $8,000, or $4,000, and this amount of $4,000 is considered an item of gross income derived from an unrelated trade or business.

(c) **Deductions—(1) Deductions allowable against gross income.** The same percentage is used in determining both the portion of the rent and the portion of the deductions taken into account with respect to the business lease in computing unrelated business taxable income. Such percentage is applicable only to the sum of the following deductions allowable under section 161:

(i) Taxes and other expenses paid or accrued during the taxable year upon or with respect to the real property subject to the business lease;

(ii) Interest paid or accrued during the taxable year on the business lease indebtedness;

(iii) A reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of the real property subject to such lease.

Where only a portion of the real property is subject to the business lease, there shall be taken into account only those amounts of the above-listed deductions which are properly allocable to the premises covered by such lease.

(2) **Excess deductions.** The deductions allowable under subparagraph (1) of this paragraph with respect to a business lease are not limited by the amount included in gross income with respect to the rent from such lease. Any excess of such deductions over such gross income shall be applied against other items of gross income in computing unrelated business taxable income taxable under section 511(a).

(3) **Example.** The application of this paragraph may be illustrated by the following example:

Example. Assume the same facts as those in example (1) in paragraph (b)(3) of this section. Assume, also that for 1954 the organization pays taxes of $4,000 on the property, interest of $6,000 on its business lease indebtedness, and that the depreciation allowable for 1954 under section 167 is $10,000. Under the facts set forth in such example (1) and in this example, the deductions to be taken into account for 1954 in computing unrelated business taxable income would be two-fifths of the total of the deductions of $20,000, that is $8,000.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7229, 37 FR 28145, Dec. 21, 1972]

§ 1.514(b)-1 Definition of debt-financed property.

(a) In general. For purposes of section 514 and the regulations thereunder, the term "debt-financed property" means any property which is held to produce income (*e.g.*, rental real estate, tangible personal property, and corporate stock), and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property) at any time during the taxable year. The term "income" is not limited to recurring income but applies as well to gains from the disposition of property. Consequently, when any property held to produce income by an organization which is not used in a manner described in section 514(b)(1)(A), (B), (C), or (D) is disposed of at a gain during the taxable year, and there was an acquisition indebtedness outstanding with respect to such property at any time during the 12-month period preceding the date of disposition (even though such period covers more than 1 taxable year), such property is "debt-financed property". For example, assume that on June 1, 1972, an organization is given mortgaged, unimproved property which it does not use in a manner described in section 514(b)(1)(A), (B), (C), or (D) and that the organization assumes payment of the mortgage on such property. On July 15, 1972, the organization sells such property for a gain. Such property is "debt-financed property" and such gain is taxable as unrelated debt-financed income. See section 514(c) and § 1.514(c)-1 for rules relating to when there is acquisition indebtedness with respect to property. See paragraph (a) of § 1.514(a)-1 for rules determining the amount of income or gain from debt-financed property which is treated as unrelated debt-financed income.

(b) Exceptions—(1) Property related to certain exempt purposes. (i) To the extent that the use of any property is substantially related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting its basis for exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function designated in section 501(c)(3)) such property shall not be treated as "debt-financed property". See § 1.513-1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

(ii) If substantially all of any property is used in a manner described in subdivision (i) of this subparagraph, such property shall not be treated as "debt-financed property". In general the preceding sentence shall apply if 85 percent or more of the use of such property is devoted to the organization's exempt purpose. The extent to which property is used for a particular purpose shall be determined on the basis of all the facts and circumstances. These may include (where appropriate)—

(a) A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,

(b) A comparison of the portion of such property that is used for exempt purposes with the portion of such property that is used for all purposes, or

(c) Both the comparisons described in (a) and (b) of this subdivision.

(iii) This subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example (1). W, an exempt organization, owns a computer with respect to which there is an outstanding principal indebtedness and which is used by W in the performance of its exempt purpose. W sells time for the use of the computer to M corporation on occasions when the computer is not in full-time use by W. W uses the computer in furtherance of its exempt purpose more than 85 percent of the time it is in use and M uses the computer less than 15 percent of the total operating time the computer is in use. In this situation, substantially all the use of the computer is related to the performance of W's exempt purpose. Therefore, no portion of the computer is treated as debt-financed property.

Example (2). X, an exempt college, owns a four story office building which has been purchased with borrowed funds. In 1971, the lower two stories of the building are used to house computers which are used by X for administrative purposes. The top two stories are rented to the public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). The gross income derived by X from the building is $6,000, all of which is attributable to the rents paid by tenants. There are $2,000 of expenses, allocable equally to each use of the building. The average adjusted basis of the building for 1971 is $100,000, and the outstanding principal indebtedness throughout 1971 is $60,000. Thus, the average acquisition indebtedness for 1971 is $60,000. In accordance with subdivision (i) of this subparagraph, only the upper half of the building is debt-financed property. Consequently, only the rental income and the deductions directly connected with such income are to be taken into account in computing unrelated business taxable income. The portion of such amounts to be taken into account is determined by multiplying the $6,000 of rental income and $1,000 of deductions directly connected with such rental income by the debt/basis percentage. The debt/basis percentage is the ratio which the allocable part of the average acquisition indebtedness is of the allocable part of the average adjusted basis of the property, that is, the ratio which $30,000 (one-half

of $60,000) bears to $50,000 (one-half of $100,000). Thus, the debt/basis percentage for 1971 is 60 percent (the ratio of $30,000 to $50,000). Under these circumstances, X shall include net rental income of $3,000 in its unrelated business taxable income for 1971, computed as follows:

Total rental income	$6,000
Deductions directly connected with rental income	$1,000
Debt/basis percentage ($30,000/$50,000)	60%
Rental income treated as gross income from an unrelated trade or business (60 percent of $6,000)	$3,600
Less the allowable portion of deductions directly connected with such income (60 percent of $1,000)	$600
Net rental income included by X in computing its unrelated business taxable income pursuant to section 514	$3,000

Example (3). Assume the facts as stated in example (2) except that on December 31, 1971, X sells the building and realizes a long-term capital gain of $10,000. This is X's only capital transaction for 1971. An allocable portion of this gain is subject to tax. This amount is determined by multiplying the gain related to the nonexempt use, $5,000 (one-half of $10,000), by the ratio which the indebtedness for the 12-month period preceding the date of sale, $30,000 (one-half of $60,000), is of the allocable part of the average adjusted basis, $50,000 (one-half of $100,000). Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 60 percent (the ratio of $30,000 to $50,000). Consequently, $3,000 (60 percent of $5,000) is a net section 1201 gain (capital gain net income for taxable years beginning after December 31, 1976). The portion of such gain which is taxable shall be determined in accordance with rules contained in subchapter P, chapter 1 of the Code (relating to capital gains and losses). See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

(2) Property used in an unrelated trade or business—(i) In general. To the extent that the gross income from any property is treated as income from the conduct of an unrelated trade or business, such property shall not be treated as "debt-financed property". However, any gain on the disposition of such property which is not included in the income of an unrelated trade or business by reason of section 512(b)(5) is includible as gross income derived "from or on account of debt-financed property" under paragraph (a)(1) of § 1.514(a)–1.

(ii) Amounts specifically taxable under other provisions of the Code. Section 514 does not apply to amounts which are otherwise included in the computation of unrelated business taxable income, such as rents from personal property includible pursuant to section 512(b)(13) or rents and interest from controlled organizations includible pursuant to section 512(b)(3). See paragraph (l)(5) of § 1.512(b)–1 for the rules determining the manner in which amounts are taken into account where such amounts may be included in the computation of unrelated business taxable income by operation of more than one provision of the Code.

(3) Examples. Subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example (1). X, an exempt scientific organization, owns a 10-story office building. During 1972, four stories are occupied by X's administrative offices, and the remaining six stories are rented to the public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). On December 31, 1972, the building is sold and X realizes a long-term capital gain of $100,000. This is X's only capital transaction for 1972. The debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 30 percent. Since 40 percent of the building was used for X's exempt purpose, only 60 percent of the building is debt-financed property. Thus, only $60,000 of the gain (60 percent of $100,000) is subject to this section. Consequently, the amount of gain treated as unrelated debt-financed income is $18,000 ($60,000 multiplied by the debt/basis percentage of 30 percent). The portion of such $18,000 which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder (relating to the minimum tax for tax preferences).

Example (2). Y, an exempt organization, owns two properties, a restaurant and an office building. In 1972, all the space in the office building, except for the portion utilized by Y to house the administrative offices of the restaurant, is rented to the public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). The average adjusted basis of the office building for 1972 is $2 million. The outstanding principal indebtedness throughout 1972 is $1 million. Thus, the highest acquisition indebtedness in the calendar year of 1972 is $1 million. It is determined that 30 percent of the space in the office building is used for the administrative functions engaged in by the employees of the organization with respect to the restaurant. Since the income attributable to the restaurant is attributable to the conduct of an unrelated trade or business, only 70 percent of the building is treated as debt-financed property for purposes of determining the portion of the rental income which is unrelated debt-financed income. On December 31, 1972, the office building is sold and Y realizes a long-term capital gain of $250,000. This is Y's only capital transaction for 1972. In accordance with subparagraph (2)(i) of this paragraph, all the gain derived from this sale is taken into account in computing the amount of such gain subject to tax. The portion of such gain which is taxable is determined by multiplying the $250,000 gain by the debt/basis percentage. The debt/basis percentage is the ratio which the highest acquisition indebtedness for the 12-month period preceding the date of sale, $1 million, is of the average adjusted basis, $2 million. Thus, the debt/basis percentage with respect to computing the gain (or loss) derived from the sale of the building is 50 percent (the ratio of $1 million to $2 million). Consequently, $125,000 (50 percent of $250,000) is a net section 1201 gain (net capital gain for taxable years beginning after December 31, 1976). The amount of such gain which is taxable shall be determined in accordance with the rules contained in subchapter P, chapter 1 of the Code. See also section 511(d) and the regulations thereunder.

Example (3). (a) Z, an exempt university, owns all the stock of M, a nonexempt corporation. During 1971 M leases from Z University a factory unrelated to Z's exempt purpose and a

dormitory for the students of Z, for a total annual rent of $100,000: $80,000 for the factory and $20,000 for the dormitory. During 1971, M has $500,000 of taxable income, disregarding the rent paid to Z: $150,000 from the dormitory and $350,000 from the factory. The factory is subject to a mortgage of $150,000. Its average adjusted basis for 1971 is determined to be $300,000. Z's deductions for 1971 with respect to the leased property are $4,000 for the dormitory and $16,000 for the factory. In accordance with subdivision (ii) of this subparagraph, section 514 applies only to that portion of the rent which is excluded from the computation of unrelated business taxable income by operation of section 512(b)(3) and not included in such computation pursuant to section 512(b)(13). Since all the rent received by Z is derived from real property, section 512(b)(3) would exclude all such rent from computation of Z's unrelated business taxable income. However, 70 percent of the rent paid to Z with respect to the factory and 70 percent of the deductions directly connected with such rent shall be taken into account by Z in determining its unrelated business taxable income pursuant to section 512(b)(15), computed as follows:

M's taxable income (disregarding rent paid to Z)	$500,000
Less taxable income from dormitory	$150,000
Excess taxable income	$350,000
Ratio ($350,000/$500,000)	7/10
Total rent paid to Z	$100,000
Total deductions ($4,000 + $16,000)	$20,000
Rental income treated under section 512(b)(15) as gross income from an unrelated trade or business (7/10 of $100,000)	$70,000
Less deductions directly connected with such income (7/10 of $20,000)	$14,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 512(b)(15)	$56,000

(b) Since only that portion of the rent derived from the factory and the deductions directly connected with such rent not taken into account pursuant to section 512(b)(15) may be included in computing unrelated business taxable income by operation of section 514, only $10,000 ($80,000 minus $70,000) of rent and $2,000 ($16,000 minus $14,000) of deductions are so taken into account. The portion of such amounts to be taken into account is determined by multiplying the $10,000 of income and $2,000 of deductions by the debt/basis percentage. The debt/basis percentage is the ratio which the average acquisition indebtedness ($150,000) is of the average adjusted basis of the property ($300,000). Thus, the debt/basis percentage for 1971 is 50 percent (the ratio of $150,000 to $300,000). Under these circumstances, Z shall include net rental income of $4,000 in its unrelated business taxable income for 1971, computed as follows:

Total rents	$10,000
Deductions directly connected with such rents	$2,000
Debt/basis percentage ($150,000/$300,000)	50%
Rental income treated as gross income from an unrelated trade or business (50 percent of $10,000)	$5,000
Less the allowable portion of deductions directly connected with such income (50 percent of $2,000)	$1,000
Net rental income included by Z in computing its unrelated business taxable income pursuant to section 514	$4,000

(4) Property related to research activities. To the extent that the gross income from any property is derived from research activities excluded from the tax on unrelated business income by paragraph (7), (8), or (9) of section 512(b), such property shall not be treated as "debt-financed property".

(5) Property used in "thrift shops", etc. To the extent that property is used in any trade or business which is excepted from the definition of "unrelated trade or business" by paragraph (1), (2), or (3) of section 513(a), such property shall not be treated as "debt-financed property".

(6) Use by a related organization. For purposes of subparagraph (1), (4), or (5) of this paragraph, use of property by a related exempt organization (as defined in paragraph (c)(2)(ii) of this section) for a purpose described in such subparagraphs shall be taken into account in order to determine the extent to which such property is used for a purpose described in such subparagraphs.

(c) Special rules—(1) Medical clinic. Property is not debt-financed property if it is real property subject to a lease to a medical clinic, and the lease is entered into primarily for purposes which are substantially related (aside from the need of such organization for income or funds or the use it makes of the rents derived) to the exercise or performance by the lessor of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. For example, assume that an exempt hospital leases all of its clinic space to an unincorporated association of physicians and surgeons who, by the provisions of the lease, agree to provide all of the hospital's out-patient medical and surgical services and to train all of the hospital's residents and interns. In this situation, the rents received by the hospital from this clinic are not to be treated as unrelated debt-financed income.

(2) Related exempt uses—(i) In general. Property owned by an exempt organization and used by a related exempt organization or by an exempt organization related to such related exempt organization shall not be treated as "debt-financed property" to the extent such property is used by either organization in furtherance of the purpose constituting the basis for its exemption under section 501. Furthermore, property shall not be treated as "debt-financed property" to the extent such property is used by a related exempt organization for a purpose described in paragraph (b)(4) or (5) of this section.

(ii) Related organizations. For purposes of subdivision (i) of this subparagraph, an exempt

organization is related to another exempt organization only if—

(a) One organization is an exempt holding company described in section 501(c)(2) and the other organization receives the profits derived by such exempt holding company,

(b) One organization has control of the other organization within the meaning of paragraph (l)(4) of § 1.512(b)–1,

(c) More than 50 percent of the members of one organization are members of the other organization, or

(d) Each organization is a local organization which is directly affiliated with a common state, national, or international organization which is also exempt.

(iii) Examples. This subparagraph may be illustrated by the following examples. For purposes of these examples it is assumed that the indebtedness is acquisition indebtedness.

Example (1). M, an exempt trade association described in section 501(c)(6), leases 70 percent of the space of an office building for furtherance of its exempt purpose. The title to such building is held by N, an exempt holding company described in section 501(c)(2), which acquired title to the building with borrowed funds. The other 30 percent of the space in this office building is leased to L, a nonstock exempt trade association described in section 501(c)(6). L uses such office space in furtherance of its exempt purpose. The members of L's Board of Trustees serves for fixed terms and M's Board of Directors has the power to select all such members. N pays over to M all the profits it derives from the leasing of space in this building to M and L. Accordingly, M is "related" to N (as such term is defined in subdivision (ii)(a) of this subparagraph) and L is "related" to M (as such term is defined in subdivision (ii)(b) of this subparagraph). Under these circumstances, since all the available space in the building is leased to either an exempt organization related to the exempt organization holding title to the building or an exempt organization related to such related exempt organization, no portion of the building is treated as debt-financed property.

Example (2). W, an exempt labor union described in section 501(c)(5), owns a 10-story office building which has been purchased with borrowed funds. Five floors of the building are used by W in furtherance of its exempt purpose. Four of the other floors are rented to X which is an exempt voluntary employees' beneficiary association described in section 501(c)(9), operated for the benefit of W's members. X uses such office space in furtherance of its exempt purpose. Seventy percent of the members of W are also members of X. Accordingly, X is "related" to W (as such term is defined in subdivision (ii)(c) of this subparagraph). The remaining floor of the building is rented to the general public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). Under these circumstances, no portion of this building is treated as debt-financed property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose. See paragraph (b)(1) of this section for rules relating to the use of property substantially related to an exempt purpose. See paragraph (b)(6) of this section for rules relating to uses by related exempt organizations.

Example (3). Assume the same facts as in example (2), except that W and X are each exempt local labor unions described in section 501(c)(5) having no common membership and are each affiliated with N, an exempt international labor union described in section 501(c)(5). Under these circumstances, no portion of this building is treated as debt-financed property since more than 85 percent of the office space available in this building is used either by W or X, an exempt organization related to W, in furtherance of their respective exempt purpose.

Example (4). Assume the same facts as in example (3), except that W and X are directly affiliated with different exempt international labor unions and that W and X are not otherwise affiliated with, or members of, a common exempt organization, other than an association of international labor unions. Under these circumstances, the portions of this building which are rented to X and to the general public are treated as debt-financed property since X is not related to W and W uses less than 85 percent of the building for its exempt purpose.

(3) Life income contracts. (i) Property shall not be treated as "debt-financed property" when—

(a) An individual transfers property to a trust or a fund subject to a contract providing that the income is to be paid to him or other individuals or both for a period of time not to exceed the life of such individual or individuals in a transaction in which the payments to the individual or individuals do not constitute the proceeds of a sale or exchange of the property so transferred, and

(b) The remainder interest is payable to an exempt organization described in section 501(c)(3).

(ii) Subdivision (i) of this subparagraph is illustrated by the following example.

Example. On January 1, 1967, A transfers property to X, an exempt organization described in section 501(c)(3), which immediately places the property in a fund. On January 1, 1971, A transfers additional property to X, which property is also placed in the fund. In exchange for each transfer, A receives income participation fund certificates which entitle him to a proportionate part of the fund's income for his life and for the life of another individual. None of the payments made by X are treated by the recipients as the proceeds of a sale or exchange of the property transferred. In this situation, none of the property received by X from A is treated as debt-financed property.

(d) Property acquired for prospective exempt use—(1) Neighborhood land—(i) In general. If an organization acquires real property for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 10 years of the time of acquisition, such property will not be treated as debt-financed property, so long as (a) such property is in the neighborhood of other property owned by the organization which is used in the performance of its exempt purpose, and (b) the organization does not abandon its intent to use the land in such a

manner within the 10-year period. The rule expressed in this subdivision is hereinafter referred to as the "neighborhood land rule".

(ii) "Neighborhood" defined. Property shall be considered in the "neighborhood" of property owned and used by the organization in the performance of its exempt purpose if the acquired property is contiguous with the exempt purpose property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property. If the acquired property is not contiguous with exempt function property, it may still be in the "neighborhood" of such property, but only if it is within 1 mile of such property and the facts and circumstances of the particular situation make the acquisition of contiguous property unreasonable. Some of the criteria to consider in determining this question include the availability of land and the intended future use of the land. For example, a university attempts to purchase land contiguous to its present campus but cannot do so because the owners either refuse to sell or ask unreasonable prices. The nearest land of sufficient size and utility is a block away from the campus. The university purchases such land. Under these circumstances, the contiguity requirement is unreasonable and the land purchased would be considered "neighborhood land".

(iii) Exception. The neighborhood land rule shall not apply to any property after the expiration of 10 years from the date of acquisition. Further, the neighborhood land rule shall apply after the first 5 years of the 10-year period only if the organization establishes to the satisfaction of the Commissioner that future use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 10-year period is reasonably certain. In order to satisfy the Commissioner, the organization does not necessarily have to show binding contracts. However, it must at least have a definite plan detailing a specific improvement and a completion date, and some affirmative action toward the fulfillment of such a plan. This information shall be forwarded to the Commissioner of Internal Revenue, Washington, D.C. 20224, for a ruling at least 90 days before the end of the fifth year after acquisition of the land.

(2) Actual use. If the neighborhood land rule is inapplicable because—

(i) The acquired land is not in the neighborhood of other property used by the organization in performance of its exempt purpose, or

(ii) The organization (for the period after the first 5 years of the 10-year period) is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purposes within the 10-year period is reasonably certain,

but the land is actually used by the organization in furtherance of its exempt purpose within the 10-year period, such property (subject to the provisions of subparagraph (4) of this paragraph) shall not be treated as debt-financed property for any period prior to such conversion.

(3) Limitations—(i) Demolition or removal required. (a) Subparagraphs (1) and (2) of this paragraph shall apply with respect to any structure on the land when acquired by the organization, or to the land occupied by the structure, only so long as the intended future use of the land in furtherance of the organization's exempt purpose requires that the structure be demolished or removed in order to use the land in such a manner. Thus, during the first 5 years after acquisition (and for subsequent years if there is a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph) improved property is not debt-financed so long as the organization does not abandon its intent to demolish the existing structures and use the land in furtherance of its exempt purpose. Furthermore, if there is an actual demolition of such structures, the use made of the land need not be the one originally intended. Therefore, the actual use requirement of this subdivision may be satisfied by using the land in any manner which furthers the exempt purpose of the organization.

(b) Subdivision (i)(a) of this subparagraph may be illustrated by the following examples. For purposes of the following examples it is assumed that but for the application of the neighborhood land rule such property would be debt-financed property.

Example (1). An exempt university acquires a contiguous tract of land on which there is an apartment building. The university intends to demolish the apartment building and build classrooms and does not abandon this intent during the first 4 years after acquisition. In the fifth year after acquisition it abandons the intent to demolish and sells the apartment building. Under these circumstances, such property is not debt-financed property for the first 4 years after acquisition even though there was no eventual demolition or use made of such land in furtherance of the university's exempt purpose. However, such property is debt-financed property as of the time in the fifth year that the intent to demolish the building is abandoned and any gain on the sale of property is subject to section 514.

Example (2). Assume the facts as stated in example (1) except that the university did not abandon its intent to demolish the existing building and construct a classroom building until the eighth year after acquisition when it sells the property.

Assume further that the university did not receive a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is debt-financed property for the sixth, seventh, and eighth years. It is not, however, treated as debt-financed property for the first 5 years after acquisition.

Example (3). Assume the facts as stated in example (2) except that the university received a favorable ruling in accordance with subparagraph (1)(iii) of this paragraph. Under these circumstances, the building is not debt-financed property for the first 7 years after acquisition. It only becomes debt-financed property as of the time in the eighth year when the university abandoned its intent to demolish the existing structure.

Example (4). (1) Assume that a university acquires a contiguous tract of land containing an office building for the principal purpose of demolishing the office building and building a modern dormitory. Five years later the dormitory has not been constructed, and the university has failed to satisfy the Commissioner that the office building will be demolished and the land will be used in furtherance of its exempt purpose (and consequently has failed to obtain a favorable ruling under subparagraph (1)(iii) of this paragraph). In the ninth taxable year after acquisition the university converts the office building into an administration building. Under these circumstances, during the sixth, seventh, and eighth years after acquisition, the office building is treated as debt-financed property because the office building was not demolished or removed. Therefore, the income derived from such property during these years shall be subject to the tax on unrelated business income.

(2) Assume that instead of converting the office building to an administration building, the university demolishes the office building in the ninth taxable year after acquisition and then constructs a new administration building. Under these circumstances, the land would not be considered debt-financed property for any period following the acquisition, and the university would be entitled to a refund of taxes paid on the income derived from such property for the sixth through eighth taxable years after the acquisition in accordance with subparagraph (4) of this paragraph.

(ii) Subsequent construction. Subparagraphs (1) and (2) of this paragraph do not apply to structures erected on the land after the acquisition of the land.

(iii) Property subject to business lease. Subparagraphs (1) and (2) of this paragraph do not apply to property subject to a lease which is a business lease (as defined in § 1.514(f)–1) whether the organization acquired the property subject to the lease or whether it executed the lease subsequent to acquisition. If only a portion of the real property is subject to a lease, paragraph (c) of § 1.514(f)–1 applies in determining whether such lease is a business lease.

(4) Refund of taxes. (i) If an organization has not satisfied the actual use condition of subparagraph (2) of this paragraph or paragraph (e)(3) of this section before the date prescribed by law (including extensions) for filing the return for the taxable year, the tax for such year shall be computed without regard to the application of such actual use condition. However, if—

(a) A credit or refund of any overpayment of taxes is allowable for a prior taxable year as a result of the satisfaction of such actual use condition, and

(b) Such credit or refund is prevented by the operation of any law or rule of law (other than chapter 74, relating to closing agreements and compromises),

such credit or refund may nevertheless be allowed or made, if a claim is filed within 1 year after the close of the taxable year in which such actual use condition is satisfied. For a special rule with respect to the payment of interest at the rate of 4 percent per annum, see section 514(b)(3)(D), prior to its amendment by section 7(b) of the Act of January 3, 1975 (Pub. L. 93–625, 88 Stat. 2115).

(ii) This subparagraph may be illustrated by the following example. For purposes of this example it is assumed that but for the neighborhood land rule such property would be debt-financed property.

Example. Y, a calendar year exempt organization, acquires real property in January 1970, which is contiguous with other property used by Y in furtherance of its exempt purpose. However, Y does not satisfy the Commissioner by January 1975, that the existing structure will be demolished and the land will be used in furtherance of its exempt purpose. In accordance with this subparagraph, from 1975 until the property is converted to an exempt use, the income derived from such property shall be subject to the tax on unrelated business income. During July 1979, Y demolishes the existing structure on the land and begins using the land in furtherance of its exempt purpose. At this time Y may file claims for refund for the open years 1976 through 1978. Further, in accordance with this subparagraph, Y may also file a claim for refund for 1975, even though a claim for such taxable year may be barred by the statute of limitations, provided such claim is filed before the close of 1980.

(e) Churches—(1) In general. If a church or association or convention of churches acquires real property, for the principal purpose of using the land in the exercise or performance of its exempt purpose, commencing within 15 years of the time of acquisition, such property shall not be treated as debt-financed property so long as the organization does not abandon its intent to use the land in such a manner within the 15-year period.

(2) Exception. This paragraph shall not apply to any property after the expiration of the 15-year period. Further, this paragraph shall apply after the first 5 years of the 15-year period only if the church or association or convention of churches establishes to the satisfaction of the Commissioner that use of the acquired land in furtherance of the organization's exempt purpose before the expiration of the 15-year period is reasonably certain.

For purposes of the preceding sentence, the rules contained in paragraph (d)(1)(iii) of this section with respect to satisfying the Commissioner that the exempt organization intends to use the land within the prescribed time in furtherance of its exempt purpose shall apply.

(3) Actual use. If the church or association or convention of churches for the period after the first 5 years of the 15-year period is unable to establish to the satisfaction of the Commissioner that the use of the acquired land for its exempt purpose within the 15-year period is reasonably certain, but such land is in fact converted to an exempt use within the 15-year period, the land (subject to the provisions of paragraph (d)(4) of this section) shall not be treated as debt-financed property for any period prior to such conversion.

(4) Limitations. The limitations stated in paragraph (d)(3)(i) and (ii) of this section shall similarly apply to the rules contained in this paragraph. [T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7229, 37 FR 28146, Dec. 21, 1972; 39 FR 6607, Feb. 21, 1974; T.D. 7384, 40 FR 49322, Oct. 22, 1975; T.D. 7632, 44 FR 42681, July 20, 1979; T.D. 7728, 45 FR 72651, Nov. 3, 1980]

§ 1.514(c)–1 Acquisition indebtedness.

(a) In general—(1) Definition of acquisition indebtedness. For purposes of section 514 and the regulations thereunder, the term "acquisition indebtedness" means, with respect to any debt-financed property, the outstanding amount of—

(i) The principal indebtedness incurred by the organization in acquiring or improving such property.

(ii) The principal indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(iii) The principal indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Whether the incurrence of an indebtedness is reasonably foreseeable depends upon the facts and circumstances of each situation. The fact that an organization did not actually foresee the need for the incurrence of an indebtedness prior to the acquisition or improvement does not necessarily mean that the subsequent incurrence of indebtedness was not reasonably foreseeable.

(2) Examples. The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). X, an exempt organization, pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase an office building which it leases to the public for purposes other than those described in section 514(b)(1)(A), (B), (C), or (D). The outstanding principal indebtedness with respect to the loan constitutes acquisition indebtedness incurred prior to the acquisition which would not have been incurred but for such acquisition.

Example (2). Y, an exempt scientific organization, mortgages its laboratory to replace working capital used in remodeling an office building which Y rents to an insurance company for purposes not described in section 514(b)(1)(A), (B), (C), or (D). The indebtedness is "acquisition indebtedness" since such indebtedness, though incurred subsequent to the improvement of the office building, would not have been incurred but for such improvement, and the indebtedness was reasonably foreseeable when, to make such improvement, Y reduced its working capital below the amount necessary to continue current operations.

Example (3). (a) U, an exempt private preparatory school, as its sole educational facility owns a classroom building which no longer meets the needs of U's students. In 1971, U sells this building for $3 million to Y, a corporation which it does not control. U receives $1 million as a down payment from Y and takes back a purchase money mortgage of $2 million which bears interest at 10 percent per annum. At the time U became the mortgagee of the $2 million purchase money mortgage, U realized that it would have to construct a new classroom building and knew that it would have to incur an indebtedness in the construction of the new classroom building. In 1972, U builds a new classroom building for a cost of $4 million. In connection with the construction of this building, U borrows $2.5 million from X Bank pursuant to a deed of trust bearing interest at 6 percent per annum. Under these circumstances, $2 million of the $2.5 million borrowed to finance construction of the new classroom building would not have been borrowed but for the retention of the $2 million purchase money mortgage. Since such indebtedness was reasonably foreseeable, $2 million of the $2.5 million borrowed to finance the construction of the new classroom building is acquisition indebtedness with respect to the purchase money mortgage and the purchase money mortgage is debt-financed property.

(b) In 1972, U receives $200,000 in interest from Y (10 percent of $2 million) and makes a $150,000 interest payment to X (6 percent of $2.5 million). In addition, assume that for 1972 the debt/basis percentage is 100 percent ($2 million/$2 million). Accordingly, all the interest and all the deductions directly connected with such interest income are to be taken into account in computing unrelated business taxable income. Thus, $200,000 of interest income and $120,000 ($150,000 × $2 million/$2.5 million) of deductions directly connected with such interest income are taken into account. Under these circumstances, U shall include net interest income of $80,000 ($200,000 of income less $120,000 of deductions directly connected with such income) in its unrelated business taxable income for 1972.

Example (4). In 1972 X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners shall share equally in the profits of the partnership, shall each invest $3 million, and that X shall be a limited partner. X invests $1 million of its own funds in

the partnership and $2 million of borrowed funds. The partnership purchases as its sole asset an office building which is leased to the general public for purposes other than those described in section 514(b)(1)(A), (B), (C), or (D). The office building cost the partnership $24 million of which $15 million is borrowed from Y bank. This loan is secured by a mortgage on the entire office building. By agreement with Y bank, X is held not to be personally liable for payment of such mortgage. By reason of section 702(b) the character of any item realized by the partnership and included in the partner's distributive share shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner. Therefore, a portion of X's income from the building is debt-financed income. Under these circumstances, since both the $2 million indebtedness incurred by X in acquiring its partnership interest and $5 million, the allocable portion of the partnership's indebtedness incurred with respect to acquiring the office building which is attributable to X in computing the debt/basis percentage (one-third of $15 million), were incurred in acquiring income-producing property, X has acquisition indebtedness of $7 million ($2 million plus $5 million). Similarly, the allocable portion of the partnership's adjusted basis in the office building which is attributable to X in computing the debt/basis percentage is $8 million (one-third of $24 million). Assuming no payment with respect to either indebtedness and no adjustments to basis in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage with respect to its share of the partnership income for 1972 is 87.5 percent ($7 million/$8 million).

(3) Changes in use of property. Since property used in a manner described in section 514(b)(1)(A), (B), (C), or (D) is not considered debt-financed property, indebtedness with respect to such property is not acquisition indebtedness. However, if an organization converts such property to a use which is not described in section 514(b)(1)(A), (B), (C), or (D) and such property is otherwise treated as debt-financed property, the outstanding principal indebtedness with respect to such property will thereafter be treated as "acquisition indebtedness". For example, assume that in 1971 a university borrows funds to acquire an apartment building as housing for married students. In 1974 the university rents the apartment building to the public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). The outstanding principal indebtedness is "acquisition indebtedness" as of the time in 1974 when the building is first rented to the public.

(4) Continued indebtedness. If—

(i) An organization sells or exchanges property, subject to an indebtedness (incurred in a manner described in subparagraph (1) of this paragraph),

(ii) Acquires another property without retiring the indebtedness, and

(iii) The newly acquired property is otherwise treated as debt-financed property,

the outstanding principal indebtedness with respect to the acquired property is "acquisition indebtedness", even though the original property was not debt-financed property. For example, to house its administrative offices, an exempt organization purchases a building with $600,000 of its own funds and $400,000 of borrowed funds secured by a pledge of its securities. It later sells the building for $1,000,000 without redeeming the pledge. It uses these proceeds to purchase an apartment building which it rents to the public for purposes not described in section 514(b)(1)(A), (B), (C), or (D). The indebtedness of $400,000 is "acquisition indebtedness" with respect to the apartment building even though the office building was not debt-financed property.

(5) Indebtedness incurred before June 28, 1966. For taxable years beginning before January 1, 1972, "acquisition indebtedness" does not include any indebtedness incurred before June 28, 1966, unless such indebtedness was incurred on rental real property subject to a business lease and such indebtedness constituted business lease indebtedness. Furthermore, in the case of a church or convention or association of churches, the preceding sentence applies without regard to whether the indebtedness incurred before June 28, 1966, constituted business lease indebtedness.

(b) Property acquired subject to lien—(1) Mortgages. Except as provided in subparagraphs (3) and (4) of this paragraph, whenever property is acquired subject to a mortgage, the amount of the outstanding principal indebtedness secured by such mortgage is treated as "acquisition indebtedness" with respect to such property even though the organization did not assume or agree to pay such indebtedness. The preceding sentence applies whether property is acquired by purchase, gift, devise, bequest, or any other means. Thus, for example, assume that an exempt organization pays $50,000 for real property valued at $150,000 and subject to a $100,000 mortgage. The $100,000 of outstanding principal indebtedness is "acquisition indebtedness" just as though the organization had borrowed $100,000 to buy the property.

(2) Other liens. For purposes of this paragraph, liens similar to mortgages shall be treated as mortgages. A lien is similar to a mortgage if title to property is encumbered by the lien for the benefit of a creditor. However, in the case where State law provides that a tax lien attaches to property prior to the time when such lien becomes due and payable, such lien shall not be treated as similar to a mortgage until after it has become due and payable and the organization has had an

opportunity to pay such lien in accordance with State law. Liens similar to mortgages include (but are not limited to):

(i) Deeds of trust,

(ii) Conditional sales contracts,

(iii) Chattel mortgages,

(iv) Security interests under the Uniform Commercial Code,

(v) Pledges,

(vi) Agreements to hold title in escrow, and

(vii) Tax liens (other than those described in the third sentence of this subparagraph).

(3) Certain encumbered property acquired by gift, bequest or devise—(i) Bequest or devise. Where property subject to a mortgage is acquired by an organization by bequest or devise, the outstanding principal indebtedness secured by such mortgage is not to be treated as "acquisition indebtedness" during the 10-year period following the date of acquisition. For purposes of the preceding sentence, the date of acquisition is the date the organization receives the property.

(ii) Gifts. If an organization acquires property by gift subject to a mortgage, the outstanding principal indebtedness secured by such mortgage shall not be treated as "acquisition indebtedness" during the 10-year period following the date of such gift, so long as—

(a) The mortgage was placed on the property more than 5 years before the date of the gift, and

(b) The property was held by the donor for more than 5 years before the date of the gift.

For purposes of the preceding sentence, the date of the gift is the date the organization receives the property.

(iii) Limitation. Subdivisions (i) and (ii) of this subparagraph shall not apply if—

(a) The organization assumes and agrees to pay all or any part of the indebtedness secured by the mortgage, or

(b) The organization makes any payment for the equity owned by the decedent or the donor in the property (other than a payment pursuant to an annuity excluded from the definition of "acquisition indebtedness" by paragraph (e) of this section).

Whether an organization has assumed and agreed to pay all or any part of an indebtedness in order to acquire the property shall be determined by the facts and circumstances of each situation.

(iv) Examples. The application of this subparagraph may be illustrated by the following examples:

Example (1). A dies on January 1, 1971. His will devises an office building subject to a mortgage to U, an exempt organization described in section 501(c)(3). U does not at any time assume the mortgage. For the period 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not acquisition indebtedness. However, after December 31, 1980, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

Example (2). Assume the facts as stated in example (1) except that on January 1, 1975, U assumes the mortgage. After January 1, 1975, the outstanding principal indebtedness secured by the mortgage is acquisition indebtedness if the building is otherwise treated as debt-financed property.

(4) Bargain sale before October 9, 1969. Where property subject to a mortgage is acquired by an organization before October 9, 1969, the outstanding principal indebtedness secured by such mortgage is not to be treated as "acquisition indebtedness" during the 10-year period following the date of acquisition if—

(i) The mortgage was placed on the property more than 5 years before the purchase, and

(ii) The organization paid the seller a total amount no greater than the amount of the seller's cost (including attorney's fees) directly related to the transfer of such property to the organization, but in any event no more than 10 percent of the value of the seller's equity in the property transferred.

(c) Extension of obligations—(1) In general. An extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness is considered as a continuation of the old indebtedness to the extent the outstanding principal amount thereof is not increased. Where the principal amount of the modified obligation exceeds the outstanding principal amount of the preexisting indebtedness, the excess shall be treated as a separate indebtedness for purposes of section 514 and the regulations thereunder. For example, if the interest rate on an obligation incurred prior to June 28, 1966, by an exempt university is modified subsequent to such date, the modified obligation shall be deemed to have been incurred prior to June 28, 1966. Thus, such an indebtedness will not be treated as acquisition indebtedness for taxable years beginning before January 1, 1972, unless the original indebtedness was business lease indebtedness (as defined in § 1.514(g)–1).

(2) **Extension or renewal.** In general, any modification or substitution of the terms of an obligation by the organization shall be an extension or renewal of the original obligation, rather than the creation of a new indebtedness to the extent that the outstanding principal amount of the indebtedness is not increased. The following are examples of acts which result in the extension or renewal of an obligation:

(i) Substitution of liens to secure the obligation;

(ii) Substitution of obligees, whether or not with the consent of the organization;

(iii) Renewal, extension or acceleration of the payment terms of the obligation; and

(iv) Addition, deletion, or substitution of sureties or other primary or secondary obligors.

(3) **Allocation.** In cases where the outstanding principal amount of the modified obligation exceeds the outstanding principal amount of the unmodified obligation and only a portion of such refinanced indebtedness is to be treated as acquisition indebtedness, payments on the amount of the refinanced indebtedness shall be apportioned prorata between the amount of the preexisting indebtedness and the excess amount. For example, assume that an organization has an outstanding principal indebtedness of $500,000 which is treated as acquisition indebtedness. It borrows another $100,000, which is not acquisition indebtedness, from the same lending institution and gives the lender a $600,000 note for its total obligation. In this situation, a payment of $60,000 on the amount of the total obligation would reduce the acquisition indebtedness by $50,000 and the excess indebtedness by $10,000.

(d) **Indebtedness incurred in performing exempt purpose.** "Acquisition indebtedness" does not include the incurrence of an indebtedness inherent in the performance or exercise of the purpose or function constituting the basis of the organization's exemption. Thus, "acquisition indebtedness" does not include the indebtedness incurred by an exempt credit union in accepting deposits from its members or the obligation incurred by an exempt organization in accepting payments from its members to provide such members with insurance, retirement or other similar benefits.

(e) **Annuities—(1) Requirements.** The obligation to make payment of an annuity is not "acquisition indebtedness" if the annuity meets all the following requirements—

(i) It must be the sole consideration (other than a mortgage to which paragraph (b)(3) of this section applies) issued in exchange for the property acquired;

(ii) At the time of the exchange, the present value of the annuity (determined in accordance with subparagraph (2) of this paragraph) must be less than 90 percent of the value of the prior owner's equity in the property received in the exchange;

(iii) The annuity must be payable over the life of one individual in being at the time the annuity is issued, or over the lives of two individuals in being at such time; and

(iv) The annuity must be payable under a contract which—

(a) Does not guarantee a minimum number of payments or specify a maximum number of payments, and

(b) Does not provide for any adjustment of the amount of the annuity payments by reference to the income received from the transferred property or any other property.

(2) **Valuation.** For purposes of this paragraph, the value of an annuity at the time of exchange shall be computed in accordance with section 1011(b), § 1.1011–2(e)(1)(iii)(b)(2), and section 3 of Rev. Rul. 62–216, C.B. 1962–2, 30.

(3) **Examples.** The application of this paragraph may be illustrated by the following examples. For purposes of these examples it is assumed that the property transferred is used for purposes other than those described in section 514(b)(1)(A), (B), (C), or (D).

Example (1). On January 1, 1971, X, an exempt organization, receives property valued at $100,000 from donor A, a male aged 60. In return X promises to pay A $6,000 a year for the rest of A's life, with neither a minimum nor maximum number of payments specified. The annuity is payable on December 31, of each year. The amounts paid under the annuity are not dependent on the income derived from the property transferred to X. The present value of this annuity is $81,156, determined in accordance with Table A of Rev. Rul. 62–216. Since the value of the annuity is less than 90 percent of A's equity in the property transferred and the annuity meets all the other requirements of subparagraph (1) of this paragraph, the obligation to make annuity payments is not acquisition indebtedness.

Example (2). On January 1, 1971, B transfers an office building to Y, an exempt university, subject to a mortgage. In return Y agrees to pay B $5,000 a year for the rest of his life, with neither a minimum nor maximum number of payments specified. The amounts paid under the annuity are not dependent on the income derived from the property transferred to Y. It is determined that the actual value of the annuity is less than 90 percent of the value of B's equity in the property

transferred. Y does not assume the mortgage. For the taxable years 1971 through 1980, the outstanding principal indebtedness secured by the mortgage is not treated as acquisition indebtedness. Further, Y's obligation to make annuity payments to B never constitutes acquisition indebtedness.

(f) Certain Federal financing. "Acquisition indebtedness" does not include an obligation to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons to the extent that it is insured by the Federal Housing Administration. Thus, for example, to the extent that an obligation is insured by the Federal Housing Administration under section 221(d)(3) (12 U.S.C. 1715(I)(d)(3)) or section 236 (12 U.S.C. 1715z–1) of title II of the National Housing Act, as amended, the obligation is not "acquisition indebtedness".

(g) Certain obligations of charitable remainder trusts. For purposes of section 664(c) and § 1.664–1(c), a charitable remainder trust (as defined in § 1.664–1(a)(1)(iii)(a)) does not incur "acquisition indebtedness" when the sole consideration it is required to pay in exchange for unencumbered property is an "annuity amount" or a "unitrust amount" (as defined in § 1.664–1(a)(1)(iii)(b) and (c)).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7229, 37 FR 28151, Dec. 21, 1972; 38 FR 21918, Aug. 14, 1973; T.D. 7698, 45 FR 33973, May 21, 1980]

§ 1.514(d)–1 Basis of debt-financed property acquired in corporate liquidation.

(a) If debt-financed property is acquired by an exempt organization in a complete or partial liquidation of a corporation in exchange for its stock, the organization's basis in such property shall be the same as it would be in the hands of the transferor corporation, increased by the amount of gain recognized to the transferor corporation upon such distribution and by the amount of any gain which is includible, on account of such distribution, in the gross income of the organization as unrelated debt-financed income.

(b) The application of this section may be illustrated by the following example:

Example. On July 1, 1970, T, an exempt trust, exchanges $15,000 of borrowed funds for 50 percent of the shares of M Corporation's stock. M uses $35,000 of borrowed funds in acquiring depreciable assets which are not used at any time for purposes described in section 514(b)(1)(A), (B), (C), or (D). On July 1, 1978, and for the 12-month period preceding this date, T's acquisition indebtedness with respect to M's stock has been $3,000. On this date, there is a complete liquidation of M Corporation to which section 331(a)(1) applies. In the liquidation T receives a distribution in kind of depreciable assets and assumes $7,000 of M's indebtedness which remains unpaid with respect to the depreciable assets. On this date, M's adjusted basis of these depreciable assets is $9,000, and such assets have a fair market value of $47,000. M recognizes gain of $6,000 with respect to this liquidation pursuant to sections 1245 and 1250. T realizes a gain of $25,000 (the difference between the excess of fair market value of the property received over the indebtedness assumed, $40,000 ($47,000–$7,000) and T's basis in M's stock, $15,000). A portion of this gain is to be treated as unrelated debt-financed income. This amount is determined by multiplying T's gain of $25,000 by the debt/basis percentage. The debt/basis percentage is 20 percent, the ratio which the average acquisition indebtedness ($3,000) is of the average adjusted basis ($15,000). Thus, $5,000 (20 percent of $25,000) is unrelated debt-financed income. This amount and the gain recognized pursuant to sections 1245 and 1250 are added to M's basis to determine T's basis in the property received. Consequently, T's basis in the property received from M Corporation is $20,000, determined as follows:

M Corporation's adjusted basis	$9,000
Gain recognized by M Corporation on the distribution	6,000
Unrelated debt-financed income recognized by T with respect to the distribution	5,000
T's transferred basis	20,000

[T.D. 7229, 37 FR 28153, Dec. 21, 1972]

§ 1.514(e)–1 Allocation rules.

Where only a portion of property is debt-financed property, proper allocation of the basis, indebtedness, income, and deductions with respect to such property must be made to determine the amount of income or gain derived from such property which is to be treated as unrelated debt-financed income. See examples (2) and (3) of paragraph (b)(1)(iii) of § 1.514(b)–1 and examples (1), (2), and (3) of paragraph (b)(3)(iii) of § 1.514(b)–1 for illustrations of proper allocation.

[T.D. 7229, 37 FR 28153, Dec. 21, 1972]

§ 1.514(f)–1 Definition of business lease.

(a) In general. The term "business lease" means any lease, with certain exceptions discussed in paragraph (c) of this section, for a term of more than 5 years of real property by an organization subject to section 511 (or by a partnership of which it is a member) if at the close of the organization's taxable year there is a business lease indebtedness as defined in section 514(g) and § 1.514(g)–1 with respect to such property. For the purpose of this section the term "real property" and the term "premises" include personal property of the lessor tax-exempt organization leased by it to a lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate. For amounts of business lease rents and deductions to be included in computing unrelated business taxable income for taxable years beginning before January 1, 1970, see § 1.514(a)–2.

(b) **Special rules.** (1) In computing the term of the lease, the period for which a lease may be renewed or extended by reason of an option contained therein shall be considered as part of the term. For example, a 3-year lease with an option for renewal for another such period is considered a lease for a term of 6 years. Another example is the case of a 1-year lease with option of renewal for another such term, where the parties at the end of each year renew the arrangement. In this case, during the fifth year (but not during the first 4 years), the lease falls within the 5-year rule, since the lease then involves 5 years and there is an option for the sixth year. In determining the term of the lease, an option for renewal of the lease is taken into account whether or not the exercise of the option depends upon conditions or contingencies.

(2) If the property is acquired subject to a lease, the term of such lease shall be considered to begin on the date of such acquisition. For example, if an exempt organization purchases, in whole or in part with borrowed funds, real property subject to a 10-year lease which has 3 years left to run, and such lease contains no right of renewal or extension, the lease shall be considered a 3-year lease and hence does not meet the definition of a business lease in section 514(f) and paragraph (a) of this section. However, if this lease contains an option to renew for a period of 3 years or more, it is a business lease.

(3) Under the provisions of section 514(f)(2)(B) a lease is considered as continuing for more than 5 years if the same lessee has occupied the premises for a total period of more than 5 years, whether the occupancy is under one or more leases, renewals, extensions, or continuations. Continued occupancy shall be considered to be by the same lessee if the occupants during the period are so related that losses in respect of sales or exchanges of property between them would be disallowed under section 267(a). Such period shall be considered as commencing not earlier than the date of the acquisition of the property by the tax-exempt organization or trust. This rule is applicable only in the sixth and succeeding years of such occupancy by the same lessee. See, however, paragraph (c)(3) of this section.

(c) **Exceptions.** (1) A lease shall not be considered a business lease if such lease is entered into primarily for a purpose which is substantially related (aside from the need of such organization for income or funds, or the use it makes of the rents derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption. For example, where a tax-exempt hospital leases real property owned by it to an association of doctors for use as a clinic, the rents derived under such lease would not be included in computing unrelated business taxable income if the clinic is substantially related to the carrying on of hospital functions. See § 1.513—1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of an organization.

(2) A lease is not a business lease if the lease is of premises in a building primarily designed for occupancy and occupied by the tax-exempt organization.

(3) If a lease for more than 5 years to a tenant is for only a portion of the real property, and space in the real property is rented during the taxable year under a lease for not more than 5 years to any other tenant of the tax-exempt organization, all leases of the real property for more than 5 years shall be considered as business leases during the taxable year only if—

(i) The rents derived from the real property during the taxable year under leases for more than 5 years represent 50 percent or more of the total rents derived during the taxable year from the real property; or the area of the premises occupied under leases for more than 5 years represents, at any time during the taxable year, 50 percent or more of the total area of the real property rented at such time; or

(ii) The rent derived from the real property during the taxable year from any tenant under a lease for more than 5 years, or from a group of tenants (under such leases) who are either members of an affiliated group (as defined in section 1504) or are partners, represents more than 10 percent of the total rents derived during the taxable year from such property; or the area of the premises occupied by any one such tenant, or by any such group of tenants, represents at any time during the taxable year more than 10 percent of the total area of the real property rented at such time.

In determining whether 50 percent or more of the total rents are derived from leases for more than 5 years, or whether 50 percent or more of the total area is occupied under leases for more than 5 years—

(iii) An occupancy which is considered to be a lease of more than 5 years solely by reason of the provisions of paragraph (b)(3) of this subpara-

graph shall not be treated as such a lease for purposes of subdivision (i) of this subparagraph, and

(iv) An occupancy which is considered to be a lease of more than 5 years solely by reason of the provisions of paragraph (b)(3) of this section shall be treated as such a lease for purposes of subdivision (ii) of this subparagraph, and

(v) If during the last half of the term of a lease a new lease is made to take effect after the expiration of such lease, the unexpired portion of the first lease will not be added to the second lease to determine whether such second lease is a lease for more than 5 years for purposes of subdivision (i) of this subparagraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. In 1954 an educational organization, which is on the calendar year basis, begins the erection of an 11-story apartment building using funds borrowed for that purpose, and immediately leases for a 10-year term the first floor to a real estate development company to sublet for stores and shops. As fast as the new apartments are completed, they are rented on an annual basis. At the end of 1959 all except the 10th and 11th floors are rented. Those two floors are completed during 1960 and rented. Assume that for 1954 and each subsequent taxable year through 1959, and for the taxable year 1963, the gross rental for the first floor represents more than 10 percent of the total gross rents derived during the taxable year from the building. Under this set of facts the 10-year lease of the first floor would be considered to be a business lease for all except the taxable years 1961, 1962, and 1964.

[T.D. 7229, 37 FR 28154, Dec. 21, 1972]

§ 1.514(g)–1 Business lease indebtedness.

(a) Definition. The term "business lease indebtedness" means, with respect to any real property leased by a tax-exempt organization for a term of more than 5 years, the unpaid amount of—

(1) The indebtedness incurred by the lessor tax-exempt organization in acquiring or improving such property;

(2) The indebtedness incurred by the lessor tax-exempt organization prior to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and

(3) The indebtedness incurred by the lessor tax-exempt organization subsequent to the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

See paragraph (i) of this section with respect to subsidiary corporations.

(b) Examples. The rules of section 514(g) respecting business leases also cover certain cases where the leased property itself is not subject to an indebtedness. For example, they apply to cases such as the following:

Example (1). A university pledges some of its investment securities with a bank for a loan and uses the proceeds of such loan to purchase (either directly or through a subsidiary corporation) a building, which building is subject to a lease that then has more than 5 years to run. This would be an example of a business lease indebtedness incurred prior to the acquisition of the property which would not have been incurred but for such acquisition.

Example (2). If the building itself in example (1) in this paragraph is later mortgaged to raise funds to release the pledged securities, the lease would continue to be a business lease.

Example (3). If a scientific organization mortgages its laboratory building to replace working capital used in remodeling another one of its buildings or a building held by its subsidiary corporation, which other building is free of indebtedness and is subject to a lease that then has more than 5 years to run, the lease would be a business lease inasmuch as the indebtedness though incurred subsequent to the improvement of such property would not have been incurred but for such improvement, and the incurrence of the indebtedness was reasonably foreseeable when, to make such improvement, the organization reduced its working capital below the amount necessary to continue current operations.

(c) Property acquired subject to lien. Where real property is acquired subject to a mortgage or similar lien, whether the acquisition be by gift, bequest, devise, or purchase, the amount of the indebtedness secured by such mortgage or lien is a business lease indebtedness (unless paragraph (d)(1) of this section applies) even though the lessor does not assume or agree to pay the indebtedness. For example, a university pays $100,000 for real estate valued at $300,000 and subject to a $200,000 mortgage. For the purpose of the tax on unrelated business taxable income, the result is the same as if $200,000 of borrowed funds had been used to buy the property.

(d) Certain property acquired by gifts, etc. (1) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a mortgage or other similar lien, the amount of such mortgage or other similar lien shall not be considered as an indebtedness of the lessor tax-exempt organization incurred in acquiring such property. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(2) Where real property was acquired by gift, bequest, or devise, before July 1, 1950, subject to a lease requiring improvements in such property upon the happening of stated contingencies, indebtedness incurred in improving such property in accordance with the terms of such lease shall not be considered as indebtedness described in section 514(g) and in this section. An indebtedness not otherwise covered by this exception is not brought within the exception by reason of a transfer of the property between a parent and its subsidiary corporation.

(e) Certain corporations described in section 501(c)(2). In the case of a title holding corporation described in section 501(c)(2), all of the stock of which was acquired before July 1, 1950, by an organization described in section 501(c)(3), (5), or (6) (and more than one-third of such stock was acquired by such organization by gift or bequest), any indebtedness incurred by such corporation before July 1, 1950, and any indebtedness incurred by such corporation on or after such date in improving real property in accordance with the terms of a lease entered into before such date, shall not be considered an indebtedness described in section 514(g) and in this section with respect to either such section 501(c)(2) corporation or such section 501(c)(3), (5), or (6) organization.

(f) Certain trusts described in section 401(a). In the case of a trust described in section 401(a), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before March 1, 1954, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(g) Business lease on portion of property. Where only a portion of the real property is subject to a business lease, proper allocation of the indebtedness applicable to the whole property must be made to the premises covered by the lease. See example (2) of paragraph (b)(3) of § 1.514(a)–2.

(h) Special rule applicable to trusts described in section 401(a). If an employees' trust described in section 401(a) lends any money to another such employees' trust of the same employer, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust—

(1) Incurs any indebtedness in order to make such loan;

(2) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(3) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

(i) Subsidiary corporations. The provisions of section 514(f), (g), and (h) are applicable whether or not a subsidiary corporation of the type described in section 501(c)(2) is availed of in making the business lease. For example, assume a parent organization borrows funds to purchase realty and sets up a separate section 501(c)(2) corporation as a subsidiary to hold the property. Such subsidiary corporation leases the property for a period of more than 5 years, collects the rents and pays over all of the income, less expenses, to the parent organization, the parent organization being liable for the indebtedness. Under these assumed facts, the lease by section 501(c)(2) subsidiary corporation would be a business lease with respect to such subsidiary corporation, and the rental income would be subject to the tax, whether or not the subsidiary itself assumes the indebtedness and whether or not the property is subject to the indebtedness.

(j) Certain trusts described in section 501(c)(17). (1) In the case of a supplemental unemployment benefit trust described in section 501(c)(17), or in the case of a corporation described in section 501(c)(2) all of the stock of which was acquired before January 1, 1960, by such a trust, any indebtedness incurred by such trust or such corporation before such date, in connection with real property which is leased before such date, and any indebtedness incurred by such trust or such corporation on or after such date necessary to carry out the terms of such lease, shall not be considered as an indebtedness described in section 514(g) and in this section.

(2) If a supplemental unemployment benefit trust described in section 501(c)(17) lends any money to another such supplemental unemployment benefit trust forming part of the same plan, for the purpose of acquiring or improving real property, such loan will not be treated as an indebtedness of the borrowing trust except to the extent that the loaning trust—

(i) Incurs any indebtedness in order to make such loan;

(ii) Incurred indebtedness before the making of such loan which would not have been incurred but for the making of such loan; or

(iii) Incurred indebtedness after the making of such loan which would not have been incurred but for the making of such loan and which was reasonably foreseeable at the time of making such loan.

[T.D. 7229, 37 FR 28155, Dec. 21, 1972]

Farmers' Cooperatives

§ 1.521–1 Farmers' cooperative marketing and purchasing associations; requirements for exemption under section 521.

(a)(1) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, livestock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of either the quantity or the value of the products furnished by them, are exempt from income tax except as otherwise provided in section 522, or part I, subchapter T chapter 1 of the Code, and the regulations thereunder. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of either the quantity or the value of milk or of butterfat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Code that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of either the quantity or the value of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Code does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Code patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association. See, however, paragraph (c)(1) of § 1.1388–1 for the meaning of "payment in money" for purposes of qualifying a written notice of allocation.

(2) An association which has capital stock will not for such reason be denied exemption (i) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (ii) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided

the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends.

(3) The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installation of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 521.

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, livestock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 521 includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (a) of this section relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either paragraph (a) or (b) of this section an association must establish that it has no taxable income for its own account other than that reflected in a reserve or surplus authorized in paragraph (a) of this section. An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Code. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 521 and this section. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 521.

(d) Cooperative organizations engaged in occupations dissimilar from those of farmers, fruit growers, and the like, are not exempt.

(e) An organization is not exempt from taxation under this section merely because it claims that it complies with the requirements prescribed therein. In order to establish its exemption every organization claiming exemption under section 521 is required to file a Form 1028. The Form 1028, executed in accordance with the instructions on the form or issued therewith, should be filed with the district director for the internal revenue district in which is located the principal place of business or principal office of the organization. However, an organization which has been granted exemption under the provisions of the Internal Revenue Code of 1939 or prior law may rely on that ruling, unless affected by substantive changes in the Internal Revenue Code of 1954 or any changes in the character, purposes, or methods of operation of the organization, and it is not necessary in such case for the organization to request a new determination as to its exempt status.

(f) A cooperative association will not be denied exemption merely because it makes payments solely in nonqualified written notices of allocation to those patrons who do not consent as provided in section 1388 and § 1.1388–1, but makes payments of 20 percent in cash and the remainder in qualified written notices of allocation to those patrons who do so consent. Nor will such an association be denied exemption merely because, in the case of patrons who have so consented, payments of less than $5 are made solely in nonqualified written notices of allocation while payments of $5 or more are made in the form of 20 percent in cash and the remainder in qualified written notices of allocation. In addition, a cooperative association will not be denied exemption if it pays a smaller amount of interest or dividends on nonqualified written notices of allocation held by persons who have not consented as provided in section 1388 and § 1.1388–1 (or on per-unit retain certificates issued to patrons who are not qualifying patrons with respect thereto within the meaning of § 1.61–5(d)(2)) than it pays on qualified written notices of allocation held by persons who have so consented (or on per-unit retain certificates issued to patrons who are qualifying patrons with respect thereto) provided that the amount of the interest or dividend reduction is reasonable in relation to

the fact that the association receives no tax benefit with respect to such nonqualified written notices of allocation (or such certificates issued to non-qualifying patrons) until redeemed. However, such an association will be denied exemption if it otherwise treats patrons who have not consented (or are not qualifying patrons) differently from patrons who have consented (or are qualifying patrons), either with regard to the original payment or allocation or with regard to the redemption of written notices of allocation or per-unit retain certificates. For example, if such an association pays patronage dividends in the form of written notices of allocation accompanied by qualified checks, and provides that any patron who does not cash his check within a specified time will forfeit the portion of the patronage dividend represented by such check, then the cooperative association will be denied exemption under this section as it does not treat all patrons alike.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6643, 28 FR 3162, April 2, 1963; T.D. 6855, 30 FR 13135, Oct. 15, 1965]

§ 1.522–1 Tax treatment of farmers' cooperative marketing and purchasing associations exempt under section 521.

(a) In general. (1) Section 522 is applicable to farmers', fruit growers', or like associations organized and operated on a cooperative basis in the manner prescribed in section 521. Although such an association is subject to both normal tax and surtax, as in the case of corporations generally, certain special rules for the computation of taxable income are provided in section 522(b) and § 1.522–2. For the purpose of any law which refers to organizations exempt from income taxes such an association shall, however, be considered as an organization exempt under section 501. Thus, the provisions of section 243, providing a credit for dividends received from a domestic corporation subject to taxation, are not applicable to dividends received from a cooperative association subject to section 522. The provisions of section 1501, relating to consolidated returns, are likewise not applicable.

(2) Rules governing the manner in which amounts allocated as patronage dividends, refunds, or rebates are to be taken into account in computing the taxable income of such an association are set forth in § 1.522–3. For the tax treatment, as to patrons, of amounts received during the taxable year as patronage dividends, rebates, or refunds, see section 61 and § 1.61–5.

(b) Meaning of terms. For purposes of §§ 1.522–1 to 1.522–3, inclusive, §§ 1.6044–1 and 1.61–5, the following terms shall have the meaning ascribed below:

(1) **Cooperative association.** The term "cooperative association" includes any corporation operating on a cooperative basis and allocating amounts to patrons on the basis of the business done with or for such patrons, except that the term does not include any cooperative or nonprofit corporation (including any cooperative or nonprofit corporation engaged in rural electrification) exempt from taxation under section 501(a) and described in section 501(c)(12) or (15) or any corporation subject to a tax imposed by subchapter L, chapter 1 of the Code (relating to insurance companies).

(2) **Patron.** The term "patron" includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

(3) **Allocation.** The term "allocation" includes distributions made by a cooperative association to a patron in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, similar documents, or in any other manner whereby there is disclosed to a patron the dollar amount apportioned on the books of the association for the account of such patron. Thus, a mere credit to the account of a patron on the books of the cooperative association, without disclosure to the patron, is not an allocation.

(4) **Patronage dividends, rebates, and refunds.** The term "patronage dividend, rebate, or refund" includes any amount allocated by a cooperative association, to the account of a patron on the basis of the business done with or for such patron. The following are not patronage dividends, rebates, or refunds:

(i) Amounts distributed in redemption of capital stock, or in redemption or satisfaction of certificates of indebtedness, revolving fund certificates, retain certificates, letters of advice, or other similar documents;

(ii) Amounts allocated (whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the amount of such dividend, refund, or rebate) by the association for

products of members or other patrons to the extent such amounts are fixed without reference to the earnings of the cooperative association. For this purpose, the term "earnings" includes the excess of amounts retained (or assessed) by the association to cover expenses or other items over the amount of such expenses or other items.

(c) Examples. The application of paragraph (b) of this section may be illustrated by the following examples:

Example (1). Cooperative A, a marketing association operating on a pooling basis, receives the products of patron W on January 5, 1954. On the same day Cooperative A advances to W 45 cents per unit for the products so delivered and allocates to him a "retain certificate" having a face value calculated at the rate of 5 cents per unit. During the operation of the pool, and before substantially all the products in the pool are disposed of, Cooperative A advances to W an additional 40 cents per unit, the amount being determined by reference to the market price of the products sold and the anticipated price of the unsold products. At the close of the pool on November 10, 1954, Cooperative A determines the excess of its receipts over the sum of its expenses and its previous advances to patrons, and allocates to W an additional 3 cents per unit and shares of the capital stock of A having an aggregate of face value calculated at the rate of 2 cents per unit.

The amount of patronage dividends, rebates, or refunds allocated to W during 1954 amount to 5 cents per unit, consisting of the aggregate of the following per-unit allocations: The amount of cash distribution (3 cents), and the face value of the capital stock of A (2 cents), which are fixed with reference to the earnings of A. The amount of the two distributions in cash (85 cents) and the face amount of the "retain certificate" (5 cents), which are fixed without reference to the earnings of A, do not constitute patronage dividends, rebates, or refunds.

Example (2). Cooperative B, a marketing association operating on a pooling basis, receives the products of patron X on March 5, 1954. On the same day Cooperative B pays to X $1.00 per unit for such products, this amount being determined by reference to the market price of the product when received, and issues to him a participation certificate having no face value but which entitles X on the close of the pool to the proceeds derived from the sale of his products less the previous payment of $1.00 and the expenses and other charges attributable to such products. On March 5, 1957, Cooperative B, having sold the products in the pool, having deducted the previous payments for such products, and having determined the expenses and other charges of the pool, redeems the participation certificate of X in cash for 10 cents per unit. The allocation made to X during 1957, amounting to 10 cents per unit, is a patronage dividend, rebate, or refund. Neither the payment to X in 1954 of $1.00 nor the issuance to him of the participation certificate in that year constitutes a patronage dividend, rebate, or refund within the meaning of this section.

Example (3). Cooperative C, a purchasing association, obtains supplies for patron Y on May 1, 1954, and receives in return therefor $100. On February 1, 1955, Cooperative C, having determined the excess of its receipts over its costs and expenses, allocates to Y a cash distribution of $1.00 and a revolving fund certificate of a face amount of $1.00. The amount of patronage dividends, rebates, or refunds allocated to Y for 1955 is $2.00, the aggregate of the cash distribution of $1.00, and the face amount, $1.00, of the revolving fund certificate.

Example (4). Cooperative D, a service association, sells the products of members on a fee basis. It receives the products of patron Z under an agreement not to pool his products with those of other members, to sell his products, and to deliver to him the proceeds of the sale. Patron Z makes payments to Cooperative D during 1954 aggregating $75 for service rendered him by Cooperative D during that year. On May 15, 1955, Cooperative D, having determined the excess of its receipts over its costs and expenses, allocates to Z a cash distribution of $2.00. Such amount is a patronage dividend, rebate, or refund allocated by Cooperative D during 1955.

(d) Returns of exempt cooperative associations. For requirements of annual returns by exempt cooperative associations, see sections 6012 and 6072(d) and paragraph (f) of § 1.6012–2.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.522–2 Manner of taxation of cooperative associations subject to section 522.

(a) In general. Farmers', fruit growers', or like associations, organized and operated in compliance with the requirements of section 521 and § 1.521–1 shall be subject to the taxes imposed by section 11 or section 1201, except that there shall be allowed as deductions from gross income, in addition to the other deductions allowable under chapter 1 of the Code, certain special deductions provided in section 522(b)(1)(A) and paragraph (c) of this section, and section 522(b)(1)(B) and paragraph (d) of this section. Amounts allocated as patronage dividends, refunds, or rebates, whether in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated, with respect to patronage for the taxable year or for preceding taxable years, shall be taken into account in the manner provided in section 522 and in § 1.522–3.

(b) Cooperative association exempt from tax before January 1, 1952. (1) For the purpose of determining the method of accounting under section 446 in the case of a cooperative association which was exempt from tax for taxable years beginning prior to January 1, 1952, the method of accounting, recognized under sections 41, 42, and 43 of the Internal Revenue Code of 1939 and the regulations prescribed thereunder and utilized in the return of such association for its last taxable year to which the Internal Revenue Code of 1939 was applicable, shall be deemed to constitute the method of accounting regularly employed by the cooperative association. Any change from this method may be made only if permission is obtained from the Commissioner to change to another recognized method in accordance with section 446 and the regulations thereunder.

(2) In any case where inventories are an income-producing factor, see sections 471 and 472 and the regulations thereunder. The elective method of inventorying goods provided in section 472 may be adopted by the cooperative association for any taxable year beginning after December 31, 1953, in accordance with the requirements of section 472 and the regulations thereunder. However, in order to use such method for such a taxable year the cooperative association (unless it has used such method for a taxable year beginning after 1951 and before 1954) pursuant to an election exercised as provided in 26 CFR (1939) 39.-22(d)–3 (Regulations 118) must exercise the election provided in section 472 and the regulations thereunder, even if it may have utilized such method for accounting purposes for taxable years beginning before January 1, 1952.

(3) The following rules shall be applicable in computing the net operating loss deduction provided in section 172: No net operating loss carryover shall be allowed from a taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. In the case of a taxable year beginning prior to January 1, 1952, for which the association was not exempt under section 101(12) of the Internal Revenue Code of 1939 and of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning prior to January 1, 1952, for which the association was exempt from tax under section 101(12) of the Internal Revenue Code of 1939. However, any taxable year beginning prior to January 1, 1952, for which the cooperative association was exempt under section 101(12) of the Internal Revenue Code of 1939 shall be taken into account in determining the period for which a net operating loss may be carried back or carried over, as the case may be.

(4) The adjustments to the cost or other basis provided in sections 1011 and 1016 and the regulations thereunder, are applicable for the entire period since the acquisition of the property. Thus, proper adjustment to basis must be made under section 1016 for depreciation, obsolescence, amortization, and depletion for all taxable years beginning prior to January 1, 1952, although the cooperative association was exempt from tax under section 521 or corresponding provisions of prior law for such years. However, no adjustment for percentage or discovery depletion is to be made for any year during which the association was exempt from tax. If a cooperative association has made a proper election in accordance with section 1020 and the regulations prescribed thereunder with respect to a taxable year beginning before 1952 in which the association was not exempt from tax, the adjustment to basis for depreciation for such years shall be limited in accordance with the provisions of section 1016(a)(2).

(5) In the case of tax exempt and partially taxable bonds purchased at a premium and subject to amortization under section 171, proper adjustment to basis must be made to reflect amortization with respect to such premium from the date of acquisition of the bond. (For principles governing the method of computation, see the example in paragraph (b) of § 1.1016–9, relating to mutual savings banks, building and loan associations, and cooperative banks.) The basis of a fully taxable bond purchased at a premium shall be adjusted from the date of the election to amortize such premium in accordance with the provisions of section 171 except that no adjustment shall be allowable for such portion of the premium attributable to the period prior to the election.

(6) In the case of a mortgage acquired at a premium where the principal of such mortgage is payable in installments, adjustments to the basis for the premium must be made for all taxable years (whether or not the association was exempt from tax under section 521 during such years) in which installment payments are received. Such adjustments may be made on an individual mortgage basis or on a composite basis by reference to the average period of payments of the mortgage loans of such association. For the purpose of this adjustment, the term "premium" includes the excess of the acquisition value of the mortgage over its maturity value. The acquisition value of the mortgage is the cost including buying commissions, attorneys' fees or brokerage fees, but such value does not include amounts paid for accrued interest.

(c) **Deduction for dividends paid.** There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1, amounts paid as dividends during the taxable year upon the capital stock of the cooperative association. For the purpose of the preceding sentence, the term "capital stock" includes common stock (whether voting or nonvoting), preferred stock, or any other form of capital represented by capital retain certificates, revolving fund certificates, letters of advice, or other evidence of a

proprietary interest in a cooperative association. Such deduction is applicable only to the taxable year in which the dividends are actually or constructively paid to the holder of capital stock or other proprietary interest of the cooperative association. If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mail, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by such holder within the taxable year, a presumption arises that the dividend was paid to such holder in such year. The determination of whether a dividend has been paid to such holder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books. For further rules as to the determination of the right to a deduction for dividends paid, under certain specific circumstances, see section 561 and the regulations thereunder.

(d) **Deduction for amounts allocated from income not derived from patronage.** There is allowable as a deduction from the gross income of a cooperative association operated in compliance with the requirements of section 521 and § 1.521–1 amounts allocated during the taxable year to patrons with respect to its income not derived from patronage (whether or not such income was derived during such taxable year) whether such amounts are paid in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or in some other manner that discloses to each patron the dollar amount allocated to him. For this purpose, allocations made after the close of the taxable year and on or before the 15th day of the ninth month following the close of the taxable year shall be considered as made on the last day of such taxable year to the extent that such allocations are attributable to income derived during the taxable year or during years prior to the taxable year. As used in this paragraph, the term "income not derived from patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, from the sale or exchange of capital assets, constitutes income not derived from patronage. Business done with the United States shall constitute income not derived from patronage. In order that the deduction for income not derived from patronage may be applicable, it is necessary that the amount sought to be deducted be allocated on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. Thus, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be allocated to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period of more than one taxable year income realized from such gains must be allocated, in proportion insofar as is practicable, to the patrons of the taxable years during which the asset was owned by the association, and to the amount of business done by such patrons during such taxable years.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.522–3 Patronage dividends, rebates, or refunds; treatment as to cooperative associations entitled to tax treatment under section 522.

(a) **General rule.** Patronage dividends, refunds, or rebates, allocated by a cooperative association entitled to tax treatment under section 522 to a patron shall be taken into account in computing the gross income of such association for the taxable year, as an increase in its other cost of goods sold in the case of an association marketing products for patrons, or as a reduction in its gross receipts, in the case of an association purchasing supplies and equipment or performing services for patrons, as the case may be, if:

(1) The allocation is made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated, and

(2) The allocation is made on or before the 15th day of the ninth month following the close of the taxable year in which the amounts allocated were received by the cooperative association.

For the purpose of subparagraph (1) of this paragraph, amounts allocated by a cooperative association entitled to tax treatment under section 522 will be deemed allocated in fulfillment and satisfaction of a valid enforceable obligation, if made pursuant to provisions of the bylaws, articles of incorporation, or other contract, whereby the association is obligated to make such allocation after the retention of "reasonable reserves" and after

payment of dividends on capital stock or other proprietary capital interests. Notwithstanding the provisions of subparagraphs (1) and (2) of this paragraph, amounts allocated as patronage dividends, refunds, or rebates during the taxable year, on or before the 15th day of the ninth month following the close of such year, with respect to patronage for years preceding the taxable year, shall be taken into account as an increase in its other cost of goods sold, or as a reduction in gross receipts, for the taxable year, as the case may be, where retention as "reasonable reserves" of the amounts so allocated beyond the year in which earned was proper in accordance with the provisions of section 521 and where the allocation is made to the patron on a patronage basis is proportion insofar as is practicable, to the amount of business done by such patrons during the taxable year or years in which the retained amounts were received by the cooperative association.

(b) Examples. This section may be illustrated by the following examples:

Example (1). E, a cooperative association entitled to tax treatment under section 522, organized without capital stock, is engaged in the business of marketing products for its patrons on a non-pool basis. The by-laws of Cooperative E provide that there shall be allocated to patrons as patronage dividends within a reasonable time following the close of the year all of the gross returns from sales, less expenses of operation for the year and amounts retained as "reasonable reserves" necessary to the operation of Cooperative E. At the close of the taxable year, 1954, it is determined that from the gross returns from sales less operating expenses and all taxes for such year, $5,000 is to be retained as "reasonable reserves" for various necessary purposes of Cooperative E. It is assumed that the retention of such amount is proper in accordance with the provisions of section 521. Such $5,000 is apportioned on the books of Cooperative E to patrons of 1954 on a patronage basis, or permanent records are kept from which an apportionment to such patrons can be made. On March 1, 1955, pursuant to the terms of the by-laws, $200,000, the balance of the gross returns for the taxable year, is allocated to patrons of 1954 on the basis of patronage. $100,000 of such $200,000 is allocated in cash. The remaining $100,000 is allocated in "retain certificates", bearing no interest and redeemable in the discretion of the Board of Directors of Cooperative E. There may be added to the cost of goods sold by Cooperative E for 1954, $200,000 ($100,000 in cash, $100,000 in retain certificates), the total amount allocated as patronage dividends, rebates, or refunds in fulfillment and satisfaction of the obligation of the by-laws, on March 1, 1955, before the 15th day of the ninth month following the close of 1954. There may not be added to the cost of goods sold by Cooperative E for 1954, $5,000, the amount retained as reserves apportioned on the books, but not allocated as patronage dividends, rebates, or refunds.

Example (2). The facts are the same as example (1), it additionally appearing that at the close of 1955 it is determined by Cooperative E to allocate as cash patronage dividends, rebates, or refunds to patrons of 1954, $5,000, the amount retained as "reasonable reserves" for 1954 in accordance with the provisions of section 521. On March 1, 1956, such amount is allocated. There may be added to the cost of goods sold by Cooperative E for 1955, $5,000, the amount allocated with respect to patronage of a preceding year, 1954, properly maintained as a reserve under section 521.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.522–4 Taxable years affected.

Section 522 and §§ 1.522–1, 1.522–2, and 1.522–3, are applicable to taxable years beginning before January 1, 1963, and also to amounts paid during taxable years beginning after December 31, 1962, the tax treatment of which is not prescribed in section 1382 and the regulations thereunder. [T.D. 6643, 28 FR 3163, April 2, 1963]

§ 1.527–1 Political organizations; Generally.

Section 527 provides that a political organization is considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes. A political organization is subject to tax only to the extent provided in section 527. In general, a political organization is an organization that is organized and operated primarily for an exempt function as defined in § 1.527–2(c). Section 527 provides that a political organization is taxed on its political organization taxable income (see § 1.527–4) which, in general, does not include the exempt function income (see § 1.527–3) of the political organization. Furthermore, section 527 provides that an exempt organization, other than a political organization, may be subject to tax under section 527 when it expends an amount for an exempt function, see § 1.527–6. The taxation of newsletter funds is provided under section 527(g) and § 1.527–7. A special rule for principal campaign committees is provided under section 527(h) and § 1.527–9.

[T.D. 7744, 45 FR 85731, Dec. 30, 1980; T.D. 8041, 50 FR 30817, July 30, 1985]

§ 1.527–2 Definitions.

For purposes of section 527 and these regulations—

(a) Political organization—(1) In general. A "political organization" is a party, committee, association, fund, or other organization (whether or not incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures for an exempt function activity (as defined in paragraph (c) of this section). Accordingly, a political organization may include a committee or other group which accepts contributions or makes expenditures for the purpose of promoting the nomination of an individual for an elective public office in a primary

election, or in a meeting or caucus of a political party. A segregated fund (as defined in paragraph (b) of this section) established and maintained by an individual may qualify as a political organization.

(2) **Organizational test.** A political organization meets the organizational test if its articles of organization provide that the primary purpose of the organization is to carry on one or more exempt functions. A political organization is not required to be formally chartered or established as a corporation, trust, or association. If an organization has no formal articles of organization, consideration is given to statements of the members of the organization at the time the organization is formed that they intend to operate the organization primarily to carry on one or more exempt functions.

(3) **Operational test.** A political organization does not have to engage exclusively in activities that are an exempt function. For example, a political organization may—

(i) Sponsor nonpartisan educational workshops which are not intended to influence or attempt to influence the selection, nomination, election, or appointment of any individual for public office,

(ii) Pay an incumbent's office expenses, or

(iii) Carry on social activities which are unrelated to its exempt function,

provided these are not the organization's primary activities. However, expenditures for purposes described in the preceding sentence are not for an exempt function. See § 1.527–2(c) and (d). Furthermore, it is not necessary that a political organization operate in accordance with normal corporate formalities as ordinarily established in bylaws or under state law.

(b) **Segregated fund—(1) General rule.** A "segregated fund" is a fund which is established and maintained by a political organization or an individual separate from the assets of the organization or the personal assets of the individual. The purpose of such a fund must be to receive and segregate exempt function income (and earnings on such income) for use only for an exempt function or for an activity necessary to fulfill an exempt function. Accordingly, the amounts in the fund must be dedicated for use only for an exempt function. Thus, expenditures for the establishment or administration of a political organization or the solicitation of political contributions may be made from the segregated fund, if necessary to fulfill an exempt function. The fund must be clearly identified and established for the purposes intended. A savings or checking account into which only contributions to the political organization are placed and from which only expenditures for exempt functions are made may be a segregated fund. If an organization that had designated a fund to be a segregated fund for purposes of segregating amounts referred to in section 527(c)(3)(A) through (D), expends more than an insubstantial amount from the segregated fund for activities that are not for an exempt function during a taxable year, the fund will not be treated as a segregated fund for such year. In such a case amounts referred to in section 527(c)(3)(A)–(D), segregated in such fund will not be exempt function income. Further, if more than insubstantial amounts segregated for an exempt function in prior years are expended for other than an exempt function the facts and circumstances may indicate that the fund was never a segregated fund as defined in this paragraph.

(2) **Record keeping.** The organization or individual maintaining a segregated fund must keep records that are adequate to verify receipts and disbursements of the fund and identify the exempt function activity for which each expenditure is made.

(c) **Exempt function—(1) Directly related expenses.** An "exempt function", as defined in section 527(e)(2), includes all activities that are directly related to and support the process of influencing or attempting to influence the selection, nomination, election, or appointment of any individual to public office or office in a political organization (the selection process). Whether an expenditure is for an exempt function depends upon all the facts and circumstances. Generally, where an organization supports an individual's campaign for public office, the organization's activities and expenditures in furtherance of the individual's election or appointment to that office are for an exempt function of the organization. The individual does not have to be an announced candidate for the office. Furthermore, the fact that an individual never becomes a candidate is not crucial in determining whether an organization is engaging in an exempt function. An activity engaged in between elections which is directly related to, and supports, the process of selection, nomination, or election of an individual in the next applicable political campaign is an exempt function activity.

(2) **Indirect expenses.** Expenditures that are not directly related to influencing or attempting to influence the selection process may also be an expenditure for an exempt function by a political

organization. These are expenses which are necessary to support the directly related activities of the political organization. Activities which support the directly related activities are those which must be engaged in to allow the political organization to carry out the activity of influencing or attempting to influence the selection process. For example, expenses for overhead and record keeping are necessary to allow the political organization to be established and to engage in political activities. Similarly, expenses incurred in soliciting contributions to the political organization are necessary to support the activities of the political organization.

(3) **Terminating activities.** An exempt function includes an activity which is in furtherance of the process of terminating a political organization's existence. For example, where a political organization is established for a single campaign, payment of campaign debts after the conclusion of the campaign is an exempt function activity.

(4) **Illegal expenditures.** Expenditures which are illegal or are for a judicially determined illegal activity are not considered expenditures in furtherance of an exempt function, even though such expenditures are made in connection with the selection process.

(5) **Examples.** The following examples illustrate the principles of paragraph (c) of this section. The term "exempt function" when used in the following examples means exempt function within the meaning of section 527(e)(2).

(i) **Example (1).** A wants to run for election to public office in State X. A is not a candidate. A travels throughout X in order to rally support for A's intended candidacy. While in X, A attends a convention of an organization for the purpose of attempting to solicit its support. The amount expended for travel, lodging, food, and similar expenses are for an exempt function.

(ii) **Example (2).** B, a member of the United States House of Representatives, is a candidate for reelection. B travels with B's spouse to the district B represents. B feels it is important for B's reelection that B's spouse accompany B. While in the district, B makes speeches and appearances for the purpose of persuading voters to reelect B. The travel expenses of B and B's spouse are for an exempt function.

(iii) **Example (3).** C is a candidate for public office. In connection with C's campaign, C takes voice and speech lessons to improve C's skills. The expenses for these lessons are for an exempt function.

(iv) **Example (4).** D, an officeholder and candidate for reelection, purchases tickets to a testimonial dinner. D's attendance at the dinner is intended to aid D's reelection. Such expenditures are for an exempt function.

(v) **Example (5).** E, an officeholder, expends amounts for periodicals of general circulation in order to keep informed on national and local issues. Such expenditures are not for an exempt function.

(vi) **Example (6).** N is an organization described in section 501(c) and is exempt from taxation under section 501(a). F is employed as president of N. F, as a representative of N, testifies in response to a written request from a Congressional committee in support of the confirmation of an individual to a cabinet position. The expenditures by N that are directly related to F's testimony are not for an exempt function.

(vii) **Example (7).** P is a political organization described in section 527(e)(2). Between elections P does not support any particular individual for public office. However, P does train staff members for the next election, drafts party rules, implements party reform proposals, and sponsors a party convention. The expenditures for these activities are for an exempt function.

(viii) **Example (8).** Q is a political organization described in section 527(e)(2). Q finances seminars and conferences which are intended to influence persons who attend to support individuals to public office whose political philosophy is in harmony with the political philosophy of Q. The expenditures for these activities are for an exempt function.

(d) **Public office.** The facts and circumstances of each case will determine whether a particular Federal, State, or local office is a "public office." Principles consistent with those found under § 53.4946-1(g)(2) (relating to the definition of public office) will be applied.

(e) **Principal campaign committee.** A "principal campaign committee" is the political committee designated by a candidate for Congress as his or her principal campaign committee for purposes of section 302(e) of the Federal Election Campaign Act of 1971 (2 U.S.C. section 432(e)), as amended, and section 527(h) and § 1.527-9.

[T.D. 7744, 45 FR 85731, Dec. 30, 1980; as amended by T.D. 8041, 50 FR 30817, July 30, 1985]

§ 1.527-3 Exempt function income.

(a) **General rule**—(1) For purposes of section 527, exempt function income consists solely of amounts received as—

(i) Contributions of money or other property,

(ii) Membership dues, fees, or assessments from a member of a political organization, or

(iii) Proceeds from a political fund raising or entertainment event, or proceeds from the sale of political campaign materials, which are not received in the ordinary course of any trade or business,

but only to the extent such income is segregated for use only for exempt functions of the political organization.

(2) Income will be considered segregated for use only for an exempt function only if it is received into and disbursed from a segregated fund as defined in § 1.527-2(b).

(b) Contributions. The rules of section 271(b)(2) apply in determining whether the transfer of money or other property constitutes a contribution. Generally, money or other property, whether solicited personally, by mail, or through advertising, qualifies as a contribution. In addition, to the extent a political organization receives Federal, State, or local funds under the $1 "check-off" provision (sections 9001–9013), or any other provision for financing of campaigns, such amounts are to be treated as contributions.

(c) Dues, fees, and assessments. Amounts received as membership fees and assessments from members of a political organization may constitute exempt function income to the political organization. Membership fees and assessments received in consideration for services, goods, or other items of value do not constitute exempt function income. However, filing fees paid by an individual directly or indirectly to a political party in order that the individual may run as a candidate in a primary election of the party (or run in a general election as a candidate of that party) are to be treated as exempt function income. For example, some States provide that a certain percentage of the first year's salary of the office sought must be paid to the State as a filing (or "qualifying") fee and party assessment. The State then transfers part of this fee to the candidate's party. In such a case, the entire amount transferred to the party is to be treated as exempt function income. Furthermore, amounts paid by an individual directly to the party as a qualification fee are treated similarly.

(d) Fund raising events—(1) In general. Amounts received from fund raising and entertainment events are eligible for treatment as exempt function income if the events are political in nature and not carried on in the ordinary course of a trade or business. Whether an event is "political" in nature depends on all facts and circumstances. One factor that indicates an event is a political event is the extent to which the event is related to a political activity aside from the need of the organization for income or funds. For example, an event that is intended to rally and encourage support for an individual for public office would be a political fund raising event. Examples of political events can include dinners, breakfasts, receptions, picnics, dances, and athletic exhibitions.

(2) Ordinary course of any trade or business. Whether an activity is in the ordinary course of a trade or business depends on the facts and circumstances of each case. Generally, proceeds from casual, sporadic fund raising or entertainment events are not in the ordinary course of a trade or business. Factors to be taken into account in determining whether an activity is a trade or business include the frequency of the activity, the manner in which the activity is conducted, and the span of time over which the activity is carried on.

(e) Sale of campaign materials. Amounts received from the sale of campaign materials are eligible for treatment as exempt function income if the sale is not carried on in the ordinary course of a trade or business (as defined in paragraph (d)(2) of this section), and is related to a political activity of the organization aside from the need of such organization for income or funds. Proceeds from the sale of political memorabilia, bumper stickers, campaign buttons, hats, shirts, political posters, stationery, jewelry, or cookbooks are related to such a political activity where such items can be identified as relating to distributing political literature or organizing voters to vote for a candidate for public office.

[T.D. 7744, 45 FR 85732, Dec. 30, 1980]

§ 1.527–4 Special rules for computation of political organization taxable income.

(a) In general. Political organization taxable income is determined according to the provisions of section 527(b) and the rules set forth in this section.

(b) Limitation on capital losses. If for any taxable year a political organization has a net capital loss, the rules of sections 1211(a) and 1212(a) apply.

(c) Allowable deductions—(1) In general. To be deductible in computing political organization taxable income, expenses, depreciation, and similar items must not only qualify as deductions allowed by chapter 1 of the Code, but must also be directly connected with the production of political organization taxable income.

(2) "Directly connected with" defined. To be "directly connected with" the production of political organization taxable income, an item of deduction must have a proximate and primary relationship to the production of such income and have been incurred in the production of such income. Items of deduction attributable solely to items of political organization taxable income are proximately and primarily related to such income. Whether an item of deduction is incurred in the production of political organization taxable income is determined on the basis of all the facts and circumstances of each case.

(3) Dual use of facilities or personnel. Expenses, depreciation, and similar items that are attributable to the production of exempt function income and political organization taxable income shall be allocated between the two on a reasonable and consistent basis. For example, where facilities are used both for an exempt function of the organization and for the production of political organization taxable income, expenses, depreciation, and similar items attributable to such facilities (for example, items of overhead) shall be allocated between the two uses of a reasonable and consistent basis. Similarly, where personnel are employed both for an exempt function and for the production of political organization taxable income, expenses and similar items attributable to such personnel (for example, items of salary) shall be allocated between the activities on a reasonable and consistent basis. The portion of any such item so allocated to the production of political organization taxable income is directly connected with such income and is allowable as a deduction in computing political organization taxable income to the extent that it qualifies as an item of deduction allowed by chapter 1 of the Code. Thus, for example, assume that X, a political organization, pays its manager a salary of $10,000 a year and that it derives political organization taxable income. If 10 percent of the manager's time during the year is devoted to deriving X's gross income (other than exempt function income), a deduction of $1,000 (10 percent of $10,000) would generally be allowable for purposes of computing X's political organization taxable income.

[T.D. 7744, 45 FR 85733, Dec. 30, 1980]

§ 1.527–5 Activities resulting in gross income to an individual or political organization.

(a) In general—(1) General rule. Amounts expended by a political organization for an exempt function are not income to the individual or individuals on whose behalf such expenditures are made. However, where a political organization expends any other amount for the personal use of any individual, the individual on whose behalf the amount is expended will be in receipt of income. Amounts are expended for the personal use of an individual where a direct or indirect financial benefit accrues to such individual. For example, if a political organization pays a personal legal obligation of a candidate for public office, such as the candidate's federal income tax liability, the amount paid is includible in such candidate's gross income. Similarly, if a political organization expends any amount of its exempt function income for other than an exempt function, and the expenditure results in a direct or indirect financial benefit to the political organization, it must include the amount of such expenditure in its gross income. For example, if a political organization expends exempt function income for making an improvement or addition to its facilities, or for equipment, which is not necessary for or used in carrying out an exempt function, the amount of the expenditure will be included in the political organization's gross income. However, if a political organization expends exempt function income to make ordinary and necessary repairs on the facilities the political organization uses in conducting its exempt function, such amounts will not be included in the political organization's gross income.

(2) Expenditure for an illegal activity. Expenditures by a political organization that are illegal or for an activity that is judicially determined to be illegal are treated as amounts not segregated for use only for the exempt function and shall be included in the political organization's taxable income. However, expenses incurred in defense of civil or criminal suits against the organization are not treated as taxable to the organization. Similarly, voluntary reimbursement to the participants in the illegal activity for similar expenses incurred by them are not taxable to the organization if the organization can demonstrate that such payments do not constitute a part of the inducement to engage in the illegal activity or part of the agreed upon compensation therefor. However, if the organization entered into an agreement with the participants to defray such expenses as part of the inducement, such payments would be treated as an expenditure for an illegal activity. Except where necessary to prevent the period of limitation for assessment and collection of a tax from expiring, a notice of deficiency will not generally be issued until after there has been a final determination of illegality by an appropriate court in a criminal proceeding.

(b) Certain uses not treated as income to a candidate. Except as otherwise provided in paragraph (a) of this section, if a political organization—

(1) Contributes any amount to or for the use of any political organization described in section 527(e)(1) or newsletter fund described in section 527(g),

(2) Contributes any amount to or for the use of any organization described in paragraph (1) and

(2) of section 509(a) which is exempt from taxation under section 501(a), or

(3) Deposits any amount in the general fund of the U.S. Treasury or in the general fund of any State or local government,

such amount shall not be treated as an amount expended for the personal use of a candidate or other person. No deduction shall be allowed under the Internal Revenue Code of 1954 for the contribution or deposit described in the preceding sentence.

(c) Excess funds—(1) General rule. Generally, funds controlled by a political organization or other person after a campaign or election are excess funds and are treated as expended for the personal use of the person having control over the ultimate use of such funds. However, such funds will not be treated as excess funds to the extent they are—

(i) Transferred within a reasonable period of time by the person controlling the funds in accordance with paragraph (b) of this section, or

(ii) Held in reasonable anticipation of being used by the political organization for future exempt functions.

(2) Excess funds transferred at death. Where excess funds are held by an individual who dies, and these funds go to the individual's estate or any other person (other than an organization or fund described in paragraph (b) of this section), the funds are income of the decedent and will be included in the decedent's gross estate unless the estate or other person receiving such funds transfers the funds within a reasonable period of time in accordance with paragraph (b) of this section.

This paragraph (c)(2) will not apply where the individual who dies provides that the funds be transferred to an organization or fund described in paragraph (b) of this section.

[T.D. 7744, 45 FR 85733, Dec. 30, 1980]

§ 1.527–6 Inclusion of certain amounts in the gross income of an exempt organization which is not a political organization.

(a) Exempt organizations—General rule. If an organization described in section 501(c) which is exempt from tax under section 501(a) expends any amount for an exempt function, it may be subject to tax. There is included in the gross income of such organization for the taxable year an amount equal to the lesser of—

(1) The net investment income of such organization for the taxable year, or

(2) The aggregate amount expended during the taxable year for an exempt function.

The amount included will be treated as political organization taxable income.

(b) Exempt function expenditures—(1) Directly related expenses. (i) Except as provided in this section, the term "exempt function" will generally have the same meaning it has in § 1.527–2(c). Thus, expenditures which are directly related to the selection process as defined in § 1.527–2(c)(1) are expenditures for an exempt function. Expenditures for indirect expenses as defined in § 1.527–2(c)(2), when made by a section 501(c) organization are for an exempt function only to the extent provided in paragraph (b)(2) of this section. Expenditures of a section 501(c) organization which are otherwise allowable under the Federal Election Campaign Act or similar State statute are for an exempt function only to the extent provided in paragraph (b)(3) of this section.

(ii) An expenditure may be made for an exempt function directly or through another organization. A section 501(c) organization will not be absolutely liable under section 527(f)(1) for amounts transferred to an individual or organization. A section 501(c) organization is, however, required to take reasonable steps to ensure that the transferee does not use such amounts for an exempt function.

(2) Indirect expenses. [Reserved].

(3) Expenditures allowed by Federal Election Campaign Act. [Reserved].

(4) Appointments or confirmations. Where an organization described in paragraph (a) of this section appears before any legislative body in response to a written request by such body for the purpose of influencing the appointment or confirmation of an individual to a public office, any expenditure directly related to such appearance is not treated as an expenditure for an exempt function.

(5) Nonpartisan activity. Expenditures for nonpartisan activities by an organization to which paragraph (a) of this section applies are not expenditures for an exempt function. Nonpartisan activities include voter registration and "get-out-the-vote" campaigns. To be nonpartisan voter registration and "get-out-the-vote" campaigns must not be specifically identified by the organization with any candidate or political party.

(c) Character of items included in gross income—(1) General rule. The items of income included in the gross income of an organization under paragraph (a) of this section retain their character as ordinary income or capital gain.

(2) Special rule in determining character of item. If the amount included in gross income is determined under paragraph (a)(2)(ii) of this section, the character of the items of income is determined by multiplying the total amount included in gross income under such paragraph by a fraction, the numerator of which is the portion of the organization's net investment income that is gain from the sale or exchange of a capital asset, and the denominator of which is the organization's net investment income. For example, if $5,000 is included in the gross income of an organization under paragraph (a)(2) of this section, and the organization had $100,000 of net investment income of which $10,000 is long term capital gain, then $500 would be treated as long term capital gain:

$$\frac{\text{Capital gain}}{\text{net investment income}} \times \text{Amount expended on an exempt function} = \text{Portion of income subject to tax under section 1201}$$

$$\frac{\$10{,}000}{\$100{,}000} \times \$5{,}000 = \$500$$

(d) Modifications. The modifications described in section 527(c)(2) apply in computing the tax under paragraph (a)(2) of this section. Thus, no net operating loss is allowed under section 172 nor is any deduction allowed under part VIII of subchapter B. However, there is allowed a specific deduction of $100.

(e) Transfer not treated as exempt function expenditures. Provided the provisions of this paragraph (e) are met, a transfer of political contributions or dues collected by a section 501(c) organization to a separate segregated fund as defined in paragraph (f) of this section is not treated as an expenditure for an exempt function (within the meaning of § 1.527-2(c)). Such transfers must be made promptly after the receipt of such amounts by the section 501(c) organization, and must be made directly to the separate segregated fund. A transfer is considered promptly and directly made if:

(1) The procedures followed by the section 501(c) organization satisfy the requirements of applicable Federal or State campaign law and regulations;

(2) The section 501(c) organization maintains adequate records to demonstrate that amounts transferred in fact consist of political contributions or dues, rather than investment income; and

(3) The political contributions or dues transferred were not used to earn investment income for the section 501(c) organization.

(f) Separate segregated fund. An organization or fund described in section 527(f)(3) is a separate segregated fund. To avoid the application of paragraph (a) of this section, an organization described in section 501(c) that is exempt from taxation under section 501(a) may, if it is consistent with its exempt status, establish and maintain such a separate segregated fund to receive contributions and make expenditures in a political campaign. If such a fund meets the requirements of § 1.527-2(a) (relating to the definition of a political organization), it shall be treated as a political organization subject to the provisions of section 527. A segregated fund established under the Federal Election Campaign Act will continue to be treated as a segregated fund when it engages in exempt function activities as defined in § 1.527-2(c), relating to State campaigns.

(g) Effect of expenditures on exempt status. Section 527(f) and this section do not sanction the intervention in any political campaign by an organization described in section 501(c) if such activity is inconsistent with its exempt status under section 501(c). For example, an organization described in section 501(c)(3) is precluded from engaging in any political campaign activities. The fact that section 527 imposes a tax on the exempt function (as defined in § 1.527-2(c)) expenditures of section 501(c) organizations and permits such organizations to establish separate segregated funds to engage in campaign activities does not sanction the participation in these activities by section 501(c)(3) organizations.

[T.D. 7744, 45 FR 85734, Dec. 30, 1980]

§ 1.527-7 Newsletter funds.

(a) In general. For purposes of this section, a fund established and maintained by an individual who holds, has been elected to, or is a candidate (within the meaning of section 41(c)(2)) for nomination or election to, any Federal, State, or local elective public office for the use by such individual exclusively for an exempt function, as defined in paragraph (c) of this section, shall be a newsletter fund. If assets of a newsletter fund are used for any purpose other than the exempt function of the newsletter fund as defined in paragraph (c) of this section, such amount shall be treated as expended for the personal use of the individual who estab-

lished and maintained such fund. In addition, future contributions to such fund are treated as income to the individual who established and maintained the fund. In such a case, the facts and circumstances may indicate that the fund was never established and maintained exclusively for an exempt function as defined in paragraph (c) of this section.

(b) **Determination of taxable income.** A newsletter fund shall be treated as if it were a political organization for purposes of determining its taxable income. However, the specific $100 deduction provided by section 527(c)(2)(A) shall not be allowed.

(c) **Exempt function.** For purposes of this section, the exempt function of a newsletter fund consists solely of the preparation and circulation of the newsletter. Among the expenditures treated as preparation and circulation expenditures of the newsletter are—

(1) Secretarial services,

(2) Printing,

(3) Addressing, and

(4) Mailing.

(d) **Nonexempt function purposes.** Newsletter fund assets may not be used for campaign activities. Therefore, an exempt function of a newsletter fund does not include—

(1) Expenditures for an exempt function as defined in § 1.527–2(c) or

(2) Transfers of unexpended amounts to a political organization described in section 527(e)(1).

(e) **Excess funds.** Excess funds held by a newsletter fund which has ceased to engage in the preparation and circulation of the newsletter are treated as expended for the personal use of the individual who established and maintained such fund. However, to the extent such excess funds are within a reasonable period of time—

(1) Contributed to or for the use of any organization described in paragraph (1) or (2) of section 509(a) which is exempt from taxation under section 501(a),

(2) Deposited in the general fund of the U.S. Treasury or in the general fund of any State or local government (including the District of Columbia), or

(3) Contributed to any other newsletter fund as described in paragraph (a) of this section,

the excess funds are not treated as expended for the personal use of such individual. In such a case the individual is not allowed a deduction under the Internal Revenue Code of 1954 for such contribution or deposit.

[T.D. 7744, 45 FR 85735, Dec. 30, 1980]

§ 1.527–8 Effective date; filing requirements; and miscellaneous provisions.

(a) **Assessment and collections.** Since the taxes imposed by section 527 are taxes imposed by subtitle A of the Code, all provisions of law and of the regulations applicable to the taxes imposed by subtitle A are applicable to the assessment and collection of the taxes imposed by section 527. Organizations subject to the tax imposed by section 527 are subject to the same provisions, including penalties, as are provided for corporations, in general, except that the requirements of section 6154 concerning the payment of estimated tax do not apply. See, generally, sections 6151, et seq., and the regulations prescribed thereunder, for provisions relating to payment of tax.

(b) **Returns.** For requirements of filing annual returns with respect to political organization taxable income, see section 6012(a)(6) and the applicable regulations.

(c) **Taxable years, method of accounting, etc.** The taxable year (fiscal year or calendar year, as the case may be) of a political organization is determined without regard to the fact that such organization may have been exempt from tax during any prior period. See sections 441 and 446, and the regulations thereunder in this part, and section 7701 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration). Similarly, in computing political organization taxable income, the determination of the taxable year for which an item of income or expense is taken into account is made under the provisions of sections 441, 446, 451, 461, and the regulations thereunder, whether or not the item arose during a taxable year beginning before, on, or after the effective date of the provisions imposing a tax upon political organization taxable income. If a method for treating bad debts was selected in a return of income (other than an information return) for a previous taxable year, the taxpayer must follow such method in its returns under section 527, unless such method is changed in accordance with the provisions of § 1.166–1. A taxpayer who has not previously selected a method for treating bad debts may, in its first return under section 6012(a)(6), exercise the option granted in § 1.166–1.

(d) Effective date. Except as provided in paragraph (b)(2) of § 1.527–6 and in paragraph (a) of § 1.527–9, the regulations under section 527 apply to taxable years beginning after December 31, 1974.

[T.D. 7744, 45 FR 85735, Dec. 30, 1980; T.D. 8041, 50 FR 30817, July 30, 1985]

§ 1.527–9 Special rule for principal campaign committees.

(a) In general. Effective with respect to taxable years beginning after December 31, 1981, the tax imposed by section 527(b) on the political organization taxable income of a principal campaign committee shall be computed by multiplying the political organization taxable income by the appropriate rates of tax specified in section 11(b). The political organization taxable income of a campaign committee not a principal campaign committee is taxed at the highest rate of tax specified in section 11(b). A candidate for Congress may designate one political committee to serve as his or her principal campaign committee for purposes of section 527(h)(1). If a designation is made, it shall be made in accordance with the requirements of paragraph (b) of this section. A candidate for Congress may have only one designation in effect at any time. Under 11 CFR 102.12, no political committee may be designated as the principal campaign committee of more than one candidate for Congress. Further, no political committee that supports or has supported more than one candidate for Congress may be designated as a principal campaign committee. No designation need be made where there is only one political campaign committee with respect to a candidate.

(b) Manner of designation. If a candidate for Congress elects to make a designation under section 527(h) and this section, he or she shall designate his or her principal campaign committee by appending a copy of his or her Statement of Candidacy (that is, the Federal Election Commission Form 2, or equivalent statement that the candidate filed with the Federal Election Commission under 11 CFR 101.1(a)), to the Form 1120–POL filed by the principal campaign committee for each taxable year for which the designation is effective. This designation may also be made by appending to the Form 1120–POL statement containing the following information: The name and address of the candidate for Congress; his or her taxpayer identification number; his or her party affiliation and the office sought; the district and State in which the office is sought; and the name and address of the principal campaign committee. This designation shall be made on or before the due date (as extended) for filing Form 1120–POL. Only a candidate for Congress may make a designation in accordance with this paragraph.

(c) Manner of revoking designation. A designation of a principal campaign committee that has been filed in accordance with this section may be revoked only with the consent of the Commissioner. In general, the Commissioner will grant such consent in every case where the candidate for Congress has revoked his or her designation in compliance with the requirements of the Federal Election Commission by filing an amended Statement of Organization or its equivalent pursuant to 11 CFR 102.2(a)(2). In the case of the revocation of the designation of a principal campaign committee by a candidate followed by the designation of another principal campaign committee by such candidate, for purposes of determining the appropriate rate of tax under section 11(b) for a taxable year, the political organization taxable income of the first principal campaign committee shall be treated as that of the subsequent principal campaign committee. In a case where consent to revoke a designation of a principal campaign committee is granted and a new designation is filed, the Commissioner may condition his consent upon the agreement of the candidate for Congress to insure compliance with the preceding sentence.

[T.D. 8041, 50 FR 30817, July 30, 1985]

Homeowners Associations

§ 1.528–1 Homeowners associations.

(a) In general. Section 528 only applies to taxable years of homeowners associations beginning after December 31, 1973. To qualify as a homeowners association an organization must either be a condominium management association or a residential real estate management association. For the purposes of Section 528 and the regulations under that section, the term "homeowners association" shall refer only to an organization described in section 528. Cooperative housing corporations and organizations based on a similar form of ownership are not eligible to be taxed as homeowners associations. As a general rule, membership in either a condominium management association or a residential real estate management

association is confined to the developers and the owners of the units, residences, or lots. Furthermore, membership in either type of association is normally required as a condition of such ownership. However, if the membership of an organization consists of other homeowners associations, the owners of units, residences, or lots who are members of such other homeowners associations will be treated as the members of the organization for the purposes of the regulations under section 528.

(b) Condominium. The term "condominium" means an interest in real property consisting of an undivided interest in common in a portion of a parcel of real property (which may be a fee simple estate or an estate for years, such as a leasehold or subleasehold) together with a separate interest in space in a building located on such property. An interest in property is not a condominium unless the undivided interest in the common elements are vested in the unit holders. In addition, a condominium must meet the requirements of applicable state or local law relating to condominiums or horizontal property regimes.

(c) Residential real estate management association. Residential real estate management associations are normally composed of owners of single-family residential units located in a subdivision, development, or similar area. However, they may also include as members, owners of multiple-family dwelling units located in such areas. They are commonly formed to administer and enforce covenants relating to the architecture and appearance of the real estate development as well as to perform certain maintenance duties relating to common areas.

(d) Tenants. Tenants will not be considered members for purposes of meeting the source of income test under section 528(c)(1)(B) and § 1.528-5. However, the fact that tenants of members of a homeowners association are permitted to be members of the association will not disqualify an association under section 528(c)(1) if it otherwise meets the requirements of section 528(c) and these regulations.

[T.D. 7692, 45 FR 26321, April 18, 1980]

§ 1.528-2 Organized and operated to provide for the acquisition, construction, management, maintenance and care of association property.

(a) Organized and operated—(1) Organized. To be treated as a homeowners association an organization must be organized and operated primarily for the purpose of carrying on one or more of the exempt functions of a homeowners association. For the purposes of section 528 and these regulations, the exempt functions of a homeowners association are the acquisition, construction, management, maintenance, and care of association property. In determining whether an organization is organized and operated primarily to carry on one or more exempt functions, all the facts and circumstances of each case shall be considered. For example, when an organization provides in its articles of organization that its sole purpose is to carry on one or more exempt functions, in the absence of other relevant factors it will be considered to have met the organizational test. (The term "articles of organization" means the organization's corporate charter, trust instruments, articles of association or other instrument by which it is created.)

(2) Operated. An organization will be treated as being operated for the purpose of carrying on one or more of the exempt functions of a homeowners association if it meets the provisions of §§ 1.528-5 and 1.528-6.

(b) Terms to be interpreted according to common meaning and usage. As used in section 528 and these regulations, the terms acquisition, construction, management, maintenance, and care are to be interpreted according to their common meaning and usage. For example, maintenance of association property includes the painting and repairing of such property as well as the gardening and janitorial services associated with its upkeep. Similarly, the term "construction" of association property includes covenants or other rules for preserving the architectural and general appearance of the area. The term also includes regulations relating to the location, color and allowable building materials to be used in all structures. (For the definition of association property see § 1.528-3.)

[T.D. 7692, 45 FR 26321, April 18, 1980]

§ 1.528-3 Association property.

(a) Property owned by the organization. "Association property" includes real and personal property owned by the organization or owned as tenants in common by the members of the organization. Such property must be available for the common benefit of all members of the organization and must be of a nature that tends to enhance the beneficial enjoyment of the private residences by their owners. If two or more facilities or items of property of a similar nature are owned by a homeowners association, and if the use of any particular facility or item is restricted to fewer than all

association members, such facilities or items nevertheless will be considered association property if all association members are treated equitably and have similar rights with respect to comparable items or facilities. Among the types of property that ordinarily will be considered association property are swimming pools and tennis courts. On the other hand, facilities or areas set aside for the use of nonmembers, or in fact used primarily by nonmembers, are not association property for the purposes of this section. For example, property owned by an organization for the purpose of leasing it to groups consisting primarily of nonmembers to be used as a meeting place or a retreat will not be considered association property.

(b) Property normally owned by a governmental unit. "Association property" also includes areas and facilities traditionally recognized and accepted as being of direct governmental concern in the exercise of the powers and duties entrusted to governments to regulate community health, safety and welfare. Such areas and facilities would normally include roadways, parklands, sidewalks, streetlights and firehouses. Property described in this paragraph will be considered association property regardless of whether it is owned by the organization itself, by its members as tenants in common or by a governmental unit and used for the benefit of the residents of such unit including the members of the organization.

(c) Privately owned property. "Association property" may also include property owned privately by members of the organization. However, to be so included the condition of such property must affect the overall appearance or structure of the residential units which make up the organization. Such property may include the exterior walls and roofs of privately owned residences as well as the lawn and shrubbery on privately owned land and any other privately owned property the appearance of which may directly affect the appearance of the entire organization. However, privately owned property will not be considered association property unless—

(1) There is a covenant or similar requirement relating to exterior appearance or maintenance that applies on the same basis to all such property (or to a reasonable classification of such property);

(2) There is a pro rata mandatory assessment (at least once a year) on all members of the association for maintaining such property; and

(3) Membership in the organization is a condition of ownership of such property.

[T.D. 7692, 45 FR 26321, April 18, 1980]

§ 1.528–4 Substantiality test.

(a) In general. In order for an organization to be considered a condominium management association or a residential real estate management association (and therefore in order for it to be considered a homeowners association), substantially all of its units, lots or buildings must be used by individuals for residences. For the purposes of applying paragraph (b) or (c) of this section, an organization which has attributes of both a condominium management association and a residential real estate management association shall be considered that association which, based on all the facts and circumstances, it more closely resembles. In addition, those paragraphs shall be applied based on conditions existing on the last day of the organization's taxable year.

(b) Condominium management associations. Substantially all of the units of a condominium management association will be considered as used by individuals for residences if at least 85% of the total square footage of all units within the project is used by individuals for residential purposes. If a completed unit has never been occupied, it will nonetheless be considered as used for residential purposes if, based on all the facts and circumstances, it appears to have been constructed for use as a residence. Similarly, a unit which is not occupied but which has been in the past will be considered as used for residential purposes if, based on all the facts and circumstances, it appears that it was constructed for use as a residence, and the last individual to occupy it did in fact use it as a residence. Units which are used for purposes auxiliary to residential use (such as laundry areas, swimming pools, tennis courts, storage rooms and areas used by maintenance personnel) shall be considered used for residential purposes.

(c) Residential real estate management associations. Substantially all of the lots or buildings of a residential real estate management association (including unimproved lots) will be considered as used by individuals as residences if at least 85% of the lots are zoned for residential purposes. Lots shall be treated as zoned for residential purposes even if under such zoning lots may be used for parking spaces, swimming pools, tennis courts, schools, fire stations, libraries, churches and other similar purposes which are auxiliary to residential use. However, commercial shopping areas (and their auxiliary parking areas) are not lots zoned for residential purposes.

(d) Exception. Notwithstanding any other provision of this section, a unit, or building will not be considered used for residential purposes, if for more than one-half the days in the association's taxable year, such unit, or building is occupied by a person or series of persons, each of whom so occupies such unit, or building for less than 30 days.

[T.D. 7692, 45 FR 26322, April 18, 1980; T.D. 7692, 45 FR 24879, May 23, 1980]

§ 1.528–5 Source of income test.

An organization cannot qualify as a homeowners association under section 528 for a taxable year unless 60 percent or more of its gross income for such taxable year is exempt function income as defined in § 1.528–9. The determination of whether an organization meets the provisions of this section shall be made after the close of the organization's taxable year.

[T.D. 7692, 45 FR 26322, April 18, 1980]

§ 1.528–6 Expenditure test.

(a) In general. An organization cannot qualify as a homeowners association under section 528 for a taxable year unless 90 percent or more of its expenditures for such taxable year are qualifying expenditures as defined in paragraphs (b) and (c) of this section. The determination of whether an organization meets the provisions of this section shall be made after the close of the organization's taxable year. Investments or transfers of funds to be held to meet future costs shall not be taken into account as expenditures. For example, transfers to a sinking fund account for the replacement of a roof would not be considered an expenditure for the purposes of this section even if the roof is association property. In addition, excess assessments which are either rebated to members or applied against the members' following year's assessments will not be considered an expenditure for the purposes of this section.

(b) Qualifying expenditures. Qualifying expenditures are expenditures by an organization for the acquisition, construction, management, maintenance, and care of the organization's association property. They include both current operating and capital expenditures on association property. Qualifying expenditures include expenditures on association property despite the fact that such property may produce income which is not exempt function income. Thus expenditures on a swimming pool are qualifying expenditures despite the fact that fees from guests of members using the pool are not exempt function income. Where expenditures by an organization are used both for association property as well as other property, an allocation shall be made between the two uses on a reasonable basis. Only that portion of the expenditures which is properly allocable to the acquisition, construction, management, maintenance or care of association property, shall constitute qualifying expenditures.

(c) Examples of qualifying expenditures. Qualifying expenditures may include (but are not limited to) expenditures for—

(1) Salaries of an association manager and secretary;

(2) Paving of streets;

(3) Street signs;

(4) Security personnel;

(5) Legal fees;

(6) Upkeep of tennis courts;

(7) Swimming pools;

(8) Recreation rooms and halls;

(9) Replacement of common buildings, facilities, air conditioning, etc.;

(10) Insurance premiums on association property;

(11) Accountant's fees;

(12) Improvement of private property to the extent it is association property; and

(13) Real estate and personal property taxes imposed on association property by a State or local government.

[T.D. 7692, 45 FR 26322, April 18, 1980]

§ 1.528–7 Inurement.

An organization is not a homeowners association if any part of its net earnings inures (other than as a direct result of its engaging in one or more exempt functions) to the benefit of any private person. Thus, to the extent that members receive a benefit from the general maintenance, etc., of association property, this benefit generally would not constitute inurement. If an organization pays rebates from amounts other than exempt function income, such rebates will constitute inurement. In general, in determining whether an organization is in violation of this section, the principles used in making similar determinations under Section 501(c) will be applied.

[T.D. 7692, 45 FR 26323, April 18, 1980]

§ 1.528–8 Election to be treated as a homeowners association.

(a) General rule. An organization wishing to be treated as a homeowners association under section 528 and this section for a taxable year must elect to be so treated. Except as otherwise provided in this section such election shall be made by the filing of a properly completed Form 1120–H (or such other form as the Secretary may prescribe). A separate election must be made for each taxable year.

(b) Taxable years ending after December 30, 1976. For taxable years ending after December 30, 1976, the election must be made not later than the time, including extensions, for filing an income tax return for the year in which the election is to apply.

(c) Taxable years ending before December 31, 1976, for which a return was filed before January 31, 1977. For taxable years ending before December 31, 1976, for which a return was filed before January 31, 1977, the election must be made not later than the time provided by law for filing a claim for credit or refund of overpayment of taxes for the year in which the election is to apply. Such an election shall be made by filing an amended return on Form 1120–H (or such other form as the Secretary may prescribe).

(d) Taxable years ending before December 31, 1976, for which a return was not filed before January 31, 1977. For taxable years ending before December 31, 1976, for which a return was not filed before January 31, 1977, the election must be made by October 20, 1980. Instead of making such an election in the manner described in paragraph (a) of this section, such an election may be made by a statement attached to the applicable income tax return or amended return for the year in which the election is made. The statement should identify the election being made, the period for which it applies and the taxpayer's basis for making the election.

(e) Revocation of exempt status. If an organization is notified after the close of a taxable year that its exemption for such taxable year under section 501(a) is being revoked retroactively, it may make a timely election under section 528 for such taxable year. Notwithstanding any other provisions of this section, such an election will be considered timely if it is made within 6 months after the date of revocation. The preceding sentence shall apply to revocations made after April 18, 1980. If the revocation was made on or before April 18, 1980, the election will be considered timely if it is made before the expiration of the period for filing a claim for credit or refund for the taxable year for which it is to apply.

(f) Effect of election—(1) Revocation. An election to be treated as an organization described in section 528 is binding on the organization for the taxable year and may not be revoked without the consent of the Commissioner.

(2) Exception. Notwithstanding paragraph (f)(1) of this section, an election under this section may be revoked prior to July 18, 1980. Such a revocation shall be made by filing a statement with the director of the Internal Revenue Service Center with whom the return of the organization for the year in which the revocation is to apply was filed. The statement shall include the following information:

(i) The name of the organization.

(ii) The fact that it is revoking an election made under section 528.

(iii) The taxable year for which the revocation is to apply.

[T.D. 7692, 45 FR 26323, April 18, 1980]

§ 1.528–9 Exempt function income.

(a) General rule. For the purposes of section 528 exempt function income consists solely of income which is attributable to membership dues, fees, or assessments of owners of residential units or residential lots. It is not necessary that the source of income be labeled as membership dues, fees, or assessments. What is important is that such income be derived from owners of residential units or residential lots in their capacity as owner-members rather than in some other capacity such as customers for services. Generally, for the membership dues, fees, or assessments with respect to a residential unit or lot to be exempt function income, the unit must be used for (or the unit or lot must be expected to be used) for residential purposes. However, dues, fees, or assessments paid to an organization by a developer with respect to unfinished or finished but unsold units or lots shall be exempt function income even though the developer does not use the units or lots. If an assessment is more in the nature of a fee for the provision of services in the course of a trade or business than a fee for a common activity undertaken by a collective group of owners for the purpose of enhancing or maintaining the value of their residences, the assessment will not be considered exempt function income to the organization. Furthermore, income attributable to dues,

fees, or assessments will not be considered exempt function income unless each member's liability for payment arises solely from membership in the association. Dues, fees, or assessments that are based on the extent, if any, to which a member avails him or herself of a facility or facilities are not exempt function income. For the purposes of section 528, dues, fees, or assessments which are based on the assessed value or size of property will be considered as arising solely as a result of membership in the organization. Regardless of the organization's method of accounting, excess assessments during a taxable year which are either rebated to the members or applied to their future assessments are not considered gross income and therefore will not be considered exempt function income for such taxable year. However, if such excess assessments are applied to a future year's assessments, they will be considered gross income and exempt function income for that future year. In addition, assessments in a taxable year, such as an assessment for a capital improvement, which are not treated as gross income do not enter into the determination of whether the organization meets the source of income test for that taxable year.

(b) Examples of exempt function income. Assessments which are considered more in the nature of a fee for common activity than for the providing of services and which will therefore generally be considered exempt function income include assessments made for the purpose of—

(1) Paying the principal and interest on debts incurred for the acquisition of association property;

(2) Paying real estate taxes on association property;

(3) Maintaining association property;

(4) Removing snow from public areas; and

(5) Removing trash.

(c) Examples of receipts which are not exempt function income. Exempt function income does not include—

(1) Amounts which are not includible in the organization's gross income other than by reason of section 528 (for example, tax-exempt interest);

(2) Amounts received from persons who are not members of the association;

(3) Amounts received from members for special use of the organization's facilities, the use of which is not available to all members as a result of having paid the dues, fees or assessments required to be paid by all members;

(4) Interest earned on amounts set aside in a sinking fund;

(5) Amounts received for work done on privately owned property which is not association property; or

(6) Amounts received from members in return for their transportation to or from shopping areas, work location, etc.

(d) Special rule. Notwithstanding paragraphs (a) and (c)(3) of this section, amounts received from members or tenants of residential units owned by members (notwithstanding § 1.528–1(d)) for special use of an association's facilities will be considered exempt function income if—

(1) The amounts paid by the members are not paid more than once in any 12 month period; and

(2) The privilege obtained from the payment of such amounts lasts for the entire 12 month period or portion thereof in which the facility is commonly in use.

Thus, amounts received as the result of payments by members of a yearly fee for use of tennis courts or a swimming pool shall be considered exempt function income. However, amounts received for the use of a building for an evening, weekend, week, etc., shall not be considered exempt function income.

[T.D. 7692, 45 FR 26323, April 18, 1980]

§ 1.528–10 Special rules for computation of homeowners association taxable income and tax.

(a) In general. Homeowners association taxable income shall be determined according to the provisions of section 528(d) and the rules set forth in this section.

(b) Limitation on capital losses. If for any taxable year a homeowners association has a net capital loss, the rules of sections 1211(a) and 1212(a) shall apply.

(c) Allowable deductions—(1) In general. To be deductible in computing the unrelated business taxable income of a homeowners association, expenses, depreciation and similar items must not only qualify as items of deduction allowed by chapter 1 of the Code but must also be directly connected with the production of gross income (excluding exempt function income). To be "di-

rectly connected with" the production of gross income (excluding exempt function income), an item of deduction must have both proximate and primary relationship to the production of such income and have been incurred in the production of such income. Items of deduction attributable solely to items of gross income (excluding exempt function income) are proximately and primarily related to such income. Whether an item of deduction is incurred in the production of gross income (excluding exempt function income) is determined on the basis of all the facts and circumstances involved in each case.

(2) Dual use of facilities or personnel. Where facilities are used both for exempt functions of the organization and for the production of gross income (excluding exempt function income), expenses, depreciation and similar items attributable to such facilities (for example, items of overhead) shall be allocated between the two uses on a reasonable basis. Similarly where personnel are employed both for exempt functions and for the production of gross income (excluding exempt function income), expenses and similar items attributable to such personnel (for example, items of salary) shall be allocated between the two activities on a reasonable basis. The portion of any such item so allocated to the production of gross income (excluding exempt function income) is directly connected with such income and shall be allowable as a deduction in computing homeowners association taxable income to the extent that it qualifies as an item of deduction allowed by chapter 1 of the Code. Thus, for example, assume that X, a homeowners association, pays its manager a salary of $10,000 a year and that it derives gross income other than exempt function income. If 10 percent of the manager's time during the year is devoted to deriving X's gross income (other than exempt function income), a deduction of $1,000 (10 percent of $10,000) would generally be allowable for purposes of computing X's homeowners association taxable income.

(d) Investment credit. A homeowners association is not entitled to an investment credit.

(e) Cross reference. For the definition of exempt function income, see § 1.528–9.

[T.D. 7692, 45 FR 26324, April 18, 1980]

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

Corporations Improperly Accumulating Surplus

§ 1.531–1 Imposition of tax.

Section 531 imposes (in addition to the other taxes imposed upon corporations by chapter 1 of the Code) a graduated tax on the accumulated taxable income of every corporation described in section 532 and § 1.532–1. In the case of an affiliated group which makes or is required to make a consolidated return see § 1.1502–43. All of the taxes on corporations under chapter 1 of the Code are treated as one tax for purposes of assessment, collection, payment, period of limitations, etc. See section 535 and §§ 1.535–1, 1.535–2, and 1.535–3 for the definition and determination of accumulated taxable income.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7937, 49 FR 3462, Jan. 27, 1984]

§ 1.532–1 Corporations subject to accumulated earnings tax.

(a) General rule. (1) The tax imposed by section 531 applies to any domestic or foreign corporation (not specifically excepted under section 532(b) and paragraph (b) of this section) formed or availed of to avoid or prevent the imposition of the individual income tax on its shareholders, or on the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of dividing or distributing them. See section 533 and § 1.533–1, relating to evidence of purpose to avoid income tax with respect to shareholders.

(2) The tax imposed by section 531 may apply if the avoidance is accomplished through the formation or use of one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation, the earnings and profits of the M Corporation would not be returned as income subject to the individual income tax until such earnings and profits of the M Corporation were distributed to the N Corporation and distributed in turn by the N Corporation to its shareholders. If either the M Corporation or the N Corporation was formed or is availed of for the purpose of avoiding or preventing the imposition of the individual income tax upon the shareholders of the N Corporation, the accumulated taxable income of the corporation so formed or availed of (M or N, as the case may be) is subject to the tax imposed by section 531.

(b) Exceptions. The accumulated earnings tax imposed by section 531 does not apply to a personal holding company (as defined in section 542), to a foreign personal holding company (as defined in section 552), or to a corporation exempt from tax under subchapter F, chapter 1 of the Code.

(c) Foreign corporations. Section 531 is applicable to any foreign corporation, whether resident or nonresident, with respect to any income derived from sources, within the United States, if any of its shareholders are subject to income tax on the distributions of the corporation by reason of being (1) citizens or residents of the United States, or (2) nonresident alien individuals to whom section 871 is applicable, or (3) foreign corporations if a beneficial interest therein is owned directly or indirectly by any shareholder specified in subparagraph (1) or (2) of this paragraph.

§ 1.533–1 Evidence of purpose to avoid income tax.

(a) In general. (1) The Commissioner's determination that a corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders is subject to disproof by competent evidence. Section 533(a) provides that the fact that earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation, by the preponderance of the evidence, shall prove to the contrary. The burden of proving that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business may be shifted to the Commissioner under section 534. See §§ 1.534–1 through 1.534–4. Section 533(b) provides that the fact that the taxpayer is a mere holding or investment company shall be prima facie evidence of the purpose to avoid income tax with respect to shareholders.

(2) The existence or nonexistence of the purpose to avoid income tax with respect to shareholders may be indicated by circumstances other than the conditions specified in section 533. Whether or not such purpose was present depends upon the particular circumstances of each case. All circumstances which might be construed as evidence of the purpose to avoid income tax with respect to shareholders cannot be outlined, but among other things, the following will be considered:

(i) Dealings between the corporation and its shareholders, such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders,

(ii) The investment by the corporation of undistributed earnings in assets having no reasonable connection with the business of the corporation (see § 1.537–3), and

(iii) The extent to which the corporation has distributed its earnings and profits.

The fact that a corporation is a mere holding or investment company or has an accumulation of earnings and profits in excess of the reasonable needs of the business is not absolutely conclusive against it if the taxpayer satisfies the Commissioner that the corporation was neither formed nor availed of for the purpose of avoiding income tax with respect to shareholders.

(b) General burden of proof and statutory presumptions. The Commissioner may determine that the taxpayer was formed or availed of to avoid income tax with respect to shareholders through the medium of permitting earnings and profits to accumulate. In the case of litigation involving any such determination (except where the burden of proof is on the Commissioner under section 534), the burden of proving such determination wrong by a preponderance of the evidence, together with the corresponding burden of first going forward with the evidence, is on the taxpayer under principles applicable to income tax cases generally. For the burden of proof in a proceeding before the Tax Court with respect to the allegation that earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, see section 534 and §§ 1.534–2 through 1.534–4. For a definition of a holding or investment company, see paragraph (c) of this section. For determination of the reasonable needs of the business, see section 537 and §§ 1.537–1 through 1.537–3. If the taxpayer is a mere holding or investment company, and the Commissioner therefore determines that the corporation was formed or availed of for the purpose of avoiding income tax with respect to shareholders, then section 533(b) gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid income tax with respect to shareholders. Further, if it is established (after complying with section 534 where applicable) that earnings and profits were permitted to accumulate beyond the reasonable needs of the business and the Commissioner has therefore determined that the corporation was formed or availed of for the purpose of avoiding income tax with respect to

shareholders, then section 533(a) adds still more weight to the Commissioner's determination. Under such circumstances, the existence of such an accumulation is made determinative of the purpose to avoid income tax with respect to shareholders unless the taxpayer proves to the contrary by the preponderance of the evidence.

(c) Holding or investment company. A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company within the meaning of section 533(b). If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 533(b).

(d) Small business investment companies. A corporation which is licensed to operate as a small business investment company under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B) and the regulations thereunder (13 CFR Part 107) will generally be considered to be a "mere holding or investment company" within the meaning of section 533(b). However, the presumption of the existence of the purpose to avoid income tax with respect to shareholders which results from the fact that such a company is a "mere holding or investment company" will be considered overcome so long as such company—

(1) Complies with all the provisions of the Small Business Investment Act of 1958 and the regulations thereunder; and

(2) Actively engages in the business of providing funds to small business concerns through investment in the equity capital of, or through the disbursement of long-term loans to, such concerns in such manner and under such terms as the company may fix in accordance with regulations promulgated by the Small Business Administration (see secs. 304 and 305 of the Small Business Investment Act of 1958, as amended (15 U.S.C. 684, 685)).

On the other hand, if such a company violates or fails to comply with any of the provisions of the Small Business Investment Act of 1958, as amended, or the regulations thereunder, or ceases to be actively engaged in the business of providing funds to small business concerns in the manner provided in subparagraph (2) of this paragraph, it will not be considered to have overcome the presumption by reason of any rules provided in this paragraph.
[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6652, 28 FR 4786, May 14, 1963]

§ 1.533–2 Statement required.

The corporation may be required to furnish a statement of its accumulated earnings and profits, the payment of dividends, the name and address of, and number of shares held by, each of its shareholders, the amounts that would be payable to each of the shareholders if the income of the corporation were distributed and other information required under section 6042.
[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.534–1 Burden of proof as to unreasonable accumulations generally.

For purposes of applying the presumption provided for in section 533(a) and in determining the extent of the accumulated earnings credit under section 535(c)(1), the burden of proof with respect to an allegation by the Commissioner that all or any part of the earnings and profits of the corporation have been permitted to accumulate beyond the reasonable needs of the business may vary under section 534 as between litigation in the Tax Court and that in any other court. In case of a proceeding in a court other than the Tax Court, see paragraph (b) of § 1.533–1.
[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.534–2 Burden of proof as to unreasonable accumulations in cases before the Tax Court.

(a) Burden of proof on Commissioner. Under the general rule provided in section 534(a), in any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation is upon the Commissioner if—

(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has not been sent to the taxpayer; or

(2) A notification, as provided for in section 534(b) and paragraph (c) of this section, has been sent to the taxpayer and, in response to such notification, the taxpayer has submitted a statement, as provided in section 534(c) and paragraph (d) of this section, setting forth the ground or grounds (together with facts sufficient to show the

basis thereof) on which it relies to establish that all or any part of its earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business. However, the burden of proof in the latter case is upon the Commissioner only with respect to the relevant ground or grounds set forth in the statement submitted by the taxpayer, and only if such ground or grounds are supported by facts (contained in the statement) sufficient to show the basis thereof.

(b) Burden of proof on the taxpayer. The burden of proof in a Tax Court proceeding with respect to an allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business is upon the taxpayer if—

(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has been sent to the taxpayer and the taxpayer has not submitted a statement, in response to such notification, as provided in section 534(c) and paragraph (d) of this section; or

(2) A statement has been submitted by the taxpayer in response to such notification, but the ground or grounds on which the taxpayer relies are not relevant to the allegation or, if relevant, the statement does not contain facts sufficient to show the basis thereof.

(c) Notification to the taxpayer. Under section 534(b) a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531 may be sent by registered mail (or by certified or registered mail, if the notification is mailed after September 2, 1958) to the taxpayer at any time before the mailing of the notice of deficiency in the case of a taxable year beginning after December 31, 1953, and ending after August 16, 1954. See § 1.534–4 for rules relating to taxable years subject to the Internal Revenue Code of 1939. See section 534(d) and § 1.534–3 with respect to a notification in the case of a jeopardy assessment.

(d) Statement by taxpayer. (1) A taxpayer who has received a notification, as provided in section 534(b) and paragraph (c) of this section, that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531, may, under section 534(c), submit a statement that all or any part of the earnings and profits of the corporation have not been permitted to accumulate beyond the reasonable needs of the business. Such statement shall set forth the ground or grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that there has been no accumulation of earnings and profits beyond the reasonable needs of the business. See paragraphs (a) and (b) of this section for rules concerning the effect of the statement with respect to burden of proof. See §§ 1.537–1 to 1.537–3, inclusive, relating to reasonable needs of the business.

(2) The taxpayer's statement, under section 534(c) and this paragraph, must be submitted to the Internal Revenue office which issued the notification (referred to in section 534(b) and paragraph (c) of this section) within 60 days after the mailing of such notification. If the taxpayer is unable, for good cause, to submit the statement within such 60-day period, an additional period not exceeding 30 days may be granted upon receipt in the Internal Revenue office concerned (before the expiration of the 60-day period provided herein) of a request from the taxpayer, setting forth the reasons for such request. See section 534(d) and § 1.534–3 with respect to a statement in the case of a jeopardy assessment.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.534–3 Jeopardy assessments in Tax Court cases.

In the case of a jeopardy assessment, a notice of deficiency is required to be sent to the taxpayer by registered mail (or by certified or registered mail, if the notice is mailed after September 2, 1958) within 60 days after the making of the assessment. See section 6861. If a jeopardy assessment is made before the mailing of the deficiency notice, then in the case of a proceeding in the Tax Court, if the deficiency notice informs the taxpayer that an amount of accumulated earnings tax is included in the deficiency, such notice shall constitute the notification provided for in section 534(b) and paragraph (c) of § 1.534–2. Under such circumstances the statement described in section 534(c) and paragraph (d) of § 1.534–2 shall instead be included in the taxpayer's petition to the Tax Court, if the taxpayer desires to submit such statement. See paragraph (b) of § 1.534–2, relating to burden of proof on the taxpayer.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.534–4 Taxable years subject to the Internal Revenue Code of 1939.

The rules prescribed in §§ 1.534–1 to 1.534–3, inclusive, apply in any proceeding tried on the merits after August 11, 1955, before the Tax Court

and involving a notice of deficiency in surtax imposed by section 102 of the Internal Revenue Code of 1939, for a taxable year subject to such code, based in whole or in part on the allegation that all or any part of the earnings and profits of the taxpayer have been permitted to accumulate beyond the reasonable needs of the business. If a notice of deficiency for a taxable year described in the preceding sentence was mailed before September 11, 1955, a notification mailed before that date shall be effective as fully as though such notification had been mailed before the notice of deficiency was mailed.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.535–1 Definition.

(a) The accumulated earnings tax is imposed by section 531 on the accumulated taxable income. Accumulated taxable income is the taxable income of the corporation with the adjustments prescribed by section 535(b) and § 1.535–2, minus the sum of the dividends paid deduction and the accumulated earnings credit. See section 561 and the regulations thereunder, relating to the definition of the deduction for dividends paid, and section 535(c) and § 1.535–3, relating to the accumulated earnings credit.

(b) In the case of a foreign corporation, whether resident or nonresident, which files or causes to be filed a return, the accumulated taxable income shall be the taxable income from sources within the United States with the adjustments prescribed by section 535(b) and § 1.535–2 minus the sum of the dividends paid deduction and the accumulated earnings credit. In the case of a foreign corporation which files no return, the accumulated taxable income shall be the gross income from sources within the United States without allowance of any deductions (including the accumulated earnings credit).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972]

§ 1.535–2 Adjustments to taxable income.

(a) Taxes—(1) United States taxes. In computing accumulated taxable income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), except that no deduction shall be allowed for (i) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (ii) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (iii) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes accrued during the taxable year, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(2) Taxes of foreign countries and United States possessions. In determining accumulated taxable income for any taxable year, if the taxpayer chooses the benefits of section 901 for such taxable year, a deduction shall be allowed for—

(i) The income, war profits, and excess profits taxes imposed by foreign countries or possessions of the United States and accrued during such taxable year, and

(ii) In the case of a domestic corporation, the foreign income taxes deemed to be paid for such taxable year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(a)(1) in accordance with § 1.960–7.

In no event shall the amount under subdivision (ii) of this subparagraph exceed the amount includible in gross income with respect to such taxes under section 78 and § 1.78–1. The credit for such taxes provided by section 901 shall not be allowed against the accumulated earnings tax imposed by section 531. See section 901(a).

(b) Charitable contributions. Section 535(b)(2) provides that, in computing the accumulated taxable income of a corporation, the deduction for charitable contributions shall be computed without regard to section 170(b)(2). Thus, the amount of charitable contributions made during the taxable year not allowable as a deduction under section 170 by reason of the limitations imposed by section 170(b)(2) shall be allowed as a deduction in computing accumulated taxable income for the taxable year. However, any excess of the amount of the charitable contributions made in a prior taxable year over the amount allowed as a deduction under section 170 for such year shall not be allowed as a deduction from taxable income in computing accumulated taxable income for the taxable year.

(c) **Special deductions disallowed.** Sections 241 through 248 provide for the allowance of special deductions for such items as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, and organizational expenses. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing accumulated taxable income.

(d) **Net operating loss.** The net operating loss deduction provided in section 172 is not allowed for purposes of computing accumulated taxable income.

(e) **Capital losses.** (1) Losses from sales or exchanges of capital assets during the taxable year, which are disallowed as deductions under section 1211(a) in computing taxable income, shall be allowed as deductions in computing accumulated taxable income.

(2) The computation of the capital losses allowable as a deduction in computing accumulated taxable income may be illustrated by the following example:

Example. X Corporation has capital losses of $30,000 which are disallowed under section 1211(a) for the taxable year ended December 31, 1956. This amount represents a loss of $25,000 from the sale or exchange of capital assets during the taxable year ended December 31, 1956, plus a $5,000 capital loss carryover resulting from the sale or exchange of capital assets during the taxable year ended December 31, 1955. In computing accumulated taxable income for the taxable year ended December 31, 1956, only the loss of $25,000 arising from the sale or exchange of capital assets during that taxable year will be allowed as a deduction.

(f) **Long-term capital gains.** (1) There is allowed as a deduction in computing accumulated taxable income, the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes attributable to such excess as provided by section 535(b)(6). The tax attributable to such excess is the difference between—

(i) The taxes (except the accumulated earnings tax) imposed by subtitle A of the Code for such year, and

(ii) The taxes (except the accumulated earnings tax) imposed by subtitle A computed for such year as if taxable income were reduced by the excess of the net long-term capital gain over net short-term capital loss (including the capital loss carryover to such year).

Where the tax (except the accumulated earnings tax) imposed by subtitle A includes an amount computed under section 1201(a)(2), the tax attributable to such excess is such amount computed under section 1201(a)(2).

(2) The application of the rule in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that D Corporation, for the taxable year ended December 31, 1956, has taxable income of $103,000 of which $8,000 is the excess of net long-term capital gain of $12,000 over a net short-term capital loss of $9,000. The $9,000 net short-term capital loss includes a capital loss carryover of $5,000. The amount allowable as a deduction under section 535(b)(6) and subparagraph (1) of this paragraph is $7,250, computed as follows: Net long-term capital gain less net short-term capital loss (computed without regard to the capital loss carryover) is $8,000 (that is, $12,000 net long-term capital gain less $4,000 net short-term capital loss computed without regard to the capital loss carryover of $5,000). The tax attributable to the excess of net long-term capital gain over net short-term capital loss (computed by taking the capital loss carryover into account) is $750, that is, 25 percent of such excess of $3,000, computed under section 1201(a)(2). The difference of $7,250 ($8,000 less $750) is the amount allowable as a deduction in computing accumulated taxable income.

(3) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application in determining the amount of the deduction allowable under section 535(b)(6).

(g) **Capital loss carrybacks and carryovers.** Capital losses carried to a taxable year under section 1212(a) shall have no application for purposes of computing accumulated taxable income for such year.

(h) **Bank affiliates.** There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U.S.C. 221a(c)).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, March 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7301, 39 FR 964, Jan. 4, 1974; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§ 1.535–3 Accumulated earnings credit.

(a) **In general.** As provided in section 535(a) and § 1.535–1, the accumulated earnings credit, provided by section 535(c), reduces taxable income in computing accumulated taxable income. In the case of a corporation, not a mere holding or investment company, the accumulated earnings credit is determined as provided in paragraph (b) of this section and, in the case of a holding or investment company, as provided in paragraph (c) of this section.

(b) **Corporation which is not a mere holding or investment company—(1) General rule.** (i) In the case of a corporation, not a mere holding or

investment company, the accumulated earnings credit is the amount equal to such part of the earnings and profits of the taxable year which is retained for the reasonable needs of the business, minus the deduction allowed by section 535(b)(6) (see paragraph (f) of § 1.535–2, relating to the deduction for long-term capital gains). In no event shall the accumulated earnings credit be less than the minimum credit provided for in section 535(c)(2) and subparagraph (2) of this paragraph. The amount of the earnings and profits for the taxable year retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction for such taxable year. See section 561 and §§ 1.561–1 and 1.561–2, relating to the deduction for dividends paid.

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 537 and §§ 1.537–1 and 1.537–2.

(2) Minimum credit. Section 535(c)(2) provides for the allowance of a minimum accumulated earnings credit in the case of a corporation which is not a mere holding or investment company. Except as otherwise provided in section 243(b)(3) and § 1.243–5 (relating to effect of 100-percent dividends received deduction under section 243(b)) and sections 1561, 1562, and 1564 (relating to limitations on certain tax benefits in the case of certain controlled corporations), in the case of such a corporation, this minimum credit shall in no case be less than the amount by which $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. See paragraph (d) of this section for the effect of dividends paid after the close of the taxable year in determining accumulated earnings and profits at the close of the preceding taxable year. In determining the amount of the minimum credit allowable under section 535(c)(2), the needs of the business are not taken into consideration. If the taxpayer has accumulated earnings and profits at the close of the preceding taxable year equal to or in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975), the credit, if any, is determined without regard to section 535(c)(2). It is not intended that the provision for the minimum credit shall in any way create an inference that an accumulation in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) is unreasonable. The reasonable needs of the business may require the accumulation of more or less than $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975), depending upon the circumstances in the case, but such needs shall not be taken into consideration to any extent in cases where the minimum accumulated earnings credit is applicable. For a discussion of the reasonable needs of the business, see section 537 and §§ 1.537–1, 1.537–2, and 1.537–3.

(3) Illustrations of accumulated earnings credit. The computation of the accumulated earnings credit provided by section 535(c) may be illustrated by the following examples:

Example (1). The X Corporation, which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $125,000 as of December 31, 1974. Thus, the minimum credit provided by section 535(c)(2) exceeds the accumulated earnings and profits of X by $25,000. It has earnings and profits for the taxable year ended December 31, 1975, in the amount of $100,000 and has a dividends paid deduction under section 561 in the amount of $30,000 so that the earnings and profits for the taxable year which are retained in the business amount to $70,000. Assume that it has been determined that the earnings and profits for the taxable year which may be retained for the reasonable needs of the business amount to $55,000 and that a deduction has been allowed under section 535(b)(6) in the amount of $5,000. Since the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is less than $50,000 ($55,000–$5,000), the minimum credit provided by section 535(c)(2) will not apply and the accumulated earnings credit must be computed under section 535(c)(1) on the basis of the reasonable needs of the business. In this case, the accumulated earnings credit for the taxable year ended December 31, 1975, will be $50,000 computed as follows:

Earnings and profits of the taxable year determined to be retained for the reasonable needs of the business	$55,000
Less: The deduction for long-term capital gains (less applicable tax) allowed under sec. 535(b)(6)	5,000
Accumulated earnings credit allowable under sec. 535(c)(1)	50,000

Example (2). The Z Corporation which is not a mere holding or investment company, has accumulated earnings and profits in the amount of $45,000 as of December 31, 1974; it has earnings and profits for the taxable year ended December 31, 1975, in the amount of $115,000 and has a dividends paid deduction under section 561 in the amount of $10,000, so that the earnings and profits for the taxable year which are retained amount to $105,000. Assume that it has been determined that the accumulated earnings and profits of the taxable year which may be retained for the reasonable needs of the business amount to $20,000 and that no deduction is allowable for long-term capital gains under section 535(b)(6). The accumu-

lated earnings credit allowable under section 535(c)(1) on the basis of the reasonable needs of the business is determined to be only $20,000. However, since the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year is more than $20,000, the minimum accumulated earnings credit provided by section 535(c)(2) is applicable. The allowable credit will be the amount by which $150,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year (*i.e.*, $105,000, $150,000 less $45,000 of accumulated earnings and profits at the close of the preceding taxable year).

(c) **Holding and investment companies.** Section 535(c)(3) provides that, in the case of a mere holding or investment company, the accumulated earnings credit shall be the amount, if any, by which $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. Thus, if such a corporation has accumulated earnings equal to or in excess of $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975) at the close of its preceding taxable year, no accumulated earnings credit is allowable in computing the accumulated taxable income. See paragraph (c) of § 1.533–1 for a definition of a holding or investment company. For the accumulated earnings credit of a mere holding or investment company which is a member of an affiliated group which has elected the 100 percent dividends received deduction under section 243(b), see section 243(b)(3) and § 1.243–5. For the accumulated earnings credit of a mere holding or investment company which is a component member of a controlled group of corporations (as defined in section 1563), see sections 1561, 1562, and 1564.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6992, 34 FR 826, Jan. 18, 1969; T.D. 7181, 37 FR 8066, April 25, 1972; T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 7376, 40 FR 42744, Sept. 16, 1975; T.D. 7528, 42 FR 64694, Dec. 28, 1977]

§ 1.536–1 Short taxable years.

Accumulated taxable income for a taxable year consisting of a period of less than 12 months shall not be placed on an annual basis for the purpose of the accumulated earnings tax imposed by section 531. In such cases accumulated taxable income shall be computed on the basis of the taxable income for such period of less than 12 months, adjusted in the manner provided by section 535(b) and § 1.535–2.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.537–1 Reasonable needs of the business.

(a) **In general.** The term "reasonable needs of the business" includes (1) the reasonable anticipated needs of the business (including product liability loss reserves, as defined in paragraph (f) of this section), (2) the section 303 redemption needs of the business, as defined in paragraph (c) of this section, and (3) the excess business holdings redemption needs of the business as described in paragraph (d) of this section. See paragraph (E) of this section for additional rules relating to the section 303 redemption needs and the excess business holdings redemption needs of the business. An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes. For purposes of this paragraph the section 303 redemption needs of the business and the excess business holdings redemption needs of the business are deemed to be directly connected with the needs of the business and for a bona fide business purpose. See § 1.537–3 for a discussion of what constitutes the business of the corporation. The extent to which earnings and profits have been distributed by the corporation may be taken into account in determining whether or not retained earnings and profits exceed the reasonable needs of the business. See § 1.537–2, relating to grounds for accumulation of earnings and profits.

(b) **Reasonable anticipated needs.** (1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion or investment plans shall be reviewed in the light of the facts during each year and as they exist as of the close of the taxable year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation shall be taken into account in determining the reasonableness of subsequent accumulations.

(c) Section 303 redemption needs of the business. **(1)** The term "section 303 redemption needs" means, with respect to the taxable year of the corporation in which a shareholder of the corporation died or any taxable year thereafter, the amount needed (or reasonably anticipated to be needed) to redeem stock included in the gross estate of such shareholder but not in excess of the amount necessary to effect a distribution to which section 303 applies. For purposes of this paragraph, the term "shareholder" includes an individual in whose gross estate stock of the corporation is includable upon his death for Federal estate tax purposes.

(2) This paragraph applies to a corporation to which section 303(c) would apply if a distribution described therein were made.

(3) If stock included in the gross estate of a decedent is stock of two or more corporations described in section 303(b)(2)(B), the amount needed by each such corporation for section 303 redemption purposes under this section shall, unless the particular facts and circumstances indicate otherwise, be that amount which bears the same ratio to the amount described in section 303(a) as the fair market value of such corporation's stock included in the gross estate of such decedent bears to the fair market value of all of the stock of such corporations included in the gross estate. For example, facts and circumstances indicating that the allocation prescribed by this subparagraph is not required would include notice given to the corporations by the executor or administrator of the decedent's estate that he intends to request the redemption of stock of only one of such corporations or the redemption of stock of such corporations in a ratio which is unrelated to the respective fair market values of the stock of the corporations included in the decedent's gross estate.

(4) The provisions of this paragraph apply only to taxable years ending after May 26, 1969.

(d) Excess business holdings redemption needs. **(1)** The term "excess business holdings redemption needs" means, with respect to taxable years of the corporation ending after May 26, 1969, the amount needed (or reasonably anticipated to be needed) to redeem from a private foundation stock which—

(i) Such foundation held on May 26, 1969 (or which was received by such foundation pursuant to a will or irrevocable trust to which section 4943(c)(5) applies), and either

(ii) Constituted excess business holdings on such date or would have constituted excess business holdings as of that date if there were taken into account (a) stock received pursuant to a will or trust described in subdivision (i) of this subparagraph and (b) the reduction in the total outstanding stock of the corporation which would have resulted solely from the redemption of stock held by the private foundation, or

(iii) Constituted stock redemption of which before January 1, 1975, or after October 4, 1976, and before January 1, 1977, is, by reason of section 101(*l*)(2)(B) of the Tax Reform Act of 1969, as amended by section 1309 of the Tax Reform Act of 1976, and § 53.4941(d)–4(b), permitted without imposition of tax under section 4941, but only to the extent such stock is to be redeemed before January 1, 1975, or after October 4, 1976, and before January 1, 1977, or is to be redeemed thereafter pursuant to the terms of a binding contract entered into on or before such date to redeem all of the stock of the corporation held by the private foundation on such date.

(2) The purpose of subparagraph (1) of this paragraph is to facilitate a private-foundation's disposition of certain excess business holdings, in order for the private foundation not to be liable for tax under section 4943. See section 4943(c) and the regulations thereunder for the definition of excess business holdings. For purposes of section 537(b)(2) and this paragraph, however, any determination of the existence of excess business holdings shall be made without taking into account the provisions of section 4943(c)(4) which treat certain excess business holdings as held by a disqualified

person (rather than by the private foundation), except that the periods described in section 4943(c)(4)(B), (C), and (D), if applicable, shall be taken into account in determining the period during which an excess business holdings redemption need may be deemed to exist. Thus, an excess business holdings redemption need may, depending upon the facts and circumstances, be deemed to exist for a part or all of the 20-year, 15-year, or 10-year period specified in section 4943(c)(4)(B) during which the interest in the corporation held by the private foundation is treated as held by a disqualified person rather than by the private foundation, and, if applicable, (i) any suspension of such 20-year, 15-year, or 10-year period as provided by section 4943(c)(4)(C) and (ii) the 15-year "second phase" specified in section 4943(c)(4)(D). The foregoing sentence is not to be construed to prevent an accumulation of earnings and profits for the purpose of effecting a redemption of excess business holdings at a time or times prior to expiration of the periods described in such sentence. This subparagraph is not to be construed to prevent an accumulation of earnings and profits for the purpose of effecting a redemption described in subdivision (iii) of subparagraph (1) of this paragraph.

(3) The extent of an excess business holdings redemption need cannot exceed the total number of shares of stock so held or received by the private foundation (i) redemption of which alone would sufficiently reduce such private foundation's proportionate share of the corporation's total outstanding stock in order for the private foundation not to be liable for tax under section 4943, or (ii) redemption of which is, by reason of § 53.4941(d)–4(b), permitted without imposition of tax under section 4941 provided that such redemption is accomplished within the period and in the manner prescribed in subdivision (iii) of subparagraph (1) of this paragraph. Thus, excess business holdings of a private foundation attributable to an increase in the private foundation's proportionate share of the corporation's total outstanding stock by reason of a redemption of stock after May 26, 1969, from any person other than the private foundation do not give rise to an excess business holdings redemption need.

(4) For purposes of subdivision (ii) of subparagraph (1) of this paragraph, an excess business holdings redemption need can arise with respect to shares of the corporation's stock under section 537(a)(3) only following actual acquisition by the private foundation of such shares and their characterization as an excess business holding. Thus, this paragraph does not apply to an accumulation of earnings and profits in one taxable year in anticipation of redemption of excess business holdings to be acquired by a private foundation in a subsequent year pursuant to a will or irrevocable trust to which section 4943(c)(5) applies or in anticipation of shares held becoming excess business holdings of the private foundation in a subsequent year by reason of additional shares to be received by the private foundation in such subsequent year pursuant to a will or irrevocable trust to which section 4943(c)(5) applies. Once having arisen, however, an excess business holdings redemption need may continue until redemption of the private foundation's excess business holdings described in this paragraph or other disposition of such excess business holdings by the private foundation.

(5) Notwithstanding any other provision of this paragraph, an excess business holdings redemption need will not be deemed to exist with respect to stock held by a private foundation the redemption of which would subject any person to tax under section 4941.

(6) For purposes of subdivision (ii) of subparagraph (1) of this paragraph, the number of shares of stock held by a private foundation on May 26, 1969 (or received pursuant to a will or irrevocable trust to which section 4943(c)(5) applies), redemption of which alone would sufficiently reduce such foundation's proportionate share of a corporation's total outstanding stock in order for the foundation not to be liable for tax under section 4943 may be determined by application of the following formula:

$$X = PH - (Y \times SO) \div 1 - Y$$

X = Number of shares to be redeemed.

Y = Maximum percentage of outstanding stock which private foundation can hold without being liable for tax under section 4943.

PH = Number of shares of stock held by private foundation on May 26, 1969, or received pursuant to a will or irrevocable trust to which section 4943(c)(5) applies.

SO = Total number of shares of stock outstanding unreduced by any redemption from a person other than the private foundation.

(7) The provisions of this paragraph may be illustrated by the following example:

Example. (i) On May 26, 1969, Private Foundation A holds 60 of the 100 outstanding shares of the capital stock of corporation X, which is not a disqualified person with respect to A. None of the remaining 40 shares is owned by a disqualified person within the meaning of section 4946(a). On June 1, 1975, X redeems 10 shares of its stock from individual B, thus reducing its outstanding stock to 90 shares. On June 1, 1976, A receives 20 additional shares of X stock by bequest under a will to which section 4943(c)(5) applies. As of June 1,

1976, then, A holds 80 of the 90 outstanding shares of X. Solely for purposes of this example and to illustrate the application of this paragraph, it will be assumed that in order not to be liable for the initial tax under section 4943, A must, before the close of the "second phase" described in section 4943(c)(4)(D), reduce its proportionate stock interest in X to 35 percent. A requests X to redeem from it a sufficient number of its shares to so reduce its proportionate stock interest in X to 35 percent, and X agrees to effect such a redemption.

(ii) As of May 26, 1969, A's excess business holdings are 25 shares of X, the number of shares which A would be required to dispose of to a person other than X in order to reduce its proportionate holdings in X to no more than 35 percent. If the disposition is to be by means of a redemption, however, A's excess business holdings on May 26, 1969, for purposes of determining X's excess business holdings redemption needs, are 39 shares, *i.e.*, the number of shares X would be required to redeem in order to reduce A's proportionate stock interest to 35 percent. Although the redemption of 10 shares from B on June 1, 1975, creates additional excess business holdings of A because it effectively increases A's proportionate stock interest in X, this increase does not create an additional excess business holdings redemption need because it resulted from a redemption from a person other than A. The bequest of 20 shares of X received by A on June 1, 1976, creates a further excess business holdings redemption need as of that date in the amount needed (or reasonably anticipated to be needed) to redeem an additional 31 shares from A, *i.e.*, the number of shares which, when added to the excess business holdings of A on May 26, 1969, would have to be redeemed to reduce A's proportionate stock interest in X to 35 percent without taking the earlier redemption from B into account.

(e)(1) A determination whether and to what extent an amount is needed (or reasonably anticipated to be needed) for the purpose described in subparagraph (1) of paragraph (c) or (d) of this section is dependent upon the particular circumstances of the case, including the total amount of earnings and profits accumulated in prior years which may be available for such purpose and the existence of a reasonable expectation that a redemption described in paragraph (c) or (d) of this section will in fact be effected. Although paragraph (c) or (d) of this section may apply even though no redemption of stock is in fact effected, the failure to effect such redemption may be taken into account in determining whether the accumulation was needed (or reasonably anticipated to be needed) for a purpose described in paragraph (c) or (d).

(2) In applying subparagraph (1) of paragraph (c) or (d) of this section, the discharge of an obligation incurred to make a redemption shall be treated as the making of the redemption.

(3) In determining whether an accumulation is in excess of the reasonable needs of the business for a particular year, the fact that one of the exceptions specified in paragraph (c) or (d) of this section applies in a subsequent year is not to give rise to an inference that the accumulation would not have been for the reasonable needs of the business in the prior year. Also, no inference is to be drawn from the enactment of section 537(a)(2) and (3) that accumulations in any prior year would not have been for the reasonable needs of the business in the absence of such provisions. Thus, the reasonableness of accumulations in years prior to a year in which one of the exceptions specified in paragraph (c) or (d) of this section applies is to be determined solely upon the facts and circumstances existing at the times the accumulations occur.

(f) Product liability loss reserves. (1) The term "product liability loss reserve" means, with respect to taxable years beginning after September 30, 1979, reasonable amounts accumulated for the payment of reasonably anticipated product liability losses, as defined in section 172(j) and § 1.172-13(b)(1).

(2) For purposes of this paragraph, whether an accumulation for anticipated product liability losses is reasonable in amount and whether such anticipated product liability losses are likely to occur shall be determined in light of all facts and circumstances of the taxpayer making such accumulation. Some of the factors to be considered in determining the reasonableness of the accumulation include the taxpayer's previous product liability experience, the extent of the taxpayer's coverage by commercial product liability insurance, the income tax consequences of the taxpayer's ability to deduct product liability losses and related expenses, and the taxpayer's potential future liability due to defective products in light of the taxpayer's plans to expand the production of products currently being manufactured, provided such plans are specific, definite and feasible. Additionally, a factor to be considered in determining whether the accumulation is reasonable in amount is whether the taxpayer, in accounting for its potential future liability, took into account the reasonably estimated present value of the potential future liability.

(3) Only those accumulations made with respect to products that have been manufactured, leased, or sold shall be considered as accumulations made under this paragraph. Thus, for example, accumulations with respect to a product which has not progressed beyond the development stage are not reasonable accumulations under this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7165, 37 FR 5022, March 9, 1972, 37 FR 5703, March 18, 1972; T.D. 7678, 44 FR 12416, Feb. 26, 1980; T.D. 8096, 51 FR 30483, Aug. 27, 1986]

§ 1.537–2 Grounds for accumulation of earnings and profits.

(a) *In general.* Whether a particular ground or grounds for the accumulation of earnings and profits indicate that the earnings and profits have been accumulated for the reasonable needs of the business or beyond such needs is dependent upon the particular circumstances of the case. Listed below in paragraphs (b) and (c) of this section are some of the grounds which may be used as guides under ordinary circumstances.

(b) *Reasonable accumulation of earnings and profits.* Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable needs of the business provided the general requirements under §§ 1.537–1 and 1.537–3 are satisfied:

(1) To provide for bona fide expansion of business or replacement of plant;

(2) To acquire a business enterprise through purchasing stock or assets;

(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

(4) To provide necessary working capital for the business, such as, for the procurement of inventories;

(5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation; or

(6) To provide for the payment of reasonably anticipated product liability losses, as defined in section 172(j), § 1.172-13(b)(1), and § 1.537-1(f).

(c) *Unreasonable accumulations of earnings and profits.* Although the following purposes are not exclusive, accumulations of earnings and profits to meet any one of such objectives may indicate that the earnings and profits of a corporation are being accumulated beyond the reasonable needs of the business:

(1) Loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders;

(2) Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons;

(3) Loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations;

(4) Investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or

(5) Retention of earnings and profits to provide against unrealistic hazards.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; T.D. 8096, 51 FR 30484, Aug. 27, 1986]

§ 1.537–3 Business of the corporation.

(a) The business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.

(b) If one corporation owns the stock of another corporation and, in effect, operates the other corporation, the business of the latter corporation may be considered in substance, although not in legal form, the business of the first corporation. However, investment by a corporation of its earnings and profits in stock and securities of another corporation is not, of itself, to be regarded as employment of the earnings and profits in its business. Earnings and profits of the first corporation put into the second corporation through the purchase of stock or securities or otherwise, may, if a subsidiary relationship is established, constitute employment of the earnings and profits in its own business. Thus, the business of one corporation may be regarded as including the business of another corporation if such other corporation is a mere instrumentality of the first corporation; that may be established by showing that the first corporation owns at least 80 percent of the voting stock of the second corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, the determination of whether the funds are employed in a business operated by the taxpayer will depend upon the particular circumstances of the case. Moreover, the business of one corporation does not include the business of another corporation if such other corporation is a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

Personal Holding Companies

§ 1.541–1 Imposition of tax.

(a) Section 541 imposes a graduated tax upon corporations classified as personal holding companies under section 542. This tax, if applicable, is in addition to the tax imposed upon corporations generally under section 11. Unless specifically excepted under section 542(c) the tax applies to domestic and foreign corporations and, to the extent provided by section 542(b), to an affiliated group of corporations filing a consolidated return. Corporations classified as personal holding companies are exempt from the accumulated earnings tax imposed under section 531 but are not exempt from other income taxes imposed upon corporations, generally, under any other provisions of the Code. Unlike the accumulated earnings tax imposed under section 531, the personal holding company tax imposed by section 541 applies to all personal holding companies as defined in section 542, whether or not they were formed or availed of to avoid income tax upon shareholders. See section 6501(f) and § 301.6501(f)–1 of this chapter (Regulations on Procedure and Administration) with respect to the period of limitation on assessment of personal holding company tax upon failure to file a schedule of personal holding company income.

(b) A foreign corporation, whether resident or nonresident, which is classified as a personal holding company is subject to the tax imposed under section 541 with respect to its income from sources within the United States, even though such income is not fixed or determinable annual or periodical income specified in section 881. A foreign corporation is not classified as a personal holding company subject to tax under section 541 if it is a foreign personal holding company as defined in section 552 or if it meets the requirements of the exception provided in section 542(c)(10).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.542–1 General rule.

A personal holding company is any corporation (other than one specifically excepted under section 542(c)) which, for the taxable year, meets—

(a) The gross income requirement specified in section 542(a)(1) and § 1.542–2, and

(b) The stock ownership requirement specified in section 542(a)(2) and § 1.542–3.

Both requirements must be satisfied with respect to each taxable year.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.542–2 Gross income requirement.

To meet the gross income requirement it is necessary that at least 80 percent of the total gross income of the corporation for the taxable year be personal holding company income as defined in section 543 and §§ 1.543–1 and 1.543–2. For the definition of "gross income" see section 61 and §§ 1.61–1 through 1.61–14. Under such provisions gross income is not necessarily synonymous with gross receipts. Further, in the case of transactions in stocks and securities and in commodities transactions, gross income for personal holding company tax purposes shall include only the excess of gains over losses from such transactions. See section 543(b), paragraph (b)(5) and (6) of § 1.543–1 and § 1.543–2. For determining the character of the amount includible in gross income under section 951(a), see paragraph (a) of § 1.951–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6795, 30 FR 934, Jan. 29, 1965]

§ 1.542–3 Stock ownership requirement.

(a) *General rule.* To meet the stock ownership requirement, it is necessary that at some time during the last half of the taxable year more than 50 percent in value of the outstanding stock of the corporation be owned, directly or indirectly, by or for not more than 5 individuals. Any organization or trust to which subparagraph (1) of this paragraph applies shall be considered as one individual for purposes of this stock ownership requirement subject, however, to the exception in subparagraph (2) of this paragraph which is applicable only to taxable years beginning after December 31, 1954. Thus, if an organization or trust which is considered as an individual owns 51 percent in value of the outstanding stock of the corporation at any time during the last half of the taxable year, the stock ownership requirement will be met by ownership of the required percentage by one individual. See section 544 and §§ 1.544–1 through 1.544–7 for the determination of stock ownership.

(1) *An organization or trust considered as an individual.* Any of the following organizations or trusts shall be considered as an individual:

(i) An organization to which section 503 applies, namely, any organization described in sec-

tion 501(c)(3) (relating to charitable, etc., organizations) or section 401(a) (relating to employees' pension trust, etc.) other than an organization excepted from the application of section 503 by paragraphs (1) to (5) of section 503(b). Therefore, a religious organization (other than a trust) excepted under section 503(b)(1) is not considered an individual for purposes of the stock ownership requirement of section 542(a)(2).

(ii) A portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c), relating to amounts set aside for charitable purposes, or described in a corresponding provision of the prior income tax law (such as section 162(a), Internal Revenue Code of 1939).

(2) **Exception.** For taxable years beginning after December 31, 1954, an organization or trust to which subparagraph (1) of this paragraph applies shall not be considered an individual if all of the following conditions are met:

(i) It was organized or created before July 1, 1950.

(ii) At all times on or after July 1, 1950, and before the close of the taxable year, it owned all of the common stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(iii) For the taxable year it is not denied exemption under section 504(a) or the unlimited charitable deduction under section 681(c). In determining whether, for the purpose of section 542(a)(2), exemption is not denied under section 504(a) or the unlimited charitable deduction is not denied under section 681(c) all the income of the corporation which is available for distribution as dividends to its shareholders shall be deemed to have been distributed at the close of the taxable year whether or not any portion of such income was in fact distributed. If the amounts described in section 504(a) or section 681(c), increased by the income of the corporation deemed distributed pursuant to the preceding sentence, would be sufficient to deny exemption or the unlimited charitable deduction, the organization or trust will be considered to be an individual for the purpose of section 542(a)(2). For the purpose of this subdivision the restrictions in sections 504(a)(1) and 681(c)(1) against unreasonable accumulations will not apply to income attributable to property of a decedent dying before January 1, 1951, which was transferred during his lifetime to a trust or property that was transferred under his will to such trust, and

(iv) This subparagraph is illustrated by the following example:

Example. The X Charitable Foundation (an organization described in section 501(c)(3) to which section 503 is applicable) has owned all of the stock of the Y Corporation since Y's organization in 1949. Both X and Y are calendar-year corporations. At the end of the year 1955, X has accumulated $100,000 out of income and has actually paid out only $75,000 of this amount, leaving a balance of $25,000 on December 31, 1955. X was not denied an exemption under section 504(a) for the year 1955. Y, during the calendar year 1955, has $400,000 taxable income of which $200,000 is available for distribution as dividends at the end of the year. X will be considered to have accumulated out of income during the calendar year 1955 the amount of $225,000 for the purpose of determining whether it would have been denied an exemption under section 504(a)(1). If X would have been denied an exemption under section 504(a)(1) by reason of having been deemed to have accumulated $225,000, the stock ownership requirement of section 542(a)(2) and this section will have been satisfied. If Y Corporation also satisfies the gross income requirement of section 542(a)(1) and § 1.542–2 it will be a personal holding company.

(b) **Changes in stock outstanding.** It is necessary to consider any change in the stock outstanding during the last half of the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof. Stock subscribed and paid for will be considered as stock outstanding, whether or not such stock is evidenced by issued certificates. Treasury stock shall not be considered as stock outstanding.

(c) **Value of stock outstanding.** The value of the stock outstanding shall be determined in the light of all the circumstances. The value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964]

§ 1.542–4 Corporations filing consolidated returns.

(a) **General rule.** A consolidated return under section 1501 shall determine the application of the personal holding company tax to the group and to any member thereof on the basis of the consolidated gross income and consolidated personal holding company income of the group, as determined under the regulations prescribed pursuant to section

1502 (relating to consolidated returns); however, this rule shall not apply to either (1) an ineligible affiliated group as defined in section 542(b)(2) and paragraph (b) of this section, or (2) an affiliated group of corporations a member of which is excluded from the definition of a personal holding company under section 542(c) and paragraph (c) of this section. Thus, in the latter two instances the gross income requirement provided in section 542(a)(1) and § 1.542–2 shall apply to each individual member of the affiliated group of corporations.

(b) Ineligible affiliated group. (1) Except for certain affiliated railroad corporations, as provided in subparagraph (2) of this paragraph, an affiliated group of corporations is an ineligible affiliated group and therefore may not use its consolidated gross income and consolidated personal holding company income to determine the liability of the group or any member thereof for personal holding company tax (as provided in paragraph (a) of this section), if (i) any member of such group, including the common parent, derived gross income from sources outside the affiliated group for the taxable year in an amount equal to 10 percent or more of its gross income from all sources for that year and (ii) 80 percent or more of the gross income from sources outside the affiliated group consists of personal holding company income as defined in section 543 and §§ 1.543–1 and 1.543–2. For purposes of subdivision (i) of this subparagraph gross income shall not include certain dividend income received by a common parent from a corporation not a member of the affiliated group which qualifies under section 542(b)(4) and paragraph (d) of this section. See particularly the examples contained in paragraph (d)(2) of this section. Intercorporate dividends received by members of the affiliated group (including the common parent) are to be included in the gross income from all sources for purposes of the test in subdivision (i) of this subparagraph. For purposes of subdivision (ii) of this subparagraph, section 543 and paragraph (a) of § 1.543–1 shall be applied as if the amount of gross income derived from sources outside the affiliated group by a corporation which is a member of such group is the gross income of such corporation.

(2) An affiliated group of railroad corporations shall not be considered to be an ineligible affiliated group, notwithstanding any other provisions of section 542(b)(2) and this paragraph, if the common parent of such group would be eligible to file a consolidated return under section 141 of the Internal Revenue Code of 1939 prior to its amendment by the Revenue Act of 1942 (56 Stat. 798).

(3) See section 562(d) and § 1.562–3 for dividends paid deduction in the case of a distribution by a member of an ineligible affiliated group.

(4) The determination of whether an affiliated group of corporations is an ineligible group under section 542(b)(2) and this paragraph, may be illustrated by the following examples:

Example (1). Corporations X, Y, and Z constitute an affiliated group of corporations which files a consolidated return for the calendar year 1954; Corporations Y and Z are wholly-owned subsidiaries of Corporation X and derive no gross income from sources outside the affiliated group; Corporation X, the common parent, has gross income in the amount of $250,000 for the taxable year 1954. $200,000 of such gross income consists of dividends received from Corporations Y and Z. The remaining $50,000 was derived from sources outside the affiliated group, $40,000 of which represents personal holding company income as defined in section 543. The $50,000 included in the gross income of Corporation X and derived from sources outside the affiliated group is more than 10 percent of X's gross income ($50,000/$250,000) and the $40,000 which represents personal holding company income is 80 percent of $50,000 (the amount considered to be the gross income of Corporation X). Accordingly, Corporations X, Y, and Z would be an ineligible affiliated group and the gross income requirement under section 542(a)(1) and § 1.542–2 would be applied to each corporation individually.

Example (2). If, in the above example, only $30,000 of the $50,000 derived from sources outside the affiliated group by Corporation X represented personal holding company income, this group of affiliated corporations would not be an ineligible affiliated group. Although the $50,000 representing the gross income of Corporation X from sources outside the affiliated group is more than 10 percent of its total gross income, the amount of $30,000 representing personal holding company income is not 80 percent or more of the amount considered to be gross income for the purpose of this test. Under section 542(b)(2) and subparagraph (1) of this paragraph both the gross income and the personal holding company income requirements must be satisfied in determining that an affiliated group constitutes an ineligible group. Since both of these requirements have not been satisfied in this example this group of affiliated corporations would not be an ineligible group.

(c) Excluded corporations. The general rule for determining liability of an affiliated group under paragraph (a) of this section shall not apply if any member thereof is a corporation which is excluded, under section 542(c), from the definition of a personal holding company.

(d) Certain dividend income received by a common parent. (1) Dividends received by the common parent of an affiliated group from a corporation which is not a member of the affiliated group shall not be included in gross income or personal holding company income, for the purpose of the test under section 542(b)(2)—

(i) If such common parent owned, directly or indirectly, more than 50 percent of the outstanding voting stock of the dividend paying corporation at

the time such common parent became entitled to the dividend, and

(ii) If the dividend paying corporation is not a personal holding company for the taxable year in which the dividends are paid.

Thus, if the tests in subdivisions (i) and (ii) of this subparagraph are met, the dividend income received by the common parent from such other corporation will not be considered gross income for purposes of the test in section 542(b)(2)(A) (paragraph (b) of this section), that is, either to determine gross income from sources outside the affiliated group or to determine gross income from all sources.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Corporation X is the common parent of Corporation Y and Corporation Z and together they constitute an affiliated group which files a consolidated return under section 1501. Corporation Y and Corporation Z derived no income from sources outside the affiliated group. Corporation X, the common parent, had gross income of $100,000 for the calendar year 1954 of which amount $20,000 represented a dividend received from Corporation W, and $4,000 represented interest from Corporation T. The remaining gross income of X, $76,000, was received from Corporations Y and Z. Corporation X, for its entire taxable year, owned 60 percent of the voting stock of Corporation W which was not a personal holding company for the calendar year 1954. For the purpose of the gross income and personal holding company income test under section 542(b)(2) and paragraph (b) of this section, the $20,000 dividend received from Corporation W would not be included in the gross income or personal holding company income of Corporation X. The affiliated group would not be an ineligible group under section 542(b)(2) because 10 percent or more of its gross income was not from sources outside the affiliated group as required by section 542(b)(2)(A). Inasmuch as the $20,000 dividend from Corporation W is not included in the gross income of Corporation X for purposes of section 542(b)(2) Corporation X only has $4,000 gross income from sources outside the affiliated group which is only 5 percent of its gross income from all sources, $80,000.

Example (2). If, in example (1), Corporation X owned 50 percent or less of the voting stock of Corporation W at the time X became entitled to the dividend, or if Corporation W had been a personal holding company for the taxable year in which the dividends were paid, the $20,000 dividends received by Corporation X would be included in gross income and personal holding company income of Corporation X for the purpose of the test under section 542(b)(2) and paragraph (b) of this section. Thus, the affiliated group would be an ineligible affiliated group under section 542(b)(2) because 24 percent of its gross income was from sources outside the affiliated group ($24,000/$100,000) and 100 percent of this $24,000 was personal holding company income.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.543–1 Personal holding company income.

(a) General rule. The term "personal holding company income" means the portion of the gross income which consists of the classes of gross income described in paragraph (b) of this section. See section 543(b) and § 1.543–2 for special limitations on gross income and personal holding company income in cases of gains from stocks', securities', and commodities' transactions.

(b) Definitions—(1) Dividends. The term "dividends" includes dividends as defined in section 316 and amounts required to be included in gross income under section 551 and §§ 1.551–1—1.551–2 (relating to foreign personal holding company income taxed to United States shareholders).

(2) Interest. The term "interest" means any amounts, includible in gross income, received for the use of money loaned. However, (i) interest which constitutes "rent" shall not be classified as interest but shall be classified as "rents" (see subparagraph (10) of this paragraph) and (ii) interest on amounts set aside in a reserve fund under section 511 or 607 of the Merchant Marine Act, 1936 (46 U.S.C. 1161 or 1177), shall not be included in personal holding company income.

(3) Royalties (other than mineral, oil, or gas royalties or certain copyright royalties). The term "royalties" (other than mineral, oil, or gas royalties or certain copyright royalties) includes amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. It does not, however, include rents. For rules relating to rents see section 543(a)(7) and subparagraph (10) of this paragraph. For rules relating to mineral, oil, or gas royalties, see section 543(a)(8) and subparagraph (11) of this paragraph. For rules relating to certain copyright royalties for taxable years beginning after December 31, 1959, see section 543(a)(9) and subparagraph (12) of this paragraph.

(4) Annuities. The term "annuities" includes annuities only to the extent includible in the computation of gross income. See section 72 and §§ 1.72–1—1.72–14 for rules relating to the inclusion of annuities in gross income.

(5) Gains from the sale or exchange of stock or securities. (i) Except in the case of regular dealers in stock or securities as provided in subdivision (ii) of this subparagraph, gross income and personal holding company income include the amount by which the gains exceed the losses from the sale or exchange of stock or securities. See section 543(b)(1) and § 1.543–2 for provisions relating to this limitation. For this purpose, there shall be taken into account all those gains includible in

gross income (including gains from liquidating dividends and other distributions from capital) and all those losses deductible from gross income which are considered under chapter 1 of the Code to be gains or losses from the sale or exchange of stock or securities. The term "stock or securities" as used in section 543(a)(2) and this subparagraph includes shares or certificates of stock, stock rights or warrants, or interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation by the Code), certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease, collateral trust certificates, voting trust certificates, bonds, debentures, certificates of indebtedness, notes, car trust certificates, bills of exchange, obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(ii) In the case of "regular dealers in stock or securities" there shall not be included gains or losses derived from the sale or exchange of stock or securities made in the normal course of business. The term "regular dealer in stock or securities" means a corporation with an established place of business regularly engaged in the purchase of stock or securities and their resale to customers. However, such corporations shall not be considered as regular dealers with respect to stock or securities which are held for investment. See section 1236 and § 1.1236–1.

(6) Gains from futures transactions in commodities. Gross income and personal holding company income include the amount by which the gains exceed the losses from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. See § 1.543–2 for provisions relating to this limitation. In general, for the purpose of determining such excess, there are included all gains and losses on futures contracts which are speculative. However, for the purpose of determining such excess, there shall not be included gains or losses from cash transactions, or gains or losses by a producer, processor, merchant, or handler of the commodity, which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others. See section 1233 and § 1.1233–1.

(7) Estates and trusts. Under section 543(a)(4) personal holding company income includes amounts includible in computing the taxable income of the corporation under part I, subchapter J, chapter 1 of the Code (relating to estates, trusts, and beneficiaries); and any gain derived by the corporation from the sale or other disposition of any interest in an estate or trust.

(8) Personal service contracts. (i) Under section 543(a)(5) amounts received under a contract under which the corporation is to furnish personal services, as well as amounts received from the sale or other disposition of such contract, shall be included as personal holding company income if—

(a) Some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(b) At any time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services. For this purpose, the amount of stock outstanding and its value shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3. It should be noted that the stock ownership requirement of section 543(a)(5) and this subparagraph relates to the stock ownership at any time during the taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544–1 through 1.544–7.

(ii) If the contract, in addition to requiring the performance of services by a 25-percent stockholder who is designated or who could be designated (as specified in section 543(a)(5) and subdivision (i) of this subparagraph), requires the performance of services by other persons which are important and essential, then only that portion of the amount received under such contract which is attributable to the personal services of the 25-percent stockholder shall constitute personal holding company income. Incidental personal services of other persons employed by the corporation to facilitate the performance of the services by the 25-percent stockholder, however, shall not constitute important or essential services. Under section 482 gross income, deductions, credits, or allowances between or among organizations, trades, or businesses may be allocated if it is determined that allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

(iii) The application of section 543(a)(5) and this subparagraph may be illustrated by the following examples:

Example (1). A, whose profession is that of an actor, owns all of the outstanding capital stock of the M Corporation. The M Corporation entered into a contract with A under which A was to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which A was to receive $10,000 a year from the M Corporation. The M Corporation entered into a contract with the O Corporation in which A was designated to perform personal services for the O Corporation in consideration of which the O Corporation was to pay the M Corporation $500,000 a year. The $500,000 received by the M Corporation from the O Corporation constitutes personal holding company income.

Example (2). Assume the same facts as in example (1), except that, in addition to A's contract with the M Corporation, B, whose profession is that of a dancer and C, whose profession is that of a singer, were also under contract to the M Corporation to perform personal services for the person or persons whom the M Corporation might designate, in consideration of which they were each to receive $25,000 a year from the M Corporation. Neither B nor C were stockholders of the M Corporation. The contract entered into by the M Corporation with the O Corporation, in addition to designating that A was to perform personal services for the O Corporation, designated that B and C were also to perform personal services for the O Corporation. Although the O Corporation particularly desired the services of A for an entertainment program it planned, it also desired the services of B and C, who were prominent in their fields, to provide a good supporting cast for the program. The services of B and C required under the contract are determined to be important and essential; therefore, only that portion of the $500,000 received by the M Corporation which is attributable to the personal services of A constitutes personal holding company income. The same result would obtain although the dancer and the singer required by the contract were not designated by name but the contract gave the M Corporation discretion to select and provide the services of a singer and a dancer for the program and such services were provided.

Example (3). The N Corporation is engaged in engineering. Its entire outstanding capital stock is owned by four individuals. The N Corporation entered into a contract with the R Corporation to perform engineering services in consideration of which the R Corporation was to pay the N Corporation $50,000. The individual who was to perform the services was not designated (by name or by description) in the contract and no one but the N Corporation had the right to designate (by name or by description) such individual. The $50,000 received by the N Corporation from the R Corporation does not constitute personal holding company income.

(9) Compensation for use of property. Under section 543(a)(6) amounts received as compensation for the use of, or right to use, property of the corporation shall be included as personal holding company income if, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property. Thus, if a shareholder who meets the stock ownership requirement of section 543(a)(6) and this subparagraph uses, or has the right to use, a yacht, residence, or other property owned by the corporation, the compensation to the corporation for such use, or right to use, the property constitutes personal holding company income. This is true even though the shareholder may acquire the use of, or the right to use, the property by means of a sublease or under any other arrangement involving parties other than the corporation and the shareholder. However, if the personal holding company income of the corporation (after excluding any such income described in section 543(a)(6) and this subparagraph, relating to compensation for use of property, and after excluding any such income described in section 543(a)(7) and subparagraph (10) of this paragraph, relating to rents) is not more than 10 percent of its gross income, compensation for the use of property shall not constitute personal holding company income. For purposes of the preceding sentence, in determining whether personal holding company income is more than 10 percent of gross income, copyright royalties constitute personal holding company income, regardless of whether such copyright royalties are excluded from personal holding company income under section 543(a)(9) and subparagraph (12)(ii) of this paragraph. For purposes of applying section 543(a)(6) and this subparagraph, the amount of stock outstanding and its value shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3. It should be noted that the stock ownership requirement of section 543(a)(6) and this subparagraph relates to the stock outstanding at any time during the entire taxable year. For rules relating to the determination of stock ownership, see section 544 and §§ 1.544–1 through 1.544–7.

(10) Rents (including interest constituting rents). Rents which are to be included as personal holding company income consist of compensation (however designated) for the use, or right to use, property of the corporation. The term "rents" does not include amounts includible in personal holding company income under section 543(a)(6) and subparagraph (9) of this paragraph. The amounts considered as rents include charter fees, etc., for the use of, or the right to use, property, as well as interest on debts owed to the corporation (to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of the corporation's trade or business was sold or exchanged by the corporation). However, if the amount of the rents includible under section 543(a)(7) and this subparagraph constitutes 50 percent or more of the gross income of the corporation, such rents shall

not be considered to be personal holding company income.

(11) Mineral, oil, or gas royalties. (i) The income from mineral, oil, or gas royalties is to be included as personal holding company income, unless (a) the aggregate amount of such royalties constitutes 50 percent or more of the gross income of the corporation for the taxable year and (b) the aggregate amount of deductions allowable under section 162 (other than compensation for personal services rendered by the shareholders of the corporation) equals 15 percent or more of the gross income of the corporation for the taxable year.

(ii) The term "mineral, oil, or gas royalties" means all royalties, including overriding royalties and, to the extent not treated as loans under section 636, mineral production payments, received from any interest in mineral, oil, or gas properties. The term "mineral" includes those minerals which are included within the meaning of the term "minerals" in the regulations under section 611.

(iii) The first sentence of subdivision (ii) of this subparagraph shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

(12) Copyright royalties—(i) In general. The income from copyright royalties constitutes, generally, personal holding company income. However, for taxable years beginning after December 31, 1959, those copyright royalties which come within the definition of "copyright royalties" in section 543(a)(9) and subdivision (iv) of this subparagraph shall be excluded from personal holding company income only if the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) Exclusion from personal holding company income. For taxable years beginning after December 31, 1959, copyright royalties (as defined in section 543(a)(9) and subdivision (iv) of this subparagraph) shall be excluded from personal holding company income only if the conditions set forth in (a), (b), and (c) of this subdivision are met.

(a) Such copyright royalties for the taxable year must constitute 50 percent or more of the corporation's gross income. For this purpose, copyright royalties shall be computed by excluding royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole or in part, by any person who, at any time during the corporation's taxable year, is a shareholder.

(b) Personal holding company income for the taxable year must be 10 percent or less of the corporation's gross income. For this purpose, personal holding company income shall be computed by excluding (1) copyright royalties (except that there shall be included royalties received for the use of, or the right to use, copyrights or interests in copyrights in works created, in whole or in part, by any shareholder owning, at any time during the corporation's taxable year, more than 10 percent in value of the outstanding stock of the corporation), and (2) dividends from any corporation in which the taxpayer owns, on the date the taxpayer becomes entitled to the dividends, at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock, provided the corporation which pays the dividends meets the requirements of subparagraphs (A), (B), and (C) of section 543(a)(9).

(c) The aggregate amount of the deductions allowable under section 162 must constitute 50 percent or more of the corporation's gross income for the taxable year. For this purpose, the deductions allowable under section 162 shall be computed by excluding deductions for compensation for personal services rendered by, and deductions for copyright and other royalties to, shareholders of the corporation.

(iii) Determination of stock value and stock ownership. For purposes of section 543(a)(9) and this subparagraph, the following rules shall apply:

(a) The amount and value of the outstanding stock of a corporation shall be determined in accordance with the rules set forth in the last two sentences of paragraph (b) and in paragraph (c) of § 1.542–3.

(b) The ownership of stock shall be determined in accordance with the rules set forth in section 544 and §§ 1.544–1 through 1.544–7.

(c) Any person who is considered to own stock within the meaning of section 544 and §§ 1.544–1 through 1.544–7 shall be a shareholder.

(iv) Copyright royalties defined. For purposes of section 543(a)(9) and this subparagraph, the term "copyright royalties" means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under Title 17 of the United States Code (other than by reason of section 2 or 6 thereof),

and to which copyright protection is also extended by the laws of any foreign country as a result of any international treaty, convention, or agreement to which the United States is a signatory. Thus, "copyright royalties" includes not only royalties from sources within the United States under protection of United States laws relating to statutory copyrights but also royalties from sources within a foreign country with respect to United States statutory copyrights protected in such foreign country by any international treaty, convention, or agreement to which the United States is a signatory. The term "copyright royalties" includes compensation for the use of, or right to use, an interest in any such copyrighted works as well as payments from any person for performing rights in any such copyrighted works.

(v) **Compensation which is rent.** Section 543(a)(9) and subdivisions (i) through (iv) of this subparagraph shall not apply to compensation which is "rent" within the meaning of the second sentence of section 543(a)(7).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7713, June 17, 1964; T.D. 7261, 38 FR 5467, March 1, 1973]

§ 1.543–2 Limitation on gross income and personal holding company income in transactions involving stocks, securities and commodities.

(a) Under section 543(b)(1) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(2) and paragraph (b)(5) of § 1.543–1, shall be the net gains from the sale or exchange of stock or securities. If there is an excess of losses over gains from such transactions, such excess (or net loss) shall not be used to reduce gross income or personal holding company income for purposes of the personal holding company tax. Similarly, under section 543(b)(2) the gains which are to be included in gross income, and in personal holding company income with respect to transactions described in section 543(a)(3) and paragraph (b)(6) of § 1.543–1, shall be the net gains from commodity transactions which reflect personal holding company income. Any excess of losses over gains from such transactions (resulting in a net loss) shall not be used to reduce gross income or personal holding company income. The capital loss carryover under section 1212 shall not be taken into account.

(b) The application of section 543(b) may be illustrated by the following examples:

Example (1). The P Corporation, not a regular dealer in stocks and securities, received rentals of $250,000 for its property from a 25-percent shareholder, and also had gains of $50,000 during the taxable year from the sale of stocks and securities. It also had losses on the sale of stocks and securities in the amount of $30,000. Accordingly, P Corporation had gross income during the taxable year of $270,000 ($250,000 plus $20,000 net gain from the sales of stocks and securities). It had personal holding company income of $20,000. (The rentals of $250,000 would not be personal holding company income under section 543(a)(6) since the personal holding company income of the corporation, $20,000 (after excluding any such income described in section 543(a)(6)), is not more than 10 percent of its gross income.)

Example (2). The R Corporation, not a regular dealer in stocks or securities, realized total gains during the taxable year of $900,000 from commodity futures transactions and $200,000 from the sales of stocks and securities. It also sustained total losses of $1,000,000 on such commodity futures transactions, resulting in a net gain for the taxable year of $100,000. None of the commodity futures transactions are hedging or other types of futures transactions excluded from the application of section 543(a)(3). No part of the loss on commodity futures transactions is to be taken into account in determining personal holding company income and gross income for personal holding company tax purposes for the taxable year. The full amount of the $200,000 in gains from the sales of stocks and securities is to be included in personal holding company income and in gross income for personal holding company tax purposes for the taxable year.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.544–1 Constructive ownership.

(a) Rules relating to the constructive ownership of stock are provided by section 544 for the purpose of determining whether the stock ownership requirements of the following sections are satisfied:

(1) Section 542(a)(2), relating to ownership of stock by five or fewer individuals.

(2) Section 543(a)(5), relating to personal holding company income derived from personal service contracts.

(3) Section 543(a)(6), relating to personal holding company income derived from property used by shareholders.

(4) Section 543(a)(9), relating to personal holding company income derived from copyright royalties.

(b) Section 544 provides four general rules with respect to constructive ownership. These rules are:

(1) Constructive ownership by reason of indirect ownership. See section 544(a)(1) and § 1.544–2.

(2) Constructive ownership by reason of family and partnership ownership. See section 544(a)(2), (4), (5), and (6), and §§ 1.544–3, 1.544–6, and 1.544–7.

(3) Constructive ownership by reason of ownership of options. See section 544(a)(3), (4), (5), and (6), and §§ 1.544–4, 1.544–6, and 1.544–7.

(4) Constructive ownership by reason of ownership of convertible securities. See section 544(b) and § 1.544–5.

Each of the rules referred to in subparagraphs (2), (3), and (4) of this paragraph is applicable only if it has the effect of satisfying the stock ownership requirement of the section to which applicable; that is, when applied to section 542(a)(2), its effect is to make the corporation a personal holding company, or when applied to section 543(a)(5), section 543(a)(6), or section 543(a)(9), its effect is to make the amounts described in such provisions includible as personal holding company income.

(c) All forms and classes of stock, however denominated, which represent the interests of shareholders, members, or beneficiaries in the corporation shall be taken into consideration in applying the constructive ownership rules of section 544.

(d) For rules applicable in treating constructive ownership, determined by one application of section 544, as actual ownership for purposes of a second application of section 544, see section 544(a)(5) and § 1.544–6.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7715, June 17, 1964]

§ 1.544–2 Constructive ownership by reason of indirect ownership.

The following example illustrates the application of section 544(a)(1), relating to constructive ownership by reason of indirect ownership:

Example. A and B, two individuals are the exclusive and equal beneficiaries of a trust or estate which owns the entire capital stock of the M Corporation. The M Corporation in turn owns the entire capital stock of the N Corporation. Under such circumstances the entire capital stock of both the M Corporation and the N Corporation shall be considered as being owned equally by A and B as the individuals owning the beneficial interest therein.

§ 1.544–3 Constructive ownership by reason of family and partnership ownership.

(a) The following example illustrates the application of section 544(a)(2), relating to constructive ownership by reason of family and partnership ownership.

Example. The M Corporation at some time during the last half of the taxable year, had 1,800 shares of outstanding stock, 450 of which were held by various individuals having no relationship to one another and none of whom were partners, and the remaining 1,350 were held by 51 shareholders as follows:

Relationships	Shares	Shares	Shares	Shares	Shares
An individual	(A)100	(B)20	(C)20	(D)20	(E)20
His father	(AF)10	(BF)10	(CF)10	(DF)10	(EF)10
His wife	(AW)10	(BW)40	(CW)40	(DW)40	(EW)40
His brother	(AB)10	(BB)10	(CB)10	(DB)10	(EB)10
His son	(AS)10	(BS)40	(CS)40	(DS)40	(ES)40
His daughter by former marriage (son's half-sister)	(ASHS)10	(BSHS)40	(CSHS)40	(DSHS)40	(ESHS)40
His brother's wife	(ABW)10	(BBW)10	(CBW)10	(DBW)160	(EBW)10
His wife's father	(AWF)10	(BWF)10	(CWF)110	(DWF)10	(EWF)10
His wife's brother	(AWB)10	(BWB)10	(CWB)10	(DWB)10	(EWB)10
His wife's brother's wife	(AWBW)10	(BWBW)10	(CWBW)10	(DWBW)10	(EWBW)110
Individual's partner	(AP)10	....	....	....	....

By applying the statutory rule provided in section 544(a)(2) five individuals own more than 50 percent of the outstanding stock as follows:

A (including AF, AW, AB, AS, ASHS, AP)	160
B (including BF, BW, BB, BS, BSHS)	160
CW (including C, CS, CWF, CWB)	220
DB (including D, DF, DBW)	200
EWB (including EW, EWF, EWBW)	170
Total, or more than 50 percent	910

Individual A represents the obvious case where the head of the family owns the bulk of the family stock and naturally is the head of the group. A's partner owns 10 shares of the stock. Individual B represents the case where he is still head of the group because of the ownership of stock by his immediate family. Individuals C and D represent cases where the individuals fall in groups headed in C's case by his wife and in D's case by his brother because of the preponderance of holdings on the part of relatives by marriage. Individual E represents the case where the preponderant holdings of others eliminate that individual from the group.

(b) For the restriction on the applicability of the family and partnership ownership rules of this section, see paragraph (b) of § 1.544–1. For rules relating to constructive ownership as actual ownership, see § 1.544–6.

§ 1.544–4 Options.

The shares of stock which may be acquired by reason of an option shall be considered to be constructively owned by the individual having the

option to acquire such stock. For example: If C, an individual, on March 1, 1955, purchases an option, or otherwise comes into possession of an option, to acquire 100 shares of the capital stock of M Corporation, such 100 shares of stock shall be considered to be constructively owned by C as if C had actually acquired the stock on that date. If C has an option on an option (or one of a series of options) to acquire such stock, he shall also be considered to have constructive ownership of the stock which may be acquired by reason of the option (or the series of options). Under such circumstances, C shall be considered to have acquired constructive ownership of the stock on the date he acquired his option. For the restriction on the applicability of the rule of this section, see paragraph (b) of § 1.544–1.

§ 1.544–5 Convertible securities.

Under section 544(b) outstanding securities of a corporation such as bonds, debentures, or other corporate obligations, convertible into stock of the corporation (whether or not convertible during the taxable year) shall be considered as outstanding stock of the corporation. The consideration of convertible securities as outstanding stock is subject to the exception that, if some of the outstanding securities are convertible only after a later date than in the case of others, the class having the earlier conversion date may be considered as outstanding stock although the others are not so considered, but no convertible securities shall be considered as outstanding stock unless all outstanding securities having a prior conversion date are also so considered. For example, if outstanding securities are convertible in 1954, 1955 and 1956, those convertible in 1954 can be properly considered as outstanding stock without so considering those convertible in 1955 or 1956, and those convertible in 1954 and 1955 can be properly considered as outstanding stock without so considering those convertible in 1956. However, the securities convertible in 1955 could not be properly considered as outstanding stock without so considering those convertible in 1954 and the securities convertible in 1956 could not be properly considered as outstanding stock without so considering those convertible in 1954 and 1955. For the restriction on the applicability of the rule of this section, see paragraph (b) of § 1.544–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.544–6 Constructive ownership as actual ownership.

(a) General rules. (1) Stock constructively owned by a person by reason of the application of the rule provided in section 544(a)(1), relating to stock not owned by an individual, shall be considered as actually owned by such person for the purpose of again applying such rule or of applying the family and partnership rule provided in section 544(a)(2), in order to make another person the constructive owner of such stock, and

(2) Stock constructively owned by a person by reason of the application of the option rule provided in section 544(a)(3) shall be considered as actually owned by such person for the purpose of applying either the rule provided in section 544(a)(1), relating to stock not owned by an individual, or the family and partnership rule provided in section 544(a)(2) in order to make another person the constructive owner of such stock, but

(3) Stock constructively owned by an individual by reason of the application of the family and partnership rule provided in section 544(a)(2) shall not be considered as actually owned by such individual for the purpose of again applying such rule in order to make another individual the constructive owner of such stock.

(b) Examples. The application of this section may be illustrated by the following examples:

Example (1). A's wife, AW, owns all the stock of the M Corporation, which in turn owns all the stock of the O Corporation. The O Corporation in turn owns all the stock of the P Corporation. Under the rule provided in section 544(a)(1), relating to stock not owned by an individual, the stock in the P Corporation owned by the O Corporation is considered to be owned constructively by the M Corporation, the sole shareholder of the O Corporation. Such constructive ownership of the stock of the M Corporation is considered as actual ownership for the purpose of again applying such rule in order to make AW, the sole shareholder of the M Corporation, the constructive owner of the stock of the P Corporation. Similarly, the constructive ownership of the stock by AW is considered as actual ownership for the purpose of applying the family and partnership rule provided in section 544(a)(2) in order to make A the constructive owner of the stock of the P Corporation, if such application is necessary for any of the purposes set forth in paragraph (b) of § 1.544–1. But the stock thus constructively owned by A may not be considered as actual ownership for the purpose of again applying the family and partnership rule in order to make another member of A's family, for example, A's father, the constructive owner of the stock of the P Corporation.

Example (2). B, an individual, owns all the stock of the R Corporation which has an option to acquire all the stock of the S Corporation, owned by C, an individual, who is not related to B. Under the option rule provided in section 544(a)(3) the R Corporation may be considered as owning constructively the stock of the S Corporation owned by C. Such constructive ownership of the stock by the R Corporation is considered as actual ownership for the purpose of applying the rule provided in section 544(a)(1), relating to stock not owned by an individual, in order to make B, the sole shareholder of the R Corporation, the constructive owner of the stock of the S Corporation. The stock thus constructively owned by B by reason of the

application of the rule provided in section 544(a)(1) likewise is considered as actual ownership for the purpose, if necessary, of applying the family and partnership rule provided in section 544(a)(2), in order to make another member of B's family, for example, B's wife, BW, the constructive owner of the stock of the S Corporation. However, the family and partnership rule could not again be applied so as to make still another individual the constructive owner of the stock of the S Corporation, that is, the stock constructively owned by BW could not be considered as actually owned by her in order to make BW's father the constructive owner of such stock by a second application of the family and partnership rule.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.544–7 Option rule in lieu of family and partnership rule.

(a) If, in determining the ownership of stock, such stock may be considered as constructively owned by an individual by an application of either the family and partnership rule (section 544(a)(2)) or the option rule (section 544(a)(3)), such stock shall be considered as owned constructively by the individual by reason of the application of the option rule.

(b) The application of this section may be illustrated by the following example:

Example. Two brothers, A and B, each own 10 percent of the stock of the M Corporation, and A's wife, AW, also owns 10 percent of the stock of such corporation. AW's husband, A, has an option to acquire the stock owned by her at any time. It becomes necessary, for one of the purposes stated in section 544(a)(4), to determine the stock ownership of B in the M Corporation. If the family and partnership rule were the only rule that applied in the case, B would be considered, under that rule, as owning 20 percent of the stock of the M Corporation, namely, his own stock plus the stock owned by his brother. In that event, B could not be considered as owning the stock held by AW since (1) AW is not a member of B's family and (2) the constructive ownership of such stock by A through the application of the family and partnership rule in his case is not considered as actual ownership so as to make B the constructive owner by a second application of the same rule with respect to the ownership of the stock. However, there is more than the family and partnership rule involved in this example. As the holder of an option upon the stock, A may be considered the constructive owner of his wife's stock by the application of the option rule and without reference to the family relationship between A and AW. If A is considered as owning the stock of his wife by application of the option rule, then such constructive ownership by A is regarded as actual ownership for the purpose of applying the family and partnership rule so as to make another member of A's family, for example, B, the constructive owner of the stock. Hence, since A may be considered as owning his wife's stock by applying either the family-partnership rule or the option rule, the provisions of section 544(a)(6) apply and accordingly A must be considered the constructive owner of his wife's stock under the option rule rather than the family-partnership rule. B thus becomes the constructive owner of 30 percent of the stock of the M corporation, namely, his own 10 percent, A's 10 percent, and AW's 10 percent constructively owned by A as the holder of an option on the stock.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.545–1 Definition.

(a) Undistributed personal holding company income is the amount which is subject to the personal holding company tax imposed under section 541. Undistributed personal holding company income is the taxable income of the corporation adjusted in the manner described in section 545(b) and § 1.545–2, and section 545(c) and § 1.545–3, less the deduction for dividends paid. See part IV (section 561 and following), subchapter G, chapter 1 of the Code, and the regulations thereunder, relating to the dividends paid deduction.

(b) For purposes of the imposition of the personal holding company tax on a foreign corporation, resident or nonresident, which files or causes to be filed a return, the undistributed personal holding company income shall be computed on the basis of the taxable income from sources within the United States, and such income shall be adjusted in accordance with the principles of section 545(b) and § 1.545–2, and section 545(c) and § 1.545–3. For purposes of the imposition of such tax on a foreign corporation, resident or nonresident, which files no return, the undistributed personal holding company income shall be computed on the basis of the gross income from sources within the United States without allowance of any deductions. For purposes of this paragraph, a nonresident foreign corporation will be considered to have filed a return for any taxable year ending before September 9, 1958, if the return for any such taxable year is filed on or before February 5, 1960.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6949, 33 FR 5525, Apr. 9, 1968]

§ 1.545–2 Adjustments to taxable income.

(a) Taxes—(1) General rule. (i) In computing undistributed personal holding company income for any taxable year, there shall be allowed as a deduction the amount by which Federal income and excess profits taxes accrued during the taxable year exceed the credit provided by section 33 (relating to taxes of foreign countries and possessions of the United States), and the income, war profits, and excess profits taxes of foreign countries and possessions of the United States accrued during the taxable year (to the extent provided by subparagraph (3) of this paragraph), except that no deduction shall be allowed for (a) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (b) the personal holding company tax imposed by section

541 (or a corresponding section of a prior law), and (c) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939, for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year, determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursement method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the taxpayer shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) Election by taxpayer which deducted taxes paid. (i) If the corporation was subject to the personal holding company tax imposed by section 500 of the Internal Revenue Code of 1939 and, for the purpose of that tax, deducted Federal taxes paid rather than such taxes accrued for each taxable year for which it was subject to such taxes, the corporation may elect for any taxable year ending after June 30, 1954, to deduct taxes accrued, including taxes of foreign countries and possessions of the United States, rather than taxes paid, for the purposes of the tax imposed by section 541 of the Internal Revenue Code of 1954. The election shall be made by deducting such taxes accrued on Schedule PH, Form 1120, to be filed with the return. The schedule shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after June 30, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) Taxes of foreign countries and United States possessions. In determining undistributed personal holding company income for any taxable year, if the taxpayer chooses the benefits of section 901 for such taxable year, a deduction shall be allowed for—

(i) The income, war profits, and excess profits taxes imposed by foreign countries or possessions of the United States and accrued (or paid, if required under subparagraph (1)(ii) of this paragraph) during such taxable year, and

(ii) In the case of a domestic corporation, the foreign income taxes deemed to be paid for such taxable year under section 902(a) in accordance with §§ 1.902–1 and 1.902–2 or section 960(a)(1) in accordance with § 1.960–7.

In no event shall the amount under subdivision (ii) of this subparagraph exceed the amount includible in gross income with respect to such taxes under section 78 and § 1.78–1. The credit for such taxes provided by section 901 shall not be allowed against the personal holding company tax imposed by section 541. See section 901(a).

(b) Charitable contributions—(1) Taxable years beginning before January 1, 1970. (i) Section 545(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1)(A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b)(2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1)(A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 545(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term "adjusted gross income" when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise

allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See § 1.170-2 with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(2) Taxable years beginning after December 31, 1969. (i) Section 545(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining undistributed personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1)(A), (B), and (D)(i) (relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii) (relating to excess charitable contributions by individuals of certain capital gain property, section 170(b)(2) (relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d)(relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1)(A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 545(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term "contribution base" when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 545(b)(8), relating to expenses and depreciation applicable to property of the taxpayer. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(1)(D)(ii) and (d), shall not be allowed as a deduction in computing undistributed personal holding company income for any taxable year.

(iii) See § 1.170A-8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) Special deductions disallowed. Part VIII, subchapter B, chapter 1 of the Code, allows corporations, in computing taxable income, special deductions for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. Such special deductions, except the deduction provided by section 248 (relating to organizational expenses) shall be disallowed in computing undistributed personal holding company income.

(d) Net operating loss. The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed personal holding company income for a taxable year beginning after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code.

(e) Long-term capital gains. (1) There is allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes attributable to such excess, as provided in section 545(b)(5).

(2) Section 631(c) (relating to gain or loss in the case of disposal of coal or domestic iron ore) shall have no application.

(f) Bank affiliates. There is allowed the deduction provided by section 601 in the case of bank affiliates (as defined in section 2 of the Banking Act of 1933; 12 U.S.C. 221a(c)).

(g) Payment of indebtedness incurred prior to January 1, 1934—(1) General rule. In computing undistributed personal holding company income, section 545(b)(7) provides that there shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness. See § 1.545-3 for the deduction in computing undistributed personal holding company income of amounts used or irrevocably set aside to pay or retire qualified

indebtedness (as defined in paragraph (d) of § 1.545–3).

(2) Indebtedness. The term "indebtedness" means an obligation absolute and not contingent, to pay on demand or within a given time, in cash or other medium, a fixed amount. The term "indebtedness" does not include the obligation of a corporation on its capital stock. The indebtedness must have been incurred (or, if incurred by assumption, assumed) by the taxpayer before January 1, 1934. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued and the amount of such indebtedness is the amount represented by the face value of the obligations. In the case of refunding, renewal, or other change in the form of an indebtedness, the giving of a new promise to pay by the taxpayer will not have the effect of changing the date the indebtedness was incurred.

(3) **Amounts used or irrevocably set aside.** The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year. The use or irrevocable setting aside must be to effect the extinguishment or discharge of indebtedness. In the case of refunding, renewal, or other change in the form of an indebtedness, the mere giving of a new promise to pay by the taxpayer will not result in an allowable deduction. If amounts are set aside in one year, no deduction is allowable for such amounts for a later year in which actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. Double deductions shall not be allowed.

(4) **Reasonableness of the amounts with reference to the size and terms of the indebtedness.** (i) The reasonableness of the amounts used or irrevocably set aside must be determined by reference to the size and terms of the particular indebtedness. Hence, all the facts and circumstances with respect to the nature, scope, conditions, amount, maturity, and other terms of the particular indebtedness must be shown in each case.

(ii) Ordinarily an amount used to pay or retire an indebtedness, in whole or in part, at or prior to the maturity and in accordance with the terms thereof will be considered reasonable, and may be allowable as a deduction for the year in which so used. However, if an amount has been set aside in a prior year for payment or retirement of the same indebtedness, the amount so set aside shall not be allowed as a deduction in the year of the payment.

(iii) All amounts irrevocably set aside for the payment or retirement of an indebtedness in accordance with and pursuant to the terms of the obligation, for example, the annual contribution to trustees required by the provisions of a mandatory sinking fund agreement, will be considered as complying with the requirement of reasonableness. To be considered reasonable, it is not necessary that the plan of retirement provide for a retroactive setting aside of amounts for years prior to that in which the plan is adopted. However, if a voluntary plan was adopted before 1934, no adjustment is allowable in respect of the amounts set aside in the years prior to 1934.

(5) **Burden of proof.** The burden of proof will rest upon the taxpayer to sustain the deduction claimed. Therefore, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(6) **Allowance to a successor corporation.** For allowance of deduction for pre-1934 indebtedness to a successor corporation, see section 381(c)(15).

(h) **Expenses and depreciation applicable to property of the taxpayer.** (1) In computing undistributed personal holding company income in the case of a personal holding company which owns or operates property, section 545(b)(8) provides a specific limitation with respect to the allowance of deductions for trade or business expenses and depreciation allocable to the operation or maintenance of such property. Under this limitation, these deductions shall not be allowed in an amount in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner—

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If, in computing undistributed personal holding company income, a personal holding company claims

deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, it shall attach to its income tax return a statement setting forth its claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to its claim and the arguments on which it relies. Such statement shall set forth:

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable or, if none was received, a statement of the reasons therefore;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business, carried on by the corporation, with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(i) Amount of a lien in favor of the United States. (1) If notices of lien are filed in the manner provided in section 6323(f), the amount of the liability to the United States outstanding at the close of the taxable year, and secured by such liens which are in effect at that time, shall be allowed as a deduction in computing undistributed personal holding company income. However, the amount of such deduction which may be allowed for any taxable year shall not exceed the taxable income (as adjusted for purposes of determining the undistributed personal holding company income, but without regard to the deduction under section 545(b)(9)) for such year. The fact that the amount of, or any part of, the outstanding obligation to the United States was deducted for one taxable year does not prevent its deduction for a subsequent taxable year to the extent the obligation is still outstanding at the close of the subsequent taxable year and is secured by a lien, notice of which has been filed.

(2) Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. If the taxpayer (on the calendar year basis) is subject to a lien (notice of which has been properly filed) in the amount of $500,000 at the close of the calendar year 1954 and has taxable income of $400,000 for such taxable year, the deduction allowable by reason of the lien for the calendar year 1954 is $400,000. If, at the close of the taxable year ended December 31, 1955, the taxpayer is still subject to the same lien of $500,000 and it has taxable income of $450,000, a deduction is allowed by reason of such lien in the amount of $450,000.

(3) When the obligation secured by the lien in favor of the United States has been satisfied or released, the sum of the amounts which have been allowed as deductions under section 545(b)(9) in respect of such obligation shall be restored to taxable income for the year in which such lien is satisfied or released. If only a part of the obligation secured by the lien has been satisfied, the sum of the amounts which have been allowed as deductions under section 545(b)(9) in respect of such part shall be included in taxable income for the year of the satisfaction for the purpose of determining undistributed personal holding company income. It should be noted, however, that only the sum of the amounts which have been allowed as deductions under section 545(b)(9) and subparagraph (1) of this paragraph shall be included in taxable income. Thus, any amounts which were allowed as deductions under section 504(e) of the Internal Revenue Code of 1939 shall not be included as taxable income for any taxable year under section 545(b)(9) and subparagraph (1) of this paragraph.

(4) The application of subparagraph (3) of this paragraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (2) of this paragraph, and assume further that the corporation has $100,000 taxable income both for 1956 (before including the $400,000 described below) and for 1957. In 1956, the corporation pays $200,000 of the obligation, thereby reducing its liability from $500,000 to $300,000. In such case, $400,000 is included in taxable income in computing its undistributed personal holding company income for 1956, that is, the sum of the $200,000 deduction for 1954 and the $200,000 deduction for 1955 in respect of the liability which is paid in 1956. In 1957, property of the corporation is discharged from the lien by reason of the fact that the value of the remaining property of the corporation exceeds double the outstanding liability. (See section 6325(b)(1).) Since this was not a release or satisfaction of the lien, no amount is added to taxable income for 1957 with respect to the property discharged from the lien. In 1958, the remaining property is released from the lien by reason of a bond being accepted under section 6325(a)(2). There is added to taxable income in computing undistributed personal holding company income for 1958, $850,000, that is, the sum of the deductions allowed for 1954, 1955, 1956, and 1957 in respect of the $300,000 liability, the lien for which was released in 1958. This amount of $850,000, is computed as follows:

Year	Outstanding liability	Taxable income	Deduction as limited by taxable income	Amount attributable to part payment of $200,000 in 1956	Amount attributable to release of lien in 1958
1954	$500,000	$400,000	$400,000	$200,000	$200,000
1955	500,000	450,000	450,000	200,000	250,000
1956	300,000	500,000	300,000		300,000
1957	300,000	100,000	100,000		100,000
Total					850,000

(5)(i) If an amount has been included in undistributed personal holding company income of the personal holding company by reason of section 545(b)(9), any shareholder of the company may elect to compute his income tax with respect to such of his dividends as are attributable to such amount as though such dividends were received ratably over the period the lien was in effect.

(ii) For purposes of section 545(b)(9), the dividends paid during the taxable year of the personal holding company (computed as of the close of such year) shall be deemed attributable first to undistributed personal holding company income by reason of section 545(b)(9) (computed as of the close of the taxable year of the personal holding company). If the period over which the lien was in effect consists of several taxable years of the personal holding company, the dividend deemed received for any taxable year shall be deemed received on the last day of such taxable year of the personal holding company.

(iii) Such election shall be made in a statement showing the amount of the deduction under section 545(b)(9) for each taxable year of the period in which the lien was in effect, the amount of such deduction, if any, which was added to undistributed personal holding company income in a later year or years as a result of partial satisfaction or release of such lien, and the details thereof, the taxable year or years to which such dividends are allocable, and a computation of tax, on the basis of the election, for all taxable years affected by such ratable allocation of the dividends. Further, the statement shall show the district director's office in which the returns, for the years to which the dividends are allocable, were filed, the kind of returns which were filed (separate returns or joint returns), and the name and address under which the returns were filed. The statement shall be attached to the shareholder's return for the taxable year for which the dividend would be reported but for such election.

(iv) The operation of this subparagraph may be illustrated as follows: If, in the example under subparagraph (4) of this paragraph, shareholder A owns 75 percent in value of the outstanding stock of the personal holding company, and receives a dividend of $540,000 from such company during 1958 (the total dividend distribution being $720,-000) he may elect to compute his income tax with respect to the $540,000 in dividends for 1958 as if he had received $127,058.82 of such dividends for 1954 ($200,000/850,000 of $540,000), $158,823.53 of such dividends for 1955 ($250,000/850,000 of $540,000), $190,588.23 of such dividends for 1956 ($300,000/850,000 of $540,000), and $63,529.41 of such dividends for 1957 ($100,000/850,000 of $540,000). Accordingly, the tax computed for 1958 with respect to such dividends shall be the aggregate of the taxes attributable to such amounts had they been distributed in the respective years.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6805, 30 FR 3209, March 9, 1965; T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 6900, 31 FR 14643, Nov. 17, 1966; T.D. 6949, 33 FR 5526, April 9, 1968; T.D. 7207, 37 FR 20796, Oct. 5, 1972; T.D. 7429, 41 FR 35492, Aug. 23, 1976; T.D. 7649, 44 FR 60086, Oct. 18, 1979]

§ 1.545–3 Special adjustment to taxable income.

(a) In general. In computing undistributed personal holding company income for any taxable year beginning after December 31, 1963, section 545(c)(1) provides that, except as otherwise provided in section 545(c), there shall be allowed as a deduction amounts used or amounts irrevocably set aside (to the extent reasonable with reference to the size and terms of the indebtedness) during such year to pay or retire qualified indebtedness (as defined in section 545(c)(3) and paragraph (d) of this section). The reasonableness of amounts irrevocably set aside shall be determined under the rules of paragraph (g)(4) of § 1.545–2.

(b) Amounts used or irrevocably set aside—(1) In general. The deduction is allowable, in any taxable year, only for amounts used or irrevocably set aside in that year to extinguish or discharge qualified indebtedness. If amounts are set aside in 1 year, no deduction is allowable for a later year in which such amounts are actually paid. As long as all other conditions are satisfied, the aggregate amount allowable as a deduction for any taxable year includes all amounts (from whatever source) used and all amounts (from whatever source) irrevocably set aside, irrespective of whether in cash or other medium. The same item shall not be deducted more than once.

(2) Refunding, etc., of qualified indebtedness. (i) A refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not result in an allowable deduction whether or not funds are obtained from such refunding, renewal, or change in form, and whether or not such funds are applied on the prior obligation, and will not constitute a reduction in the amount of such qualified indebtedness. For purposes of this section, if, in connection with a refunding, renewal, or other change in the form of an indebtedness, the rate of interest or principal amount of such debt, or the date when payment is due with respect to such debt or significantly changed, or if, after the refunding, renewal, or other change in the form of such debt, the creditor to whom such debt is owed is neither the creditor to whom such debt was owed before such refunding, renewal, or other change, nor a person standing in a relationship to such creditor described in section 267(b), then a substantial change in the economic terms of such indebtedness will normally have occurred.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example (1). On December 31, 1963, M owes $10,000 to X represented by a 6-percent, 90-day note payable on January 31, 1964. On January 31, 1964, M renews the debt, giving X a new 6-percent, 90-day note (payable on Apr. 30, 1964) and paying the accrued interest on the old note. Since the date when payment is due has been significantly changed, a substantial change in the economic terms of the indebtedness has occurred.

Example (2). On December 31, 1963, S owes $5,000 to T represented by a 6-percent note payable on January 1, 1965. On December 23, 1964, S liquidates the note, giving T a new note for $5,000 due on January 2, 1965, and bearing interest at 6 percent. Since the transaction does not involve a substantial change in the economic terms of the indebtedness, the transaction will not result in an allowable deduction, and the amount of the qualified indebtedness will not be reduced.

Example (3). (i) On December 31, 1963, Q owes $45,000 to R represented by a demand note. On July 1, 1964, Q renews $30,000 of the indebtedness by issuing a new demand note to R and liquidates $15,000 of the debt. Since the principal amount of the debt has been significantly changed, there has been a substantial change in the economic terms of the indebtedness.

(ii) If Q had issued renewal notes for $44,000 and had paid only $1,000 of the total indebtedness, then a significant change in the principal amount of the debt would not have occurred and Q would have been entitled to only a $1,000 deduction (the amount actually paid during the taxable year). In addition, the amount of qualified indebtedness would have been reduced to $44,000.

(c) Corporations to which applicable. Section 545(c)(2) describes the corporations to which section 545(c) applies. In order to qualify under section 545(c)(2), the corporation must be one:

(1) Which for at least one of its two most recent taxable years ending before February 26, 1964, was not a personal holding company under section 542, but which would have been a personal holding company under section 542 for such taxable year if the law applicable for the first taxable year beginning after December 31, 1963, had been applicable to such taxable year; or

(2) Which is an acquiring corporation treated as a corporation described in subparagraph (1) of this paragraph by reason of section 381(c)(15)(relating to the carryover of certain indebtedness in corporate acquisitions), but only to the extent of the qualified indebtedness to which it has succeeded under section 381(c)(15) and the indebtedness referred to in paragraph (d)(1)(ii) of this section incurred to replace qualified indebtedness to which it has succeeded under section 381(c)(15).

The law applicable for the first taxable year beginning after December 31, 1963, for purposes of this paragraph means part II (section 541 and following), subchapter G, chapter 1 of the Code as applicable to such year but does not include amendments to other parts of the Code first appli-

cable with respect to such year. For an example of a corporation described in subparagraph (1) of this paragraph see paragraph (f)(1) of § 1.333–5.

(d) **Qualified indebtedness—(1) General definition.** Except as provided in subparagraphs (2), (3), and (4) of this paragraph the term "qualified indebtedness" means:

(i) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1933, and before January 1, 1964, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies), and

(ii) The outstanding indebtedness (as defined in subparagraph (6) of this paragraph) incurred after December 31, 1963, by the taxpayer (or to which the taxpayer succeeded in a transaction to which section 381(c)(15) applies) for the purpose of making a payment or set-aside referred to in paragraph (a) of this section in the same taxable year of the debtor in which such indebtedness was incurred. An indebtedness shall be deemed not to have been incurred for the purpose of making a payment or set-aside referred to in paragraph (a) of this section when such indebtedness is a consequence of a refunding, renewal or mere change in the form of a qualified indebtedness which does not involve a substantial change in the economic terms of the qualified indebtedness. (See paragraph (b)(2) of this section for the meaning of "substantial change in the economic terms of the indebtedness".) In the case of such a payment or set-aside which is made on or after the first day of the first taxable year beginning after December 31, 1963, such indebtedness incurred after December 31, 1963, is treated as qualified indebtedness only to the extent that the deduction from taxable income otherwise allowed by section 545(c)(1) with respect to such payment or set-aside is treated as nondeductible by reason of the election referred to in paragraph (e) of this section.

(2) Exception for indebtedness owed to certain shareholders. For purposes of subparagraph (1) of this paragraph, qualified indebtedness does not include any amounts which were, at any time after December 31, 1963, and before the payment or set-aside to which this section applies, owed directly or indirectly to a person who at such time owned more than 10 percent in value of the taxpayer's outstanding stock. The rules of section 318(a) and the regulations thereunder apply for the purpose of determining ownership under this subparagraph. Amounts which cease to be qualified indebtedness by reason of this subparagraph may not subsequently become qualified indebtedness as a result of any change in the facts (for example, a subsequent sale of stock by the person to whom the amounts are directly or indirectly owed).

(3) Reduction for amounts irrevocably set aside. For purposes of subparagraph (1) of this paragraph, qualified indebtedness with respect to a particular contract is reduced when and to the extent that amounts are irrevocably set aside to pay or retire such indebtedness. An amount is not considered to be irrevocably set aside if any person could use such amount for any purpose other than the retirement of the qualified indebtedness with respect to which it was set aside. No deduction is allowed under section 545(c)(1) and this section for payments out of amounts previously set aside. Thus, for example, if a corporation, which is a June 30 fiscal year taxpayer, incurs indebtedness of $1 million on February 1, 1962, and, in accordance with its contract of indebtedness, irrevocably sets aside $50,000 in a sinking fund on February 1, of each of the years 1963, 1964, and 1965, then its qualified indebtedness on January 1, 1964, is $950,000 ($1 million less one set-aside of $50,000 in 1963). The corporation is not allowed a deduction under section 545(c)(1) for the set-aside of $50,000 made during its taxable year ending on June 30, 1964, since section 545(c) is applicable only to taxable years beginning after December 31, 1963, but the qualified indebtedness is nevertheless reduced by such amount. The corporation is allowed a deduction of $50,000 for its taxable year ending June 30, 1965, as a result of the set-aside made during such taxable year, and qualified indebtedness on July 1, 1965, is $850,000. No deduction is allowed to the corporation for a payment in any subsequent taxable year from the amounts so set aside.

(4) Reduction on disposition of certain property. (i) Section 545(c)(6) provides that the total amount of the taxpayer's qualified indebtedness (as determined under subdivision (ii) of this subparagraph) shall be reduced if property of a character subject to the allowance for exhaustion, wear and tear, obsolescence, amortization, or depletion is disposed of after December 31, 1963. The reduction is made pro rata (in accordance with subdivision (iii) of this subparagraph) for the taxable year of such disposition and is equal in total amount to the excess, if any, of:

(a) The adjusted basis of the property disposed of (determined under section 1011 and the regulations thereunder) immediately before such disposition; over

(b) The amount of qualified indebtedness which ceased to be qualified indebtedness with respect to the taxpayer by reason of the assumption of indebtedness by the transferee of the property disposed of (whether or not such indebtedness was incurred by the taxpayer in connection with the property disposed of).

For purposes of (b) of this subdivision, the transferee will be treated as having assumed qualified indebtedness if such transferee acquires real estate of which the taxpayer is the legal or equitable owner immediately before the transfer and which is subject to indebtedness that, with respect to the taxpayer, is qualified indebtedness immediately before the transfer, provided the taxpayer shows to the satisfaction of the Commissioner that under all the facts and circumstances it no longer bears the burden of discharging such indebtedness.

(ii) The indebtedness reduced under the rule of this subparagraph is the qualified indebtedness which is outstanding with respect to the taxpayer immediately after the disposition referred to in subdivision (i) of this subparagraph.

(iii) The reduction with respect to any particular contract of indebtedness under the rules of this subparagraph shall be determined by multiplying the total reduction (determined under subdivision (i) of this subparagraph) by the ratio which the amount of the qualified indebtedness owed with respect to such contract by the taxpayer on the date referred to in subdivision (ii) of this subparagraph bears to the aggregate qualified indebtedness owed by the taxpayer with respect to all contracts on such date.

(5) **Total debt consisting of both qualified and nonqualified indebtedness.** In any case where, with respect to a particular contract of indebtedness, a part of the total indebtedness owed with respect to such contract is qualified indebtedness and the other part is indebtedness which is not qualified indebtedness, then, any amount paid or irrevocably set aside with respect to such contract shall be allocated between both such parts pro rata unless the taxpayer clearly indicates in its return the part of the payment or set-aside which shall be allocated to the qualified indebtedness.

(6) **Outstanding indebtedness.** For purposes of determining qualified indebtedness, the term "indebtedness" has the same meaning that it has under section 545(b)(7) and paragraph (g)(2) of § 1.545–2. Indebtedness ceases to be outstanding when the taxpayer no longer has an obligation absolute and not contingent with respect to the payment of such debt. An indebtedness evidenced by bonds, notes, or other obligations issued by a corporation is ordinarily incurred as of the date such obligations are issued, and the amount of such indebtedness is the amount represented by the face value of the obligations. However, a refunding, renewal, or mere change in the form of an indebtedness which does not involve a substantial change in the economic terms of the indebtedness will not have the effect of changing the date the indebtedness was incurred. (See paragraph (b)(2) of this section for the meaning of "substantial change in the economic terms of the indebtedness".) For purposes of this section, the outstanding indebtedness of a taxpayer includes a mortgage or other security interest on real estate of which such taxpayer is the legal or equitable owner (even though the taxpayer is not directly liable on the underlying evidence of indebtedness secured by such mortgage or security interest) provided such taxpayer shows to the satisfaction of the Commissioner that under all of the facts and circumstances it bears the burden of discharging such indebtedness. Thus, for example, if X acquires from Y property which is subject to a mortgage (X not assuming the indebtedness underlying such mortgage) and if X actually bears the burden of discharging the indebtedness, then, after the date of acquisition, such underlying indebtedness is outstanding indebtedness with respect to X, and, since Y's obligation to pay is in fact contingent upon X failing to discharge the indebtedness, such indebtedness is not outstanding indebtedness with respect to Y.

(7) **Examples.** The application of this paragraph may be illustrated by the following examples:

Example (1). M Corporation, a calendar year taxpayer has $600,000 of indebtedness outstanding on December 31, 1963 (which was incurred after 1933), represented by three demand notes. Individuals A and B (who are not shareholders) each hold one of M Corporation's notes in the amount of $150,000 and N Corporation (which is not a shareholder) holds M Corporation's note in the amount of $300,000. The note held by N Corporation is secured by a mortgage on certain depreciable real estate owned by M Corporation which has an adjusted basis to it on July 1, 1964, of $500,000. On July 1, 1964, M Corporation sells the depreciable real estate to O Corporation in consideration for $200,000 in cash and the assumption by O Corporation of the indebtedness on the note held by N Corporation. M Corporation borrows $200,000 on September 30, 1964, of which amount $150,000 is simultaneously applied to liquidate the note held by B. M Corporation's qualified indebtedness is reduced on July 1, 1964, by $300,000, the qualified indebtedness which ceased to be outstanding by reason of the transfer. In addition, the reduction (computed under section 545(c)(6) and subparagraph (4) of this paragraph) of M Corporation's qualified indebtedness by reason of the disposition of depreciable property on July 1, 1964, is as follows:

Outstanding qualified indebtedness after reduction of qualified indebtedness which ceased to be outstanding by reason of the transfer but before the sec. 545(c)(6) reduction	$300,000
Reduced by:	
The excess of the adjusted basis of depreciable real estate disposed of on July 1, 1964 ($500,000), over the amount of qualified indebtedness assumed by O Corporation ($300,000)...........................	200,000
Qualified indebtedness after reductions from transfer and assumption of indebtedness	100,000

The pro-rata share of the reduction with respect to each debt is computed as follows:

Note held by A:	
Qualified indebtedness owed by taxpayer on the note held by A before the disposition of depreciable property	$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $200,000 × ($150,000 ÷ $300,000)	100,000
Qualified indebtedness owed on the note held by A after the transfer	50,000
Note held by B:	
Qualified indebtedness owed by taxpayer on the note held by B before the transfer of depreciable property	$150,000
Less the pro-rata share of the total reduction computed under subparagraph (4) of this paragraph allocable to such note $200,000 × ($150,000 ÷ $300,000)	100,000
Qualified indebtedness owed on the note held by B after the transfer	50,000

Of the $150,000 paid by M Corporation on September 30, 1964, to retire the note held by B only $50,000 qualified as a use of an amount to pay or retire qualified indebtedness and, thus, only $50,000 is allowable as a deduction for purposes of computing undistributed personal holding company income for 1964.

Example (2). The facts are the same as in example (1) except that M Corporation elects in accordance with paragraph (e) of this section not to deduct $25,000 of the $50,000 amount otherwise deductible. Then $25,000 of the $200,000 of new indebtedness incurred by M Corporation is qualified indebtedness. If the payment on the note held by B had not been made until January 1, 1965, then the new indebtedness would not be qualified indebtedness since the payment was not made in the taxable year in which the new indebtedness was incurred. If M Corporation pays $40,000 on April 1 and July 1, 1965, on the indebtedness incurred September 30, 1964, then (unless M indicates otherwise in its return for 1965 in accordance with subparagraph (5) of this paragraph) the payments made on such dates must be allocated between qualified and nonqualified indebtedness in the following manner:

	Qualified	Nonqualified
April 1 payment:		
$40,000 × $25,000 (qualified) ÷ $200,000 (total indebtedness)	$5,000	
$40,000 × $175,000 (nonqualified) ÷ $200,000 (total indebtedness)...............	....	$35,000
July 1 payment:		
$40,000 × $20,000 (qualified) ÷ $160,000 (total indebtedness)	$5,000	
$40,000 × $140,000 (nonqualified) ÷ $160,000 (total indebtedness)...............	....	35,000
Total	10,000	70,000

Thus, a total of $10,000 of the two payments would be considered used to pay or retire qualified indebtedness. The results in examples (1) and (2) would be the same if O Corporation purchased the real estate subject to the indebtedness (not assuming the indebtedness) on the note held by N Corporation, provided M Corporation does not bear the burden of discharging such indebtedness after July 1, 1964.

Example (3). C owns all of the 1000 shares of outstanding capital stock of P Corporation. On December 31, 1963, P Corporation, a calendar year taxpayer, owes $200,000 of outstanding indebtedness to D and $500,000 of outstanding indebtedness to E. These debts were incurred after 1933. On January 15, 1964, P Corporation pays $100,000 in partial liquidation of the $500,000 indebtedness. On March 15, 1964, P Corporation pays $50,000 into a sinking fund with respect to the $200,000 indebtedness owed to D. On April 15, 1964, D purchases one-half of the shares owned by C, constituting 50 percent in value of P Corporation's outstanding stock. P Corporation, on June 15, 1964, pays $50,000 into a sinking fund with respect to the indebtedness owed to D. For purposes of the March 15, 1964, set-aside, the indebtedness owed to D ($200,000) is qualified indebtedness. However, the indebtedness owed to D is not qualified indebtedness for purposes of the June set-aside with respect to such indebtedness since D is a person who after December 31, 1963, and before the June set-aside, owned more than 10 percent in value of P Corporation's outstanding stock. Moreover, any subsequent set-asides made with respect to the indebtedness owed to D will not be made with respect to qualified indebtedness even if the shares owned by D are subsequently sold. Assuming no payments or set-asides are made by P Corporation after June 15, 1964, the P Corporation is entitled to a deduction of $150,000 under section 545(c)(1) for the calendar year 1964 for amounts paid and for amounts irrevocably set aside to pay or retire qualified indebtedness, and the total qualified indebtedness at the end of 1964 is $400,000. No additional deduction is allowed in subsequent taxable years for amounts paid out of the amounts set aside in 1964.

(e) **Election not to deduct—(1) In general.** Section 545(c)(4) provides that a taxpayer may elect to treat as nondeductible amounts otherwise deductible under section 545(c)(1) for the taxable year. The election shall be in the form of a statement of election filed on or before the 15th day of the third month following the close of the taxable year with respect to which the election applies. The election shall be irrevocable after such date.

(2) Statement of election. The statement of election referred to in subparagraph (1) of this paragraph shall be attached to the taxpayer's Schedule PH (Form 1120) for the year with respect to which such election applies, if such schedule is filed on or before the date referred to in subparagraph (1) of this paragraph. If the taxpayer's Schedule PH (Form 1120) is not filed on or

before such date, then the statement of election shall clearly set forth the taxpayer's name, address, and employer identification number, shall be signed by an officer of the taxpayer who is authorized to sign a return of the taxpayer with respect to income, and shall be filed with the district director for the internal revenue district in which the taxpayer's income tax return (for the year with respect to which the election is applicable) would be filed. The following information shall be included in the statement of election:

(i) A statement that the taxpayer wishes to elect in accordance with section 545(c)(4);

(ii) The amounts paid or set aside which are to be treated as nondeductible under section 545(c)(4) and this section;

(iii) All information necessary to identify the qualified indebtedness with respect to which such amounts were paid or set aside;

(iv) The date on which such payments or set-asides were made; and

(v) All information necessary to identify the indebtedness (referred to in section 545(c)(3)(A)(ii) and paragraph (d)(1)(ii) of this section) incurred for the purpose of making the payments or set-asides which the taxpayer elects to treat as nondeductible, including:

(a) The date on which such indebtedness was incurred;

(b) The amount of such indebtedness;

(c) The person or persons to whom such indebtedness is owed; and

(d) A statement that such person or persons do not own more than 10 percent in value of the taxpayer's outstanding stock.

(f) Limitation on deduction—(1) In general. Section 545(c)(5) provides certain limitations on the deduction otherwise allowed by section 545(c)(1). Such deduction is reduced by the sum of the following amounts:

(i) The amount, if any, by which—

(a) The deductions allowed for the taxable year and all preceding taxable years beginning after December 31, 1963, for exhaustion, wear and tear, obsolescence, amortization, or depletion (other than such deductions which are disallowed in computing undistributed personal holding company income under the rule of paragraph (h) of § 1.545–2), exceed

(b) Any reduction, by reason of section 545(c)(5)(A) and this subdivision (i), of the deductions otherwise allowed by section 545(c)(1) for such preceding years; and

(ii) The amount, if any, by which—

(a) The deductions allowed under section 545(b)(5)(relating to long-term capital gain deduction) in computing undistributed personal holding company income for the taxable year and all preceding taxable years beginning after December 31, 1963, exceed

(b) Any reduction, by reason of section 545(c)(5)(B) and this subdivision (ii), of the deductions otherwise allowed by section 545(c)(1) for such preceding years.

(2) Allocation of reduction. If the total reduction required by subparagraph (1) of this paragraph is greater than the amount of the payment or set-aside made in respect of qualified indebtedness in a taxable year, then the portion of the reduction which is attributable to either section 545(c)(5)(A) or section 545(c)(5)(B), as the case may be, is that portion which bears the same ratio to the total reduction as the total reduction available under either section 545(c)(5)(A) or section 545(c)(5)(B), respectively, bears to the total reduction available under both such sections.

(3) Example. The provisions of this paragraph may be illustrated by the following example:

Example. (i) Q Corporation, a calendar year taxpayer, has qualified indebtedness of $400,000 on January 1, 1964, with respect to which payments of $50,000 are made on April 15, 1964, and 1965, and $300,000 on April 15, 1966. In the years 1964 and 1966, Q Corporation is allowed a deduction under section 545(b)(5) of $50,000 for the excess of its net long-term capital gain over its net short-term capital loss, minus the taxes attributable to such excess. Q Corporation is allowed a depreciation deduction of $50,000 for each of its taxable years 1964 through 1966. Q Corporation is a personal holding company with taxable income of $200,000 in each of the years 1964 and 1966.

(ii) For 1964, in computing undistributed personal holding company income, Q Corporation's taxable income is reduced by $50,000 by reason of the deduction under section 545(b)(5). No part of the depreciation deduction is disallowed under the rule of paragraph (h) of § 1.545–2. Q Corporation's deduction for payment of qualified indebtedness otherwise allowable under section 545(c)(1) and this section is reduced to zero by reason of the depreciation deduction and the capital gains deduction. The reduction by reason of section 545(c)(5)(A) and subparagraph (1)(i) of this paragraph (depreciation) is $25,000 [($50,000 ÷ $100,000) × $50,000], and the reduction by reason of section 545(c)(5)(B) and subparagraph (1)(ii) of this paragraph (capital gain) is $25,000 [($50,000 ÷ $100,000) × $50,000].

(iii) For 1966, Q Corporation is allowed a deduction for payment of qualified indebtedness of $100,000 computed as follows:

Amount paid in 1966 to retire qualified indebtedness			$300,000
Less the sum of:			
(a) Depreciation deductions allowed for 1964 through 1966 (3 × $50,000)	$150,000		
Reduction of deductions in preceding taxable years (1964)	25,000	$125,000	
(b) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966	100,000		
Reduction of deductions in preceding taxable years (1964)	25,000	75,000	200,000
Deduction after reduction			100,000

(iv) If, in the year 1966, Q Corporation's depreciation deduction had been limited for purposes of computing undistributed personal holding company income to $25,000 by reason of section 545(b)(8), then Q Corporation's deduction for payment of qualified indebtedness would be $125,000, computed as follows:

Amounts paid in 1966 to retire qualified indebtedness			$300,000
Less the sum of:			
(a) Depreciation deductions allowed for 1964 through 1966	$125,000		
Reduction of deductions in preceding taxable year (1964)	25,000		
	$100,000		
(b) Deduction allowed under section 545(b)(5) (relating to long-term capital gains) for 1964 through 1966	100,000		
Reduction of deductions in preceding taxable years (1964)	25,000	75,000	175,000
Deduction after reduction			125,000

(g) **Burden of proof.** The burden of proof rests upon the taxpayer to sustain the deduction claimed under this section. In addition to any information required by this section, the taxpayer must furnish the information required by the return, and such other information as the district director may require in substantiation of the deduction claimed.

(h) **Application of section 381(c)(15).** Under section 381(c)(15), if an acquiring corporation assumes liability for qualified indebtedness in a transaction to which section 381(a) applies, then the acquiring corporation is considered to be the distributor or transferor corporation for purposes of section 545(c). Paragraph (c)(2) of this section reflects the application of section 381(c)(15) by including an acquiring corporation within the definition of corporation to which this section applies. Thus, the acquiring corporation is not required to meet the requirements of paragraph (c)(1) or paragraph (d)(1) of this section with respect to such acquired qualified indebtedness to which section 381(c)(15) is applicable. All the other provisions of this section apply in full to the acquiring corporation with respect to such acquired indebtedness.

[T.D. 6949, 33 FR 5526, April 9, 1968; 33 FR 6091, April 20, 1968]

§ 1.547–1 General rule.

Section 547 provides a method under which, by virtue of dividend distributions, a corporation may be relieved from the payment of a deficiency in the personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law), or may be entitled to a credit or refund of a part or all of any such deficiency which has been paid. The method provided by section 547 is to allow an additional deduction for a dividend distribution (which meets the requirements of this section) in computing undistributed personal holding company income for the taxable year for which a deficiency in personal holding company tax is determined. The additional deduction for deficiency dividends will not, however, be allowed for the purpose of determining interest, additional amounts, or assessable penalties, computed with respect to the personal holding company tax prior to the allowance of the additional deduction for deficiency dividends. Such amounts remain payable as if section 547 had not been enacted.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.547–2 Requirements for deficiency dividends.

(a) **In general.** There are certain requirements which must be fulfilled before a deduction is allowed for a deficiency dividend under section 547 and this section. These are—

(1) The taxpayer's liability for personal holding company tax shall be determined only in the manner provided in section 547(c) and paragraph (b)(1) of this section.

(2) The deficiency dividend shall be paid by the corporation on, or within 90 days after, the date of such determination and prior to the filing of a claim under section 547(e) and paragraph (b)(2) of

this section for deduction for deficiency dividends. This claim must be filed within 120 days after such determination.

(3) The deficiency dividend must be of such a nature as would have permitted its inclusion in the computation of a deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if it had been distributed during such year. See section 562 and §§ 1.562–1 through 1.562–3. In this connection, it should be noted that under section 316(b)(2), the term "dividend" means (in addition to the usual meaning under section 316(a)) any distribution of property (whether or not a dividend as defined in section 316(a)) made by a corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 and §§ 1.545–1 and 1.545–2 without regard to section 316(b)(2)) for the taxable year in respect of which the distribution is made.

(b) Special rules—(1) Nature and details of determination. (i) A determination of a taxpayer's liability for personal holding company tax shall, for the purposes of section 547, be established in the manner specified in section 547(c) and this subparagraph.

(ii) The date of determination by a decision of the Tax Court of the United States is the date upon which such decision becomes final, as prescribed in section 7481.

(iii) The slate upon which a judgment of a court becomes final, which is the date of the determination in such cases, must be determined upon the basis of the facts in the particular case. Ordinarily, a judgment of a United States district court becomes final upon the expiration of the time allowed for taking an appeal, if no such appeal is duly taken within such time; and a judgment of the United States Court of Claims becomes final upon the expiration of the time allowed for filing a petition for certiorari if no such petition is duly filed within such time.

(iv) The date of determination by a closing agreement, made under section 7121, is the date such agreement is approved by the Commissioner.

(v) A determination under section 547(c)(3) may be made by an agreement signed by the district director or such other official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the total amount of the liability for personal holding company tax for the taxable year or years. An agreement under this subdivision which is signed by the district director (or such other official to whom authority to sign the agreement is delegated) on or after July 15, 1963, shall be sent to the taxpayer at his last known address by either registered or certified mail. If registered mail is used for such purpose, the date of registration shall be treated as the date of determination; if certified mail is used for such purpose, the date of the postmark on the sender's receipt for such mail shall be treated as the date of determination. However, if a dividend is paid by the corporation before such registration or postmark date but on or after the date such agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be such date of signing. The date of determination with respect to an agreement which is signed by the district director (or such other official to whom authority to sign the agreement is delegated) before July 15, 1963, shall be the date of the postmark on the cover envelope in which such agreement is sent by ordinary mail, except that if a dividend is paid by the corporation before such postmark date but on or after the date such agreement is signed by the district director or such other official to whom authority to sign the agreement is delegated, the date of determination shall be such date of signing.

(2) Claim for deduction—(i) Contents of claim. A claim for deduction for a deficiency dividend shall be made with the requisite declaration, on Form 976 and shall contain the following information:

(a) The name and address of the corporation;

(b) The place and date of incorporation;

(c) The amount of the deficiency determined with respect to the tax imposed by section 541 (or a corresponding provision of a prior income tax law) and the taxable year or years involved; the amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof; a statement as to how the deficiency was established, if unpaid; or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid and, in either case whether it was by an agreement under section 547(c)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment and the date thereof; if established by a final judgment in a suit against the United States for refund, the date of payment of the deficiency, the date the claim for refund was filed, and the

date the suit was brought; if established by a Tax Court decision or court judgment, a copy thereof shall be attached, together with an explanation of how the decision became final; if established by an agreement under section 547(c)(3), a copy of such agreement shall be attached;

(d) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(e) A statement setting forth the various classes of stock outstanding, the name and address of each shareholder, the class and number of shares held by each on the date of payment of the dividend with respect to which the claim is filed, and the amount of such dividend paid to each shareholder;

(f) The amount claimed as a deduction for deficiency dividends; and

(g) Such other information as may be required by the claim form.

(ii) Filing of claim and corporate resolution. The claim together with a certified copy of the resolution of the board of directors or other authority, authorizing the payment of the dividend with respect to which the claim is filed, shall be filed with the district director for the internal revenue district in which the return is filed.

(iii) Carryover of deficiency dividends paid by acquiring corporation. In the case of the acquisition of assets of a corporation by another corporation in a distribution or transfer described in section 381(a), the distributor or transferor corporation shall be entitled to a deduction for any deficiency dividends (as defined in section 547(d)) paid by the acquiring corporation with respect to such distributor or transferor corporation. See section 381(c)(17).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6657, 28 FR 5720, June 12, 1963; T.D. 7604, 44 FR 18661, March 29, 1979]

§ 1.547–3 Claim for credit or refund.

(a) If a deficiency in personal holding company tax is asserted for any taxable year, and the corporation has paid any portion of such asserted deficiency, it is entitled to a credit or refund of such payment to the extent that such payment constitutes an overpayment as the result of a deduction for a deficiency dividend as provided in section 547 and §§ 1.547–1 through 1.547–7. It should be noted that a "determination" under section 547(c) and paragraph (b)(1) of § 1.547–2, of taxpayer's liability for personal holding company tax may take place subsequent to the time the deficiency was paid. To secure credit or refund of such overpayment, the taxpayer must file a claim on Form 843 in addition to the claim for the deduction for deficiency dividends required under section 547(e) and paragraph (b)(2) of § 1.547–2.

(b) No interest shall be allowed on such credit or refund.

(c) Such credit or refund will be allowed as if, on the date of the determination under section 547(c) and paragraph (b)(1) of § 1.547–2, two years remained before the expiration of the period of limitation on the filing of claim for refund for the taxable year to which the overpayment relates.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.547–4 Effect on dividends paid deduction.

The deficiency dividends deduction shall be allowed as of the date the claim is filed. No duplication of deductions with respect to any deficiency dividends is permitted. If a corporation claims and receives the benefit of the provisions of section 547 (or the corresponding section 506 of the Internal Revenue Code of 1939, or section 407 of the Revenue Act of 1938 (52 Stat. 447)), based upon a distribution of deficiency dividends, that distribution does not become a part of the dividends paid deduction under section 561. Likewise, it will not be made the basis of a dividends paid deduction under section 561 by reason of the application of section 563(b), relating to dividends paid after the close of the taxable year and on or before the 15th day of the third month following the close of such taxable year.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.547–5 Deduction denied in case of fraud or wilful failure to file timely return.

No deduction for deficiency dividends shall be allowed under section 547(a) if the determination contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or to wilful failure to file an income tax return within the time prescribed by law or prescribed by the Secretary or his delegate in pursuance of law. See § 1.547–7 for effective date.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.547–6 Suspension of statute of limitations and stay of collection.

(a) Statute of limitations. If the corporation files a claim for a deduction for deficiency divi-

dends under section 547(e) and paragraph (b)(2) of § 1.547–2, the running of the statute of limitations upon assessment, distraint, and collection in court in respect of the deficiency, and all interest, additional amounts, or assessable penalties, shall be suspended for a period of two years after the date of the determination under section 547(c) and paragraph (b)(1) of § 1.547–2.

(b) Stay of collection. If a deficiency in personal holding company tax is established by a determination under section 547(c) and paragraph (b)(1) of § 1.547–2, collection by distraint or court proceeding (except in case of jeopardy), of the deficiency and all interest, additional amounts, and assessable penalties, shall be stayed for a period of 120 days after the date of such determination, and, to the extent any part of such deficiency remains after deduction for deficiency dividends, for an additional period until the date the claim is disallowed. After such claim is allowed or rejected, either in whole or in part, the amount of the deficiency which was not eliminated by the application of section 547, together with interest, additional amounts and assessable penalties, will be assessed and collected in the usual manner.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.547–7 Effective date.

The deduction for deficiency dividends, in computing personal holding company tax for any taxable year, is allowable only with respect to determinations under section 547(c) made after November 14, 1954 (the date falling 90 days after the date of enactment of the Internal Revenue Code of 1954). If the taxable year with respect to which the deficiency is asserted began before January 1, 1954, the deficiency dividends deduction shall include only the amounts which would have been includible in the computation of the basic surtax credit for such taxable year under the Internal Revenue Code of 1939. Section 547(g), relating to the denial of a deficiency dividends deduction if the determination contains a finding that any part of the deficiency is due to fraud, etc., shall apply only if the taxable year with respect to which the deficiency is asserted begins after December 31, 1953.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

Foreign Personal Holding Companies

§ 1.551–1 General rule.

Part III (section 551 and following), subchapter G, chapter 1 of the Code, does not impose a tax on foreign personal holding companies. The undistributed foreign personal holding company income of such companies, however, must be included in the manner and to the extent set forth in section 551, in the gross income of their "United States shareholders," that is, the shareholders who are individual citizens or residents of the United States, domestic corporations, domestic partnerships, and estates or trusts other than estates or trusts the gross income of which under subtitle A of the Code includes only income from sources within the United States.

§ 1.551–2 Amount included in gross income.

(a) The undistributed foreign personal holding company income is included only in the gross income of the United States shareholders who were shareholders in the company on the last day of its taxable year on which a United States group (as defined in section 552(a)(2)) existed with respect to the company. Such United States shareholders, accordingly, are determined by the stock holdings as of such specified time. This rule applies to every United States shareholder who was a shareholder in the company at the specified time regardless of whether the United States shareholder is included within the United States group. For example, a domestic corporation which is a United States shareholder at the specified time must return its distributive share in the undistributed foreign personal holding company income even though the domestic corporation cannot be included within the United States group since, under section 554, the stock it owns in the foreign corporation is considered as being owned proportionately by its shareholders for the purpose of determining whether the foreign corporation is a foreign personal holding company.

(b) The United States shareholders must include in their gross income their distributive shares of that proportion of the undistributed foreign personal holding company income for the taxable year of the company which is equal in ratio to that which the portion of the taxable year up to and including the last day on which the United States group with respect to the company existed bears to the entire taxable year. Thus, if the last day in the taxable year on which the required United States group existed was also the end of the taxable year, the portion of the taxable year up to and

including such last day would be equal to 100 percent and, in such case, the United States shareholders would be required to return their distributive shares in the entire undistributed foreign personal holding company income. But if the last day on which the required United States group existed was September 30, and the taxable year was a calendar year, the portion of the taxable year up to and including such last day would be equal to nine-twelfths and, in that case, the United States shareholders would be required to return their distributive shares in only nine-twelfths of the undistributed foreign personal holding company income.

(c) The amount which each United States shareholder must return is that amount which he would have received as a dividend if the above-specified portion of the undistributed foreign personal holding company income had in fact been distributed by the foreign personal holding company as a dividend on the last day of its taxable year on which the required United States group existed. Such amount is determined, therefore, by the interest of the United States shareholder in the foreign personal holding company, that is, by the number of shares of stock owned by the United States shareholder and the relative rights of his class of stock, if there are several classes of stock outstanding. Thus, if a foreign personal holding company has both common and preferred stock outstanding and the preferred shareholders are entitled to a specified dividend before any distribution may be made to the common shareholders, then the assumed distribution of the stated portion of the undistributed foreign personal holding company income must first be treated as a payment of the specified dividend on the preferred stock before any part may be allocated as a dividend on the common stock.

(d) The assumed distribution of the required portion of the undistributed foreign personal holding company income must be returned as dividend income by the United States shareholders for their respective taxable years in which or with which the taxable year of the foreign personal holding company ends. For example, if the M Corporation, whose taxable year is the calendar year, is a foreign personal holding company for 1954 and if A, one of its United States shareholders, makes returns on a calendar year basis, while B, another United States shareholder, makes returns on the basis of a fiscal year ending November 30, A must return his assumed dividend as income for the taxable year 1954 and B must return his distributive share as income for the fiscal year ending November 30, 1955. In applying this rule, the date as of which the United States group last existed with respect to the company is immaterial. Thus, in the foregoing example, if September 30, 1954, was the last day on which the United States group with respect to the M Corporation existed, B would still be required to return his assumed dividend as income for the fiscal year ending November 30, 1955, even though September 30, 1954, the date as of which the distribution is assumed to have been made, does not fall within such fiscal year.

(e) For the treatment of gain on the sale of certain stock, see section 306(f) and paragraph (h) of § 1.306–3.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.551–3 Deduction for obligations of the United States and its instrumentalities.

(a) Each United States shareholder required to return his distributive share of undistributed foreign personal holding company income for any taxable year shall take into account in computing the credit against tax under section 35, or the deduction under section 242, whichever is allowable to such shareholder, his proportionate share of whatever interest on obligations of the United States or its instrumentalities (as specified in sections 35 or 242, as the case may be) may be included in the gross income of the company for such taxable year, with the exception of any such interest as may be so included by reason of the application of the provisions of section 555. For reduction of credit for such interest on account of amortizable bond premium, see section 171 and the regulations thereunder.

(b) The rule set forth in paragraph (a) of this section may be illustrated by the following example:

Example. The M Corporation is a foreign personal holding company which owns all the stock of the N Corporation, another foreign personal holding company. Both companies receive interest on obligations of the United States or its instrumentalities as specified in section 35. In determining the amount of the credit allowable under section 35 (if the shareholder is an individual) or the deduction allowable under section 242 (if the shareholder is a corporation), the United States shareholder of the M Corporation would be entitled to a credit or a deduction, as the case may be, only for his proportionate share of the interest received by that Company and not for any part of the interest received by the N Corporation, regardless of whether the interest received by the N Corporation is included in the gross income of the M Corporation as an actual dividend or as a constructive dividend under section 555.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.551–4 Information in return.

The information required by section 551(d) in the returns of certain United States shareholders relates only to the taxable year of a foreign personal holding company for which any part of such corporation's undistributed foreign personal holding company income must be included in gross income by the United States shareholder of whom the information is required. The information shall be submitted as a part of the income tax return in the form of a statement attached to the return. [T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.551–5 Effect on capital account of foreign personal holding company and basis of stock in hands of shareholders.

(a) Sections 551(e) and 551(f) are designed to prevent double taxation with respect to the undistributed foreign personal holding company income.

(b) The application of sections 551(e) and 551(f) may be illustrated by the following examples:

Example (1). The M Corporation is a foreign personal holding company. Seventy-five percent in value of its capital stock is owned by A, a citizen of the United States, and the remainder, or 25 percent, of its stock is owned by B, a nonresident alien individual. For the calendar year 1954 the M Corporation has an undistributed foreign personal holding company income of $100,000. A is required to include $75,000 of such income in gross income as a dividend in his return for the calendar year 1954. The $100,000 is treated as paid-in surplus or as a contribution to the capital of the M Corporation and its accumulated earnings and profits as of the close of the calendar year 1954 are correspondingly reduced. If after treating such $100,000 as paid-in surplus or as a contribution to capital, the M Corporation has no accumulated earnings and profits at the close of 1954, and if for the calendar year 1955, the M Corporation had no earnings and profits, but distributed $40,000, the amount so distributed would be a nontaxable distribution and would not be included in the gross income of either A or B for the calendar year 1955. If, however, after treating the $100,000 as paid-in surplus or as a contribution to capital, the M Corporation had accumulated earnings and profits of $100,000 at the close of 1954, the facts otherwise being the same, the distributions in 1955 would be taxable to A as a dividend, and the taxability of such distributions to B would depend upon the application of section 861(a)(2), relating to the treatment of dividends from a foreign corporation as income from sources within or without the United States.

Example (2). In example (1) assume the basis of A's stock to be $300,000. If A includes in gross income in his return for the calendar year 1954, $75,000 as a dividend from the M Corporation, the basis of his stock would be $375,000. After the nontaxable distribution of $30,000 to A by the M Corporation in 1955 (75 percent of the $40,000 distribution) the basis of A's stock, assuming no other changes, would be $345,000. If A failed to include the $75,000 as a dividend in gross income in his return for 1954 and his failure was not discovered until after the 6-year period of limitations had expired, the application of the rule would not increase the basis of A's stock. The subsequent nontaxable distribution of $30,000 to A in 1955 would reduce his basis of $300,000 to $270,000, thus tending to compensate for his failure to include the amount of $75,000 as a dividend in his gross income for 1954. If the undistributed foreign personal holding company income of the M Corporation is readjusted within the statutory period of limitations, thus increasing or decreasing the amount A would have to include in his gross income, proper adjustment is required to be made to the basis of A's stock on account of such readjustment.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.552–1 Definition of foreign personal holding company.

(a) A foreign personal holding company is any foreign corporation, other than a corporation exempt from taxation under subchapter F (section 501 and following), chapter 1 of the Code, and other than certain banking institutions which satisfy the requirements of section 552(b)(2) and paragraph (b) of § 1.552–4 which for the taxable year meets (1) the gross income requirement specified in section 552(a)(1); and (2) the stock ownership requirement specified in section 552(a)(2). Both requirements must be satisfied with respect to each taxable year.

(b) A foreign corporation which comes within the classification of a foreign personal holding company is not subject to taxation either under section 531 or section 541. See sections 532(b)(2) and 542(c)(5). The fact that a foreign corporation is a foreign personal holding company does not relieve the corporation from liability for the taxes imposed generally upon foreign corporations, such as the taxes imposed by sections 881 and 882, since such taxes apply regardless of the classification of the foreign corporation as a foreign personal holding company.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.552–2 Gross income requirement.

(a) To meet the gross income requirement, it is necessary that either of the following percentages of gross income of the corporation for the taxable year (including the additions to gross income provided in section 555(b) as required by section 555(c)(2)) be foreign personal holding company income as defined in section 553:

(1) 60 percent or more; or

(2) 50 percent or more if the foreign corporation has been classified as a foreign personal holding company for any taxable year ending after August 26, 1937, unless—

(i) A taxable year has intervened since the last taxable year for which it was so classified, during no part of which the stock ownership requirement specified in section 552(a)(2) exists; or

(ii) Three consecutive years have intervened since the last taxable year for which it was so classified, during each of which its foreign personal holding company income was less than 50 percent of its gross income.

(b) In determining whether the foreign personal holding company income is equal to the required percentage of the total gross income, the determination must not be made upon the basis of gross receipts, since gross income is not synonymous with gross receipts. For meaning of gross income in this part, see section 555 and § 1.555–1.
[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.552–3 Stock ownership requirement.

(a) To meet the stock ownership requirement, it is necessary that at some time in the taxable year more than 50 percent in value of the outstanding stock of the foreign corporation be owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, herein referred to as "United States group." For the purpose of the requirement under section 552(a)(2), section 554 provides that the ownership of the stock must be determined under the rules prescribed by section 544 (relating to rules for determining stock ownership in the case of personal holding companies generally). Accordingly, section 544 and §§ 1.544–1 through 1.544–7 are applicable for purposes of section 552(a)(2) and this section as if each reference in section 544 and §§ 1.544–1 through 1.544–7 to a personal holding company or to part II (section 541 and following), subchapter G, chapter 1 of the Code, was a reference to a foreign personal holding company or to part III (section 551 and following), subchapter G, chapter 1 of the Code, as the case may be.

(b) It is necessary to consider any change in the stock outstanding during the taxable year, whether in the number of shares or classes of stock, or in the ownership thereof, since a corporation comes within the classification if the statutory conditions with respect to stock ownership are present at any time during the taxable year.

(c) In determining whether the statutory conditions with respect to stock ownership are present at any time during the taxable year, the phrase "in value" shall, in the light of all the circumstances, be deemed the value of the corporate stock outstanding at such time (not including treasury stock). This value may be determined upon the basis of the company's net worth, earning and dividend paying capacity, appreciation of assets, together with such other factors as have a bearing upon the value of the stock. If the value of the stock which is used is greatly at variance with that reflected by the corporate books, the evidence of such value should be filed with the return. In any case where there are two or more classes of stock outstanding, the total value of all the stock should be allocated among the different classes according to the relative value of each class therein.
[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.552–4 Certain excluded banks.

(a) A corporation is excluded from the definition of "foreign personal holding company" if it is organized and doing business under the banking and credit laws of a foreign country and if it establishes to the satisfaction of the Commissioner that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders. If this is established, the Commissioner, or such other official to whom authority may be delegated, will certify, by letter to the corporation, that it is not a foreign personal holding company.

(b) An application for certification under section 552(b)(2) shall be made in writing to the Commissioner of Internal Revenue, Washington D.C. 20225, Attention: Director of International Operations. A separate application shall be filed for each taxable year for which certification is requested, and the application shall be accompanied by a completed Form 958 for the taxable year. See section 6035. The following information shall be set forth in, or submitted with, the application:

(1) A complete reference to the banking or credit laws of the foreign country under which the corporation operates;

(2) A statement as to the extent of the corporation's business in receiving deposits and making loans and discounts and similar banking and credit operations;

(3) A statement as to the extent of the operations of the corporation other than such banking and credit operations;

(4) A statement as to whether the banking and credit operations of the corporation are customary for it;

(5) A statement setting forth the degree and manner of supervision exercised over it by the foreign government under its banking and credit laws; a copy (in English) of the corporation's last annual financial statement, as submitted to the

Government authority having jurisdiction over it, shall be submitted with the application;

(6) A statement setting forth the business reasons of the corporation for not distributing the amount which would be its undistributed foreign personal holding company income if the corporation were not excluded under section 552(b);

(7) A statement setting forth the extent of the corporation's profits which must be retained as reserves under the foreign law;

(8) A statement setting forth the date or dates when the corporation reasonably expects to distribute is undistributed foreign personal holding company income for the taxable year;

(9) A statement setting forth the name and address of each of the individuals described in section 552(a)(2), the extent of their stock ownership in the corporation, and the amount of distributions or other payments to such stockholders, including, but not limited to, dividends, compensation, interest, and rents; and

(10) Any other facts or information the corporation may wish to submit to show that it was not formed or availed of for the purpose of evading or avoiding United States income taxes which would otherwise be imposed on its shareholders.

The corporation shall also furnish such other information requested as necessary by the Director of International Operations. The application for certification, together with the information required by this paragraph, should be filed within 60 days after the close of the taxable year of the corporation or before November 9, 1958, whichever is later. However, if the corporation is unable, for good cause, to submit the application for certification within such 60-day period, additional time may be granted by the Director of International Operations upon receipt of a request from the corporation setting forth the reasons for such request.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.552-5 United States shareholder of excluded bank.

A copy of the certification issued to an excluded bank under section 552(b)(2) and § 1.552-4 shall be filed with, and made a part of, the income tax return for the taxable year of each United States shareholder of such foreign corporation, if he has been a shareholder of such corporation for any part of such year. If the certificate has not been issued at the time the return of the United States shareholder is filed, the shareholder shall compute the tax on his return by treating the bank as a foreign personal holding company. If a certificate is issued after the return is filed, the United States shareholder may file a claim for refund or an amended return, and shall attach thereto a copy of the certification.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.553-1 Foreign personal holding company income.

Foreign personal holding company income shall consist of the items defined under section 543 and §§ 1.543-1 and 1.543-2, relating to personal holding company income, with the following exceptions:

(a) The entire amount received as "interest", whether or not treated as rent, shall be considered to be foreign personal holding company income. Thus, the exception in the second sentence of section 543(a)(1) and paragraph (b)(2) of § 1.543-1 (relating to interest treated as rent under section 543(a)(7) and paragraph (b)(10) of § 1.543-1), is inapplicable for the purpose of determining foreign personal holding company income. Similarly, section 543(a)(7) and paragraph (b)(10) of § 1.543-1 are applied for this purpose without regard to the interest described in that section.

(b)(1) The entire amount received as "royalties", whether or not mineral, oil, or gas royalties, or copyright royalties, shall be considered to be foreign personal holding company income. Thus, subparagraphs (A) and (B) of section 543(a)(8) and paragraph (b)(11)(i)(a) and (b) of § 1.543-1 (relating to mineral, oil, or gas royalties), and subparagraphs (A), (B), and (C) of section 543(a)(9) and paragraph (b)(12)(ii) of § 1.543-1 (relating to copyright royalties), are inapplicable for the purpose of determining foreign personal holding company income.

(2) In computing foreign personal holding company income, the first sentence of paragraph (b)(11)(ii) of § 1.543-1 shall apply to overriding royalties received from the sublessee by the operating company which originally leased and developed the natural resource property in respect of which such overriding royalties are paid, and to mineral, oil, or gas production payments, only with respect to amounts received after September 30, 1958.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6739, 29 FR 7715, June 17, 1964]

§ 1.554–1 Stock ownership.

For regulations under section 554, see § 1.552–3.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.555–1 General rule.

The gross income of a foreign corporation which is a foreign personal holding company is computed the same as if the foreign corporation were a domestic corporation which is a personal holding company. See section 542(a)(1) and § 1.542–2. The gross income of a foreign personal holding company thus includes income from all sources, whether within or without the United States, which is not specifically excluded from gross income under any other provisions of the Code. For example, the gross income of a foreign personal holding company includes all income from sources outside the United States even though the foreign personal holding company is a foreign corporation not engaged in trade or business within the United States. However, the gross income of a foreign corporation which is a foreign personal holding company shall not include, with respect to a United States shareholder described in section 951(b), dividends received by such corporation which are excluded under section 959(b) from the income of such corporation with respect to such shareholder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6795, 30 FR 934, Jan. 29, 1965]

§ 1.555–2 Additions to gross income.

(a) If, for any taxable year—

(1) A foreign corporation meets the stock ownership requirement specified in section 552(a)(2) and § 1.552–3, regardless of whatever day in its taxable year is the last day on which the required United States group exists, and

(2) Such foreign corporation is a shareholder in a foreign personal holding company on any day of a taxable year of the second company which ends with or within the taxable year of the first company and such day is the last day in the taxable year of the second company in which the United States group exists with respect to the second company, then for the purpose of—

(i) Determining whether the first company meets the specified gross income requirement so as to come within the classification of a foreign personal holding company, and

(ii) Determining the undistributed foreign personal holding company income of the first company which (in the event the first company is a foreign personal holding company) is to be included, in whole or in part, in the gross income of its shareholders, whether United States shareholders or other foreign personal holding companies,

there shall be included as a dividend in the gross income of the first company for the taxable year in which or with which the taxable year of the second company ends, the amount the first company would have received as a dividend, if on the last day referred to in this subparagraph there had been distributed by the second company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the second company for its taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year. The foregoing rules apply to any chain of foreign corporations regardless of the number of corporations included in the chain.

(b) The application of section 555(b) may be illustrated by the following examples:

Example (1). The X Corporation is a foreign corporation whose stock is owned by A, a United States citizen. The X Corporation owns the entire stock of the Y Corporation, another foreign corporation. The taxable year of the X Corporation is the calendar year and the taxable year of the Y Corporation is the fiscal year ending June 30. For the fiscal year ending June 30, 1955, more than the required percentage of the Y Corporation's gross income consists of foreign personal holding company income and no part of the earnings for such year is distributed as dividends. On the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1955. The X Corporation meets the stock ownership requirement and constitutes a foreign personal holding company for 1955, if it also meets the gross income requirement. For the purpose of determining whether the X Corporation meets the gross income requirements, the entire undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1955, must be included as a dividend in the gross income of the X Corporation for 1955, since—

(1) The X Corporation was a shareholder in the Y Corporation on a day (June 30, 1955) in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation, which day was the last day in the taxable year of the Y Corporation on which the United States group required with respect to the Y Corporation existed,

(2) Such last day was also the end of the Y Corporation's taxable year so that the portion of the taxable year of the Y Corporation up to and including such last day is equal to 100 percent of the taxable year of the Y Corporation, and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders is likewise equal to 100 percent, and

(3) The X Corporation being the sole shareholder of the Y Corporation must include such portion in its gross income for 1955, the taxable year in which or with which the taxable year of the Y Corporation ends. If, after the inclusion of the presumptive dividend in its gross income, the X Corporation is a foreign personal holding company for 1955, then the undis-

tributed foreign personal holding company income of the Y Corporation must also be included as a dividend in the gross income of the X Corporation in determining its undistributed foreign personal holding company income which is to be included in the gross income of A, the sole shareholder in the X Corporation. On the other hand, if, after including such presumptive dividend, the X Corporation does not constitute a foreign personal holding company, the undistributed foreign personal holding company income of the Y Corporation is not includible in the gross income of the X Corporation.

Example (2). The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date no United States group existed with respect to the Y Corporation. For the fiscal year ending June 30, 1956, more than the required percentage of the gross income of the Y Corporation consists of foreign personal holding company income. The taxable income of the Y Corporation for such fiscal year amounts to $1,000,000, of which $900,000 is distributed in dividends after September 30, 1955. The undistributed foreign personal holding company income of the Y Corporation for such fiscal year amounts to $100,000. Upon the basis of these facts the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, since at one time in such fiscal year, or from July 1 to and including September 30, 1955, it meets the stock ownership requirement, and the gross income requirement is also satisfied. In determining whether the X Corporation constitutes a foreign personal holding company for 1956, a portion of the undistributed foreign personal holding company income of the Y Corporation for the fiscal year ending June 30, 1956 (three-twelfths of $100,000, or $25,000), must be included as a dividend in the gross income of the X Corporation, since—

(1) The X Corporation was a shareholder in the Y Corporation on September 30, 1955, or on a day in the taxable year of the Y Corporation ending with or within the taxable year of the X Corporation which day was the last day in the Y Corporation's taxable year on which the United States group required with respect to the Y Corporation existed.

(2) The portion of the taxable year of the Y Corporation up to and including such day is three-twelfths of the entire taxable year of the Y Corporation and, therefore, the portion of the undistributed foreign personal holding company income of the Y Corporation includible in the gross income of its shareholders also is equal to three-twelfths, and

(3) The X Corporation, being the sole shareholder of the Y Corporation at the time the United States group with respect to the Y Corporation last existed, must include all of such portion in its gross income for 1956, the taxable year of the X Corporation in which or with which the taxable year of the Y Corporation ends.

It is to be observed that three-twelfths of the undistributed foreign personal holding company income of the Y Corporation for the entire taxable year and not the earnings realized by the Y Corporation up to and including September 30, 1955, the last day on which the United States group with respect to the Y Corporation existed, must be included in the gross income of the X Corporation.

Example (3). The X Corporation referred to in example (1) sold the stock in the Y Corporation to other interests on September 30, 1955, so that after that date a different United States group existed with respect to the Y Corporation. Assuming that the Y Corporation is a foreign personal holding company for the fiscal year ending June 30, 1956, no part of the undistributed foreign personal holding company income of the Y Corporation for such fiscal year would, in this instance, be includible in the gross income of the X Corporation for the year 1956, in determining whether the X Corporation is a foreign personal holding company for that year. In such case, the undistributed foreign personal holding company income of the Y Corporation is includible in the gross income of the other foreign personal holding companies, if any, and of the United States shareholders who are shareholders in the Y Corporation the day after September 30, 1955, which was the last day in the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation existed. If, however, the X Corporation sells 90 percent of its stock in the Y Corporation and thus is a minority shareholder in the Y Corporation on the last day of the taxable year of the Y Corporation on which the United States group with respect to the Y Corporation exists, the portion of the undistributed foreign personal holding company income allocable to the minority interests of the X Corporation would be includible in the gross income of the X Corporation, even though on such last day the United States group is not the same with respect to both corporations.

Example (4). If the Y Corporation in example (1) owns all of the stock of the Z Corporation, another foreign corporation, there would be a chain of three foreign corporations. In such case, assuming that the Z Corporation is a foreign personal holding company for a taxable year ending with or within the taxable year of the Y Corporation, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation for the purpose of determining whether the Y Corporation comes within the classification of a foreign personal holding company. If, after the inclusion of such presumptive dividend, the Y Corporation is a foreign personal holding company, the undistributed foreign personal holding company income of the Z Corporation would be included in the gross income of the Y Corporation in determining the undistributed foreign personal holding company income of the Y Corporation which is includible in the gross income of its shareholder, the X Corporation. The same process would be repeated with respect to determining whether the X Corporation is a foreign personal holding company and in determining its undistributed foreign personal holding company income. If all three corporations are foreign personal holding companies, the undistributed foreign personal holding company income of each would, in this manner, be reflected as a dividend in the gross income of A, the ultimate beneficial shareholder of the chain. In the event that after the inclusion of the undistributed foreign personal holding company income of the Z Corporation in the gross income of the Y Corporation, the Y Corporation is not a foreign personal holding company, then no part of the income of either the Z Corporation or the Y Corporation would be includible in the gross income of the X Corporation. In that event, whether the X Corporation is a foreign personal holding company, and its undistributed foreign personal holding company income, would be determined independently of the income of the Y Corporation and the Z Corporation.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.556–1 Definition.

Undistributed foreign personal holding company income is the amount which is to be included in the gross income of the United States shareholders under section 551(b) and § 1.551–2. Undistributed foreign personal holding company income is the taxable income of the foreign personal holding company, as defined in section 63(a)(computed without regard to subchapter N, chapter 1 of the Code), and adjusted in the manner described in

section 556(b) and § 1.556–2, less the deduction for dividends paid (§§ 1.561–1 through 1.565–6). See § 1.556–3 for an illustration of the computation of undistributed foreign personal holding company income.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.556–2 Adjustments to taxable income.

(a) **Taxes—(1) General rule.** (i) In computing undistributed foreign personal holding company income for any taxable year, there shall be allowed as a deduction the Federal income and excess profits taxes accrued during the taxable year except that no deduction shall be allowed for (a) the accumulated earnings tax imposed by section 531 (or a corresponding section of a prior law), (b) the personal holding company tax imposed by section 541 (or a corresponding section of a prior law), and (c) the excess profits tax imposed by subchapter E, chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940. The deduction is for taxes for the taxable year determined under the accrual method of accounting, regardless of whether the corporation uses an accrual method of accounting, the cash receipts and disbursements method, or any other allowable method of accounting. In computing the amount of taxes accrued, an unpaid tax which is being contested is not considered accrued until the contest is resolved.

(ii) However, the corporation shall deduct taxes paid, rather than taxes accrued, if it used that method with respect to Federal taxes for each taxable year for which it was subject to the provisions of supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, unless an election is made under subparagraph (2) of this paragraph to deduct taxes accrued.

(2) Election by corporation which deducted taxes paid. (i) If the corporation was subject to supplement P, subchapter C, chapter 1 of the Internal Revenue Code of 1939, and, for the purpose of computing undistributed supplement P net income under such Code, deducted Federal taxes paid, rather than such taxes accrued, for each taxable year for which it was subject to supplement P of the 1939 Code, the corporation may elect for any taxable year ending after August 16, 1954, to deduct taxes accrued, rather than taxes paid, for the purpose of computing its undistributed foreign personal holding company income. The election shall be made by deducting such taxes accrued in the return (Form 958) required to be filed for such taxable year. The return shall, in addition, contain a statement that the corporation has made such election and shall set forth the year to which such election was first applicable. The deduction of taxes accrued in the year of election precludes the deduction of taxes paid during such year. The election, if made, shall be irrevocable and the deduction for taxes accrued shall be allowed for the year of election and for all subsequent taxable years. See section 6035 and the regulations thereunder for rules relative to the filing of returns of officers, directors, and shareholders of foreign personal holding companies.

(ii) Pursuant to section 7851(a)(1)(C), the election provided for in subdivision (i) of this subparagraph may be made with respect to a taxable year ending after August 16, 1954, even though such taxable year is subject to the Internal Revenue Code of 1939.

(3) Taxes of foreign countries and United States possessions. In computing taxable income, a foreign personal holding company is allowed a deduction under section 164 for income, war profits, and excess-profits taxes paid or accrued during the taxable year to foreign countries or possessions of the United States, but is not allowed the foreign tax credit under section 901. Therefore, in computing undistributed foreign personal holding company income for any taxable year, no adjustment under section 556(b)(1) is allowed for such taxes.

(b) Charitable contributions—(1) Taxable years beginning before January 1, 1970. (i) Section 556(b)(2) provides that, in computing the deduction for charitable contributions for purposes of determining the undistributed foreign personal holding company income of a corporation for taxable years beginning before January 1, 1970, the limitations in section 170(b)(1)(A) and (B), relating to charitable contributions by individuals, shall apply and section 170(b)(2) and (5), relating to charitable contributions by corporations and carryover of certain excess charitable contributions made by individuals, respectively, shall not apply.

(ii) Although the limitations of section 170(b)(1)(A) and (B) are 10 and 20 percent, respectively, of the individual's adjusted gross income, the limitations are applied for purposes of section 556(b)(2) by using 10 and 20 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applied. Thus, the term "adjusted gross income" when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the

5-percent limitation, provided in the first sentence of section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(2) and, with respect to contributions paid in taxable years beginning after December 31, 1963, in section 170(b)(5), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See § 1.170–2 with respect to the charitable contributions to which the 10-percent limitation is applicable and the charitable contributions to which the 20-percent limitation is applicable.

(2) Taxable years beginning after December 31, 1969. (i) Section 556(b)(2) provides that, in computing the deduction allowable for charitable contributions for purposes of determining the undistributed foreign personal holding company income of a corporation for taxable years beginning after December 31, 1969, the limitations in section 170(b)(1)(A), (B), and (D)(i)(relating to charitable contributions by individuals) shall apply, and section 170(b)(1)(D)(ii)(relating to excess charitable contributions by individuals of certain capital gain property), section 170(b)(2)(relating to the 5-percent limitation on charitable contributions by corporations), and section 170(d)(relating to carryovers of excess contributions of individuals and corporations) shall not apply.

(ii) Although the limitations of section 170(b)(1)(A), (B), and (D)(i) are 50, 20, and 30 percent, respectively, of an individual's contribution base, these limitations are applied for purposes of section 556(b)(2) by using 50, 20, and 30 percent, respectively, of the corporation's taxable income as adjusted for purposes of section 170(b)(2), that is, the same amount of taxable income to which the 5-percent limitation applies. Thus, the term "contribution base" when used in section 170(b)(1) means the corporation's taxable income computed with the adjustments, other than the 5-percent limitation, provided in section 170(b)(2). However, a further adjustment for this purpose is that the taxable income shall also be computed without the deduction of the amount disallowed under section 556(b)(5), relating to expenses and depreciation applicable to property of the taxpayer, and section 556(b)(6), relating to taxes and contributions to pension trusts, and without the inclusion of the amounts includible as dividends under section 555(b), relating to the inclusion in gross income of a foreign personal holding company of its distributive share of the undistributed foreign personal holding company income of another company in which it is a shareholder. The carryover of charitable contributions made in a prior year, otherwise allowable as a deduction in computing taxable income to the extent provided in section 170(b)(1)(D)(ii) and (d), shall not be allowed as a deduction in computing undistributed foreign personal holding company income for any taxable year.

(iii) See § 1.170A–8 for the rules with respect to the charitable contributions to which the 50-, 20-, and 30-percent limitations apply.

(c) Special deductions disallowed. Part VIII, subchapter B, chapter 1 of the Code allows corporations special deductions in computing taxable income for such matters as partially tax-exempt interest, certain dividends received, dividends paid on certain preferred stock of public utilities, organizational expenses, etc. See section 241. For purposes of computing undistributed foreign personal holding company income, such special deductions, except the deduction provided by section 248 (relating to organizational expenditures) and, with respect to such a computation for a taxable year ending before January 1, 1958, the deduction provided by section 242 (relating to partially tax-exempt interest), shall be disallowed.

(d) Net operating loss. The net operating loss deduction provided in section 172 is not allowed for purposes of the computation of undistributed foreign personal holding company income. For purposes of such a computation, however, there is allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year, except that, in computing undistributed foreign personal holding company income for a taxable year ending after December 31, 1957, the amount of such net operating loss shall be computed without the deductions provided in part VIII (section 241 and following) except section 248, relating to organizational expenditures, subchapter B, chapter 1 of the Code.

(e) **Expenses and depreciation applicable to property of the corporation.** (1) Section 556(b)(5) provides a specific limitation in computing undistributed foreign personal holding company income, with respect to the allowance of deductions for trade or business expenses and depreciation which are allocable to the operation and maintenance of property owned or operated by a foreign personal holding company. Under this limitation these deductions shall not be allowed in excess of the aggregate amount of the rent or other compensation received for the use of, or the right to use, the property, unless it is established to the satisfaction of the Commissioner—

(i) That the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable;

(ii) That the property was held in the course of a business carried on bona fide for profit; and

(iii) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(2) The burden of proof will rest upon the taxpayer to sustain the deduction claimed. If a United States shareholder, in computing his distributive share of undistributed foreign personal holding company income to be included in gross income in his individual return (see section 551, and §§ 1.551–1 and 1.551–2), claims deductions for expenses and depreciation allocable to the operation and maintenance of property owned or operated by the company, in an aggregate amount in excess of the rent or other compensation received for the use of, or the right to use, the property, he shall attach to his income tax return a statement setting forth his claim for allowance of the additional deductions, together with a complete statement of the facts and circumstances pertinent to his claim and the arguments on which he relies. Such statement shall set forth—

(i) A description of the property;

(ii) The cost or other basis to the corporation and the nature and value of the consideration paid for the property;

(iii) The name and address of the person from whom the property was acquired and the date the property was acquired;

(iv) The name and address of the person to whom the property is leased or rented, or the person permitted to use the property, and the number of shares of stock, if any, held by such person and the members of his family;

(v) The nature and gross amount of the rent or other compensation received for the use of, or the right to use, the property during the taxable year and for each of the five preceding years and the amount of the expenses incurred with respect to, and the depreciation sustained on, the property for such years;

(vi) Evidence that the rent or other compensation was the highest obtainable, or, if none was received, a statement of the reasons therefor;

(vii) A copy of the contract, lease or rental agreement;

(viii) The purpose for which the property was used;

(ix) The business carried on by the corporation with respect to which the property was held and the gross income, expenses, and taxable income derived from the conduct of such business for the taxable year and for each of the five preceding years;

(x) A statement of any reasons which existed for expectation that the operation of the property would be profitable, or a statement of the necessity for the use of the property in the business of the corporation, and the reasons why the property was acquired; and

(xi) Any other information pertinent to the taxpayer's claim.

(f) **Taxes and contributions to pension trusts.** Section 164(e) provides for deduction by a corporation for taxes of a shareholder paid by it; section 404 provides for deduction by an employer for its contributions to an employees' trust, etc. For the purpose of computing undistributed foreign personal holding company income, neither of these deductions is allowable.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6900, 31 FR 14644, Nov. 17, 1966; T.D. 7207, 37 FR 20796, Oct. 5, 1972]

§ 1.556–3 Illustration of computation of undistributed foreign personal holding company income.

The method of computation of the undistributed foreign personal holding company income may be illustrated by the following example:

Example. (a) The following facts exist with respect to the M Corporation, a foreign personal holding company, for the calendar year 1954:

(1) The gross income of the corporation as defined in section 555 amounts to $300,000, of which $85,000 represents its distributive share of the undistributed foreign personal holding company income of another foreign personal holding company in which it is a shareholder, $200,000 consists of dividends, $10,000 consists of fully taxable interest, and the remainder ($5,000) consists of rent received from the principal shareholder of the corporation for the use of property owned by the corporation.

(2) The expenses of the corporation amount to $85,000, of which $75,000 is allocable to the maintenance and operation of the property used by the principal shareholder and $10,000 consists of ordinary and necessary office expenses allowable as a deduction. The claim for deduction for the expenses of, and depreciation on, the rented property in excess of the rent received for its use is not established as provided in section 556(b)(5). The yearly depreciation on the rented property amounts to $30,000.

(3) Federal income tax withheld at the source on the income of the corporation from sources within the United States amounts to $59,125.

(4) No gain from the sale or exchange of stock or securities is realized during the taxable year, but losses in the amount of $10,000 are sustained from the sale of stock or securities which constitute capital assets. Such losses are not allowed as a deduction in any amount. See section 1211(a).

(5) Contributions, payment of which is made to or for the use of donees described in section 170(b)(1)(A) for the purposes therein specified, amount to $15,000, of which $5,000 is deductible in computing taxable income under section 63.

(6) Dividends paid by the corporation to its shareholders during the taxable year amount to $50,000.

(b) The taxable income of the corporation (including the distributive share of the undistributed foreign personal holding company income of the other foreign personal holding company) is $180,000, computed as follows (assuming for the purposes of this example only that the expenses of, and depreciation on, the rental property are deductible under sections 162 and 167):

Income (Section 61)	
Dividends	$200,000
Interest	10,000
Rent	5,000
Gross income as defined in section 61	215,000
Add:	
Distributive share of undistributed income of the other foreign personal holding company (considered as a dividend)	$85,000
Gross income as defined in section 555	300,000
Deductions (Section 161)	
Expenses allocable to operation of the rented property	$75,000
Depreciation of the rented property	30,000
Ordinary and necessary expenses (office)	10,000
Contributions (within the 5-percent limitation specified in section 170(b)(2)	5,000
	120,000
Taxable income for purposes of computing undistributed foreign personal holding company income	180,000

(c) The undistributed foreign personal holding company income of the corporation is $160,875, computed as follows:

Taxable income for purposes of computing undistributed foreign personal holding company income	$180,000
Add (see section 556(b)):	
Contributions deductible in computing taxable income under section 63	5,000
Excess property expenses and depreciation over amount of rent received for use of property ($105,000 – $5,000)	100,000
Total	105,000
Deduct (see section 556(b)):	
Federal income taxes	59,125
Contributions (within the percentage limitations specified in section 170(b)(1)(A) and (B), determined under the rules provided in section 556(b)(2))	15,000
Total	74,125
Net additions under section 556(b)	30,875
Taxable income, as adjusted under section 556(b)	210,875
Less: Deduction for dividends paid (see section 561)	50,000
Undistributed foreign personal holding company income	160,875

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

Deduction For Dividends Paid

§ 1.561–1 Deduction for dividends paid.

(a) The deduction for dividends paid is applicable in determining accumulated taxable income under section 535, undistributed personal holding company income under section 545, undistributed foreign personal holding company income under section 556, investment company taxable income under section 852, and real estate investment trust taxable income under section 857. The deduction for dividends paid includes—

(1) The dividends paid during the taxable year;

(2) The consent dividends for the taxable year, determined as provided in section 565; and

(3) In the case of a personal holding company, the dividend carryover computed as provided in section 564.

(b) For dividends for which the dividends paid deduction is allowable, see section 562 and § 1.562–1. As to when dividends are considered paid, see § 1.561–2.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4093, April 28, 1962]

§ 1.561–2 When dividends are considered paid.

(a) *In general.* (1) A dividend will be considered as paid when it is received by the shareholder. A deduction for dividends paid during the taxable year will not be permitted unless the shareholder receives the dividend during the taxable year for which the deduction is claimed. See section 563 for special rule with respect to dividends paid after the close of the taxable year.

(2) If a dividend is paid by check and the check bearing a date within the taxable year is deposited in the mails, in a cover properly stamped and addressed to the shareholder at his last known address, at such time that in the ordinary handling of the mails the check would be received by the shareholder within the taxable year, a presumption arises that the dividend was paid to the shareholder in such year.

(3) The payment of a dividend during the taxable year to the authorized agent of the shareholder will be deemed payment of the dividend to the shareholder during such year.

(4) If a corporation, instead of paying the dividend directly to the shareholder, credits the account of the shareholder on the books of the corporation with the amount of the dividend, the deduction for a dividend paid will not be permitted unless it be shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

(5) A deduction will not be permitted for the amount of a dividend credited during the taxable year upon an obligation of the shareholder to the corporation unless it is shown to the satisfaction of the Commissioner that such crediting constituted payment of the dividend to the shareholder within the taxable year.

(6) If the dividend is payable in obligations of the corporation, they should be entered or registered in the taxable year on the books of the corporation, in the name of the shareholder (or his nominee or transferee), and, in the case of obligations payable to bearer, should be received in the taxable year by the shareholder (or his nominee or transferee) to constitute payment of the dividend within the taxable year.

(7) In the case of a dividend from which the tax has been deducted and withheld as required by chapter 3 (section 1441 and following), of the Code the dividend is considered as paid when such deducting and withholding occur.

(b) Methods of accounting. The determination of whether a dividend has been paid to the shareholder by the corporation during its taxable year is in no way dependent upon the method of accounting regularly employed by the corporation in keeping its books or upon the method of accounting upon the basis of which the taxable income of the corporation is computed.

(c) Records. Every corporation claiming a deduction for dividends paid shall keep such permanent records as are necessary (1) to establish that the dividends with respect to which such deduction is claimed were actually paid during the taxable year and (2) to supply the information required to be filed with the income tax return of the corporation. Such corporation shall file with its return (i) a copy of the dividend resolution; and (ii) a concise statement of the pertinent facts relating to the payment of the dividend, clearly specifying (a) the medium of payment and (b) if not paid in money, the fair market value and adjusted basis (or face value, if paid in its own obligations) on the date of distribution of the property distributed and the manner in which such fair market value and adjusted basis were determined. Canceled dividend checks and receipts obtained from shareholders acknowledging payment of dividends paid otherwise than by check need not be filed with the return but shall be kept by the corporation as a part of its records.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.562–1 Dividends for which the dividends paid deduction is allowable.

(a) General rule. Except as otherwise provided in section 562(b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562(c) and § 1.562–2 shall be eligible for the dividends paid deduction. Moreover, when computing the dividends paid deduction with respect to a U.S. person (as defined in section 957(d)), no distribution which is excluded from the gross income of a foreign corporation under section 959(b) with respect to such person or from gross income of such person under section 959(a) shall be eligible for such deduction. Further, for purposes of the dividends paid deduction, the term "dividend" does not include a distribution in liquidation unless the distribution is treated as a dividend under section

316(b)(2) and paragraph (b)(2) of § 1.316–1, or under section 333(e)(1) and paragraph (c) of § 1.333–4 or paragraph (c)(2), (d)(1)(ii), or (d)(2) of § 1.333–5, or qualifies under section 562(b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. See paragraph (b)(2) of this section for special rules with respect to liquidating distributions by personal holding companies occurring during a taxable year of the distributing corporation beginning after December 31, 1963. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

(b) Distributions in liquidation—(1) General rule—(i) In general. In the case of amounts distributed in liquidation by any corporation during a taxable year of such corporation beginning before January 1, 1964, or by a corporation other than a personal holding company (as defined in section 542) or a foreign personal holding company (as defined in section 552) during a taxable year of such a corporation beginning after December 31, 1963, section 562(b) makes an exception to the general rule that a deduction for dividends paid is permitted only with respect to dividends described in section 316. In order to qualify under that exception, the distribution must be one either in complete or partial liquidation of a corporation pursuant to sections 331, 332, or 333. See subparagraph (2) of this paragraph for rules relating to the treatment of distributions in complete liquidation made by a corporation which is a personal holding company to corporate shareholders during a taxable year of such distributing corporation beginning after December 31, 1963. As provided by section 346(a), for the purpose of section 562(b), a partial liquidation includes a redemption of stock to which section 302 applies. Amounts distributed in liquidation in a transaction which is preceded, or followed, by a transfer to another corporation of all or part of the assets of the liquidating corporation, may not be eligible for the dividends paid deduction.

(ii) Amount of dividends paid deduction allowable—(a) General rule. In the case of distributions in liquidation with respect to which a deduction for dividends paid is permissible under subdivision (i) of this subparagraph, the amount of the deduction is equal to the part of such distribution which is properly chargeable to the earnings and profits accumulated after February 28, 1913. To determine the amount properly chargeable to the earnings and profits accumulated after February 28, 1913, there must be deducted from the amount of the distribution that part allocable to capital account. The capital account, for the purposes of this subdivision, includes not only amounts representing the par or stated value of the stock with respect to which the liquidation distribution is made, but also that stock's proper share of the paid-in surplus, and such other corporate items, if any, which, for purposes of income taxation, are treated like capital in that they are not taxable dividends when distributed but are applied against and reduce the basis of the stock. The remainder of the distribution in liquidation is, ordinarily, properly chargeable to the earnings and profits accumulated after February 28, 1913. Thus, if there is a deficit in earnings and profits on the first day of a taxable year, and the earnings and profits for such taxable year do not exceed such deficit, no dividends paid deduction would be allowed for such taxable year with respect to a distribution in liquidation; if the earnings and profits for such taxable year exceed the deficit in earnings and profits which existed on the first day of such taxable year, then a dividends paid deduction would be allowed to the extent of such excess.

(b) Special rule. Section 562(b)(1)(B) provides that in the case of a complete liquidation occurring within 24 months after the adoption of a plan of liquidation the amount of the deduction is equal to the earnings and profits for each taxable year in which distributions are made. Thus, if there is a distribution in liquidation pursuant to section 333, or a distribution in complete liquidation pursuant to section 331(a)(1) or 332 which occurs within a 24-month period after the adoption of a plan of liquidation, a dividends paid deduction will be allowable to the extent of the current earnings and profits for the taxable year or years even though there was a deficit in earnings and profits on the first day of such taxable year or years. In computing the earnings and profits for the taxable year in which the distributions are made, computation shall be made with the inclusion of capital gains and without any deduction for capital losses.

(c) Examples. The application of this subparagraph may be illustrated by the following examples:

Example (1). The Y Corporation, which makes its income tax returns on the calendar year basis, was organized on January 1, 1910, with an authorized and outstanding capital stock of 2,000 shares of common stock of a par value of $100 each and 1,000 shares of participating preferred stock of a par value of $100 each. The preferred stock was to receive annual dividends of $7 per share and $100 per share on complete liquidation of the corporation in priority to any payments on

common stock, and was to participate equally with the common stock in either instance after the common stock had received a similar amount. However, the preferred stock was redeemable in whole or in part at the option of the board of directors at any time at $106 per share plus its proportion of the earnings of the company at the time of such redemption. In 1910 the preferred stock was issued at $106 per share, for a total of $106,000 and the common stock was issued, at $100 per share, for a total of $200,000. On July 15, 1954, the company had a paid-in surplus of $6,000, consisting of the premium received on the preferred stock; earnings and profits of $30,000 accumulated prior to March 1, 1913; and earnings and profits accumulated since February 28, 1913, of $75,000. On July 15, 1954, the option with respect to the preferred stock was exercised and the entire amount of such stock was redeemed at $141 per share or a total of $141,000 in a transaction upon which gain or loss to the distributees resulting from the exchange was determined and recognized under section 302(a). The amount of the distribution allocable to capital account was $116,000 ($100,000 attributable to par value, $6,000 attributable to paid-in surplus, and $10,000 attributable to earnings and profits accumulated prior to March 1, 1913). The remainder, $25,000 ($141,000, the amount of the distribution, less $116,000, the amount allocable to capital account) is properly chargeable to the earnings and profits accumulated since February 28, 1913, and is deductible as dividends paid.

Example (2). The M Corporation, a calendar year taxpayer, is completely liquidated on November 1, 1955, pursuant to a plan of liquidation adopted April 1, 1955. On January 1, 1955, the M Corporation has a deficit in earnings and profits of $100,000. During the period January 1, 1955, to the date of liquidation, November 1, 1955, it has earnings and profits of $10,000. The M Corporation is entitled to a dividends paid deduction in the amount of $10,000 as a result of its distribution in complete liquidation on November 1, 1955.

Example (3). The N Corporation, a calendar year taxpayer, is completely liquidated on July 1, 1958, pursuant to a plan of liquidation adopted February 1, 1955. No distributions in liquidation were made pursuant to the plan of liquidation adopted February 1, 1955, until the distribution in complete liquidation on July 1, 1958. On January 1, 1958, N Corporation had a deficit in earnings and profits of $30,000. During the period January 1, 1958, to the date of liquidation, July 1, 1958, the N Corporation has earnings and profits of $5,000. The N Corporation is not entitled to any deduction for dividends paid as a result of the distribution in complete liquidation on July 1, 1958. If the earnings and profits for the period January 1, 1958, to July 1, 1958, had been $32,000, the N Corporation would have been entitled to a deduction for dividends paid in the amount of $2,000.

(2) Special rule—(i) Distributions to corporate shareholders. In the case of amounts distributed in complete liquidation of a personal holding company (as defined in section 542) within 24 months after the adoption of a plan of liquidation, section 562(b)(2) makes a further exception to the general rule that a deduction for dividends paid is permitted only with respect to dividends described in section 316. The exception referred to in the preceding sentence applies only to distributions made in any taxable year of the distributing corporation beginning after December 31, 1963. Under the exception, the amount of any distribution within the 24-month period pursuant to the plan shall be treated as a dividend for purposes of computing the dividends paid deduction, but:

(a) Only to the extent that such amount is distributed to corporate distributees, and

(b) Only to the extent that such amount represents such corporate distributees' allocable share of undistributed personal holding company income for the taxable year of such distribution (computed without regard to section 316(b)(2)(B) and section 562(b)(2)).

Amounts distributed in liquidation in a transaction which is preceded, or followed, by a transfer to another corporation of all or part of the assets of the liquidating corporation, may not be eligible for the dividends paid deduction.

(ii) Corporate distributees' allocable share. For purposes of subdivision (i)(b) of this subparagraph—

(a) Except as provided in (b) of this subdivision, the corporate distributees' allocable share of undistributed personal holding company income for the taxable year of the distribution (computed without regard to sections 316(b)(2)(B) and 562(b)(2)) shall be determined by multiplying such undistributed personal holding company income by the ratio which the aggregate value of the stock held by all corporate shareholders immediately before the record date of the last liquidating distribution in such year bears to the total value of all stock outstanding on such date. For rules applicable in a case where the distributing corporation has more than one class of stock, see (c) of this subdivision (ii).

(b) If more than one liquidating distribution was made during the year, and if, after the record date of the first distribution but before the record date of the last distribution, there was a change in the relative shareholdings as between corporate shareholders and noncorporate shareholders, then the corporate distributees' allocable share of undistributed personal holding company income for the taxable year of the distributions (computed without regard to sections 316(b)(2)(B) and 562(b)(2)) shall be determined as follows:

(1) First, allocate the corporation's undistributed personal holding company income for the taxable year among the distributions made during such year by reference to the ratio which the aggregate amount of each distribution bears to the total amount of all distributions during such year;

(2) Second, determine the corporate distributees' allocable share of the corporation's undistributed personal holding company income for each

distribution by multiplying the amount determined under (1) of this subdivision (b) for each distribution by the ratio which the aggregate value of the stock held by all corporate shareholders immediately before the record date of such distribution bears to the total value of all stock outstanding on such date; and

(3) Last, determine the sum of the corporate distributees' allocable share of the corporation's undistributed personal holding company income for all such distributions.

For rules applicable in a case where the distributing corporation has more than one class of stock, see (c) of this subdivision (ii).

(c) Where the distributing corporation has more than one class of stock—

(1) The undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made shall be treated as a fund from which dividends may properly be paid and shall be allocated between or among the classes of stock in a manner consistent with the dividend rights of such classes under local law and the pertinent governing instruments, such as, for example, the distributing corporation's articles or certificate of incorporation and bylaws;

(2) The corporate distributees' allocable share of the undistributed personal holding company income for each class of stock shall be determined separately in accordance with the rules set forth in (a) and (b) of this subdivision (ii) as if each class of stock were the only class of stock outstanding; and

(3) The sum of the corporate distributees' allocable share of the undistributed personal holding company income for the taxable year in which, or in respect of which, the distribution was made shall be the sum of the corporate distributees' allocable share of the undistributed personal holding company income for all classes of stock.

(d) For purposes of this subdivision (ii), in any case where the record date of a liquidating distribution cannot be ascertained, the record date of the distribution shall be the date on which the liquidating distribution was actually made.

(iii) Example. The application of this subparagraph may be illustrated by the following example:

Example. O Corporation, a calendar year taxpayer is completely liquidated on December 31, 1964, pursuant to a plan of liquidation adopted July 1, 1964. No distributions in liquidation were made pursuant to the plan of liquidation adopted July 1, 1964, until the distribution in complete liquidation on December 31, 1964. O Corporation has undistributed personal holding company income of $300,000 for the year 1964 (computed without regard to section 316(b)(2)(B) and section 562(b)(2)). On December 31, 1964, immediately before the record date of the distribution in complete liquidation, P Corporation owns 100 shares of O Corporation's outstanding stock and individual A owns the remaining 200 shares. All shares are equal in value. The amount which represents P Corporation's allocable share of undistributed personal holding company income is $100,000(100 shares ÷ 300 shares × $300,-000), and for purposes of computing the dividends paid deduction, such amount is treated as a dividend under section 562(b)(2) provided that the liquidating distribution to P Corporation equals or exceeds $100,000. P Corporation does not treat the $100,000 distributed to it as a dividend to which section 301 applies. For an example of the treatment of the distribution to individual A see example (5) of paragraph (e) of § 1.316–1.

(iv) Distributions to noncorporate shareholders. For the rules for determining the extent to which distributions in complete liquidation made to noncorporate shareholders by a personal holding company are dividends within the meaning of section 562(a), see section 316(b)(2)(B) and paragraph (b)(2) of § 1.316–1.

(c) **Special definition of dividend for nonliquidating distributions by personal holding companies.** Section 316(b)(2)(A) provides that in the case of a corporation which, under the law applicable to the taxable year in which or in respect of which a distribution is made, is a personal holding company, the term "dividend" (in addition to the general meaning set forth in section 316(a)) also means a nonliquidating distribution to its shareholders to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to such distributions) for the taxable year in which or in respect of which the distribution is made. See paragraph (b)(1) of § 1.316–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6949, 33 FR 5529, April 9, 1968; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.562–2 Preferential dividends.

(a) Section 562(c) imposes a limitation upon the general rule that a corporation is entitled to a deduction for dividends paid with respect to all dividends which it actually pays during the taxable year. Before a corporation may be entitled to any such deduction with respect to a distribution regardless of the medium in which the distribution is made, every shareholder of the class of stock with respect to which the distribution is made must be treated the same as every other shareholder of that class, and no class of stock may be treated otherwise than in accordance with its dividend rights as a class. The limitation imposed by section 562(c) is unqualified, except in the case of an actual

distribution made in connection with a consent distribution (see section 565), if the entire distribution composed of such actual distribution and consent distribution is not preferential. The existence of a preference is sufficient to prohibit the deduction regardless of the fact (1) that such preference is authorized by all the shareholders of the corporation or (2) that the part of the distribution received by the shareholder benefited by the preference is taxable to him as a dividend. A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class. Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated. The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. As used in this section, the term "distribution" includes a dividend as defined in subchapter C, chapter 1 of the Code, and a distribution in liquidation referred to in section 562(b).

(b) The application of the provisions of section 562(c) may be illustrated by the following examples:

Example (1). A, B, C, and D are the owners of all the shares of class A common stock in the M Corporation, which makes its income tax returns on a calendar year basis. With the consent of all the shareholders, the M Corporation on July 15, 1954, declared a dividend of $5 a share payable in cash on August 1, 1954, to A. On September 15, 1954, it declared a dividend of $5 a share payable in cash on October 1, 1954, to B, C, and D. No allowance for dividends paid for the taxable year 1954 is permitted to the M Corporation with respect to any part of the dividends paid on August 1, 1954, and October 1, 1954.

Example (2). The N Corporation, which makes its income tax returns on the calendar year basis, has a capital of $100,000 (consisting of 1,000 shares of common stock of a par value of $100) and earnings or profits accumulated after February 28, 1913, in the amount of $50,000. In the year 1954, the N Corporation distributes $7,500 in cancellation of 50 shares of the stock owned by three of the four shareholders of the corporation. No deduction for dividends paid is permissible under section 562(c) and paragraph (a) of this section with respect to such distribution.

Example (3). The P Corporation has two classes of stock outstanding, 10 shares of cumulative preferred, owned by E, entitled to $5 per share and on which no dividends have been paid for two years, and 10 shares of common, owned by F. On December 31, 1954, the corporation distributes a dividend of $125, $50 to E, and $75 to F. The corporation is entitled to no deduction for any part of such dividend paid, since there has been a preference to F. If, however, the corporation had distributed $100 to E and $25 to F, it would have been entitled to include $125 as a dividend paid deduction.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.562–3 Distributions by a member of an affiliated group.

A personal holding company which files or is required to file a consolidated return with other members of an affiliated group may be required to file a separate personal holding company schedule by reason of the limitations and exceptions provided in section 542(b) and § 1.542–4. Section 562(d) provides that in such case the dividends paid deduction shall be allowed to the personal holding company, with respect to a distribution made to any member of the affiliated group, if such distribution would constitute a dividend if it were made to a shareholder which is not a member of the affiliated group.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.563–1 Accumulated earnings tax.

In the determination of the dividends paid deduction for purposes of the accumulated earnings tax imposed by section 531, a dividend paid after the close of any taxable year and on or before the 15th day of the third month following the close of such taxable year shall be considered as paid during such taxable year, and shall not be included in the computation of the dividends paid deduction for the year of payment. However, the rule provided in section 563(a) is not applicable to dividends paid during the first two and one-half months of the first taxable year of the corporation subject to tax under chapter 1 of the Internal Revenue Code of 1954.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.563–2 Personal holding company tax.

In the case of a personal holding company subject to the provisions of section 541, dividends paid after the close of the taxable year and before the 15th day of the third month thereafter shall be included in the computation of the dividends paid deduction for the taxable year only if the taxpayer so elects in its return for such taxable year. The election shall be made by including such dividends in computing its dividends paid deduction. The amount of such dividends which may be included in computing the dividends paid deduction for the taxable year shall not exceed either—

(a) The undistributed personal holding company income of the corporation for the taxable year, computed without regard to this section, or

(b) In the case of a taxable year beginning after December 31, 1969, 20 percent (10 percent, in the case of a taxable year beginning before Jan. 1, 1970) of the sum of the dividends paid during the taxable year (not including consent dividends), computed without regard to this section.

In computing the amount of the dividends paid deduction allowable for any taxable year, the amount allowed by reason of section 563(b) for any preceding taxable year is considered a dividend paid in such preceding taxable year and not in the year of actual distribution. Thus, a double deduction is not allowable.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7079, 35 FR 18587, Dec. 8, 1970]

§ 1.563-3 Dividends considered as paid on last day of taxable year.

(a) **General rule.** Where a distribution made after the close of the taxable year is considered as paid during such taxable year, for purposes of applying section 562(a) the distribution shall be considered as made on the last day of such taxable year.

(b) **Personal holding company tax.** In the case of a corporation which under the law applicable to the taxable year in respect of which a distribution is made under section 563(b) and § 1.563-2 is a personal holding company under the law applicable to such taxable year, section 316(b)(2) provides that the term dividend means (in addition to the general rule under section 316(a)) any distribution to the extent of the corporation's undistributed personal holding company income (determined under section 545 without regard to distributions under section 316(b)(2)) for such year. See paragraph (b) of § 1.316-1.

(c) **Dividends paid on or before December 15, 1955.** The Act of June 15, 1955 (Public Law 74, 84th Cong., 69 Stat. 136), repealed sections 452 and 462 of the Code, relating to prepaid income and reserve for estimated expenses. Under section 4(c)(4) of that Act, dividends paid after the 15th day of the third month following the close of the taxable year and on or before December 15, 1955, may be treated as having been paid on the last day of the taxable year for purposes of the accumulated earnings tax or the personal holding company tax and in the case of regulated investment companies, but only to the extent that such dividends are attributable to an increase in taxable income for the taxable year by reason of the repeal of sections 452 and 462. See paragraph (b) of § 1.9000-8, relating to treatment of certain dividends, prescribed pursuant to section 4(c)(4) of the Act of June 15, 1955.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.564-1 Dividend carryover.

(a) **General rule.** The dividend carryover from the two preceding years, allowable only to personal holding companies, is includible in the dividends paid deduction under section 561. It is computed as follows:

(1) If, for each of the preceding two years, the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to each such year) exceeds the taxable income (adjusted as provided in section 545 for purposes of determining undistributed personal holding company income) then the dividend carryover to the taxable year is the sum of both such excess amounts.

(2) If the deduction for dividends paid under section 561 for the second preceding year (determined without regard to the dividend carryover to such year) exceeds the taxable income for such year (adjusted as provided in section 545), and if the taxable income for the first preceding year (as so adjusted) exceeds the dividends paid deduction for such first preceding year (as so determined), then the dividend carryover to the taxable year shall be such excess amount for the second preceding year, less such excess amount for the first preceding year.

(3) If for the first preceding year the deduction for dividends paid under section 561 (determined without regard to the dividend carryover to such year) exceeds the taxable income (adjusted as provided in section 545) for such year, and such excess is not present in the second preceding year, then the dividend carryover to the taxable year shall be such excess amount for the first preceding year.

(b) **Dividend carryover from year in which taxpayer was not a personal holding company.** In computing the dividend carryover, the taxable income as adjusted under section 545 of any preceding taxable year shall be determined as if the corporation was, under the law applicable to such taxable year, a personal holding company.

(c) **Dividend carryover from year in which taxpayer was subject to 1939 Code.** In a case where the first or the second preceding taxable year

began before the taxpayer's first taxable year under the Internal Revenue Code of 1954, the amount of the dividend carryover shall be determined under the Internal Revenue Code of 1939.

(d) **Statement to be filed with return.** Every corporation claiming a dividend carryover for any taxable year shall file with its return for such year a concise statement setting forth the amount of the dividend carryover claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the dividend carryover claimed.

(e) **Computation of dividend carryover.** The computation of the dividend carryover may be illustrated by the following examples:

Example (1). The X Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $110,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $300,000. The dividend carryover to the year 1956 is $140,000, computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	110,000
Dividend carryover from 1954	40,000
Dividends paid deduction for 1955	300,000
Taxable income for 1955	200,000
Dividend carryover from 1955	100,000
Dividend carryover for 2 preceding taxable years, allowable as a deduction for the year 1956	140,000

Example (2). The Y Corporation, which files its income tax returns on the calendar year basis, has taxable income, adjusted as required by section 545, in the amount of $100,000 and has a dividends paid deduction of $150,000 for the year 1954. For 1955, its taxable income, adjusted as required by section 545, is $200,000 and its dividends paid deduction is $170,000. The dividend carryover to the year 1956 is $20,000 computed as follows:

Dividends paid deduction for 1954	$150,000
Taxable income for 1954	100,000
Dividend carryover from 1954	50,000
Taxable income for 1955	200,000
Dividends paid deduction for 1955	170,000
Excess of taxable income over dividends paid deduction	30,000
Dividend carryover for second preceding taxable year, allowable as a deduction for the year 1956	20,000

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.565–1T General rule (temporary).

(a) **Consent dividends.** The dividends paid deduction, as defined in section 561, includes the consent dividends for the taxable year. A consent dividend is a hypothetical distribution (as distinguished from an actual distribution) made by:

(1) A corporation that has a reasonable basis to believe that it is subject to the accumulated earnings tax imposed in Part I of Subchapter G, Chapter 1 of the Code, or

(2) A corporation described in Part II (personal holding companies) or Part III (foreign personal holding companies) of Subchapter G or in Part I (regulated investment companies) or Part II (real estate investment trusts) of Subchapter M, Chapter 1 of the Code.

A consent dividend may be made by a corporation described in this paragraph to any person who owns consent stock on the last day of the taxable year of such corporation and who agrees to treat the hypothetical distribution as an actual dividend, subject to the limitations in section 565, § 1.565–2T, and paragraph (c)(2) of this section, by filing a consent at the time and in the manner specified in paragraph (b) of this section.

(b) **Making and filing of consents.** (1) A consent shall be made on Form 972 in accordance with this section and the instructions on the form issued therewith. It may be made only by or on behalf of a person who was the actual owner on the last day of the corporation's taxable year of any class of consent stock, that is, the person who would have been required to include in gross income any dividends on such stock actually distributed on the last day of such year. Form 972 shall contain or be verified by a written declaration that it is made under the penalties of perjury. In the consent such person must agree to include in gross income for his taxable year in which or with which the taxable year of the corporation ends a specific amount as a taxable dividend.

(2) See paragraph (c) of this section and § 1.565–2T for the rules as to when all or a portion of the amount so specified will be disregarded for tax purposes.

(3) A consent may be filed at any time not later than the due date of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed. With such return, and not later than the due date thereof, the corporation must file Forms 972 duly executed by each consenting shareholder, and a return on Form 973 showing by classes the stock outstanding on the first and last days of the taxable year, the dividend rights of such stock, distributions made during the taxable year to shareholders, and giving all the other information required by the form. Form 973 shall contain or be verified by a written

declaration that is made under the penalties of perjury.

(c) Taxability of amounts specified in consents. **(1)** The filing of a consent is irrevocable, and except as otherwise provided in section 565(b), § 1.565–2T, and paragraph (c)(2) of this section, the full amount specified in a consent filed by a shareholder of a corporation described in paragraph (a) of this section shall be included in the gross income of the shareholder as a taxable dividend. Where the shareholder is taxable on a dividend only if received from sources within the United States, the amount specified in the consent of the shareholder shall be treated as a dividend from sources within the United States in the same manner as if the dividend had been paid in money to the shareholder on the last day of the corporation's taxable year. See paragraph (b) of this section relating to the making and filing of consents, and section 565(e) and § 1.565–5T, with respect to the payment requirement in the case of nonresident aliens and foreign corporations.

(2) To the extent that the Commissioner determines that the corporation making a consent dividend is not a corporation described in paragraph (a) of this section, the amount specified in the consent is not a consent dividend and the amount specified in the consent will not be included in the gross income of the shareholder. In addition, where a corporation is described in paragraph (a)(1) of this section, but not paragraph (a)(2) of this section, to the extent that the Commissioner determines that the amount specified in a consent is larger than the amount of earnings subject to the accumulated earnings tax imposed by Part I of Subchapter G, such excess is not a consent dividend under paragraph (a) of this section and will not be included in the gross income of the shareholder.

(3) Except as provided in section 565(b), § 1.565–2T and paragraph (c)(2) of this section, once a shareholder's consent is filed, the full amount specified in such consent must be included in the shareholder's gross income as a taxable dividend, and the ground upon which a deduction for consent dividends is denied the corporation does not affect the taxability of a shareholder whose consent has been filed for the amount specified in the consent. For example, although described in Part I, II, or III, of Subchapter G, or Part I or II of subchapter M, Chapter I of the Code, the corporation's taxable income (as adjusted under section 535(b), 545(b), 556(b), 852(b)(2), or 857(b)(2), as appropriate) may be less than the total of the consent dividends.

(4) A shareholder who is a nonresident alien or a foreign corporation is taxable on the full amount of the consent dividend that otherwise qualifies under this section even though that payment has not been made as required by section 565(e) and § 1.565–5T.

(5) Income of a foreign corporation is not subject to the tax on accumulated earnings under Part I, of Subchapter G, Chapter 1 of the Code except to the extent of U.S. source income, adjusted as permitted under section 535. See section 535(b) and (d) and § 1.535–1(b). Therefore, foreign source earnings (other than those distributions subject to resourcing under section 535(d)) of a foreign corporation that is not described in paragraph (a)(2) of this section cannot qualify for consent dividend treatment. Accordingly, a consent dividend made by a foreign corporation described in paragraph (a)(1) of this section shall not be effective with respect to all of the corporation's earnings, but shall relate solely to earnings which would have been, in the absence of the consent dividend, subject to the accumulated earnings tax.

[T.D. 8166, 52 FR 47555, Dec. 15, 1987; T.D. 8166, 53 FR 1103, Jan. 15, 1988]

§ 1.565–2T Limitations (temporary).

(a) Amounts specified in consents filed by shareholders or other beneficial owners of a corporation described in § 1.565–1T(a) are not treated as consent dividends to the extent that—

(1) They would constitute a preferential dividend; or

(2) They would not constitute a dividend (as defined in section 316), if distributed in money to shareholders on the last day of the taxable year of the corporation. If any portion of any amount specified in a consent filed by a shareholder of a corporation described in the preceding sentence is not treated as a consent dividend under section 565(b) and this section, it is disregarded for all tax purposes. For example, it is not taxable to the consenting shareholder, and paragraph (c) of § 1.565–1T is not applicable to this portion of the amount specified in the consent.

(b)(1) A preferential distribution is an actual distribution, or a consent distribution, or a combination of the two, which involves a preference to one or more shares of stock as compared with other shares of the same class or to one class of stock as compared with any other class of stock. See section 562(c) and § 1.562–2.

(2) The application of section 565(b)(1) may be illustrated by the following examples:

Example (1). The X Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has 200 shares of stock outstanding, owned by A and B in equal amounts. On December 15, 1987, the corporation distributes $600 to B and $100 to A. As a part of the same distribution, A executes a consent to include $500 in his gross income as a taxable dividend although such amount is not distributed to him. The X Corporation, assuming the other requirements of section 565 have been complied with, is entitled to a consent dividends deduction of $500. Although the consent dividend is deemed to have been paid on December 31, 1987, the last day of the taxable year of the corporation, they constitute a single nonpreferential distribution of $1200.

Example (2). The Y corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has one class of consent stock outstanding, owned in equal amounts by A, B, and C. On December 15, 1987, the corporation makes a distribution in cash of $5,000 each to A and B, and $3,000 to C. The distribution is preferential. If A and B, each receive a distribution in cash of $5,000 and C consents to include $3,000 in gross income as a taxable dividend, the combined actual and consent distribution is preferential. Similarly, if no one receives a distribution in cash, but A and B each consents to include $5,000 as a taxable dividend in gross income and C agrees to include only $3,000, the consent distribution is preferential.

Example (3). The Z Corporation, which makes its income tax returns on the calendar year basis and is subject, for the taxable year in question, to the accumulated earnings tax, has only two classes of stock outstanding, each class being consent stock and consisting of 500 shares. Class A, with a par value of $40 per share, is entitled to two-thirds of any distribution of earnings and profits. Class B, with a par value of $20 per share, is entitled to one-third of any distribution of earnings and profits. On December 15, 1987, there is distributed on the class B stock $2 per share, or $1,000, and shareholders of the class A stock consent to include in gross income amounts equal to $2 per share, or $1,000. The distribution is preferential, inasmuch as the class B stock has received more than its pro rata share of the combined amounts of the actual distributions and the consent distributions.

(c)(1) An additional limitation under section 565(b) is that the amounts specified in consents which may be treated as consent dividends cannot exceed the amounts which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation. If only a portion of such total would constitute a dividend, then only a corresponding portion of each specified amount is treated as a consent dividend.

(2) The application of section 565(b)(2) may be illustrated by the following example:

Example. The X Corporation, a personal holding company, which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1987. Its earnings and profits for the calendar year 1987 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1987. The sum of the amounts specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X corporation on December 31, 1987, only $8,000 would have constituted a dividend under section 316(a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes. The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the personal holding company tax is $10,000 (assuming that the undistributed personal holding company income, determined without regard to distributions under section 316(b)(2), is equal to at least that amount). In that event, A and B would each include $5,000 in gross income as a dividend received on December 31, 1987.

[T.D. 8166, 52 FR 47556, Dec. 15, 1987; T.D. 8166, 52 FR 1103, Jan. 15, 1988]

§ 1.565–3T Effect of consent (temporary).

(a) The amount of the consent dividend that is described in paragraph (a) of § 1.565–1T shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to the corporation on such day. Thus, the amount of the consent dividend will be treated by the shareholder as a dividend. The shareholder will be entitled to the dividends received deduction under section 243 or 245 with respect to such consent dividend. The basis of the shareholder's consent stock in a corporation will be increased by the amount thus treated in his hands as dividend which he is considered as having contributed to the corporation as paid-in capital. The amount of the current dividend will also be treated as a dividend received from sources within the United States in the same manner as if the dividend has been paid in money to the shareholders. Among other effects of the consent dividend, the earnings and profits of the corporation will be decreased by the amount of the consent dividends. Moreover, if the shareholder is a corporation, its accumulated earnings and profits will be increased by the amount of the consent dividend with respect to which it makes a consent.

(b) The application of section 565(c) to a corporate shareholder may be illustrated by the following example:

Example. Corporation A, a personal holding company and a calendar year taxpayer, has one shareholder, individual B, whose consent to include $10,000 in his gross income for the calendar year 1987 has been timely filed. A has $8,000 of

earnings and profits in 1987 and had no accumulated earnings and profits at the beginning of 1987. A has $10,000 of undistributed personal holding company income (determined without regard to distributions under section 316(b)(2)) for 1987. B must include $10,000 in his gross income as a taxable income and is treated as having immediately contributed $10,000 to A as paid-in capital. See section 316(b)(2).

[T.D. 8166, 52 FR 47556, Dec. 15, 1987]

§ 1.565–4 Consent dividends and other distributions.

Section 565(d) provides a rule applicable where a distribution is made in part in consent dividends and in part in money or other property. With respect to such a distribution the entire amount specified in the consents and the amount of such money or other property shall be considered together. Thus, if as a part of the same distribution consents are filed by some of the shareholders and cash is distributed to other shareholders, for example, those who may be unwilling to sign consents, the total amount of the cash and the amounts specified in the consents will be viewed as a single distribution to determine the tax effects of such distribution. For example, the total of such amounts must be considered to determine whether the distribution (including the amounts specified in the consents) is preferential and whether any part of such distribution would not be dividends if the total amounts specified in the consents were distributed in cash. See paragraph (b)(2) of § 1.565–2 for examples illustrating the treatment of distributions which consist in part of consent dividends and in part of other property.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.565–5T Nonresident aliens and foreign corporations (temporary).

In the event that any consent filed by a corporation that is described in paragraph (a) of § 1.565–1T is made by a shareholder to whom the payment of a dividend in cash on the last day of the taxable year of the corporation would have made it necessary for the corporation to deduct and withhold any amount as a tax under section 1441 or section 1442, such consent, when filed by the corporation, must be accompanied by payment of the amount which would have been required to be deducted and withheld if the amount specified in such consent had, on the last day of the corporation's taxable year, been paid to the shareholder in cash as a dividend. Such payment must be in one of the following forms:

(a) Cash;

(b) United States postal money order;

(c) Certified check drawn on a domestic bank, provided that the law of the place where the bank is located does not permit the certification to be rescinded prior to presentation;

(d) A cashier's check of a domestic bank, or

(e) A draft on a domestic bank or a foreign bank maintaining a United States agency or branch and payable in United States funds.

The amount of such payment shall be credited against the tax imposed on the shareholder.

[T.D. 8166, 52 FR 47557, Dec. 15, 1987]

§ 1.565–6T Definitions (temporary).

(a) *Consent stock.* (1) The term "consent stock" includes what is generally known as common stock. It also includes participating preferred stock, the participation rights of which are unlimited.

(2) The definition of consent stock may be illustrated by the following example:

Example. If in the case of the X Corporation, a personal holding company, there is only one class of stock outstanding, it would all be consent stock. If, on the other hand, there were two classes of stock, class A and class B, and class A was entitled to 6 percent before any distribution could be made on class B, but class B was entitled to everything distributed after class A had received its 6 percent, only class B stock would be consent stock. Similarly, if class A, after receiving its 6 percent, was to participate equally or in some fixed proportion with class B until it had received a second 6 percent, after which class B alone was entitled to any further distributions, only class B stock would be consent stock. The same result would follow if the order of preferences were class A 6 percent, then class B 6 percent, then class A a second 6 percent, either alone or in conjunction with class B, then class B the remainder. If, however, class A stock is entitled to ultimate participation without limit as to amount, then it, too, may be consent stock. For example, if class A is to receive 3 percent and then share equally or in some fixed proportion with class B in the remainder of the earnings or profits distributed, both class A stock and class B stock are consent stock.

(b) *Preferred dividends.* (1) The term "preferred dividends" includes all fixed amounts (whether determined by percentage of par value, a stated return expressed in a certain number of dollars per share, or otherwise) the distribution of which on any class of stock is a condition precedent to a further distribution of earnings or profits (not including a distribution in partial or complete liquidation). A distribution, though expressed in terms of a fixed amount, is not a preferred dividend, however, unless it is preferred over a subsequent distribution within the taxable year upon some class or classes of stock other than one on which it is payable.

(2) The definition of preferred dividends may be illustrated by the following example:

Example. If, in the case of the X Corporation, there are only two classes of stock outstanding, class A and class B, and class A is entitled to a distribution of 6 percent of par, after which the balance of the earnings and profits are distributable on class B exclusively, class A's 6 percent is a preferred dividend. If the order of preferences is class A $6 per share, class B $6 per share, then class A and class B in fixed proportions until class A receives $3 more per share, then class B the remainder, all of class A's $9 per share and $6 per share of the amount distributable on class B are preferred dividends. The amount which class B is entitled to receive in conjunction with the payment to class A of its last $3 per share is not a preferred dividend, because the payment of such amount is preferred over no subsequent distribution except one made on class B itself. Finally, if a distribution must be $6 on class A, $6 on class B, then on class A and class B share and share alike, the distribution on class A of $6 and the distribution on class B of $6 are both preferred dividends.

[T.D. 8166, 52 FR 47557, Dec. 15, 1987]

BANKING INSTITUTIONS

Rules Of General Application To Banking Institutions

§ 1.581–1 Tax on banks.

A bank, as defined in section 581, is subject to the tax on corporations imposed by section 11. [T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.581–2 Mutual savings banks, building and loan associations, and cooperative banks.

(a) Mutual savings banks, building and loan associations, and cooperative banks not having capital stock represented by shares are subject to tax as in the case of other corporations. For special rules governing the taxation of a mutual savings bank conducting a life insurance business, see section 594 and § 1.594–1.

(b) While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank not having capital stock represented by shares, there are certain exceptions and special rules governing the computation in the case of such institutions. See section 593 and § 1.593–1 for special rules concerning additions to reserves for bad debts. See section 591 and § 1.591–1, relating to dividends paid by banking corporations, for special rules concerning deductions for amounts paid to, or credited to the accounts of, depositors or holders of withdrawable accounts as dividends. See also section 592 and § 1.592–1, relating to deductions for repayment of certain loans.

(c) For the purpose of computing the net operating loss deduction provided in section 172, any taxable year for which a mutual savings bank, building and loan association, or a cooperative bank not having capital stock represented by shares was exempt from tax shall be disregarded. Thus, no net operating loss carryover shall be allowed from a taxable year beginning before January 1, 1952, and, in the case of any taxable year beginning after December 31, 1951, the amount of the net operating loss carryback or carryover from such year shall not be reduced by reference to the income of any taxable year beginning before January 1, 1952.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.581–3 Definition of bank prior to September 28, 1962.

Prior to September 28, 1962, for purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U.S.C. 248(k)), and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

[T.D. 6651, 28 FR 4950, May 17, 1963]

§ 1.582–1 Bad debts, losses, and gains with respect to securities held by financial institutions.

(a) **Bad debt deduction for banks.** A bank, as defined in section 581, is allowed a deduction for bad debts to the extent and in the manner provided by subsections (a), (b), and (c) of section 166 with respect to a debt which has become worthless in whole or in part and which is evidenced by a security (a bond, debenture, note, certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money) issued by any corpo-

ration (including governments and their political subdivisions), with interest coupons or in registered form.

(b) Worthless stock in affiliated bank. For purposes of section 165(g)(1), relating to the deduction for losses involving worthless securities, if the taxpayer is a bank (as defined in section 581) and owns directly at least 80 percent of each class of stock of another bank, stock in such other bank shall not be treated as a capital asset.

(c) Pre-1970 sales and exchanges of bonds, etc., by banks. For taxable years beginning before July 12, 1969, with respect to the taxation under subtitle A of the Code of a bank (as defined in section 581), if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset.

(d) Post-1969 sales and exchanges of securities by financial institutions. For taxable years beginning after July 11, 1969, the sale or exchange of a security is not considered the sale or exchange of a capital asset if such sale or exchange is made by a financial institution to which any of the following sections applies: Section 585 (relating to banks), 586 (relating to small business investment companies and business development corporations), or 593 (relating to mutual savings banks, domestic building and loan associations, and cooperative banks). This paragraph shall apply to determine the character of gain or loss from the sale or exchange of a security notwithstanding any other provision of subtitle A of the Code, such as section 1233 (relating to short sales). However, this paragraph shall have no effect in the determination of whether a security is a capital asset under section 1221 for purposes of applying any other provision of the Code, such as section 1232 (relating to original issue discount). For purposes of this paragraph, a security is a bond, debenture, note, or certificate or other evidence of indebtedness, issued by any person. See paragraphs (e) and (f) of this section for special transitional rules applicable, respectively, to banks and to small business investment companies and business development corporations.

(e) Transition rule for qualifying securities held by banks—(1) In general. Notwithstanding the provisions of paragraph (d) of this section, if the net long-term capital gain from sales and exchanges of qualifying securities exceeds the net short-term capital loss from such sales and exchanges in any taxable year beginning after July 11, 1969, such excess shall be treated as long-term capital gain, but in an amount not to exceed the net gain from sales and exchanges of securities in such year. For purposes of computing such net gain, a capital loss carried to the taxable year under section 1212 shall not be taken into account. See section 1222 and the regulations thereunder for definitions of the terms "net long-term capital gain" and "net short-term capital loss". For purposes of this paragraph:

(i) The term "security" means a security within the meaning of paragraph (d) of this section.

(ii) The term "qualifying security" means a security which is held by the bank on July 11, 1969, and continuously thereafter until it is first sold or exchanged by the bank.

See also subparagraph (4) of this paragraph for rules under which the time certain securities are held is deemed to include a period of time determined under section 1223(1) and (2) with respect to such security.

(2) Computation of capital gain or loss. For purposes of this paragraph, the amount of gain or loss from the sale or exchange of a qualifying security treated as capital gain or loss is determined by multiplying the amount of gain or loss recognized from such sale or exchange by a fraction the numerator of which is the number of days before July 12, 1969, that such security was held by the bank and the denominator of which is the sum of the number of days included in the numerator and the number of days the security was held by the bank after July 11, 1969.

(3) Special rules. For purposes of subparagraphs (1) and (2) of this paragraph, the following items are not taken into account:

(i) Any amount treated as original issue discount under section 1232, and

(ii) Any amount which, without regard to section 582(c) and this section, would be treated as gain or loss from the sale or exchange of property which is not a capital asset, such as an amount which is realized from the sale or exchange of a security which is held by a bank as a dealer in securities.

(4) Holding period in certain cases. For purposes of this paragraph—

(i) The time a security received in an exchange is deemed to have been held by a bank includes a

period of time determined under section 1223(1) with respect to such security.

(ii) The time a security transferred to a bank from another bank is deemed to have been held by the transferee bank includes a period of time determined under section 1223(2) with respect to such security.

For example, if a bank on December 3, 1972, surrendered an obligation of the United States which it held as a capital asset on July 11, 1969, in a transaction to which section 1037 applied, the time during which the newly received obligation is deemed to have been held includes the time during which the surrendered obligation was deemed to have been held by the bank. Because the surrendered obligation was held on July 11, 1969, the newly acquired obligation is deemed to have been held on that date and is a qualifying security. The period during which the surrendered obligation is deemed to have been held is taken into account in computing the fraction determined under subparagraph (2) of this paragraph with respect to the newly received obligation.

(5) **Examples.** The provisions of this paragraph may be illustrated by the following examples:

Example (1). Bank A, a calendar year taxpayer, purchased a qualifying security on July 14, 1968, and held it to maturity on August 20, 1970, when it was redeemed. The redemption resulted in a taxable gain of $10,000. The security was held by the bank for 363 days before July 12, 1969, and for a total of 768 days. During the taxable year, the bank had no other gains and no losses from sales or exchanges of qualifying securities, but had a net loss of $4,000 from sales of securities other than qualifying securities. The portion of the gain from the redemption of the qualifying security treated as capital gain under subparagraph (2) of this paragraph is $4,726.56 (363/768 × $10,000). Because the net gain of the taxable year from sales and exchanges of securities, $6,000 ($10,000–$4,000), exceeds the portion of the gain on the sale of the qualifying security treated as capital gain under this paragraph, $4,726.56 is treated as long-term capital gain on the sale of the qualifying security for the taxable year.

Example (2). Assume the same facts as in example (1), except that the bank's net loss of the taxable year from the sale of securities other than qualifying securities was $7,000. The amount considered as long-term capital gain under this paragraph is limited by the amount of gain on the sale of securities to $3,000 ($10,000–$7,000).

(f) **Small business investment companies and business development corporations—(1) Election.** In the case of a small business investment company or a business development corporation, described in section 586(a), section 582(c) does not apply for taxable years beginning after July 11, 1969, and before July 11, 1974, unless the taxpayer elects that such section shall apply. In the case of a small business investment company, see paragraph (a)(1) of § 1.1243-1 if such an election is made, but see paragraph (a)(2) of § 1.1243-1 if such an election is not made. Such election applies to all such taxable years and, except as provided in subparagraph (3) of this paragraph, is irrevocable. Such election must be made not later than (i) the time, including extensions thereof, prescribed by law for filing the taxpayer's income tax return for its first taxable year beginning after July 11, 1969, or (ii) June 8, 1970, whichever is later.

(2) **Manner of making election.** An election pursuant to the provisions of this paragraph is made by the taxpayer by a written statement attached to the taxpayer's income tax return (or an amended return) for its first taxable year beginning after July 11, 1969. Such statement shall indicate that the election is made pursuant to section 433(d) of the Tax Reform Act of 1969 (83 Stat. 624). The taxpayer shall attach to its income tax return for each subsequent taxable year to which such election is applicable a statement indicating that the election has been made and the amount to which it applies for such year.

(3) **Revocation of election.** An election made pursuant to subparagraph (2) of this paragraph shall be irrevocable unless—

(i) A written application for consent to revoke the election, setting forth the reasons therefor, is filed with the Commissioner within 90 days after the permanent regulations relating to section 433(d)(2) of the Tax Reform Act of 1969 (83 Stat. 624) are filed with the Office of the Federal Register, and

(ii) The Commissioner consents to the revocation.

The revocation is effective for all taxable years to which the election applied.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7171, 37 FR 5620, March 17, 1972; 37 FR 6400, March 29, 1972]

§ 1.584-1 Common trust funds.

(a) **Method of taxation.** A common trust fund maintained by a bank is not subject to taxation under this chapter and is not considered a corporation. Its participants are taxed on their proportionate share of income from the common trust fund.

(b) **Conditions for qualification.** (1) For a fund to be qualified as a common trust fund it must be maintained by a bank (as defined in section 581) in conformity with the rules and regulations of the Comptroller of the Currency, exclusively for the

collective investment and reinvestment of contributions to the fund by the bank. The bank may either act alone or with one or more other fiduciaries, but it must act solely in its capacity as one or a combination of the following: (i) As a trustee of a trust created by will, deed, agreement, declaration of trust, or order of court; (ii) as an executor of a will or as an administrator of an estate; (iii) as a guardian (by whatever name known under local law) of the estate of an infant, of an incompetent individual, or of an absent individual; or (iv) on or after October 3, 1976, as a custodian of a Uniform Gifts to Minors account. A Uniform Gifts to Minors account is an account established pursuant to a State law substantially similar to the Uniform Gifts to Minors Act. (See the Uniform Gifts to Minors Act of 1956 or the Uniform Gifts to Minors Act of 1966, as published by the National Conference of Commissioners on Uniform State Laws.) The Commissioner will publish a list of the States whose laws he determines to be substantially similar to such uniform acts. A bank that maintains a Uniform Gifts to Minors Act account must establish, to the satisfaction of the Commissioner or his delegate, that with respect to the account the bank has duties and responsibilities similar to the duties and responsibilities of a trustee or guardian.

(2) A common trust fund may be a participant in another common trust fund.

(c) Affiliated groups. For taxable years beginning after December 31, 1975, two or more banks that are members of the same affiliated group (within the meaning of section 1504) are treated, for purposes of section 584, as one bank for the period of their affiliation. A common trust fund may be maintained by one or by more than one member of an affiliated group. Any member of the group may, but need not, contribute to the fund. Further, for purposes of this paragraph, members of an affiliated group may be, but need not be, co-trustees of the common trust fund.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6651, 28 FR 4950, May 17, 1963; T.D. 7935, 49 FR 1694, Jan. 13, 1984]

§ 1.584–2 Income of participants in common trust fund.

(a) Each participant in a common trust fund is required to include in computing its taxable income for its taxable year within which or with which the taxable year of the fund ends, whether or not distributed and whether or not distributable:

(1) Its proportionate share of short-term capital gains and losses, computed as provided in § 1.584–3;

(2) Its proportionate share of long-term capital gains and losses, computed as provided in § 1.584–3; and

(3) Its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in § 1.584–3.

(b)(1) Each participant's proportionate share of dividends and interest to which section 116 or 128 applies received by the common trust fund shall be deemed to have been received by such participant as such dividends and as such interest.

(2) Any tax withheld at the source from income of the fund (e.g., under section 1441) is deemed to have been withheld proportionately from the participants to whom such income is allocated.

(c)(1) The proportionate share of each participant's short-term capital gains and losses, long-term capital gains and losses, ordinary taxable income or ordinary net loss, dividends and interest received, and tax withheld at the source shall be determined under the method of accounting adopted by the bank in accordance with the written plan by which the common trust fund is established and administered, provided such method clearly reflects the income of each participant.

(2) Items of income and deductions shall be allocated to the periods between valuation dates established by the plan within the taxable year in which they were realized. Ordinary taxable income or ordinary net loss, short-term capital gains and losses, long-term capital gains and losses, and tax withheld at the source shall be computed for each period. The participants' proportionate shares of income and losses for each period shall then be determined.

(3) For taxable years beginning on or after September 22, 1980, any amount of income or loss of the common trust fund which is included in the computation of a participant's taxable income for the taxable year shall be treated as income or loss from an unrelated trade or business to the extent that such amount would have been income or loss from an unrelated trade or business if such participant had made directly the investments of the common trust fund.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. (i) The plan of a common trust fund provides for quarterly valuation dates and for the computation and the distribution of the income upon a quarterly basis, except that there shall be no distribution of capital gains. The participants are as follows: Trusts A, B, C, and D for the first quarter; Trusts A, B, C, and E for the second quarter; and Trusts A, B, F, and G for the third and fourth quarters, the participants having equal participating interests. As computed upon the quarterly basis, the ordinary taxable income, the short-term capital gain, and the long-term capital loss for the taxable year were as follows:

	First quarter	Second quarter	Third quarter	Fourth quarter	Total
Ordinary taxable income	$200	$300	$200	$400	$1,100
Short-term capital gain	200	100	200	100	600
Long-term capital loss	100	200	100	200	600

(ii) The participants' shares of ordinary taxable income are as follows:

PARTICIPANTS' SHARES OF ORDINARY TAXABLE INCOME

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$75	$50	$100	$275
B	50	75	50	100	275
C	50	75	......	......	125
D	50	......	......	......	50
E	......	75	......	......	75
F	......	......	50	100	150
G	......	......	50	100	150
Total	200	300	200	400	1,100

(iii) The participants' shares of the short-term capital gain are as follows:

PARTICIPANTS' SHARES OF SHORT-TERM CAPITAL GAIN

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$50	$25	$50	$25	$150
B	50	25	50	25	150
C	50	25	......	......	75
D	50	......	......	......	50
E	......	25	......	......	25
F	......	......	50	25	75
G	......	......	50	25	75
Total	200	100	200	100	600

(iv) The participants' shares of the long-term capital loss are as follows:

PARTICIPANTS' SHARES OF LONG-TERM CAPITAL LOSS

Participant	First quarter	Second quarter	Third quarter	Fourth quarter	Total
A	$25	$50	$25	$50	$150
B	25	50	25	50	150
C	25	50	......	......	75
D	25	......	......	......	25
E	......	50	......	......	50
F	......	......	25	50	75
G	......	......	25	50	75
Total	100	200	100	200	600

(v) If in the above example the common trust fund also had short-term capital losses and long-term capital gains, the treatment of such gains or losses would be similar to that accorded to the short-term capital gains and long-term capital losses in the above example.

(vi) Assume in the above example that participant Trust A qualified as a trust forming part of a pension, profit sharing, or stock bonus plan under section 401(a). Assume further that 20 percent of the ordinary taxable income of the common trust fund would be unrelated business taxable income (as defined under section 512(a)(1)) if received directly by Trust A. Under paragraph (c)(3), participant Trust A, for purposes of computing its taxable income, must treat its proportionate share of the common trust fund's ordinary taxable income as income from an unrelated trade or business to the extent such amount would have been income from an unrelated trade or business if Trust A had directly made the investments of the common trust fund. Therefore, participant Trust A must take into account 20 percent of its proportionate share of the common trust fund's ordinary taxable income as income from an unrelated trade or business.

(d) The provisions of part I, subchapter J, chapter 1 of the Code, or, as the case may be, the provisions of subchapters D, F, or H of chapter 1 of the Code, are applicable in determining the extent to which each participant's proportionate share of any income or loss of the common trust fund is taxable to the participant, or to a person other than the participant.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17808, Dec. 16, 1964; T.D. 7935, 49 FR 1692, Jan. 13, 1984]

§ 1.584–3 Computation of common trust fund income.

The taxable income of the common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that:

(a) No deduction shall be allowed under section 170 (relating to charitable, etc., contributions and gifts);

(b) The gains and losses from sales or exchanges of capital assets of the common trust fund are required to be segregated. A common trust fund is not allowed the benefit of the capital loss carryover provided by section 1212; and

(c) The ordinary taxable income (the excess of the gross income over deductions) or the ordinary net loss (the excess of the deductions over the

gross income) shall be computed after excluding all items of gain and loss from sales or exchanges of capital assets.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7935, 49 FR 1692, Jan. 13, 1984]

§ 1.584–4 Admission and withdrawal of participants in the common trust fund.

(a) Gain or loss. The common trust fund realizes no gain or loss by the admission or withdrawal of a participant, and the basis of the assets and the period for which they are deemed to have been held by the common trust fund for the purposes of section 1202 are unaffected by such an admission or withdrawal. For taxable years of participants ending after April 7, 1976, and for transfers occurring after that date, the transfer of property by a participant to a common trust fund is treated as a sale or exchange of the property transferred. If a participant withdraws the whole or any part of its participating interest from the common trust fund, such withdrawal shall be treated as a sale or exchange by the participant of the participating interest or portion thereof which is so withdrawn. A participant is not deemed to have withdrawn any part of its participating interest in the common trust fund so as to have completed a closed transaction by reason of the segregation and administration of an investment of the fund, pursuant to the provisions of 12 CFR 9.18(b)(7) (or, for periods before September 28, 1962, 12 CFR 206.17(c)(7)), for the benefit of all the then participants in the common trust fund. Such segregated investment shall be considered as held by, or on behalf of, the common trust fund for the benefit ratably of all participants in the common trust fund at the time of segregation, and any income or loss arising from its administration and liquidation shall constitute income or loss to the common trust fund apportionable among the participants for whose benefit the investment was segregated. When a participating interest is transferred by a bank or by two or more banks that are members of the same affiliated group (within the meaning of section 1504), as a result of the combination of two or more common trust funds or the division of a single common trust fund, the transfer to the surviving or divided common trust fund is not considered to be an admission or a withdrawal if—

(1) The combining, dividing, and resulting common trust funds have diversified portfolios within the meaning of section 368(a)(2)(F)(ii) and the regulations thereunder, and

(2) In the case of a division, each participant's pro rata interest in each of the resulting common trust funds is substantially the same as was the participant's pro rata interest in the dividing fund. However, in the case of the division of a common trust fund maintained by two or more banks that are members of the same affiliated group resulting from the termination of such affiliation, the division will be treated as meeting the requirements of this subparagraph if the written plans of operation of the resulting common trust funds are substantially identical to the plan of operation of the dividing common trust fund, each of the assets of the dividing common trust fund are distributed substantially pro rata to each of the resulting common trust funds, and each participant's aggregate interest in the assets of the resulting common trust funds of which he or she is a participant is substantially the same as was the participant's pro rata interest in the assets of the dividing common trust fund. The plan of operation of a resulting common trust fund will not be considered to be substantially identical to that of the dividing common trust fund where, for example, the plan of operation of the resulting common trust fund contains restrictions as to the types of participants that may invest in the common trust fund where such restrictions were not present in the plan of operation of the dividing common trust fund.

(b) Basis for gain or loss upon withdrawal. The participant's gain or loss upon withdrawal of its participating interest or portion thereof shall be measured by the difference between the amount received upon such withdrawal and the adjusted basis of the participating interest or portion thereof withdrawn plus the additions prescribed in paragraph (c) of this section and minus the reductions prescribed in paragraph (d) of this section. The amount received by the participant shall be the sum of any money plus the fair market value of property (other than money) received upon such withdrawal. The basis of the participating interest or portion thereof withdrawn shall be the sum of any money plus the fair market value of any property (other than money) contributed by the participant to the common trust fund to acquire the participating interest or portion thereof withdrawn. Such basis shall not be reduced on account of the segregation of any investment in the common trust fund pursuant to the provisions of 12 CFR 9.18(b)(7) (or, for periods before September 28, 1962, 12 CFR 206.17(c)(7)). For the purpose of making the adjustments, additions, and reductions with respect to basis as prescribed in this paragraph, the ward, rather than the guardian, shall be deemed to be the participant; and the grantor, rather than the trust, shall be deemed to be the participant, to the extent that the income of

the trust is taxable to the grantor under subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code.

(c) **Additions to basis.** As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, there shall be added to the basis of the participating interest or portion thereof withdrawn an amount equal to the aggregate of the following items (to the extent that they were properly allocated to the participant for a taxable year of the common trust fund and were not distributed to the participant prior to withdrawal):

(1) Wholly exempt income of the common trust fund for any taxable year,

(2) Net income of the common trust fund for the taxable years beginning after December 31, 1935, and prior to January 1, 1938,

(3) Net short-term capital gain of the common trust fund for each taxable year beginning after December 31, 1937,

(4) The excess of the gains over the losses recognized to the common trust fund upon sales or exchanges of capital assets held (i) for more than 18 months for taxable years beginning after December 31, 1937, and before January 1, 1942, (ii) for more than 6 months for taxable years beginning after December 31, 1941, and before January 1, 1977, (iii) for more than 9 months for taxable years beginning in 1977, and (iv) for more than 1 year for taxable years beginning after December 31, 1977, and

(5) Ordinary net or taxable income of the common trust fund for each taxable year beginning after December 31, 1937.

(d) **Reductions in basis.** As prescribed in paragraph (b) of this section, in computing the gain or loss upon the withdrawal of a participating interest or portion thereof, the basis of the participating interest or portion thereof withdrawn shall be reduced by such portions of the following items as were allocable to the participant with respect to the participating interest or portion thereof withdrawn:

(1) The amount of the excess of the allowable deductions of the common trust fund over its gross income for the taxable years beginning after December 31, 1935, and before January 1, 1938, and

(2) The amount of the net short-term capital loss, net long-term capital loss, and ordinary net loss of the common trust fund for each taxable year beginning after December 31, 1937.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6651, 28 FR 4950, May 17, 1963; T.D. 7935, 49 FR 1695, Jan. 13, 1984]

§ 1.584–5 Returns of banks with respect to common trust funds.

For rules applicable to filing returns of common trust funds, see section 6032 and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.584–6 Net operating loss deduction.

The net operating loss deduction is not allowed to a common trust fund. Each participant in a common trust fund, however, will be allowed the benefits of such deduction. In the computation of such deduction, a participant in a common trust fund shall take into account its pro rata share of items of income, gain, loss, deduction, or credit of the common trust fund. The character of any such item shall be determined as if the participant had realized such item directly from the source from which realized by the common trust fund, or incurred such item in the same manner as incurred by the common trust fund.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.585–1 Reserve for losses on loans of banks.

(a) **General rule.** As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a financial institution to which section 585 and this section apply shall be allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts provided such financial institution has adopted or adopts the reserve method of treating bad debts in accordance with paragraph (b) of § 1.166–1. In the case of such a taxpayer the amount of the reasonable addition to such reserve for a taxable year beginning after July 11, 1969, shall be an amount determined by the taxpayer which does not exceed the amount computed under § 1.585–2. Such reasonable addition for the taxable year shall be an amount at least equal to the amount provided by § 1.585–2(a)(2). For each taxable year the taxpayer must include in its income tax return (or amended return) for that year a computation of the amount of the addition determined under this section showing the method used to determine that amount. The use of a particular method in the return for a taxable year is not a binding election by the taxpayer to apply

such method either for such taxable year or for subsequent taxable years. A financial institution to which section 585 and this section apply which adopts the reserve method is not entitled to charge off any bad debts pursuant to section 166(a) with respect to a loan (as defined in § 1.585–2(e)(2)). Except as provided by § 1.585–3, the reserve for bad debts of a financial institution to which section 585 and this section apply shall be established and maintained in the same manner as is provided by section 166(c) and the regulations thereunder with respect to reserves for bad debts. Except as provided by this section, no deduction is allowable for an addition to a reserve for losses on loans as defined in § 1.585–2(e)(2) of a financial institution to which section 585 and this section apply. For rules relating to deduction with respect to debts which are not loans (as defined in § 1.585–2(e)(2)), see section 166(a) and the regulations thereunder. For rules relating to a debt evidenced by a security (as defined in section 165(g)(2)(C)), see sections 166(a), (b), and (c) and 582(a) and the regulations thereunder. For the definition of certain terms, see paragraph (e) of § 1.585–2. For rules relating to a transaction to which section 381(a) applies, see § 1.585–4.

(b) Application of section. Section 585 and this section apply only to the following financial institutions—

(1) Any bank (as defined in section 581 and the regulations thereunder) other than a mutual savings bank, domestic building and loan association, or cooperative bank, to which section 593 applies, and

(2) Any corporation to which subparagraph (1) of this paragraph would apply except for the fact that it is a foreign corporation and in the case of any such foreign corporation, the rules provided by section 585, this section. §§ 1.585–2, 1.585–3, and 1.585–4 apply only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

[T.D. 7532, 43 FR 3109, Jan. 23, 1978]

§ 1.585–2 Addition to reserve.

(a) In general—(1) Maximum addition. For taxable years beginning before January 1, 1988, the maximum reasonable addition to the reserve for losses on loans as defined in paragraph (e)(2) of this section is the amount allowable under the percentage method provided by paragraph (b) of this section or the experience method provided by paragraph (c) of this section, whichever is greater. For taxable years beginning after December 31, 1987, the maximum reasonable addition to the reserve for losses on loans is the amount determined under the experience method provided by paragraph (c) of this section.

(2) Minimum addition. For taxable years beginning after December 31, 1976, and before January 1, 1988, a taxpayer to which this section applies shall make a minimum addition to the reserve for losses on loans as defined in paragraph (e)(2) of this section. For purposes of this subparagraph, the term "minimum addition" means an addition to the reserve for losses on loans in an amount equal to the lesser of (i) the amount allowable under section 585 (b)(3)(A) and paragraph (c)(1)(ii) of this section, or (ii) the maximum amount allowable under section 585(b)(2) and paragraph (b) of this section. For taxable years beginning after December 31, 1987, a taxpayer to which this section applies shall make a minimum addition to the reserve for losses on loans for each taxable year in an amount equal to the amount allowable under section 585(b)(3)(A) and paragraph (c)(1)(ii) of this section.

(b) Percentage method—(1) In general—(i) Maximum addition. Except as limited under subparagraph (2) of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method for a taxable year is the amount determined under paragraph (b)(1)(ii), (iii), or (iv) of this section, whichever is applicable. For purposes of this paragraph, the term "allowable percentage" means 1.8 percent for taxable years beginning before 1976; 1.2 percent for taxable years beginning after 1975 but before 1982; 1.0 percent for taxable years beginning in 1982; and 0.6 percent for taxable years beginning after 1982 and before 1988. This paragraph does not apply for taxable years beginning after 1987.

(ii) Reserve less than allowable percentage of eligible loans. (A) If the reserve for losses on loans as of the close of the base year is less than the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year, the amount determined under this subdivision for the taxable year is the amount necessary to increase the balance of the reserve for losses on loans as of the close of the taxable year to an amount equal to the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of that year, except that the amount determined with respect to the reserve deficiency shall not exceed one-fifth of the reserve deficiency. For purposes of this section, the term "reserve deficiency" means the ex-

cess of the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year over the reserve for losses on loans as of the close of the base year. Where a taxpayer has recoveries of bad debts for a taxable year which exceed the bad debts sustained for such year, the taxpayer is not required to reduce its otherwise permissible current addition by the amount of the net recovery. A reasonable addition attributable to an increase in eligible loans outstanding at the close of the taxable year over eligible loans outstanding at the close of the base year may be made only for the portion of such increase which does not exceed the excess of eligible loans outstanding at the close of the taxable year over the sum of the amount of eligible loans outstanding at the close of the base year and the amount of previous increases in such loans for which an addition was made in taxable years ending after the close of the base year. For purposes of this subdivision, the order in which the factors which make up the annual reserve addition shall be claimed is:

(1) An amount equal to one-fifth of the reserve deficiency;

(2) Net bad debts charged to the reserve; and

(3) An amount attributable to an increase in the amount of eligible loans outstanding.

(B) For its first taxable year, a newly organized financial institution to which § 1.585–1 and this section apply shall be considered to have no reserve deficiency. For example, a new financial institution would compute its annual reserve addition by including in such addition an amount not in excess of the sum of (1) the amount of its net bad debts charged to the reserve for the taxable year, and (2) the allowable percentage of the increase in its eligible loans outstanding at the close of the taxable year over the amount of its loans outstanding (zero) at the end of the year preceding its first taxable year. Such amount would be subject to the 0.6 percent limitations provided in subparagraph (2) of the paragraph.

(C) The application of the rules provided by this subdivision may be illustrated by the following example:

Example. The X Bank is a commercial bank which has a calendar year as its taxable year. X adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, X has $1,000,000 of outstanding eligible loans and a balance of $13,000 in its reserve for losses on loans. The base year is 1969 and, consequently, X has a reserve deficiency of $5,000 ((1.8% × $1,000,000) – $13,000).

(a) During 1970, X has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, X has $1,050,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method is $2,900 which consists of $1,000 of reserve deficiency (⅕ × $5,000), the $1,000 in net bad debts charged to the reserve for losses on loans, and $900 attributable to the increase in the balance of eligible loans (1.8% × ($1,050,000 – $1,000,000)). Assuming that X makes an addition to the reserve for losses on loans of $2,900 for the year, the balance of the reserve as of December 31, 1970 is $14,900 ($13,000 – $1,000 + $2,900).

(b) During 1971, X has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, X has $800,000 of outstanding eligible loans. The allowable percentage of eligible loans is $14,400 (1.8% × $800,000). The maximum reasonable addition under the percentage method is $500 which is a portion of one-fifth of the reserve deficiency. Assuming that X makes an addition to the reserve for losses on loans of $500 for the year, the balance of the reserve as of December 31, 1971, is $14,400 ($14,900 – $1,000 + $500).

(c) During 1972, X has net bad debts of $600 charged to the reserve for losses on loans. On December 31, 1972, X has $850,000 of outstanding eligible loans. The allowable percentage of eligible loans is $15,300 (1.8% × $850,000). The maximum reasonable addition under the percentage method is $1,500 which consists of $1,000 of reserve deficiency (⅕ × $5,000) and $500 of the net bad debts charged to the reserve for losses on loans in 1971. Even though the full addition with respect to the reserve deficiency in 1971 was not made, the amount of the addition that can be made in 1972 with respect to the reserve deficiency is limited to one-fifth of such deficiency. Assuming that X makes an addition to the reserve for losses on loans of $1,500 for the year, the balance of the reserve as of December 31, 1972, is $15,300 ($14,400 – $600 + $1,500).

(d) During 1973, X did not have any net bad debts charged to the reserve for losses on loans. On December 31, 1973, X has $1,000,000 of outstanding eligible loans. The allowable percentage of eligible loans is $18,000 (1.8% × $1,000,000). The maximum reasonable addition under the percentage method is $2,100 which consists of $1,000 of reserve deficiency (⅕ × $5,000), $500 of net bad debts charged to the reserve for losses in 1971, and $600 of net bad debts charged to the reserve in 1972. Although outstanding eligible loans increased from $850,000 in 1972 to $1,000,000 in 1973, no addition is permitted with respect to the increase because the amount of eligible loans outstanding at the close of 1973 ($1,000,000) does not exceed the sum of the amount of such loans at the close of the base year ($1,000,000) and the amount of previous increases in such loans for which an addition was made in taxable years ending after the close of the base year ($50,000 loan increase in 1970). Assuming that X makes an addition to the reserve for losses on loans of $2,100, the balance of the reserve as of December 31, 1973, is $17,400 ($15,300+$2,100).

(iii) Reserve equal to or greater than allowable percentage and eligible loans have not declined. If the reserve for losses on loans as of the close of the base year is equal to or greater than the allowable percentage for the taxable year multiplied by the eligible loans outstanding at the close of the base year and if the amount of eligible loans outstanding at the close of the taxable year is equal to or greater than the amount of eligible loans outstanding at the close of the base year, the amount determined under this subdivision is the amount necessary to increase the reserve to the greater of (A) the allowable percentage for the taxable year

multiplied by the eligible loans outstanding at the close of the year, or (B) the balance of the reserve as of the close of the base year. The application of the rule provided by this subdivision may be illustrated by the following example:

Example. The M Bank is a commercial bank which has a calendar year as its taxable year. M adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, M has $1,000,000 of outstanding eligible loans and a balance of $20,000 in its reserve for losses on loans.

(a) During 1970, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, M has $1,100,000 of outstanding eligible loans. The allowable percentage of eligible loans is $19,800 (1.8% × $1,100,000). The maximum reasonable addition under the percentage method is $1,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the 1969 base year ($20,000). Assuming that M makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve as of December 31, 1970, is $20,000 ($20,000 – $1,000 + $1,000).

(b) During 1971, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, M has $1,300,000 of outstanding eligible loans. The allowable percentage of eligible loans is $23,400 (1.8% × $1,300,000). The maximum reasonable addition under the percentage method is $4,400 which is the amount sufficient to increase the balance of the reserve to the allowable percentage of eligible loans outstanding at the close of the taxable year. Assuming that M makes an addition to the reserve for losses on loans of $4,400 for the year, the balance of the reserve as of December 31, 1971, is $23,400 ($20,000 – $1,000 + $4,400).

(c) During 1972, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1972, M has $1,200,000 of outstanding eligible loans. The allowable percentage of eligible loans is $21,600 (1.8% × $1,200,000). No reasonable addition may be made under the percentage method because the reserve for losses on loans ($22,400, i.e., $23,400 – $1,000) is greater than the allowable percentage of eligible loans outstanding at the close of the taxable year ($21,600) and the balance of the reserve as of the close of the base year ($20,000). Assuming that no amount is added under the experience method provided by paragraph (c) of this section, the balance of the reserve for losses on loans as of December 31, 1972, is $22,400 ($23,400 – $1,000).

(d) During 1973, M has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1973, M has $1,200,000 of outstanding eligible loans. The allowable percentage of eligible loans is $21,600 (1.8% × $1,200,000). The maximum reasonable addition under the percentage method is $200 which is the amount sufficient to increase the reserve for losses on loans to the allowable percentage of eligible loans outstanding at the close of the taxable year. Assuming that M makes an addition to the reserve for losses on loans of $200 for the year, the balance of the reserve as of December 31, 1973, is $21,600 ($22,400 – $1,000 + $200).

(iv) Reserve greater than allowable percentage and eligible loans have declined. If the reserve for losses on loans as of the close of the base year is equal to or greater than the allowable percentage of eligible loans outstanding at such time and if the amount of eligible loans at the close of the taxable year is less than the amount of eligible loans outstanding at the close of the base year, the amount determined under this subdivision is the amount necessary to increase the balance of the reserve to the amount which bears the same ratio to eligible loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of eligible loans outstanding at the close of the base year. The application of the rule provided by this subdivision may be illustrated by the following example:

Example. The N Bank is a commercial bank which has a calendar year as its taxable year. N adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, N has $1,000,000 of outstanding eligible loans and a balance of $20,000 in its reserve for losses on loans.

(a) During 1970, N has net bad debts of $3,000 charged to the reserve for losses on loans. On December 31, 1970, N has $900,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method is $1,000, which is the amount necessary to increase the balance of the reserve to the amount ($18,000) which bears the same ratio to eligible loans outstanding at the close of the taxable year ($900,000) as the balance of the reserve as of the close of the base year ($20,000) bears to the amount of the eligible loans outstanding at the close of the base year ($1,000,000). Assuming that N makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve as of December 31, 1970, is $18,000 ($20,000 – $3,000 + $1,000).

(b) During 1971, N has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1971, N has $1,100,000 of outstanding eligible loans. The maximum reasonable addition under the percentage method, determined under subdivision (iii) of this subparagraph, is $3,000 which is the amount necessary to increase the balance of the reserve to the greater of the allowable percentage of eligible loans outstanding at the close of the taxable year ($19,800) or the balance of the reserve at the close of the base year ($20,000). Assuming that N makes an addition to the reserve for losses on loans of $3,000 for the year, the balance of the reserve as of December 31, 1971 is $20,000 ($18,000 – $1,000 + $3,000).

(2) Limitations. Notwithstanding any other provision of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method shall not exceed the greater of:

(i) Six-tenths of 1 percent of the eligible loans outstanding at the close of the taxable year, or

(ii) An amount sufficient to increase the reserve for losses on loans at the close of the taxable year to six-tenths of 1 percent of the eligible loans outstanding at the close of the taxable year.

The application of the rules provided by this subparagraph may be illustrated by the following example:

Example. The Y Bank begins business as a commercial bank on July 1, 1974. Y adopts the calendar year as its taxable year and the reserve method of accounting for bad debts.

(a) During 1974, Y has net bad debts of $1,000. On December 31, 1974, Y has $1,000,000 of outstanding eligible loans. Under subparagraph (1)(ii)(B) of this paragraph, be-

cause Y is a newly-organized financial institution, there is no reserve deficiency. Except for the limitations of this subparagraph, the maximum reasonable addition under subparagraph (1)(ii)(A) of this paragraph would be the amount of net bad debts charged to the reserve for losses ($1,000) plus the allowable percentage of outstanding eligible loans at the close of the taxable year $18,000 (1.8% × $1,000,000). However, because of the limitations of this subparagraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method is an amount sufficient to increase the balance of the reserve for losses on loans to $6,000 which is 0.6 percent of the eligible loans outstanding at the close of the taxable year. Assuming that Y makes an addition to the reserve for losses on loans of $7,000 for the year, the balance of the reserve as of December 31, 1974, is $6,000 ($7,000 – $1,000). The $7,000 consists of the $1,000 in net bad debts and $6,000 attributable to the increase in eligible loans outstanding.

(b) During 1975, Y has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1975, Y has $1,000,000 of outstanding eligible loans. Except for the limitations of this subparagraph, the maximum reasonable addition under subparagraph (1)(ii)(A) of this paragraph would be the amount of net bad debts charged to the reserve for losses ($1,000) plus an amount attributable to the increase in the amount of eligible loans outstanding with respect to which no reasonable addition was allowed in 1974 ($12,000, *i.e.*, $18,000 – $6,000). However, because of the limitations of this paragraph, the maximum reasonable addition to the reserve for losses on loans under the percentage method is $6,000 which is an amount equal to 0.6 percent of the eligible loans outstanding at the close of the taxable year. This amount consists of net bad debts of $1,000 and $5,000 attributable to a portion of the increase in eligible loans in 1974 with respect to which no reasonable addition was allowable for 1974. Assuming that Y makes an addition to the reserve for losses on loans of $6,000 for the year, the balance of the reserve as of December 31, 1975, is $11,000 ($6,000 – $1,000 + $6,000).

(c) During 1976, Y has net bad debts charged to the reserve for losses on loans of $1,000. On December 31, 1976, Y has $1,000,000 in outstanding eligible loans. At the close of 1975 (Y's base year for 1976), the amount of outstanding eligible loans was also $1,000,000. Consequently, there is a reserve deficiency of $1,000 ((1.2% × $1,000,000) – $11,000). The maximum reasonable addition to the reserve for losses under subparagraph (1)(ii)(A) of this paragraph is $1,200 which consists of one-fifth of the reserve deficiency ($1,000 × ⅕ = $200) and the net bad debts charged to the reserve for losses on loans for the year ($1,000). Because that amount is less than 0.6 percent of the eligible loans outstanding at the close of the taxable year (0.6% × $1,000,000 = $6,000), the limitations of this subparagraph do not apply. Assuming that Y makes an addition to the reserve for losses on loans of $1,200 for the year, the balance of the reserve as of December 31, 1976, is $11,200 ($11,000 – $1,000 + $1,200).

(c) Experience method—(1) In general—(i) Maximum addition. The amount determined under this paragraph for a taxable year is the amount necessary to increase the balance of the reserve for losses on loans (as of the close of the taxable year) to the greater of the amount determined under subdivision (ii) or (iii) of this subparagraph. For special rules for a new financial institution, see subparagraph (2) of this paragraph.

(ii) Six-year moving average amount. The amount determined under this subdivision is the amount which bears the same ratio to loans outstanding at the close of the taxable year as (A) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (B) the sum of the loans outstanding at the close of such 6 (or fewer) taxable years. For purposes of applying this subdivision, a period shorter than 6 years generally would be appropriate only where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased. For example, if the major portion of a bank's portfolio of loans changes from agricultural loans to industrial loans which results in a substantial increase in the risk of loss, a period shorter than 6 years may be appropriate. Similarly, a bank which has recently altered its lending practices to include in its portfolio of loans consumer-installment loans, when it had previously made only commercial loans, may also qualify to use a period shorter than six years. A decline in the general economic conditions in the area, which substantially increase the risk of loss, is a relevant factor which may be considered. In any case, however, approval to use a shorter period will not be granted unless the taxpayer supplies specific evidence that the loans outstanding at the close of the taxable years for the shorter period requested are not comparable in nature and risk to loans outstanding at the close of the six taxable years. The fact that a bank's bad debt experience has shown a substantial increase is not, by itself, sufficient to justify use of a shorter period. If approval is granted to use a shorter period, the experience for those taxable years which are excluded shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which such approval is requested.

(iii) Base year amount. The amount determined under this subdivision is the lower of (A) the balance of the reserve as of the close of the base year, or (B) if the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of loans outstanding at the close of the base year.

(2) Special rules for new financial institutions—(i) In general. In the case of any taxable year preceded by less than 5 authorization years (as defined in paragraph (e)(5) of this section), subparagraph (1) of this paragraph shall be applied with the adjustments provided by subdivision (ii) of this subparagraph.

(ii) Adjustments. (A) The total bad debts for the 6-year period computed under subparagraph (1)(ii)(A) of this paragraph shall be the sum of:

(1) The bad debts sustained by the taxpayer during its authorization years, adjusted for recoveries of bad debts for such years, and

(2) That fraction of the total bad debts sustained by a comparable bank (as defined in paragraph (e)(7) of this section) during the comparison years (as defined in paragraph (e)(6) of this section), adjusted for recoveries of bad debts for such years, which bears the same ratio to such total as the average loans outstanding of the taxpayer during the authorization years bears to the average loans outstanding of the comparable bank during the comparison years.

(B) The total amount of loans outstanding during the 6-year period computed under subparagraph (1)(ii)(B) of this paragraph shall be six times the average loans outstanding of the taxpayer during the authorization years.

(d) Change in accounting method from specific charge-off method to reserve method of treating bad debts—(1) In general. If a bank is granted permission in accordance with § 1.446–1(e)(3) to change its method of accounting for bad debts from a method under which specific bad debt items are deducted to the reserve method of treating bad debts, the taxpayer shall effect the change as provided in subparagraphs (2) and (3) of this paragraph.

(2) Initial balance of the reserve. The initial balance of the reserve at the close of the year of change shall be no less than the minimum addition as described in paragraph (a)(2) of this section and shall be no larger than the greater of—

(i) The allowable percentage of eligible loans outstanding at the close of the taxable year of change, or

(ii) The amount which bears the same ratio to loans outstanding at the close of the taxable year as the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to the sum of the loans outstanding at the close of such 6 or fewer taxable years.

In the case of taxable years beginning after 1987, the initial balance of the reserve at the end of the year of change shall be the amount specified in subdivision (ii) of this subparagraph.

(3) Deduction with respect to initial balance. The deduction with respect to the initial balance of the reserve at the close of the taxable year of change, determined under subparagraph (2) of this paragraph, is allowable ratably over a period of 10 years commencing with the taxable year of change (or a shorter period as may be approved by the Commissioner). Thus, the bad debt deduction under section 166 for the taxable year of change will consist of the amount of debts determined to be wholly or partially worthless and charged-off during such taxable year plus one-tenth (if a 10-year period is used) of the amount of the reserve determined under subparagraph (2) of this paragraph. For each of the 9 taxable years following the taxable year of change, the bad debt deduction will consist of the reasonable addition to the reserve for bad debts for each such year as provided by section 585, as otherwise determined, plus one-tenth of the amount determined to be the initial balance of the reserve under subparagraph (2) of this paragraph. The amount established as a bad debt reserve for the taxable year of change under subparagraph (2) of this paragraph shall be considered as the balance of the reserve for purposes of determining the amount of subsequent additions to such reserve, even though the entire amount of the reserve may not have been deducted under section 166(c) because of the requirement that it be deducted over a number of years.

(e) Definitions—(1) Base year—(i) Percentage method. For purposes of paragraph (b) of this section (relating to the percentage method), the term "base year" means: For years beginning before 1976, the last taxable year beginning on or before July 11, 1969; for taxable years beginning after 1975 but before 1983, the last taxable year beginning before 1976; and, for taxable years beginning after 1982, the last taxable year beginning before 1983. However, for purposes of section 585(b)(2)(A) the term "base year" means the last taxable year before the most recent adoption of the percentage method, if later than the base year as determined under the preceding sentence.

(ii) Experience method. For purposes of paragraph (c) of this section (relating to the experience method), the term "base year" means (A) the last taxable year before the most recent adoption of the

experience method, or (B) the last taxable year beginning on or before July 11, 1969, which ever is later; and for taxable years beginning after 1987, the last taxable year beginning before 1988.

(iii) **Example.** The application of the rules provided by this subparagraph may be illustrated by the following example:

Example. The T Bank is a commercial bank which has a calendar year as its taxable year. T adopted the reserve method of accounting for bad debts in 1950. On December 31, 1969, T has $1,000,000 of outstanding eligible loans and a balance of $19,300 in its reserve for losses on loans.

(a) During 1970, T has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1970, T has $1,050,000 of outstanding eligible loans. T elects the percentage method. The base year is 1969. The maximum reasonable addition under the percentage method of $1,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the base year 1969 ($19,300). Assuming that T makes an addition to the reserve for losses on loans of $1,000 for the year, the balance of the reserve for losses on loans as of December 31, 1970, is $19,300 ($19,300 – $1,000 + $1,000).

(b) During 1971, T has net bad debts of $8,000 charged to the reserve for losses on loans. On December 31, 1971, T has $1,100,000 of outstanding eligible loans. T elects the experience method. The base year is 1970. The maximum reasonable addition under the experience method is $8,000 which is the amount sufficient to increase the balance of the reserve as of the close of the taxable year to the balance of the reserve as of the close of the 1970 base year ($19,300). Assuming that T makes an addition to the reserve for losses on loans of $8,000 for the year, the balance of the reserve for losses on loans as of December 31, 1971, is $19,300 ($19,300 – $8,000 + $8,000).

(c) During 1972, T has net bad debts of $1,000 charged to the reserve for losses on loans. On December 31, 1972, T has $1,200,000 of outstanding eligible loans. T elects the percentage method. The base year is 1971 and there is a reserve deficiency of $500 ((1.8% × $1,100,000) – $19,300). The maximum reasonable addition under the percentage method is $2,900 which consists of $100 of reserve deficiency (1/5 × $500), the $1,000 in net bad debts charged to the reserve for losses on loans, and $1,800 attributable to the increase in the balance of eligible loans (1.8% × ($1,200,000 – $1,100,000)). Assuming that T makes an addition to the reserve for losses on loans of $2,900 for the year, the balance of the reserve for losses on loans as of December 31, 1972, is $21,200 ($19,300 – $1,000 + $2,900).

(2) **Loan**—(i) **General rule.** For purposes of this section and §§ 1.585–1, 1.585–3, and 1.585–4, the term "loan" means debt as the term "debt" is used in section 166 and the regulations thereunder. The term "loan" includes (but is not limited to) the following items:

(A) An overdraft in one or more deposit accounts by a customer in good faith whether or not other deposit accounts of the same customer have balances in excess of the overdraft;

(B) A bankers acceptance purchased or discounted by a bank; and

(C) A loan participation to the extent that the taxpayer bears a risk of loss.

For purposes of (B) of this subdivision (i), a bankers acceptance shall be considered as a loan made by the bank which purchased or discounted the bankers acceptance and not a loan made by the originating bank.

(ii) **Exceptions.** Notwithstanding the provisions of subdivision (i) of this subparagraph, the term "loan" does not include the following items:

(A) Discount or interest receivable reflected in the face amount of an outstanding loan, which discount or interest has not been included in gross income;

(B) For taxable years beginning after December 31, 1976, commercial paper, however acquired by the bank, including, for example, short-term promissory notes which may be purchased on the open market;

(C) For taxable years beginning after December 31, 1976, a debt evidenced by a security (as defined in section 165(g)(2)(C) and the regulations thereunder);

(D) Any loan which is entered into or acquired for the primary purpose of enlarging the otherwise available bad debt deduction;

(E) Loans which have been contractually committed to the extent that funds have not been disbursed to the borrower or disbursed on behalf of the borrower; and

(F) Any transaction which is in violation of a Federal or State statute that governs the activities of the financial institution.

(3) **Eligible loan**—(i) **General rule.** For purposes of this section and §§ 1.585–3 and 1.585–4, the term "eligible loan" means a loan (as defined in subparagraph (2) of this paragraph) which is incurred in the course of the normal customer loan activities of a financial institution and which is not a loan described in subdivision (ii) of this subparagraph. Nothing within the preceding sentence will be construed to exclude from the term "eligible loan" a bona fide loan in a new market or under a novel repayment arrangement if the likelihood of nonrepayment is at least as great as that of other customer loans of the financial institution.

(ii) **Exceptions.** Loans which do not constitute eligible loans include:

(A) A loan to a bank (as defined in section 581 and the regulations thereunder) or to a domestic branch of a foreign corporation to which

§ 1.585–1 applies, including a repurchase transaction or other similar transaction;

(B) Bank funds on deposit in any bank (foreign or domestic) such as a deposit represented by a certificate of deposit or any other form of instrument evidencing the deposit of a sum of money with the issuing bank that will be available on or after a stated date or period of time;

(C) A sale or loan of Federal funds irrespective of the purchaser or borrower;

(D) A loan, to the extent that it is directly or indirectly made to, guaranteed by, or insured by the United States, a possession or instrumentality thereof, or a State or political subdivision thereof; and

(E) A loan which is secured by a deposit in the lending financial institution or in a bank as defined in section 581 or a domestic branch of a foreign corporation to which this section applies to the extent that the financial institution has control over withdrawal of such deposit.

(iii) Definition of loan which is secured by a deposit. For purposes of subdivision (ii)(E) of this subparagraph:

(A) A loan is considered secured if the loan is on the security of any instrument which makes the deposit specific security for the payment of the loan, provided that such instrument is of such a nature that in the event of default the deposit could be subjected to the satisfaction of the loan;

(B) A deposit includes a guarantee deposit in the form of a "holdback", pledged collateral that has been reduced to cash, and loan payments that are maintained in a separate account; and

(C) Control over the withdrawal of a deposit is evidenced by possession of a passbook, certificate of deposit, note, or other similar instrument the possession of which is normally required to permit withdrawal. The lending financial institution does not have control over withdrawal of the deposit if the deposit can be withdrawn without consent of the lending financial institution. Thus, the lending financial institution normally does not have control over the withdrawal of a deposit in an account merely because the borrower agrees to maintain a minimum, average, or compensating balance.

(4) Predecessor. For purposes of this section, the term "predecessor" means (i) any taxpayer which transferred more than 50 percent of the total amount of its assets to the taxpayer and is described in § 1.585–1, or (ii) any predecessor of such predecessor.

(5) Authorization years. For purposes of this section, the term "authorization years" means the number of years, containing 12 complete months, between (i) the first day of the first full taxable year of the taxpayer for which it (or any predecessor) was authorized to do business as a financial institution described in § 1.585–1, and (ii) the taxable year.

(6) Comparison years. For purposes of this section, the term "comparison years" means those consecutive taxable years containing 12 complete months of a comparable bank, the last of which ends within 12 months immediately preceding the beginning of the first taxable year of the taxpayer, which are equal in number to six minus the number of authorization years of the taxpayer.

(7) Comparable bank. For purposes of this section, the term "comparable bank" means all the financial institutions described in § 1.585–1 located within the same Federal Reserve district.

(8) Average loans outstanding. For purposes of this section, the term "average loans outstanding" means the sum of the loans outstanding at the close of each taxable year of a period divided by the number of taxable years in such period.

(9) Adjusted for recoveries of bad debts. For purposes of this section, the term "adjusted for recoveries of bad debts" means an adjustment for the full amount recovered with respect to bad debts previously charged to the reserve during any of the applicable taxable years.

[T.D. 7532, 43 FR 3109, Jan. 23, 1978; T.D. 7835, 47 FR 42342, Sept. 27, 1982]

§ 1.585–3 Special rules.

(a) Treatment of reserve. For taxable years beginning after July 11, 1969, if a financial institution to which section 585 and § 1.585–1 apply establishes a reserve pursuant to section 166(c), any bad debt in respect of a loan (whether or not such loan is an eligible loan) must be charged to the reserve for losses on loans provided for by § 1.585–1 for the taxable year in which the bad debt occurs. For such a year, any recovery of a bad debt previously charged to the reserve account in respect of a loan (whether or not such loan is an eligible loan) must be credited to such reserve in the taxable year of recovery regardless of whether such credit causes the reserve to exceed the permissible amount. If, as a result of net recoveries during the taxable year, the reserve balance ex-

ceeds the permissible amount, a taxpayer is not required to report the excess as taxable income. In such a case, the excess over the otherwise permissible amount in the reserve account precludes current reasonable additions to the reserve and may affect future reasonable additions. Recoveries of bad debts which were not charged to the reserve shall not be credited to such reserve, but shall be treated as taxable income subject to the provisions of section 111. No item other than a loan as defined in § 1.585–2(e)(2) shall be charged to the reserve for losses on loans.

(b) **Accounting for reserve.** A financial institution to which section 585 and § 1.585–1 apply which establishes a reserve pursuant to section 166(c) shall establish and maintain a permanent record of such reserve. Copies of Federal income tax returns and amended returns with attached schedules satisfy the requirements of this paragraph provided that such returns are permanently maintained by the financial institution and the balance of the reserve for losses on loans established pursuant to section 166(c) can be readily reconciled with the reserve for losses on loans maintained by the financial institution for financial statement purposes. The requirements of this paragraph would also be satisfied if a financial institution establishes and maintains a permanent subsidiary ledger reflecting an account for the reserve for losses on loans established pursuant to section 166(c) provided the balance in such account can be readily reconciled with the balance of the reserve for losses on loans for financial statement purposes maintained in any other ledger. The permanent records maintained pursuant to this section must reflect any changes in the amount initially added to the reserve for losses on loans and the amount finally determined by the taxpayer to be a reasonable addition to the reserve for losses on loans.

[T.D. 7532, 43 FR 3114, Jan. 23, 1978]

§ 1.585–4 Reorganizations and asset acquisitions.

(a) **In general.** In computing a reasonable addition to the reserve for losses on loans for the first taxable year ending after a transaction to which section 381(a) applies and for subsequent taxable years, the separate reserves for losses on loans, the amount of loans outstanding, the total bad debts sustained (adjusted for recoveries), and the amount of eligible loans outstanding of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) shall be combined for all applicable years. Thus, for example, in applying § 1.585–2(c)(1)(i) for the first taxable year ending after the distribution or transfer, the total bad debts sustained during the 5 preceding taxable years are the sum of the bad debts sustained by the acquiring corporation for the 5 preceding taxable years and bad debts sustained by the distributor or transferor corporation for the taxable year ending on the date of distribution or transfer and the 4 preceding taxable years.

(b) **Base year and base year amounts of acquiring corporation—(1) Base year.** For transactions to which section 381(a) applies, the base year of the acquiring corporation for the first taxable year ending after the date of distribution or transfer shall be the last taxable year ending on or before the date of distribution or transfer. The balance of the reserve, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of such base year shall be determined in accordance with the provisions of subparagraph (2)(i) of this paragraph. For taxable years subsequent to the first taxable year ending after the date of distribution or transfer, the base year of the acquiring corporation shall be the more recent of the base year provided by the first sentence of this subparagraph or the base year provided by § 1.585–2(e)(1). If § 1.585–2(e)(1) provides the more recent base year, the balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding shall be determined at the close of such base year without regard to this paragraph.

(2) **Base year amounts—(i) Method of determination.** The balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of the base year provided by the first sentence of subparagraph (1) of this paragraph shall be the total of such amounts of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) at the close of what would have been their respective base years determined under § 1.585–2(e)(1) if the distribution or transfer to which section 381(a) applies had not occurred, except that the method (experience or percentage) used or adopted by the acquiring corporation to determine its reasonable addition to a reserve for losses on loans for the first taxable year ending after the date of the distribution or transfer shall be considered to be the method that the distributor or transferor corporation (or, in the case of a consolidation, that the transferor corporation) would have used or adopted for its first taxable

year ending after the date of distribution or transfer if the distribution or transfer had not occurred.

(ii) Examples. The application of the rule provided by this subparagraph may be illustrated by the following examples:

Example (1). The X Corporation and the Y Corporation are commercial banks both of which have a calendar year as a taxable year. Both X and Y adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable years 1970 through 1973, X and Y determined their reasonable additions to a reserve for losses on loans as defined in § 1.585–2(e)(2) under the percentage method. On June 30, 1974, the X Bank is merged into the Y Bank; for its short taxable year ending on June 30, 1974, X determines its reasonable addition under the percentage method. If, for the taxable year ending on December 31, 1974 (the first taxable year ending after the date of distribution or transfer), Y determines its reasonable addition to a reserve for losses on loans under the percentage method, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of X's and Y's respective amounts at the close of the taxable year ending December 31, 1969 (the base year of both X and Y determined under § 1.585–2(e)(1) as if the distribution or transfer had not taken place). If, instead of the above, Y adopts the experience method of determining its reasonable addition to a reserve for losses for the taxable year 1974, then at the close of the base year (1973) the reserve balances, the amount of loans outstanding, and the amount of eligible loans outstanding are the sum of X's respective amounts at the close of its short taxable year ending on June 30, 1974 (X's last taxable year before its (Y's) most recent adoption of the experience method) and of Y's respective amounts at the close of its taxable year 1973 (Y's last taxable year before its most recent adoption of the experience method).

Example (2). The M Corporation and the N Corporation are commercial banks. M has a fiscal year ending September 30, as its taxable year and N has a calendar year as its taxable year. Both M and N adopted the reserve method of accounting for bad debts prior to July 11, 1969. For the taxable years ending in 1970, 1971, and 1972, M determined its reasonable addition to a reserve for losses under the percentage method; for the taxable year ending in 1973 M adopted the experience method. For the taxable years 1970 through 1973 N determined its reasonable addition under the percentage method. M is merged into N on June 30, 1974, and for its short taxable year ending on June 30, 1974, M determines its reasonable addition under the experience method. If, for the taxable year ending on December 31, 1974 (the first taxable year ending after the date of distribution or transfer), N determines its reasonable addition to a reserve for losses under the percentage method, then at the close of the base year (1973) the reserve balance, the amount of loans outstanding, and the amount of eligible loans outstanding are the sum of M's respective amounts at the close of (a) if M had a reserve deficiency as of June 30, 1974, its short taxable year ending on June 30, 1974 (M's last taxable year before its (N's) most recent adoption of the percentage method), or (b) if M did not have a reserve deficiency, the taxable year ending on September 30, 1969, and N's respective amounts at the close of its taxable year 1979. If, instead of the above, N adopts the experience method for the taxable year 1974, then at the close of the base year the reserve balance, the amount of outstanding loans, and the amount of eligible loans outstanding are the sum of M's respective amounts at the close of its taxable year ending on September 30, 1972 (the last taxable year before M's most recent adoption of the experience method), and N's respective amounts at the close of the taxable year 1973 (the last taxable year ending before N's most recent adoption of the experience method).

[T.D. 7532, 43 FR 3114, Jan. 23, 1978]

§ 1.586–1 Reserve for losses on loans of small business investment companies, etc.

(a) General rule. As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a taxpayer which is a financial institution to which section 586 and this section apply is allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts provided such financial institution has adopted or adopts the reserve method of treating bad debts in accordance with paragraph (b) of § 1.166–1. In the case of such a taxpayer, the amount of the reasonable addition to such reserve for a taxable year beginning after July 11, 1969, shall be an amount determined by the taxpayer which does not exceed the amount computed under § 1.586–2. A financial institution to which section 586 and this section apply which adopts the reserve method is not entitled to charge-off any bad debts pursuant to section 166(a) with respect to a loan (as defined in § 1.586–2(c)(2)). Except as provided by § 1.586–2, regarding the manner of computation of the addition to the reserve for bad debts, the reserve for bad debts of a financial institution to which this section applies shall be maintained in the same manner as is provided by section 166(c) and the regulations thereunder with respect to reserves for bad debts. Except as provided by this section, no deduction is allowable for an addition to a reserve for bad debts of a financial institution to which section 586 and this section apply. For rules relating to deduction with respect to debts which are not loans (as defined in § 1.586–2(c)(2)), see section 166(a) and the regulations thereunder.

(b) Application of section. Section 586 and this section shall apply only to the following financial institutions—

(1) Any small business investment company operating under the Small Business Investment Act of 1958 as amended and supplemented (72 Stat. 689), and

(2) Any business development corporation, which for purposes of this section, means a corporation which was created by or pursuant to an act of a State legislature for purposes of promoting, maintaining, and assisting the economy and industry within such State on a regional or statewide basis by making loans which would generally not

be made by banks (as defined in section 581 and the regulations thereunder) within such region or State in the ordinary course of their businesses (except on the basis of a partial participation), and which is operated primarily for such purposes. [T.D. 7444, 41 FR 53482, Dec. 7, 1976]

§ 1.586–2 Addition to reserve.

(a) **General rule.** Except as provided by paragraph (b) of this section, the amount computed under this section is the amount necessary to increase the balance of the reserve for bad debts (as of the close of the taxable year) to the greater of—

(1) The amount which bears the same ratio to loans outstanding at the close of the taxable year as (i) the total bad debts sustained during the taxable year and the 5 preceding taxable years (or, with the approval of the Commissioner, a shorter period), adjusted for recoveries of bad debts during such period, bears to (ii) the sum of the loans outstanding at the close of such 6 or fewer taxable years, or

(2) The lower of—

(i) The balance of the reserve as of the close of the base year, or

(ii) If the amount of loans outstanding at the close of the taxable year is less than the amount of loans outstanding at the close of the base year, the amount which bears the same ratio to loans outstanding at the close of the taxable year as the balance of the reserve as of the close of the base year bears to the amount of loans outstanding at the close of the base year. For purposes of subparagraph (2) of this paragraph, the term "base year" means the last taxable year beginning on or before July 11, 1969. For purposes of applying this paragraph, a period shorter than the 6 years generally would be appropriate only where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased. For example, if the major portion of a business development corporation's portfolio of loans changes from agricultural loans to industrial loans which results in a substantial increase in the risk of loss, a period shorter than the 6 years may be appropriate. If approval is granted to use a shorter period, the experience for those taxable years which are excluded shall not be used for any subsequent year. A request for approval to exclude the experience of a prior taxable year shall not be considered unless it is sent to the Commissioner at least 30 days before the close of the current taxable year. The request shall include a statement of the reasons such experience should be excluded.

(b) **New financial institutions—(1) Small business investment companies.** In the case of a new financial institution which is a small business investment company to which section 586 applies, the amount computed under this section is the greater of the amount computed under paragraph (a) of this section or the amount necessary to increase the balance of the reserve for bad debts as of the close of the taxable year to the amount which bears the same ratio to loans outstanding at the close of the taxable year as—

(i) The total bad debts (as determined by the Commissioner) sustained by all such small business investment companies during the 12-month period ending on March 31 that ends with or within the taxpayer's previous taxable year, and during the five 12-month periods ending on March 31 that precede such 12-month period, adjusted for recoveries of bad debts during such periods (as determined by the Commissioner), bears to

(ii) The sum of the loans outstanding (as determined by the Commissioner) by all such small business investment companies at the close of each of such six 12-month periods ending on March 31.

(2) **Business development corporations.** In the case of a new financial institution which is a business development corporation to which section 586 applies, the amount computed under this section is the greater of the amount computed under paragraph (a) of this section or the amount necessary to increase the balance of the reserve for bad debts as of the close of the taxable year to the amount which bears the same ratio to loans outstanding at the close of the taxable year as—

(i) The total bad debts (as determined by the Commissioner) sustained by all such business development corporations during the calendar year ending with or within the taxpayer's previous taxable year and during the 5 calendar years preceding such calendar year, adjusted for recoveries of bad debts during such period (as determined by the Commissioner), bears to

(ii) The sum of the loans outstanding (as determined by the Commissioner) by all such business development corporations at the close of each of such 6 calendar years.

(c) **Definitions.** For purposes of this section—

(1) **New financial institution.** A financial institution is a new financial institution for any taxable

year beginning less than 10 years after the day on which it (or any predecessor) was authorized to do business as a financial institution described in the applicable subparagraph of § 1.586–1(b). For this purpose, the term "predecessor" means (i) any taxpayer which transferred more than 50 percent of the total amount of its assets to the taxpayer and is described in the same subparagraph of § 1.586–1(b) which describes the taxpayer, or (ii) any predecessor of such predecessor.

(2) Loan. (i) The term "loan" means debt, as the term "debt" is used in section 166 and the regulations thereunder.

(ii) The term "loan" does not include the following items:

(A) Discount or interest receivable reflected in the face amount of an outstanding loan, which discount or interest has not been included in gross income;

(B) A debt evidenced by a security (as defined in section 165(g)(2)(C) and the regulations thereunder); and

(C) Any loan which is entered into or acquired for the primary purpose of enlarging the otherwise available bad debt deduction.

[T.D. 7444, 41 FR 53482, Dec. 7, 1976]

Mutual Savings Banks, Etc.

§ 1.591–1 Deduction for dividends paid on deposits.

(a) In general. (1) In the case of a taxpayer described in paragraph (c)(1) or (2) of this section, whichever is applicable, there are allowed as deductions from gross income amounts which during the taxable year are paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

(2) The deduction provided in section 591 is applicable to the taxable year in which amounts credited as dividends or interest become withdrawable by the depositor or holder of an account subject only to customary notice of intention to withdraw. Thus, amounts which, as of the last day of the taxable year, are credited as dividends or interest, but which are not withdrawable by depositors or holders of accounts until the following business day, are deductible under section 591 in the year subsequent to the taxable year in which they were so credited. A deduction under this section will not be denied by reason of the fact that the amounts credited as dividends or interest, otherwise deductible under section 591, are subject to the terms of a pledge agreement between the taxpayer and the depositor or holder of an account. In the case of a domestic building and loan association having nonwithdrawable capital stock represented by shares, no deduction is allowable under this section for amounts paid or credited as dividends on such shares. In the case of a taxable year ending after December 31, 1962, for special rules governing the treatment of dividends or interest paid or credited for periods representing more than 12 months, see section 461(e).

(b) Serial associations, bonus plans, etc. If a taxpayer described in paragraph (c)(1) or (2) of this section, whichever is applicable, operates in whole or in part as a serial association, maintains a bonus plan, or issues shares, or accepts deposits, subject to fines, penalties, forfeitures, or other withdrawal fees, it may deduct under section 591 the total amount credited as dividends or interest upon such shares or deposits, credited to a bonus account for such shares or deposits, or allocated to a series of shares for the taxable year, notwithstanding that as a customary condition of withdrawal:

(1) Amounts invested in, and earnings credited to, series shares must be withdrawn in multiples of even shares, or

(2) Such taxpayer has the right, pursuant to bylaw, contract, or otherwise, to retain or recover a portion of the total amount invested in, or credited as earnings upon, such shares or deposits, such bonus account, or series of shares, as a fine, penalty, forfeiture, or other withdrawal fee.

In any taxable year in which the right referred to in subparagraph (2) of this paragraph is exercised, there is includible in the gross income of such taxpayer for such taxable year amounts retained or recovered by the taxpayer pursuant to the exercise of such right. If the provisions of paragraph (a) of § 1.163–4 (relating to deductions for original issue discount) apply to deposits made with respect to a certificate of deposit, time deposit, bonus plan or other deposit arrangement, the provisions of this paragraph shall not apply.

(c) Effective date. The provisions of paragraphs (a) and (b) of this section shall apply to—

(1) Dividends or interest paid or credited after October 16, 1962, by any taxpayer which (at the time of such payment or credit) qualifies as (i) a mutual savings bank not having capital stock represented by shares, (ii) a domestic building and loan association (as defined in section 7701(a)(19)), (iii) a cooperative bank (as defined in section 7701(a)(32)), or (iv) any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law; and

(2) Dividends paid or credited before October 17, 1962, by any taxpayer which (at the time of such payment or credit) qualifies as (i) a mutual savings bank not having capital stock represented by shares, (ii) a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (iii) a domestic building and loan association (as defined in section 7701(a)(19) before amendment by section 6(c) of the Revenue Act of 1962 (76 Stat. 982)).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6728, 29 FR 5855, May 5, 1964; T.D. 7154, 36 FR 24997, Dec. 28, 1971]

§ 1.592-1 Repayment of certain loans by mutual savings banks, building and loan associations, and cooperative banks.

There is deductible, under section 592, from the gross income of a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, amounts paid by such institutions during the taxable year in repayment of loans made before September 1, 1951, by the United States or any agency or instrumentality thereof which is wholly owned by the United States, or by any mutual fund established under the authority of the laws of any State. For example, amounts paid by such institution in repayment of loans made by the Reconstruction Finance Corporation before September 1, 1951, are deductible under this section. Section 592 is not applicable, however, in the case of amounts paid in repayment of loans made by an agency or instrumentality not wholly owned by the United States.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.593-1 Additions to reserve for bad debts.

(a) In general. A mutual savings bank not having capital stock represented by shares, a domestic building and loan association, and a cooperative bank without capital stock organized and operated for mutual purposes and without profit may, as an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, deduct amounts credited to a reserve for bad debts in the manner and under the circumstances prescribed in this section and § 1.593-2. In the case of such an institution, the selection of either of the alternative methods for treating bad debts may be made by the taxpayer in the return for its first taxable year beginning after December 31, 1951. The method selected shall be subject to the approval of the Commissioner upon examination of the return. If the method selected is approved, it must be followed in returns for subsequent years, unless permission is granted by the Commissioner to change to another method. Application for permission to change the method of treating bad debts shall be made at least 30 days prior to the close of the taxable year for which the change is to be effective.

(b) Addition to reserve. Except as otherwise provided in § 1.593-2, the reasonable addition to a reserve for bad debts shall be any amount determined by the taxpayer which does not exceed the lesser of:

(1) The amount of its taxable income for the taxable year, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), or

(2) The amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the beginning of the taxable year.

(c) Adjustments to reserve. Bad debt losses sustained during the taxable year shall be charged against the bad debt reserve. Recoveries of debts charged against the bad debt reserve during a prior taxable year in which the institution was subject to tax under chapter 1 of the Internal Revenue Code of 1954 or under chapter 1 of the Internal Revenue Code of 1939 shall be credited to the bad debt reserve. The establishment of such reserve and all adjustments made thereto must be reflected on the regular books of account of the institution at the close of the taxable year, or as soon as practicable thereafter. Minimum amounts credited in compliance with Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or

similar accounts and permissive under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by an institution, will be deemed to have been credited to the bad debt reserve.

(d) Definitions. When used in this section and in § 1.593–2:

(1) Institution. The term "institution" means either a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 7701(a)(19), or a cooperative bank without capital stock organized and operated for mutual purposes and without profit.

(2) Surplus, undivided profits, and reserves. (i) The phrase "surplus, undivided profits, and reserves" means the amount by which the total assets of an institution exceed the amount of the total liabilities of such an institution.

(ii) For this purpose the term "total assets" means the sum of money, plus the aggregate of the adjusted basis of the property other than money, held by an institution. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes. (See sections 1011 through 1022, and the regulations thereunder. For special rules with respect to adjustments to basis for prior taxable years during which the institution was exempt from tax, see section 1016(a)(3) and the regulations thereunder.) The determination of the total assets of any taxpayer shall conform to the method of accounting employed by such taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits.

(iii) The term "total liabilities" means all liabilities of the taxpayer, which are fixed and determined, absolute and not contingent, and includes those items which constitute liabilities in the sense of debts or obligations. The total deposits or withdrawable accounts, as defined in subparagraph (3) of this paragraph, shall be considered a liability. In the case of a building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. Reserves for contingencies and other reserves, however, which are mere appropriations of surplus, are not liabilities.

(3) Total deposits or withdrawable accounts. The phrase "total deposits or withdrawable accounts" means the aggregate of (i) amounts placed with an institution for deposit or investment and (ii) earnings outstanding on the books of account of the institution at the close of the taxable year which have been credited as dividends upon such accounts prior to the close of the taxable year, except that such term, in the case of a building and loan association, does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

(e) **Examples.** The provisions of this section may be illustrated by the following examples:

Example (1). (i) Institution X, which keeps its books on the basis of the calendar year, has surplus, reserves, and undivided profits of $800,000 as of January 1, 1955, and total deposits or withdrawable accounts of $10,000,000 as of December 31, 1955. During 1955 the institution credits $30,000, as required by a Federal agency, to a Federal insurance reserve for the sole purpose of absorbing losses. Likewise, it credits $25,000, as permitted by State statute, to another reserve fund for the purpose of absorbing losses. In 1955 Institution X charges $5,000 against its bad debt reserve for losses sustained during the taxable year.

(ii) The taxable income of Institution X for the taxable year 1955, computed without regard to section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is $200,000.

(iii) Upon the basis of the facts as stated in subdivision (i) of this example, the amount by which 12 percent of the total deposits or withdrawable accounts of Institution X at the close of taxable year 1955 exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $400,000 (12 percent of $10,000,000, minus $800,000).

(iv) Institution X, therefore, may deduct, for the taxable year 1955, as an addition to a reserve for bad debts, any amount it may determine that does not exceed the lesser of the amounts determined in subdivision (ii) or (iii) of this example. That amount is $200,000 (as determined in subdivision (ii) of this example). Since under paragraph (c) of this section, the $30,000 credited to the reserve as required by the Federal agency and the $25,000 credited to the reserve as permitted by the State statute are regarded as amounts credited to a reserve for bad debts account Institution X can credit an additional $145,000 ($200,000 minus $55,000) to a general reserve for bad debts account at any time during the taxable year.

(v) The loss of $5,000 charged to the bad debt reserve during the taxable year does not affect the amount of the addition to the bad debt reserve provided for in paragraph (b) of this section. It is of significance only in determining the surplus, undivided profits, and reserves of Institution X as of January 1, 1956.

Example (2). The taxable income of Institution Y for the taxable year 1955, computed without regard to the deduction under section 593 and without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income, is determined to be $250,000. The amount by which 12 percent of the total deposits or withdrawable accounts of Institution Y at the close of the taxable year exceeds the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year is $500,000. Institution Y credits $250,000 to its bad debt reserve in 1955. In 1957, it is determined that the correct taxable income of Institution Y for 1955, computed without regard to any deduction under section 593 and without regard to any section

providing for a deduction the amount of which is dependent upon the amount of taxable income, is $275,000 and not $250,000. Assuming that Institution Y credits the additional $25,000 to its bad debt reserve, $275,000 is allowable as a deduction from gross income for such institution for the taxable year 1955.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.593–2 Additions to reserve for bad debts where surplus, reserves, and undivided profits equal or exceed 12 percent of deposits or withdrawable accounts.

Where 12 percent of the total deposits or withdrawable accounts of an institution at the close of the taxable year is equal to or less than the sum of such institution's surplus, undivided profits, and reserves at the beginning of the taxable year, a reasonable addition to the reserve for bad debts as determined under the general provisions of section 166(c) may be allowable as a deduction from gross income. In making such determination, there shall be taken into account (a) surplus or bad debt reserves existing at the close of December 31, 1951 (*i.e.,* the amount of surplus, undivided profits, and reserves accumulated prior to January 1, 1952, and in existence at the close of December 31, 1951), and (b) changes in the surplus, undivided profits, and reserves of the institution from December 31, 1951, until the beginning of the taxable year. A deduction for an addition to the reserve for bad debts pursuant to this section will be authorized only in those cases where the institution proves to the satisfaction of the Commissioner that the bad debt experience of the institution warrants an addition to the reserve for bad debts in excess of that provided in paragraph (b) of § 1.593–1. For definitions, see paragraph (d) of § 1.593–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.593–3 Taxable years affected.

Sections 1.593–1 and 1.593–2 apply only to taxable years beginning after December 31, 1953, and ending after August 16, 1954, but before January 1, 1963, and all references to sections of the Code are to the Internal Revenue Code of 1954 before amendment by the Revenue Act of 1962. Sections 1.593–4 through 1.593–11 apply only to taxable years ending after December 31, 1962, and all references to sections of the Code are to the Internal Revenue Code of 1954 after amendment by the Revenue Act of 1962.

[T.D. 6728, 29 FR 5857, May 5, 1964]

§ 1.593–4 Organizations to which section 593 applies.

The provisions of section 593 and §§ 1.593–5 through 1.593–11 (except subsection (f) of section 593 and § 1.593–10) apply to any mutual savings bank not having capital stock represented by shares, any domestic building and loan association, and any cooperative bank without capital stock organized and operated for mutual purposes and without profit. The term "thrift institution", as used in this section and §§ 1.593–5 through 1.593–11, refers to any such financial institution. For definition of the terms "domestic building and loan association" and "cooperative bank", see paragraphs (19) and (32), respectively, of section 7701(a).

[T.D. 6728, 29 FR 5857, May 5, 1964 as amended by T.D. 7549, 43 FR 21454, May 18, 1978]

§ 1.593–5 Addition to reserves for bad debts.

(a) Amount of addition. As an alternative to a deduction from gross income under section 166(a) for specific debts which become worthless in whole or in part, a thrift institution is allowed a deduction under section 166(c) for a reasonable addition to a reserve for bad debts. In the case of a thrift institution, the amount of the reasonable addition to such reserve for a taxable year may not exceed:

(1) For taxable years beginning after July 11, 1969, the sum of (i) the amount determined to be the reasonable addition to the reserve for losses on nonqualifying loans, determined in the same manner as is provided with respect to additions to the reserve for losses on qualifying real property loans under paragraph (d) of § 1.593–6A (relating to the experience method), and (ii) the amount determined under § 1.593–6A to be the reasonable addition to the reserve for losses on qualifying real property loans, or

(2) For taxable years beginning before July 12, 1969, the sum of (i) the amount determined under § 1.166–4 to be the reasonable addition to the reserve for losses on nonqualifying loans, and (ii) the amount determined under § 1.593–6 to be the reasonable addition to the reserve for losses on qualifying real property loans.

(b) Crediting to reserves required—(1) In general. The amounts referred to in paragraph (a)(1) and (2) of this section must be credited, respectively, to the reserve for losses on nonqualifying loans and to the reserve for losses on qualifying real property loans by the close of the taxable year, or as soon as practicable thereafter. For rules with respect to accounting for such reserves see paragraph (a)(2) of § 1.593–7.

(2) Subsequent adjustments. If an adjustment with respect to the income tax return for a taxable year is made, and if such adjustment (whether initiated by the taxpayer or the Commissioner) has the effect of permitting an increase, or requiring a reduction, in the amount claimed on such return as an addition to the reserve for losses on nonqualifying loans or to the reserve for losses on qualifying real property loans, then the amount initially credited to such reserve for such year pursuant to subparagraph (1) of this paragraph may have to be increased or decreased, as the case may be, to the extent necessary to reflect such adjustment.

(c) Transition year. For rules governing the computation of taxable income in the case of a taxable year beginning in 1962 and ending in 1963, see § 1.593–9.

[T.D. 6728, 29 FR 5857, May 5, 1964, as amended by T.D. 549, 43 FR 21455, May 18, 1978]

§ 1.593–6 Pre-1970 addition to reserve for losses on qualifying real property loans.

(a) In general. For purposes of paragraph (a)(2)(ii) of § 1.593–5, the amount of the addition to the reserve for losses on qualifying real property loans for any taxable year beginning before July 12, 1969, is the amount which the taxpayer determines to constitute a reasonable addition to such reserve for such year. However, the amount so determined for such year—

(1) Cannot exceed the largest of the amounts computed under one of the three methods described in paragraph (b), (c), or (d) of this section (relating, respectively, to the percentage of taxable income method, the percentage of real property loans method, and the experience method),

(2) Cannot exceed the maximum permissible addition described in paragraph (e) of this section (if applicable), and

(3) Shall be determined without regard to any amount charged for any taxable year against the reserve for losses on qualifying real property loans pursuant to § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

For each taxable year the taxpayer must include in its income tax return for such year a computation of the addition under this section. The use of a particular method in the return for a taxable year is not a binding election by the taxpayer to apply such method either for such taxable year or for subsequent taxable years. Thus, in the case of a subsequent adjustment described in paragraph (b)(2) of § 1.593–5 which has the effect of permitting an increase, or requiring a reduction, in the amount claimed in the return for a taxable year as an addition to the reserve for losses on qualifying real property loans, the amount of such addition may be recomputed under whichever method the taxpayer selects for the purposes of such recomputation, irrespective of the method initially applied for such taxable year. However, a taxpayer may not subsequently reduce the amount claimed in the return for a taxable year for the purpose of obtaining a larger deduction in a later year.

(b) Percentage of taxable income method—(1) In general. The amount determined under the percentage of taxable income method for any taxable year is an amount equal to 60 percent of the taxable income for such year, minus the amount determined under § 1.166–4 as a reasonable addition for such year to the reserve for losses on nonqualifying loans. However, the amount determined under such method shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to an amount equal to 6 percent of such loans outstanding at such time.

(2) Taxable income defined. For purposes of this paragraph, taxable income shall be computed—

(i) By excluding from gross income any amount included therein by reason of the application of § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association);

(ii) Without regard to any deduction allowable under section 166(c) for an addition to a reserve for bad debts;

(iii) Without regard to any section providing for a deduction the amount of which is dependent upon the amount of taxable income (such as section 170, relating to charitable, etc., contributions and gifts), other than sections 243, 244, and 245 (relating to deductions for dividends received); and

(iv) Without regard to any net operating loss carryback to such year under section 172.

In computing the deductions under sections 243, 244, and 245, section 246(b) (relating to limitation on aggregate amount of deduction) shall not apply. For purposes of subdivision (iii) of this subparagraph, a net operating loss deduction under section

172 is not a deduction the amount of which is dependent upon the amount of taxable income.

(c) **Percentage of real property loans method—(1) General rule.** The amount determined under the percentage of real property loans method for any taxable year is the amount necessary to increase the balance (as of the close of such year) of the reserve for losses on qualifying real property loans to—

(i) An amount equal to 3 percent of such loans outstanding at such time, plus

(ii) In the case of a taxpayer described in subparagraph (2) of this paragraph, an amount equal to—

(a) The lesser of 2 percent of such loans outstanding at such time, or $80,000, reduced (but not below zero) by

(b) The balance as of the close of such year, if any, of such taxpayer's supplemental reserve for losses on loans.

(2) **Certain new companies.** (i) Subparagraph (1)(ii) of this paragraph applies only in the case of a taxpayer which is a new company, and which does not have capital stock with respect to which distributions of property (as defined in section 317(a)) are not allowable as a deduction under section 591.

(ii) For purposes of this subparagraph, a taxpayer is a new company for any taxable year only if such year begins not more than 10 calendar years after the first day on which such taxpayer, or any predecessor of such taxpayer, was authorized by Federal or State law to do business as (a) a mutual savings bank not having capital stock represented by shares, (b) a domestic building and loan association, (c) a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (d) any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law.

(iii) As used in subdivision (ii) of this subparagraph, the term "calendar year" has the meaning assigned to such term in section 441 (relating to the period for computation of taxable income); and the term "predecessor" means any organization which transferred more than 50 percent of the total amount of its assets to the taxpayer, and which, prior to the time of such transfer, was (a) authorized by Federal or State law to do business as a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit, or (b) any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law. The term "predecessor" also means any predecessor of such predecessor.

(d) **Experience method.** The amount determined under the experience method for any taxable year is the amount determined under § 1.166–4 to be a reasonable addition for such year to the reserve for losses on qualifying real property loans.

(e) **Maximum permissible addition where percentage of taxable income method or percentage of real property loans method is applied—(1) 12 percent of deposits limitation.** If, for the taxable year, the taxpayer uses either the percentage of taxable income method described in paragraph (b) of this section or the percentage of real property loans method described in paragraph (c) of this section, then (unless subparagraph (2) of this paragraph applies) the maximum permissible addition for such year is equal to the lesser of:

(i) The amount determined under such paragraph (b) or (c), or

(ii) An amount which, when added to the amount determined under § 1.166–4 as an addition for such year to the reserve for losses on nonqualifying loans, equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of the taxpayer's surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof which is attributable to the period before the first taxable year beginning after December 31, 1951).

For definition of the terms "surplus, undivided profits, and reserves" and "total deposits or withdrawable accounts", see paragraph (f) of this section.

(2) **Special rule where a domestic building and loan association or cooperative bank exceeds certain assets limitations.** If, for the taxable year, the taxpayer uses either the percentage of taxable income method described in paragraph (b) of this section or the percentage of real property loans method described in paragraph (c) of this section, and if for such year such taxpayer qualifies as a domestic building and loan association under the first sentence of paragraph (19) of section 7701(a) (or as a cooperative bank under paragraph (32) thereof) solely by reason of the application of the

second sentence of such paragraph (19) (that is, solely by reason of the fact that for such year more than 36 percent, but not more than 41 percent, of the amount of the total assets of such association or bank consists of assets other than assets described in section 7701(a)(19)(D)(ii)), then the maximum permissible addition for such year is equal to the amount determined under subparagraph (1) of this paragraph, reduced in accordance with the following table:

If the percentage of the taxpayer's assets which are not assets described in section 7701(a)(1)(D)(ii) exceeds—*Percent*	But does not exceed —*Percent*	The reduction shall be the following proportion of the amount determined under such subparagraph (1)—
36	37	1/12
37	38	1/6
38	39	1/4
39	40	1/3
40	41	5/12

(f) Definitions. For purposes of this section—

(1) Surplus, undivided profits, and reserves. The term "surplus, undivided profits, and reserves" means the amount by which the total assets of the taxpayer exceed its total liabilities. The determination of such total assets and total liabilities shall conform to the method of accounting employed by the taxpayer in determining taxable income and to the rules applicable in determining its earnings and profits. Total deposits or withdrawable accounts (as defined in subparagraph (3) of this paragraph but determined as of the beginning of the taxable year) shall be considered a liability. In the case of a domestic building and loan association having permanent nonwithdrawable capital stock represented by shares, the paid-in amount of such stock shall also be considered a liability. However, reserves for contingencies and other reserves which are mere appropriations of surplus are not liabilities for purposes of this section.

(2) Total assets. The term "total assets" means the sum of money (including time or demand deposits with, or withdrawable accounts in, any financial institution), plus the aggregate of the adjusted basis (determined under § 1.1011–1) of the property other than money held by the taxpayer. For special rules with respect to adjustments to basis in the case of property acquired by the taxpayer in a transaction described in section 595(a), see section 595.

(3) Total deposits or withdrawable accounts. The term "total deposits or withdrawable accounts" means the total of the amounts placed with the taxpayer for deposit or investment. Such term also includes earnings outstanding on the books of account of the taxpayer at the close of the taxable year which have been credited as dividends or interest upon such deposits or withdrawable accounts prior to the close of such taxable year, and which are withdrawable on demand subject only to customary notice of intention to withdraw. In the case of a domestic building and loan association, however, such phrase does not include permanent nonwithdrawable capital stock represented by shares, or earnings credited thereon.

(g) Examples. The provisions of this section may be illustrated by the following examples:

Example (1)—(i) Facts. X is a domestic building and loan association which was organized in 1947 and which makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. X's accounts contain the following entries:

Account	Balance as of— Jan. 1, 1965	Dec. 31, 1965
Total deposits or withdrawable accounts	$1,000,000	$1,200,000
Nonqualifying loans	50,000	60,000
Qualifying real property loans	900,000	940,000
Reserve for losses on nonqualifying loans	200	*160
Reserve for losses on qualifying real property loans	24,000	*21,000
Supplemental reserve for losses on loans	60,800	60,800
Surplus, undivided profits, and other reserves	15,000	18,040

* Computed before any addition for 1965 under section 166(c).

X's taxable income for 1965 (before any deductible addition to a reserve for bad debts and without regard to charitable contributions of $200) is $20,000, computed as follows:

Interest and other income	$19,940
Dividends received from Y Corporation, a domestic corporation subject to taxation under chapter 1 of the Code	400
	20,340
Deduction for 85 percent of dividends received computed without regard to the limitation of section 246(b)	340
Taxable income	20,000

It is assumed that under § 1.166–4 X's addition for 1965 to its reserve for losses on nonqualifying loans is $80.

(ii) Computation of addition to reserve for losses on qualifying real property loans—(a) In general. X determines that the reasonable addition for 1965 to its reserve for losses on qualifying real property loans is $11,920. Such amount, compared under the percentage of taxable income method, is the largest of the amounts determined under (b), (c), and (d) of this subdivision, and does not exceed the 12 percent of deposits limitation computed under (e) of this subdivision.

(b) **Percentage of taxable income method.** The amount determined under the percentage of taxable income method is $11,920, that is, 60 percent of the taxable income for 1965, or $12,000 (60 percent of $20,000), minus $80, the addition for such year to the reserve for losses on nonqualifying loans. This amount is not subject to reduction under the 6 percent of qualifying real property loans limitation described in paragraph (b)(1) of this section since the addition of $11,920 to the $21,000 balance of the reserve for losses on qualifying real property loans at the close of 1965 will not increase such balance to an amount in excess of $56,400, that is, 6 percent of such loans of $940,000 outstanding at such time.

(c) **Percentage of real property loans method.** Since X is not a new company within the meaning of paragraph (c)(2) of this section, the amount determined under the percentage of real property loans method is $7,200, that is, the amount necessary to increase the balance of the reserve for losses on qualifying real property loans at the close of 1965 from $21,000 to an amount equal to 3 percent of such loans outstanding at such time, or $28,200 (3 percent of $940,000).

(d) **Experience method.** The amount determined under the experience method is zero since it is assumed that the $21,000 balance of the reserve for losses on qualifying real property loans at the close of 1965 before any addition for such year exceeds the maximum amount to which such reserve could be increased under such method.

(e) **12 percent of deposits limitation.** The amount determined under the 12 percent of deposits limitation is $43,920, that is, $44,000 (the excess of 12 percent of $1,200,000 of deposits at the close of 1965, or $144,000, over the $100,000 of surplus, undivided profits, and reserves at the beginning of such year), minus $80, the addition for such year to the reserve for losses on nonqualifying loans. Since such $43,920 is greater than $11,920 (the amount determined under (b) of this subdivision), the 12 percent of deposits limitation does not apply for 1965.

(iii) **Computation of taxable income for 1965.** X's taxable income for 1965, after deducting the additions for such year to its reserves for losses on nonqualifying loans and on qualifying real property loans, after deducting the charitable contributions which were not taken into account in computing taxable income for purposes of the addition to the reserve for losses on qualifying real property loans, after including in taxable income dividends received from Y Corporation, and after taking into account the deduction for dividends received under section 243 (subject to the limitation in section 246(b)), is $7,800, computed as follows:

Interest and other income	$19,940	
Dividends received from Y Corporation	400	
		$20,340
Less:		
Deduction for charitable contributions	200	
85 percent of dividends received from Y Corporation	340	
Additions to reserves for bad debts	12,000	
		12,540
Taxable income		7,800

Example (2). Assume the same facts as in example (1), except that X Corporation was organized in 1957, and qualifies for the taxable year 1965 as a new company within the meaning of paragraph (c)(2) of this section. The maximum permissible addition for 1965 to X's reserve for losses on qualifying real property loans is $18,000, the amount computed under the percentage of real property loans method, since such amount is greater than (i) $11,920, the amount computed under the percentage of taxable income method, or (ii) zero, the amount computed under the experience method. The $18,000 amount (as computed under the percentage of real property loans method) is the amount necessary to increase the reserve for losses on qualifying real property loans from the $21,000 closing balance to $39,000, computed as follows:

3 percent of $940,000 of qualifying real property loans at close of 1965		$28,200
Plus:		
Lesser of $80,000 or $18,800 (2 percent of such loans of $940,000)	$18,800	
Reduced by the balance of supplemental reserve for losses on loans	8,000	
	10,800	
		39,000

Example (3). Assume the same facts as in example (1), except that for 1965, 38.4 percent of X's total assets consist of assets other than the assets described in section 7701(a)(19)(D)(ii). In such case, the maximum permissible addition of $11,920 for such year to the reserve for losses on qualifying real property loans (as determined under subdivision (ii) of example (1)) would be reduced by $2,980 (¼ of $11,920) to $8,940.

[T.D. 6728, 29 FR 5857, May 5, 1964, as amended by T.D. 7549, 43 FR 21455, May 18, 1978]

§ 1.593–6A Post-1969 addition to reserve for losses on qualifying real property loans.

(a) **In general—(1) Amount of addition determined for the taxable year.** For purposes of paragraph (a)(1)(ii) of § 1.593–5, the amount of the addition to the reserve for losses on qualifying real property loans for any taxable year beginning after July 11, 1969, is the amount which the taxpayer determines to constitute a reasonable addition to such reserve for such year. However, the amount so determined for such year—

(i) Cannot exceed the largest of the amount determined under section 593 (b)(2), (3), or (4) (relating, respectively, to the percentage of taxable income method, the percentage method, and the experience method), and

(ii) Shall be determined without regard to any amount charged for any taxable year against the reserve for losses on qualifying real property loans pursuant to § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

For each taxable year the taxpayer must include in its income tax return for such year a computation of the amount of the addition determined under this section. The use of a particular method in the

return for a taxable year is not a binding election by the taxpayer to apply such method either for such taxable year or for subsequent taxable years. Thus, in the case of a subsequent adjustment described in paragraph (b)(2) of § 1.593–5 which has the effect of permitting an increase, or requiring a reduction, in the amount claimed in the return for a taxable year as an addition to the reserve for losses on qualifying real property loans, the amount of such addition may be recomputed under whichever method the taxpayer selects for the purpose of such recomputation, irrespective of the method initially applied for such taxable year.

(2) Method of determination. For purposes of this section and § 1.596–1 (relating to limitation on dividends received deduction), a thrift institution is deemed to have determined the addition to its reserve for losses on qualifying real property loans for the taxable year under the percentage of taxable income method provided by section 593(b)(2) and paragraph (b) of this section if the amount finally determined to be a reasonable addition for such year to such reserve exceeds the amount determined for such year under section 593(b)(3) (relating to the percentage method) and exceeds the amount determined for such year under section 593(b)(4) (relating to the experience method).

(b) Percentage of taxable income method—(1) In general. Subject to the limitations described in subparagraph (4) of this paragraph and in paragraph (e) of this section, the amount determined under section 593(b)(2) and this paragraph for the taxable year, if such section and paragraph are applicable, is an amount equal to the applicable percentage of the taxable income for such year, reduced by the amount determined under subparagraph (3) of this paragraph. For this purpose, taxable income is computed as provided in subparagraph (5) of this paragraph, and the applicable percentage (except as reduced under subparagraph (2) of this paragraph) is determined under the following table:

For a taxable year beginning in—	The applicable percentage under this subparagraph is—
1969	60 percent.
1970	57 percent.
1971	54 percent.
1972	51 percent.
1973	49 percent.
1974	47 percent.
1975	45 percent.
1976	43 percent.
1977	42 percent.
1978	41 percent.
1979 or thereafter	40 percent.

(2) Reduction of applicable percentage in certain cases—(i) General rules. If for the taxable year the percentage of the assets of a thrift institution, which are assets described in section 7701(a)(19)(C) (relating to assets of a domestic building and loan association) is less than—

(a) 82 percent of the total assets in the case of a thrift institution other than a mutual savings bank, the applicable percentage for such year provided by subparagraph (1) of this paragraph is reduced by three-fourths of 1 percentage point for each 1 percentage point of such difference; or

(b) 72 percent of the total assets in the case of a thrift institution which is a mutual savings bank, the applicable percentage for such year provided by subparagraph (1) of this paragraph is reduced by 1½ percentage points for each 1 percentage point of such difference.

If such percentage is less than 60 percent of the total assets in the case of any thrift institution (less than 50 percent of the total assets for a taxable year beginning before 1973 in the case of a thrift institution which is a mutual savings bank), section 593(b)(2) and this paragraph are not applicable. The percentage of total assets specified in this subparagraph is computed as of the close of the taxable year or, at the option of the taxpayer, may be computed on the basis of the average assets outstanding during the taxable year. Such average is determined by computing such percentage either as of the close of each month, as of the close of each quarter, or as of the close of each semiannual period during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentages. A thrift institution which is a mutual savings bank and which determines the amount of the reasonable addition for the taxable year to the reserve for losses on qualifying real property loans under this paragraph shall file for such taxable year a statement which shall show the amount of assets defined in paragraph (e) of § 402.1–2 (Temporary Regulations on Procedure and Administration under Tax Reform Act of 1969) as of the close of the taxable year and a brief description and the amount of all other assets, together with a description of the method used in determining such amounts. If the percentage specified in this subparagraph is computed by such thrift institution on the basis of the average assets outstanding during the taxable year, the statement shall also show such information as of the end of

each month, each quarter, or each semiannual period and the manner of calculating the average.

(ii) **Example.** The provisions of this subparagraph may be illustrated by the following example:

Example. M is a cooperative bank to which section 593 applies. For its taxable year beginning in 1970, 80.4 percent of M's assets (computed as of the close of such year) constitute assets described in section 7701(a)(19)(C). M's assets which are assets described in section 7701(a)(19)(C), when computed on semiannual, quarterly, and monthly bases, constitute 79.8, 79.6, and 79.5 percent, respectively, of its total assets computed on the corresponding bases. M's applicable percentage for 1970 is 56.25 percent, determined as follows:

	Percent
Percentage of total assets specified in (*a*) of subdivision (i) of this subparagraph	82.0
Percentage of total assets constituting assets described in section 7701(a)(19)(C)	80.4
Difference	1.6
Applicable percentage determined under table in subparagraph (1) of this paragraph	57.0
Reduction of applicable percentage required by (*a*) of subdivision (i) of this subparagraph (¾ of 1 percentage point for each full percentage point of difference)	.75
Applicable percentage	56.25

(3) **Reduction for addition to reserve for nonqualifying loans—(i) General rule.** Subparagraph (1) of this paragraph provides that, subject to certain limitations, the amount determined under the percentage of taxable income method provided by section 593(b)(2) and this paragraph for the taxable year is an amount equal to the applicable percentage of the taxable income for such year, reduced by the amount determined under this subparagraph. In the case of a thrift institution other than a mutual savings bank, the amount determined under this subparagraph is an amount equal to the amount determined under paragraph (a)(1)(i) of § 1.593–5 to be a reasonable addition for the taxable year to the reserve for losses on nonqualifying loans multiplied by a fraction—

(a) The numerator of which is 18 percent, and

(b) The denominator of which is the percentage (in no case less than 18 percent) of the assets of the taxpayer for such year which are not assets defined in paragraph (e) of § 402.1–2 of this chapter.

In the case of a thrift institution which is a mutual savings bank, the amount determined under this subparagraph is an amount determined in the manner described in the preceding sentence, except that the numerator of the fraction described therein is 28 percent, and the denominator of such fraction shall not be less than 28 percent. For purposes of this subparagraph, the percentage of assets for a taxable year which are not assets defined in paragraph (e) of § 402.1–2 of this chapter is determined upon the same annual or average basis as is used in determining the percentage specified in subparagraph (2) of this paragraph.

(ii) **Examples.** The provisions of this subparagraph may be illustrated by the following examples:

Example (1). K is a domestic building and loan association to which section 593 applies. The amount determined under subparagraph (1) of this paragraph (before reduction by the amount determined under this subparagraph) to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans is $100,000. The amount determined under paragraph (a)(1)(i) of § 1.593–5 as the reasonable addition for the taxable year to the association's reserve for losses on nonqualifying loans is $10,000. The percentage of K's assets which are not assets defined in paragraph (e) of § 402.1–2 is 24 percent. The amount determined under subparagraph (1) of this paragraph ($100,000) must be reduced by $7,500.

$10,000 × 18 percent/24 percent.

Therefore, subject to the limitations described in subparagraph (4) of this paragraph and in paragraph (e) of this section, the amount determined under this paragraph to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans is $92,500 ($100,000 less $7,500).

Example (2). The facts are the same as in example (1), except that the percentage of K's assets which are not assets defined in paragraph (e) of § 402.1–2 is 12 percent. The amount determined under subparagraph (1) of this paragraph (before reduction by the amount determined under this subparagraph) to be the reasonable addition for the taxable year to K's reserve for losses on qualifying real property loans must be reduced by $10,000.

$10,000 × 18 percent/18 percent.

Because the denominator of the fraction may not be less than 18 percent, the fraction used in determining the amount of such reduction is equal to 1.

(4) **Overall limitation.** The amount determined under this paragraph shall not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time.

(5) **Computation of taxable income.** For purposes of this paragraph, taxable income is computed—

(i) By excluding from gross income any amount included therein by reason of the application of section 593(e) and § 1.593–10 (relating to certain distributions to shareholders by a domestic building and loan association).

(ii) Without regard to any deduction allowable under section 166(c) (whether or not determined under section 593) and the regulations thereunder for an addition to a reserve for bad debts.

(iii)(a) By excluding from gross income an amount equal to the excess (if any) or (1) the total gains of the taxable year arising from sales and exchanges at a gain of (i) obligations the interest on which is excludable from gross income under section 103, and (ii) corporate stock, over (2) the total losses of such year arising from sales and exchanges at a loss of such obligations and stock.

(b) The provisions of this subdivision (iii) may be illustrated by the following example:

Example. For its taxable year beginning in 1971, the gains and losses of a domestic building and loan association from sales of stock and securities (all of which were made on December 31, 1971) were as follows:

	Gain	Loss
Municipal bonds acquired July 1, 1969, the interest on which is excludable from income under sec. 103	$25,000	....
Stock of Corporation A, acquired July 14, 1971	....	$6,000
Stock of Corporation B, acquired Dec. 22, 1970	$3,000	....

For purposes of this paragraph, the association's taxable income for 1971 is computed by excluding $22,000 ($25,000 + $3,000 – $6,000) from its gross income.

(iv) By excluding from gross income an amount equal to the lesser of (a) three-eighths of the net long-term capital gain for the taxable year or (b) three-eighths of the net long-term capital gain for the taxable year from the sale or exchange of property other than property described in subdivision (iii) of this subparagraph.

(v)(a) By excluding from gross income so much of the amount of dividends with respect to which a deduction is allowable under part VIII, subchapter B, chapter 1, subtitle A of the Code (section 241 and following) as is in excess of the applicable percentage (determined under subparagraphs (1) and (2) of this paragraph) of the dividends received deduction (determined under part VIII, subchapter B, chapter 1, subtitle A of the Code, without regard to section 596) for the taxable year.

(b) The provisions of this subdivision (v) may be illustrated by the following example:

Example. For its taxable year beginning in 1977, a domestic building and loan association receives dividends of $100 with respect to which a dividends received deduction of $85 is allowable under section 243(a)(1). The association receives no other dividends for the taxable year. The association's applicable percentage for the taxable year, as determined under subparagraphs (1) and (2) of this paragraph, is 42 percent. For purposes of this paragraph, the association's taxable income is computed by excluding from gross income the excess of the amount of dividends received ($100) over the applicable percentage of the allowable dividends received deduction (42 percent of $85, or $35.70), computed without regard to section 596. Thus, for purposes of this paragraph, $64.30 ($100 less $35.70) is excluded from gross income. See section 596 and § 1.596–1 with respect to the computation of the dividends received deduction for purposes of determining taxable income under section 63(a).

(vi) For taxable years beginning before January 1, 1978, without regard to any deduction the amount of which is computed upon, or may be subject to a limitation computed upon, the amount of taxable income, and without regard to any net operating loss carryback to such year from a taxable year beginning before January 1, 1979. (For purposes of this subparagraph, a net operating loss deduction under section 172 is not a deduction the amount of which may be subject to a limitation computed upon the amount of taxable income.)

(vii) For taxable years beginning after December 31, 1977, by taking into account any deduction the amount of which is computed upon or may be subject to a limitation computed upon the amount of taxable income, and any other deduction or loss allowed under subtitle A of the Code, such as any deduction allowable under section 172 or any loss allowable under section 1212(a), unless otherwise provided in this subparagraph.

(c) **Percentage method.** [Reserved]

(d) **Experience method.** [Reserved]

(e) **Percentage of deposits limitation where percentage of taxable income method or percentage method is applied.** If the amount determined by the taxpayer to constitute a reasonable addition for the taxable year to the reserve for losses on qualifying real property loans is greater than the amount determined under paragraph (d) of this section (relating to the experience method), the amount so determined cannot exceed an amount which, when added to the amount determined under paragraph (a)(1)(i) of § 1.593–5 to be a reasonable addition for such year to the reserve for losses on nonqualifying loans, equals the amount by which 12 percent of the total deposits or withdrawable accounts of depositors of the taxpayer at the close of such year exceeds the sum of the taxpayer's surplus, undivided profits, and reserves at the beginning of such year (taking into account any portion thereof which is attributable to the period before the first taxable year beginning after December 31, 1951. The terms "surplus, undivided profit, and reserves" and "total deposits or withdrawable accounts" have the same meanings as are assigned to them in paragraph (f) of § 1.593–6.

[T.D. 7549, 43 FR 21455, May 18, 1978, as amended by T.D. 7626, 44 FR 31177, May 31, 1979]

§ 1.593–7 Establishment and treatment of reserves for bad debts.

(a) Establishment of reserves—(1) In general. A taxpayer described in § 1.593–4 shall establish and maintain a reserve for losses on nonqualifying loans, a reservé for losses on qualifying real property loans, and, if required under paragraph (b)(4) or (c)(3)(i)(c) of this section, a supplemental reserve for losses on loans. For rules governing the crediting of additions to the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans, see paragraph (b) of § 1.593–5.

(2) Accounting for reserves. (i) The taxpayer shall establish and maintain as a permanent part of its regular books of account an account for each of the reserves established pursuant to subparagraph (1) of this paragraph. For purposes of the preceding sentence, a taxpayer may establish and maintain a permanent subsidiary ledger containing an account for each of such reserves. If a taxpayer maintains such a permanent subsidiary ledger, the total of the reserve accounts in such ledger and the total of the reserve accounts in any other ledger must be reconciled.

(ii) Any credit or charge to a reserve established pursuant to subparagraph (1) of this paragraph must be made to such reserve irrespective of whether the amount thereof is also credited or charged to any surplus, reserve, or other account which the taxpayer may be required or permitted to maintain pursuant to any Federal or State statute, regulation, or supervisory order. Minimum amounts credited in compliance with such Federal or State statutes, regulations, or supervisory orders to reserve or similar accounts, or additional amounts credited to such reserve or similar accounts and permissible under such statutes, regulations, or orders, against which charges may be made for the purpose of absorbing losses sustained by the taxpayer, may also be credited to the reserve for losses on nonqualifying loans or the reserve for losses on qualifying real property loans, provided that the total of the amounts so credited to the reserve for losses on nonqualifying loans, or to the reserve for losses on qualifying real property loans, for any taxable years does not exceed the amount described in subparagraph (1) or (2) of § 1.593–5(a) (whichever applies) as the addition to such reserve for such year.

(b) Allocation of pre-1963 reserves—(1) In general. In the case of a taxpayer described in § 1.593–4, the pre-1963 reserves, if any, of such taxpayer shall be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans, the reserve for losses on qualifying real property loans, and, if required under subparagraph (4) of this paragraph, the supplemental reserve for losses on loans. The term "pre-1963 reserves" means the net amount (determined as of the close of December 31, 1962) accumulated for taxable years beginning after December 31, 1951, in the taxpayer's reserve for bad debts pursuant to section 166(c) of the Internal Revenue Code of 1954 and section 23(k)(1) of the Internal Revenue Code of 1939 (including the amount of any bad debt reserves acquired from another taxpayer). For purposes of the preceding sentence in the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the part of such year occurring before January 1, 1963, shall be treated as a taxable year. Thus, the pre-1963 reserves of the taxpayer shall be an amount equal to—

(i) The sum of the amounts allowed as deductions for additions to a reserve for bad debts for taxable years beginning after December 31, 1951, and ending before January 1, 1963, plus

(ii) In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the amount (determined under § 1.593–1 or 1.593–2) which would be allowable under section 166(c) as a deduction for an addition to a reserve for bad debts for the part of such year occurring before January 1, 1963, if such part year constituted a taxable year, minus

(iii) The total amount of bad debts charged against a reserve for bad debts during the period which begins with the opening of the first taxable year beginning after December 31, 1951, and which ends at the close of December 31, 1962 plus

(iv) The total amount of recoveries during the period described in subdivision (iii) of this subparagraph, on bad debts charged against a reserve for bad debts in a taxable year beginning after December 31, 1951.

(2) Allocation to opening balance of reserve for losses on nonqualifying loans. (i) As of the close of December 31, 1962 the pre-1963 reserves shall first be allocated to (and constitute the opening balance of) the reserve for losses on nonqualifying loans in an amount equal to the lesser of (a) the amount of such pre-1963 reserves, or (b) the amount determined under subdivision (ii) of this subparagraph.

(ii) The amount referred to in subdivision (i)(b) of this subparagraph shall be the amount which

would constitute a reasonable addition to the reserve for losses on nonqualifying loans under § 1.166–4 for a period in which the taxpayer's nonqualifying loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(3) Allocation to opening balance of reserve for losses on qualifying real property loans. (i) Any portion of the pre-1963 reserves remaining after the allocation provided in subparagraph (2) of this paragraph shall, as of the close of December 31, 1962, be allocated to (and constitute the opening balance of) the reserve for losses on qualifying real property loans in an amount equal to the lesser of (a) the amount of such remaining portion, or (b) the amount determined under subdivision (ii) of this subparagraph. If the amount described in (a) of the preceding sentence is less than the amount described in (b) thereof, see § 1.593–8 for allocation of pre-1952 surplus, if any, to the opening balance of such reserve.

(ii) The amount referred to in subdivision (i)(b) of this subparagraph shall be an amount equal to the greater of—

(a) 3 percent of the taxpayer's qualifying real property loans outstanding at the close of December 31, 1962, or

(b) The amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166–4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962.

(4) Allocation to supplemental reserve for losses on loans. Any portion of the pre-1963 reserves remaining after the allocations provided in subparagraphs (2) and (3) of this paragraph shall be allocated in its entirety to the supplemental reserve for losses on loans.

(5) Examples. This paragraph may be illustrated by the following examples:

Example (1)—(i) Facts. X Corporation, a domestic building and loan association organized on April 1, 1954, makes its returns on the basis of a taxable year ending March 31 and the reserve method of accounting for bad debts. For its taxable years ending March 31, 1955, through March 31, 1962, X was allowed a total of $750,000 as deductible additions to its reserve for bad debts under section 166(c). For its taxable year ending March 31, 1963, X was allowed a deduction under section 166(c) for an addition to a reserve for bad debts. Of such deduction $46,000 was determined under § 1.593–1 (relating to additions to reserve for bad debts) by reference to § 1.593–9 (relating to taxable income for taxable years beginning in 1962 and ending in 1963) as the amount which would be allowable for the period April 1 through December 31, 1962, if such period constituted a taxable year. During the taxable years ending March 31, 1955, through March 31, 1963, X charged bad debts of $55,000 against its reserve for bad debts and made recoveries on such debts of $10,000. Of such bad debt charges and recoveries, $50,000 was charged off and $9,000 was recovered prior to January 1, 1963. At the close of December 31, 1962, X had outstanding nonqualifying loans of $500,000 and outstanding qualifying real property loans of $10 million. It is assumed that, under § 1.166–4, $2,000 would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $500,000 and $20,000 would constitute a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to $10 million.

(ii) Pre-1963 reserves determined. X's pre-1963 reserves are $755,000, computed as follows:

Deductible additions to reserve for bad debts:		
Years ending March 31, 1955 through March 31, 1962....	$750,000	
Period April 1 through December 31, 1962	46,000	
		$796,000
Less:		
Net bad debt losses for period April 1, 1954 through December 31, 1962:		
Bad debts	50,000	
Recoveries	(9,000)	41,000
		755,000

(iii) Allocation to opening balance of reserve for losses on nonqualifying loans. The portion of the $755,000 of pre-1963 reserves to be allocated to the reserve for losses on nonqualifying loans as the opening balance thereof is $2,000 since such amount would constitute a reasonable addition to the reserve for losses on nonqualifying loans under § 1.166–4 for a period in which the amount of such loans increased from zero to $500,000.

(iv) Allocation to opening balance of reserve for losses on qualifying real property loans. Of the $753,000 ($755,000 minus $2,000) of pre-1963 reserves remaining after the allocation described in subdivision (iii) of this example, $300,000 (3 percent of $10 million, the total amount of qualifying real property loans outstanding at the close of December 31, 1962) is allocated to the opening balance of the reserve for losses on qualifying real property loans, since such amount is greater than $20,000, the amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166–4 for a period in which the amount of such loans increased from zero to $10 million.

(v) Allocation to supplemental reserve for losses on loans. The balance of the pre-1963 reserves, or $453,000 ($755,000 minus the sum of $2,000 and $300,000), is allocated in its entirety to the supplemental reserve for losses on loans.

Example (2). Assume the same facts as in example (1), except that X was organized in 1936, and on December 31, 1962, had pre-1963 reserves of only $15,000 (rather than $755,000). In such case, $2,000 of such pre-1963 reserves would be allocated to, and constitute the opening balance of, the reserve for losses on nonqualifying loans, and $13,000 ($15,000 minus $2,000) would be allocated to and constitute part of the opening balance of the reserve for losses on qualifying real property loans. However, since such $13,000 is less than $300,000 (3 percent of $10 million), the opening balance of the reserve for losses on qualifying real property loans must be increased by so much of the taxpayer's pre-1952

surplus as is necessary to increase such opening balance to $300,000. For rules on the allocation of pre-1952 surplus to the opening balance of the reserve for losses on qualifying real property loans, see § 1.593–8.

(c) **Treatment of reserves—(1) In general.** Except as provided in paragraph (d) of § 1.593–8 (relating to the allocation of pre-1952 surplus), each of the reserves established pursuant to paragraph (a) of this section shall be treated, for purposes of subtitle A of the Code, as a reserve for bad debts, except that no deduction shall be allowed under section 166 for any addition to the supplemental reserve for losses on loans. Accordingly, if in any taxable year the taxpayer charges any of the reserves established pursuant to paragraph (a) of this section for an item other than a bad debt, gross income for such year shall be increased by the amount of such charge. For special rules in case of certain nondeductible distributions to shareholders by a domestic building and loan association, see § 1.593–10.

(2) **Bad debt losses.** Any bad debt in respect of a nonqualifying loan shall be charged against the reserve for losses on nonqualifying loans, and any bad debt in respect of a qualifying real property loan shall be charged against the reserve for losses on qualifying real property loans. At the option of the taxpayer, however, any bad debt in respect of either class of loans may be charged in whole or in part against the supplemental reserve for losses on loans.

(3) **Recoveries of bad debts.** Any amount recovered after December 31, 1962, in respect of a bad debt shall be credited to the reserves established pursuant to paragraph (a) of this section in the following manner:

(i) If the recovery is in respect of a bad debt which was charged prior to January 1, 1963, against a reserve for bad debts established pursuant to section 166(c) of the Internal Revenue Code of 1954, or section 23(k)(1) of the Internal Revenue Code of 1939, then the amount recovered shall be credited—

(a) First, to the reserve for losses on nonqualifying loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(2) of this section exceeds the opening balance of such reserve (determined under such paragraph (b)(2)),

(b) Second, to the reserve for losses on qualifying real property loans in an amount equal to the amount, if any, by which the amount determined under subdivision (ii) of paragraph (b)(3) of this section exceeds the opening balance of such reserve (determined under such paragraph (b)(3)), and

(c) Finally, to the supplemental reserve for losses on loans.

For purposes of determining the amounts of the credits under (a) and (b) of this subdivision, the opening balances of the reserve for losses on nonqualifying loans and the reserve for losses on qualifying real property loans shall be deemed to include the sum of the amounts of any prior credits made to such reserves pursuant to this subdivision.

(ii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against only one of the reserves established pursuant to paragraph (a) of this section, the entire amount recovered shall be credited to the reserve so charged.

(iii) If the recovery is in respect of a bad debt which is charged after December 31, 1962, against more than one of the reserves established pursuant to paragraph (a) of this section, then the amount recovered shall be credited to each of the reserves so charged in the ratio which the amount of the bad debt charged against such reserve bears to the total amount of such bad debt charged against both such reserves.

(iv) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example. In 1962, the taxpayer sustained a bad debt of $10,000, which was charged against a reserve for bad debts established pursuant to section 166(c). As of the close of December 31, 1962, the balance of the taxpayer's reserve for losses on nonqualifying loans was $2,000, the amount determined under paragraph (b)(2)(ii) of this section. As of the same time, the balance of the taxpayer's reserve for losses on qualifying real property loans was $100,000, but the amount determined under paragraph (b)(3)(ii) of this section was $106,-000. In 1963, the taxpayer recovers $8,000 of the $10,000 charged off in 1962. Of the $8,000 recovered in 1963, $6,000 ($106,000 minus $100,000) is credited to the reserve for losses on qualifying real property loans, and the balance of $2,000 is credited to the supplemental reserve for losses on loans.

[T.D. 6728, 29 FR 5859, May 5, 1964, as amended by T.D. 7549, 43 FR 21457, May 18, 1978]

§ 1.593–8 Allocation of pre-1952 surplus to opening balance of reserve for losses on qualifying real property loans.

(a) **General rule.** In the case of a taxpayer described in § 1.593–4, if the amount of pre-1963 reserves allocated (under paragraph (b)(3)(i) of § 1.593–7) to the opening balance of the reserve for losses on qualifying real property loans is less than an amount equal to the greater of—

(1) The total amount of qualifying real property loans outstanding at the close of December 31, 1962, multiplied by 3 percent, or

(2) The amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166–4 for a period in which the amount of such loans increased from zero to the amount thereof outstanding at the close of December 31, 1962,

then such opening balance shall be increased by an amount equal to so much of the "pre-1952 surplus" of the taxpayer as is necessary to increase such opening balance to the greater of the amounts described in subparagraph (1) or (2) of this paragraph. The amount of such increase shall be deemed to be included in such opening balance solely for the limited purpose described in paragraph (d) of this section.

(b) Pre-1952 surplus defined—(1) In general. For purposes of this section and § 1.593–7, the term "pre-1952 surplus" means an amount equal to—

(i) The sum of the taxpayer's surplus, undivided profits, and reserves determined (under the principles of paragraph (d)(2) of § 1.593–1) as of the close of the taxpayer's last taxable year beginning before January 1, 1952 (including any amount acquired from another taxpayer), minus

(ii) The amount of any impairments of such sum (as determined under paragraph (c) of this section).

(2) Reduction for certain excludable interest. **(i)** The amount otherwise determined under subparagraph (1) of this paragraph may, at the option of the taxpayer, be reduced by the portion, if any, of such amount which is attributable to interest which would have been excludable from gross income of such taxpayer under section 22(b)(4) of the Internal Revenue Code of 1939 (relating to interest on governmental obligations) or the corresponding provisions of prior revenue laws, had such taxpayer been subject, when such interest was received or accrued, to the income tax imposed by such Code or prior revenue laws.

(ii) For purposes of subdivision (i) of this subparagraph, the portion of the amount otherwise determined under subparagraph (1) of this paragraph which is attributable to interest which would have been excludable from gross income shall be determined by multiplying such amount by the ratio which—

(a) The total amount of such excludable interest for the period before the taxpayer's first taxable year beginning after December 31, 1951, bears to

(b) The total amount of the taxpayer's gross income, plus the total amount of such excludable interest, for such period.

If the amount determined under subparagraph (1)(i) of this paragraph includes any amount acquired from another taxpayer, then the gross income and excludable interest of the taxpayer for the period before its first taxable year beginning after December 31, 1951, shall include the gross income and excludable interest (for the same period) of such other taxpayer.

(c) Impairment of surplus, undivided profits, and reserves—(1) General rule. In the case of a taxable year beginning after December 31, 1951, and ending before January 1, 1963, if for such year—

(i) The amount described in paragraph (b)(1)(i) of this section (as decreased under subparagraph (3)(i) of this paragraph), exceeds

(ii) The sum of the taxpayer's surplus, undivided profits, and reserves (excluding the amount of any pre-1963 reserves) determined as of the close of such year under the principles of paragraph (d)(2) of § 1.593–1,

then the amount described in paragraph (b)(1)(i) of this section may, at the option of the taxpayer, be reduced by the amount of such excess.

(2) Transition year. In the case of a taxable year beginning before January 1, 1963, and ending after December 31, 1962, the part of such year which occurs before January 1, 1963, shall be considered to be a taxable year for purposes of subparagraph (1) of this paragraph.

(3) Rules for applying subparagraph (1). **(i)** For purposes of subparagraph (1)(i) of this paragraph, the amount described in paragraph (b)(1)(i) of this section shall be decreased by the total of any reductions under subparagraph (1) of this paragraph for prior taxable years; and

(ii) For purposes of subparagraph (1)(ii) of this paragraph, the term "pre-1963 reserves" means the amount determined under the principles of paragraph (b)(1) of § 1.593–7 for the period which begins with the first day of the first taxable year beginning after December 31, 1951, and which ends at the close of the taxable year with respect to which the computation under subparagraph (1) is being made.

(d) **Treatment of pre-1952 surplus.** Any portion of the taxpayer's pre-1952 surplus which, pursuant to paragraph (a) of this section, is deemed to be included in the opening balance of the reserve for losses on qualifying real property loans shall not be treated as a reserve for bad debts for any purpose other than computing for any taxable year the amount determined under the method described in paragraph (b), (c), or (d) of § 1.593–6 (relating, respectively, to the percentage of taxable income method, the percentage of real property loans method, and the experience method) or paragraph (b), (c), or (d) of § 1.593–6A (relating, respectively, to the percentage of taxable income method, the percentage method, and the experience method). For such limited purpose, such portion shall be deemed to remain in, and constitute a part of, the reserve for losses on qualifying real property loans. For all other purposes, such portion will retain its character as part of the taxpayer's pre-1952 surplus.

(e) **Example.** The provisions of this section may be illustrated by the following example:

Example—(1) Facts. X Corporation, a mutual savings bank organized in 1934, makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. For the taxable years 1934 through 1951, X's gross income was $2.7 million, in addition to which X received $300,000 of interest which would have been excludable from gross income under section 22(b)(4) of the Internal Revenue Code of 1939, or the corresponding provisions of prior revenue laws, if X had been subject to the income tax imposed by such Code or prior revenue laws when such interest was received. At the close of 1951, the sum of X's surplus, undivided profits, and reserves was $650,000. At the close of 1954, X had pre-1963 reserves of $10,000, and surplus, undivided profits, and reserves of $630,000. At the close of 1955, X had pre-1963 reserves of $15,000, and surplus, undivided profits, and reserves of $625,000. At the close of 1962, X had pre-1963 reserves of $55,000, nonqualifying loans of $4 million, and qualifying real property loans of $10 million. It is assumed that, under § 1.166–4, $16,000 would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $4 million and $20,000 would constitute a reasonable addition to the reserve for losses on qualifying real property loans for a period in which such loans increased from zero to $10 million.

(2) Impairment of surplus, undivided profits, and reserves for 1954. The sum of X's surplus, undivided profits, and reserves at the close of 1951 was impaired during 1954 by $30,000, computed as follows:

Sum of surplus, undivided profits, and reserves at close of 1951	$650,000
Less:	
Sum of surplus, undivided profits, and reserves at close of 1954, excluding pre-1963 reserves at close of such year ($630,000 minus $10,000)	620,000
	30,000

(3) Impairment of surplus, undivided profits, and reserves for 1955. The sum of X's surplus, undivided profits, and reserves at the close of 1951 was further impaired during 1955 by $10,000, computed as follows:

Sum of surplus, undivided profits, and reserves at close of 1951, decreased by amount of 1954 impairment ($650,000 minus $30,000)	$620,000
Less:	
Sum of surplus, undivided profits, and reserves at close of 1955, excluding pre-1963 reserves at close of such year ($625,000 minus $15,000)	610,000
	10,000

(4) Pre-1952 surplus. X's pre-1952 surplus is $549,000, computed as follows:

Sum of surplus, undivided profits and reserves at close of 1951	$650,000	
Less:		
Sum of impairments for 1954 and 1955 ($30,000 plus $10,000)	40,000	
		$610,000
Less:		
Portion of such $610,000 which is attributable to excludable interest ($610,000 multiplied by $300,000/$3 million)		61,000
		549,000

(5) Allocation of pre-1963 reserves to reserve for losses on nonqualifying loans and to reserve for losses on qualifying real property loans. Of the $55,000 of pre-1963 reserves at the close of 1962, $16,000 (the amount which would constitute a reasonable addition to the reserve for losses on nonqualifying loans for a period in which such loans increased from zero to $4 million) shall be allocated to, and constitute the opening balance of, the reserve for losses on nonqualifying loans, and the balance of $39,000 ($55,000 minus $16,000) shall be allocated to, and constitute a part of the opening balance of, the reserve for losses on qualifying real property loans.

(6) Allocation of pre-1952 surplus to reserve for losses on qualifying real property loans. X's pre-1963 reserves are not sufficient to bring the opening balance of the reserve for losses on qualifying real property loans to $300,000, which is an amount equal to the greater of—

(i) $300,000 (*i.e.*, $10 million of qualifying real property loans outstanding at the close of 1962, multiplied by 3 percent), or

(ii) $20,000 (the amount which would constitute a reasonable addition to the reserve for losses on such loans under § 1.166–4 for a period in which the amount of such loans increased from zero to the $10 million).

Therefore, $261,000 ($300,000 minus $39,000) of X's pre-1952 surplus of $549,000 shall be deemed to be included in the opening balance of such reserve in order to increase such opening balance to $300,000.

[T.D. 6728, 29 FR 5861, May 5, 1964, as amended by T.D. 7549, 43 FR 21457, May 18, 1978]

§ 1.593–9 Taxable income for taxable years beginning in 1962 and ending in 1963.

(a) **In general.** For purposes of subtitle A of the Code, in the case of a taxable year beginning

before January 1, 1963, and ending after December 31, 1962, of a taxpayer described in § 1.593–4, taxable income for such taxable year shall be the sum of—

(1) An amount equal to (i) the portion of taxable income (as determined under paragraph (b) of this section) allocable to the part of such year occurring before January 1, 1963, minus (ii) the amount determined under § 1.593–1 or § 1.593–2 which would be allowable under section 166(c) as a deduction for an addition to a reserve for bad debts if such part year constituted a taxable year, and

(2) An amount equal to (i) the portion of taxable income (as determined under paragraph (b) of this section) allocable to the part of such year occurring after December 31, 1962, minus (ii) the amount determined under § 1.593–5 which would be allowable under section 166(c) as a deduction for an addition to a reserve for bad debts if such part year constituted a taxable year.

(b) Rules for applying paragraph (a). For purposes of paragraph (a)(1) and (2) of this section—

(1) In determining taxable income the rules of paragraph (b)(2) of § 1.593–6 shall apply.

(2) Taxable income (as determined under subparagraph (1) of this paragraph) shall be allocated to each part year (that is, the part occurring before January 1, 1963, and the part occurring after December 31, 1962) in the ratio which the number of days in such part year bears to the number of days in the entire taxable year.

(3) The sum of surplus, undivided profits, and reserves, the total deposits or withdrawable accounts, the amount of outstanding qualifying real property loans and nonqualifying loans, and any other account balance necessary to determine the addition to a reserve for bad debts for each part year, shall be the actual account balance as of the beginning or ending, as the case may be, of each such part year. See example (1) of paragraph (b)(5) of § 1.593–7.

(c) Example. This section may be illustrated by the following example:

Example. (i) For its taxable year beginning October 1, 1962, and ending September 30, 1963, corporation X, a domestic building and loan association, has taxable income of $1,825,000, determined without regard to any deduction under section 166(c) for an addition to a reserve for bad debts, without regard to a charitable contribution of $500, and without regard to $1,000 which is includible in gross income by reason of the application of § 1.593–10.

(ii) Under this section, $460,000 (92/365 of $1,825,000) of such taxable income is allocated to the part of the taxable year occurring before January 1, 1963 (that is, October 1 through December 31, 1962) and $1,365,000 (273/365 of $1,825,000) of such taxable income is allocated to the part of the taxable year occurring after December 31, 1962 (that is, January 1 through September 30, 1963). Corporation X's taxable income for the taxable year ending September 30, 1963, is $546,500, computed as follows:

Part year occurring in 1962:		
Taxable income	$460,000	
Amount of deduction assumed to be allowable under § 1.593–1 if such part year constituted a taxable year	460,000	
Part year occurring in 1963:		
Taxable income	$1,365,000	
Amount of deduction assumed to be allowable under § 1.593–5 if such part year constituted a taxable year	819,000	
		$546,000
		546,000
Add:		
Amount includible in gross income by reason of application of § 1.593–10		1,000
Less:		
Charitable contribution		500
Taxable income for taxable year; ending September 30, 1963		546,500

[T.D. 6728, 29 FR 5862, May 5, 1964]

§ 1.593–10 Certain distributions to shareholders by a domestic building and loan association.

(a) In general. Section 593(f) provides that if a domestic building and loan association (as defined in section 7701(a)(19) and the regulations thereunder) distributes property after December 31, 1962, to a shareholder with respect to its stock and if the amount of such distribution is not allowable to the association as a deduction under section 591 (relating to deduction for dividends paid on deposits), then, notwithstanding any other provision of the Code, the distribution shall be treated as provided in paragraphs (b) and (c) of this section. For purposes of the preceding sentence, the term "distribution" includes any distribution in redemption of stock to which section 302(a) or 303 applies, or in partial or complete liquidation of the association, as well as any other distribution which the association may make to a shareholder with respect to its stock. For definition of the term "property", see section 317(a). For determination of the amount of a distribution, see section 301(b). For taxable years beginning after July 11, 1969, this paragraph is not applicable to any transaction to which section 381 (relating to carryovers in certain corporate acquisitions) and the regulations thereunder apply.

(b) **Distributions out of certain reserves—(1) Distributions not in exchange for stock.** If the distribution is not a redemption to which section 302(a) or 303 applies or in partial or complete liquidation of the association, then to the extent that the distribution is not out of earnings and profits of the taxable year (within the meaning of section 316(a)(2)) or out of earnings and profits accumulated in taxable years beginning after December 31, 1951, the distribution shall be treated as made out of—

(i) First, the reserve for losses on qualifying real property loans (determined under subparagraph (3) of this paragraph), to the extent thereof,

(ii) Second, the supplemental reserve for losses on loans, to the extent thereof, and

(iii) Finally, such other accounts as may be proper.

(2) **Distributions in redemption of stock or in liquidation.** If the distribution is a redemption to which section 302(a) or 303 applies, or in partial or complete liquidation of the association, the distribution shall be treated as made out of—

(i) First, the reserve for losses on qualifying real property loans (as determined under subparagraph (3) of this paragraph), to the extent thereof,

(ii) Second, the supplemental reserve for losses on loans, to the extent thereof,

(iii) Third, earnings and profits of the taxable year (within the meaning of section 316(a)(2)),

(iv) Fourth, earnings and profits accumulated in taxable years beginning after December 31, 1951, and

(v) Finally, such other accounts as may be proper.

(3) **Special rule.** For purposes of subparagraphs (1)(i) and (2)(i) of this paragraph, the reserve for losses on qualifying real property loans shall be an amount equal to—

(i) The balance of such reserve determined as of the close of the taxable year after all adjustments for such year have been made (including the addition for such year determined under § 1.593–6 or § 1.593–6A (whichever is applicable)), minus.

(ii) The sum of—

(a) The amount which would have constituted the opening balance of such reserve (at the close of December 31, 1962) if such opening balance had been determined under the experience method described in paragraph (b)(3)(ii)(b) of § 1.593–7 (relating to allocation of pre-1963 reserves to the opening balance of the reserve for losses on qualifying real property loans), and

(b) The total amount of the annual additions which would have been made to such reserve under section 166(c) for taxable years ending after December 31, 1962, if each such addition had been determined under the experience method described in paragraph (d) of § 1.593–6 or paragraph (d) of § 1.593–6A, whichever is applicable for the taxable year of such addition.

For purposes of subdivision (i) of this subparagraph, the balance of the reserve for losses on qualifying real property loans shall include the total amount of any pre-1963 reserves allocated thereto under paragraph (b)(3) of § 1.593–7, but shall not include any pre-1952 surplus which is deemed to be included therein under paragraph (a) of § 1.593–8 (relating to allocation of pre-1952 surplus to the opening balance of the reserve for losses on qualifying real property loans).

(c) **Amount charged against reserve and included in gross income—(1) In general.** If a distribution is treated under paragraph (b)(1) or (2) of this section as having been made out of the reserve for losses on qualifying real property loans or out of the supplemental reserve for losses on loans, such reserves shall be charged with, and gross income for the taxable year shall be increased by, an amount equal to the lesser of—

(i) The amount of such reserves, or

(ii) The amount which, when reduced by the amount of income tax imposed by chapter 1 of the Code and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution.

(2) **Special rule.** For purposes of subparagraph (1)(ii) of this paragraph, in determining the income tax attributable to the inclusion of an amount in gross income, taxable income shall be determined without regard to any net operating loss carryback to the taxable year under section 172.

(d) **Examples.** This section may be illustrated by the following examples:

Example (1)—(i) Facts. X Corporation, a domestic building and loan association having nonwithdrawable capital stock represented by shares, was organized in 1946, and makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. As of the close of December 31, 1962, X had $6,900 of earnings and profits accumulated in taxable years beginning after December 31, 1951. X's taxable income for 1963 is $30,000 (computed prior to the inclusion of any amount in gross income for such year under section 593(f)) and during such year X received tax-ex-

empt interest of $500. X's earnings and profits for 1963 (computed at the close of the taxable year without diminution by reason of any distributions made during the taxable year) is $20,400. The opening balance of X's reserve for losses on qualifying real property loans as of the close of December 31, 1962 (determined under paragraph (b)(3)(ii)(a) of § 1.593–7) was $24,500. Pre-1963 reserves of $22,500 were included in such opening balance, but it is assumed that pre-1963 reserves of only $2,500 would have been included in the opening balance if the opening balance had been determined under the experience method described in paragraph (b)(3)(ii)(b) of § 1.593–7. Pre-1952 surplus of $2,000 was deemed included in such opening balance under paragraph (a) of § 1.593–8. The deductible addition to such reserve for 1963 is $47,000. It is assumed that the addition to such reserve for 1963 would have been $2,200 if such addition had been computed under the experience method described in paragraph (d) of § 1.593–6. On each of four dates during 1963 (January 1, April 1, July 1, and October 1), X made a $12,000 distribution (which was not a redemption to which section 302(a) or 303 applied or in partial or complete liquidation of X) to its shareholders with respect to its stock.

(ii) Reserve for losses on qualifying real property loans. For purposes of paragraph (b)(1)(i) of this section, X's reserve for losses on qualifying real property loans is $64,800, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1963 ($24,500 opening balance plus $47,000 addition)		$71,500
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under experience method	2,500	
Total additions which would have been made under experience method	2,200	
Pre-1952 surplus included in opening balance	2,000	
		6,700
		64,800

(iii) Treatment of distributions. Of each $12,000 quarterly distribution, $5,100 ($20,400) (earnings and profits of the taxable year divided by 4) is out of X's earnings and profits of the taxable year (within the meaning of section 316(a)(2)); the remainder of the January 1 distribution, $6,900 ($12,000 minus $5,100), is out of X's earnings and profits accumulated in taxable years beginning after December 31, 1951. Since $20,700 ($6,900 multiplied by 3) is not out of X's earnings and profits, such amount shall be treated as made out of X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example).

(iv) Amount charged against reserve for losses on qualifying real property loans and included in gross income. The reserve for losses on qualifying real property loans is charged with, and X's gross income for 1963 is increased by, $43,124, which is the lesser of—

(a) $64,800 (the reserve as of December 31, 1963, as determined under subdivision (ii) of this example), or

(b) $43,124, *i.e.*, the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $22,424 ($43,124 multiplied by a tax rate of 52 percent), is equal to the amount of such distribution, $20,700.

Example (2)—(i) Facts. Assume the same facts as in example (1) and the following additional facts: X's taxable income for 1964 is $6,000. The deductible addition to the reserve for losses on qualifying real property loans for 1964 is $11,000, but it is assumed that only $2,676 would have been the addition to such reserve for 1964 if such addition had been computed under the experience method described in paragraph (d) of § 1.593–6. On December 31, 1964, X makes a $10,000 distribution in a redemption to which section 302(a) applies.

(ii) Reserve for losses on qualifying real property loans. For purposes of paragraph (b)(2)(i) of this section, X's reserve for losses on qualifying real property loans is $30,000, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1964 ($71,500 opening balance plus $11,000 addition)		$82,500
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under the experience method	$2,500	
Total additions which would have been made under the experience method ($2,200 for 1963 plus $2,676 for 1964)	4,876	
Pre-1952 surplus included in opening balance	2,000	
		9,376
		73,124
Less charge against reserve under subdivision (iv) of example (1) for 1963 distribution		43,124
		30,000

(iii) Treatment of distribution. The $10,000 distribution in a redemption to which section 302(a) applies shall be treated as made out of X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example).

(iv) Amount charged against reserve for losses on qualifying real property loans and included in gross income. The reserve for losses on qualifying real property loans is charged with, and X's gross income for 1964 is increased by, $12,820, which is the lesser of—

(a) $30,000 (the reserve as of December 31, 1964, as determined under subdivision (ii) of this example), or

(b) $12,820, *i.e.*, the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $2,820 ($12,820 multiplied by a tax rate of 22 percent), is equal to the amount of such distribution, $10,000.

Example (3)—(i) Facts. X Corporation, a domestic building and loan association having nonwithdrawable capital stock represented by shares, was organized in 1946, and makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. As of the close of December 31, 1962, X had $6,900 of earnings and profits accumulated in taxable years beginning after December 31, 1951. X's taxable income for 1963 is $30,000 (computed prior to the inclusion of any amount in gross income for such year under section 593(f)) and during such year X received tax-exempt interest of $500. X's earnings and profits for 1963 (computed at the close of the taxable year without diminution by reason of any distributions made during the taxable year) is $20,400. The opening balance of X's reserve for losses on qualifying real property loans as of the close of December 31,

1962 (determined under paragraph (b)(3)(ii)(a) of § 1.593–7) was $24,500. Pre-1963 reserves of $24,500 were included in such opening balance, but it is assumed that pre-1963 reserves of only $4,500 would have been included in the opening balance if the opening balance had been determined under the experience method described in paragraph (b)(3)(ii)(b) of § 1.593–7. The deductible addition to such reserve for 1963 is $500. It is assumed that the addition to such reserve for 1963 would have been $100 if such addition had been computed under the experience method described in paragraph (d) of § 1.593–6. As of December 31, 1963, the balance of X's supplemental reserve for losses on loans is $30,000. On each of four dates during 1963 (January 1, April 1, July 1, and October 1), X made a $12,000 distribution (which was not a redemption to which section 302(a) or 303 applied or in partial or complete liquidation of X) to its shareholders with respect to its stock.

(ii) **Reserve for losses on qualifying real property loans.** For purposes of paragraph (b)(1)(i) of this section, X's reserve for losses on qualifying real property loans is $20,400, computed as follows:

Closing balance of reserve for losses on qualifying real property loans after addition for 1963 ($24,500 opening balance plus $500 addition)		$25,000
Minus:		
Amount of pre-1963 reserves which would have been included in opening balance under experience method......	$4,500	
Total additions which would have been made under experience method	100	
		4,600
		20,400

(iii) **Treatment of distributions.** Of each $12,000 quarterly distribution, $5,100 ($20,400 earnings and profits of the taxable year divided by 4) is out of X's earnings and profits of the taxable year (within the meaning of section 316(a)(2)); the remainder of the January 1 distribution, $6,900 ($12,000 minus $5,100), is out of X's earnings and profits accumulated in taxable years beginning after December 31, 1951. Since $20,-700 ($6,900 multiplied by 3) is not out of X's earnings and profits, $20,400 of such amount shall be treated as made out of X's reserve for losses on qualifying real property loans (as determined under subdivision (ii) of this example) and $300 ($20,700 minus $20,400) shall be treated as made out of X's supplemental reserve for losses on loans.

(iv) **Amount included in gross income.** X's gross income for 1963 is increased by $43,124, which is the lesser of—

(a) $50,400 ($20,400, the reserve for losses on qualifying real property loans, as determined under subdivision (ii) of this example, plus $30,000, the supplemental reserve for losses on loans), or

(b) $43,124, *i.e.,* the amount which, when reduced by the amount of income tax attributable to the inclusion of such amount in gross income, $22,424 ($43,124 multiplied by a tax rate of 52 percent), is equal to the amount of such distribution, $20,700.

(v) **Amount charged against reserve for losses on qualifying real property loans and supplemental reserve for losses on loans.** The reserve for losses on qualifying real property loans is charged with $20,400 (the balance of the reserve as of December 31, 1963, as determined under subdivision (ii) of this example), and the supplemental reserve for losses on loans is charged with $22,724 ($43,124, the amount included in gross income under subdivision (iv) of this example, minus $20,400).

[T.D. 6728, 29 FR 5862, May 5, 1964, as amended by T.D. 7549, 43 FR 21457, May 18, 1978]

§ 1.593–11 Qualifying real property loan and nonqualifying loan defined.

(a) **Loan defined.** For purposes of this section, the term "loan" means debt, as the term "debt" is used in section 166 and the regulations thereunder. The term "loan" also includes a redeemable ground rent (as defined in section 1055(c)) which is owned by the taxpayer, and any property acquired by the taxpayer in a transaction described in section 595(a). For determination of the amount of a loan, see paragraph (d) of this section.

(b) **Qualifying real property loan defined—(1) General rule.** For purposes of §§ 1.593–4 through 1.593–10, the term "qualifying real property loan" means any loan (other than a loan described in subparagraph (5) of this paragraph) which is secured by an interest in qualifying real property. For purposes of this section, the term "real property" means any property which, under the law of the jurisdiction in which such property is situated, constitutes real property. The term "real property" also includes a mobile unit which is permanently fixed to real property. The determination of whether a mobile unit is permanently fixed to real property shall be made on the basis of facts and circumstances in each particular case. For example, a mobile unit is permanently fixed to real property during a taxable year if, except for a brief period during which the unit is transported to a site, such unit was placed upon a foundation at a site with wheels and axles removed, affixed to the ground by means of straps, and connected to water, sewer, gas, and electric facilities.

(2) **Meaning of "secured".** A loan will be considered as "secured" only if the loan is on the security of any instrument (such as a mortgage, deed of trust, or land contract) which makes the interest of the debtor in the property described therein specific security for the payment of the loan, provided that such instrument is of such a nature that, in the event of default, the property could be subjected to the satisfaction of the loan with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated.

(3) **Meaning of "interest".** The word "interest" means an interest in real property which, under the law of the jurisdiction in which such property is situated, constitutes either (i) an interest in fee in such property, (or in the case of a

mobile unit, an ownership interest), (ii) a leasehold interest in such property extending or renewable automatically for a period of at least 30 years, or at least 10 years beyond the date scheduled for the final payment on the loan secured by such interest, (iii) a leasehold interest in improved residential real property consisting of a structure or structures containing, in the aggregate, no more than four family units extending for a period of at least 2 years beyond the date scheduled for the final payment on the loan secured by such interest, or (iv) a leasehold interest in such property held subject to a redeemable ground rent defined in section 1055(c).

(4) **Meaning of "qualifying real property".** The term "qualifying real property" means any real property which is improved real property, or which from the proceeds of the loan will become improved real property. As used in the preceding sentence, the term "improved real property" means—

(i) Land on which is located any building of a permanent nature (such as a house, mobile unit, apartment house, office building, hospital, shopping center, warehouse, garage, or other similar permanent structure), provided that the value of such building is substantial in relation to the value of such land,

(ii) Any building lot or site which, by reason of installations and improvements that have been completed in keeping with applicable governmental requirements and with general practice in the community, is a building lot or site ready for the construction of any building of a permanent nature within the meaning of paragraph (b)(4)(i) of this section.

(iii) Real property which, because of its state of improvement, produces sufficient income to maintain such real property and retire the loan in accordance with the terms thereof, or

(iv) A mobile unit which is permanently fixed to real property.

(5) **Loans not included.** The term "qualifying real property loan" does not include—

(i) Any loan evidenced by a security as defined in section 165(g)(2)(C),

(ii) Any loan (whether or not evidenced by a security as so defined) the primary obligor on which is (a) a government or a political subdivision or instrumentality thereof, (b) a bank (as defined in section 581), or (c) another member of the same affiliated group,

(iii) Any loan to the extent such loan is secured by a deposit in or share of the taxpayer (including a share of nonwithdrawable capital stock), determined as of the close of the taxable year, and

(iv) Any loan which (within a 60-day period beginning in one taxable year of the taxpayer and ending in the next taxable year of such taxpayer) is made or acquired, and then repaid or disposed of, unless both the transaction by which the loan is made or acquired and the transaction by which the loan is repaid or disposed of are established to the satisfaction of the district director to be for bona fide business purposes.

As used in subdivision (ii)(c) of this subparagraph, the term "affiliated group" shall have the meaning assigned to such term by section 1504(a) (relating to the definition of an affiliated group), except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place the latter phrase appears in section 1504(a), and all corporations shall be treated as includible corporations (without regard to any of the exclusions provided in section 1504(b)).

(c) **Nonqualifying loan defined.** For purposes of §§ 1.593–4 through 1.593–9, the term "nonqualifying loan" means any loan which is not a qualifying real property loan.

(d) **Amount of loan determined—(1) General rule.** Except as provided in subparagraph (2) of this paragraph, the amount of any qualifying real property loan or nonqualifying loan, for purposes of section 593, is the adjusted basis of such loan as determined under § 1.1011–1. However, the adjusted basis, determined under § 1.1011–1, of any "loan in process" does not include the unadvanced portion of such loan. For the basis of a redeemable ground rent reserved or created by the taxpayer before April 11, 1963, see section 1055(b)(3); and for the basis of a loan represented by property acquired by the taxpayer in a transaction described in section 595(a), see section 595(c).

(2) **Limitation.** If the total amount advanced on any loan exceeds the loan value of any interest in qualifying real property which secures such loan, then the portion of such loan which, as of the close of any taxable year, will be considered as a qualifying real property loan shall be determined under the principles of section 7701(a)(19) and the regulations thereunder.

[T.D. 6728, 29 FR 5864, May 5, 1964, as amended by T.D. 7549, 43 FR 21458, May 18, 1978]

§ 1.594–1 Mutual savings banks conducting life insurance business.

(a) **Scope of application.** Section 594 applies to the case of a mutual savings bank not having capital stock represented by shares which conducts a life insurance business, if:

(1) The conduct of the life insurance business is authorized under State law,

(2) The life insurance business is carried on in a separate department of the bank,

(3) The books of account of the life insurance business are maintained separately from other departments of the bank, and

(4) The life insurance department of the bank would, if it were treated as a separate corporation, qualify as a life insurance company under section 801.

(b) **Computation of tax.** In the case of a mutual savings bank conducting a life insurance business to which section 594 is applicable, the tax upon such bank consists of the sum of the following:

(1) A partial tax computed under section 11 upon the taxable income of the bank determined without regard to any items of income or deduction properly allocable to the life insurance department, and

(2) A partial tax computed on the income (or, in the case of taxable years beginning before January 1, 1955, the taxable income (as defined in section 803)) of the life insurance department determined without regard to any items of income or deduction not properly allocable to such department, at the rates and in the manner provided in subchapter L (section 801 and following), chapter 1 of the Code, with respect to life insurance companies.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.595–1 Treatment of foreclosed property by certain creditors.

(a) Nonrecognition of gain or loss on the acquisition of security property by certain creditors—(1) In general. Section 595(a) provides that in the case of a creditor which is an organization described in section 593(a) (that is, a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank without capital stock organized and operated for mutual purposes and without profit), no gain or loss shall be recognized, and no debt shall be considered as becoming worthless or partially worthless for purposes of section 166 (relating to bad debts), as the result of a transaction by which such creditor bids in at foreclosure, or reduces to ownership or possession by agreement or process of law, any property (whether real or personal, tangible or intangible) which was security for the payment of any indebtedness (whether or not a qualifying real property loan as defined in section 593(e)(1)). The treatment provided by section 595(a) is mandatory (regardless of whether such creditor utilizes the specific deduction or reserve method of accounting for bad debts) if, for the taxable year in which the property is bid in at foreclosure, or reduced to ownership or possession by agreement or process of law, the creditor is an organization described in section 593(a), even though the creditor subsequently becomes an organization not described in section 593(a). For definition of the terms "domestic building and loan association" and "cooperative bank" for taxable years beginning after October 16, 1962, see paragraphs (19) and (32), respectively, of section 7701(a).

(2) **Effective date.** Section 595 applies to any transaction (described in subparagraph (1) of this paragraph) occurring after December 31, 1962, except that such section does not apply to any such transaction in which the taxable event determined without regard to section 595 (that is, the sale or exchange to the creditor of the security property by reason of the default or anticipated default of the debtor) occurred before January 1, 1963.

(b) Rules for determining when security property is reduced to ownership or possession by agreement or process of law—(1) Ownership or possession. For purposes of this section, security property shall be considered as reduced to ownership or possession by agreement or process of law on the earliest date on which the creditor, by reason of the default or anticipated default of the debtor—

(i) Acquires, by agreement or process of law, a title to, or a right or interest in, the security property which under local law is indefeasible and which the creditor can validly dispose of apart from the indebtedness which the property secures, or

(ii) Acquires, by agreement or process of law, an enforceable right to direct the use to which the security property shall be put, including, in the case of real property, whether or not the property shall continue to be occupied by the debtor who

has defaulted (regardless of whether such creditor has obtained indefeasible title to the property), or

(iii) Sells or otherwise disposes of the security property or any interest therein.

(2) **Agreement or process of law.** The reduction of security property to ownership or possession by agreement includes, where valid under local law, such methods as voluntary conveyance from the debtor (including a conveyance directly to the Federal Housing Commissioner) and abandonment to the creditor. The reduction of security property to ownership or possession by process of law includes foreclosure proceedings in which a competitive bid is entered, such as foreclosure by judicial sale or by power of sale contained in the loan agreement without recourse to the courts, as well as those types of foreclosure proceedings in which a competitive bid is not entered, such as strict foreclosure and foreclosure by entry and possession, by writ of entry, or by publication or notice.

(c) **Examples.** The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). On January 31, 1963, X, a creditor which is an organization described in section 593(a), purchases at a foreclosure sale residential real property which was security for a debt owing to X, and with respect to which the debtor has defaulted. Under local law, there is a 1-year statutory redemption period (during which period the debtor is entitled to remain in possession) so that X must wait until February 1, 1964, to obtain indefeasible title to the property. No gain or loss is recognized by reason of the purchase at the foreclosure sale on January 31, 1963. However, the date on which the security property is considered as reduced to ownership or possession by agreement or process of law is February 1, 1964. If, under local law, there were no statutory redemption period so that X obtained indefeasible title to the security property at the foreclosure sale, the date on which the security property would be considered as so reduced is January 31, 1963. Furthermore, with respect to either of the preceding situations, if the foreclosure sale had occurred on November 1, 1962 (instead of on January 31, 1963), section 595 would not apply to the transaction since the taxable event in respect of such transaction occurred prior to January 1, 1963.

Example (2). The facts are the same as in example (1), except that instead of purchasing the property at a foreclosure sale, X, pursuant to the provisions of local law, enters upon the security property on January 31, 1963, and acquires an enforceable right to direct whether the property shall continue to be occupied by the debtor. X does not obtain indefeasible title to the property until February 1, 1964. The date on which the security property is considered as reduced to ownership or possession by agreement or process of law is January 31, 1963.

(d) **Basis of acquired property.** Section 595(c) provides that the basis of any property to which section 595(a) applies (hereinafter referred to as "acquired property") shall be the adjusted basis of the indebtedness for which such property was security, determined as of the date of acquisition of such property, properly increased for costs of acquisition. The date of acquisition is the date, determined under paragraph (b) of this section, on which the security property is reduced to ownership or possession by agreement or process of law. Costs of acquisition are expenditures incurred by the creditor (for example, fees for an attorney, master, trustee, auctioneer, for publication, acquiring title, clearing liens, filing and recording, and court costs) which are directly related to the foreclosure sale or proceeding, or to the other process used to reduce the security property to ownership or possession, or both, by agreement or process of law. For purposes of determining the adjusted basis of the indebtedness for which the acquired property was security, there shall be included the amount of any unpaid interest with respect to such indebtedness, but only to the extent that it has been included in gross income. The basis of the acquired property, as determined under this paragraph, shall be adjusted in accordance with the rules provided in paragraph (e) of this section.

(e) **Characteristics of acquired property—(1) Depreciation; decline in fair market value.** Section 595(b) provides, in part, that for purposes of section 166 (relating to bad debts) acquired property shall be considered as property having the same characteristics as the indebtedness for which such property was security. Thus, no deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed to a creditor with respect to acquired property. However, if, at any time, the adjusted basis of the acquired property exceeds the fair market value of such property (determined by proper appraisal and without regard to any outstanding right of redemption), and the creditor can establish (in the same manner as worthlessness in whole or in part is established for purposes of section 166) that an amount equal to any portion of such excess will not be collected with respect to the indebtedness for which such property was security, the creditor may treat such portion, under the provisions of section 166, as a worthless debt. In such case, the basis of the acquired property shall be reduced by the amount treated as a worthless debt.

(2) **Example.** The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. X Corporation, a creditor which is an organization described in section 593(a), makes its returns on the basis of the calendar year and the reserve method of accounting for bad debts. In 1963, A defaults in his payments on a debt owed to X which is secured by residential real property. X reduces

the property to ownership or possession by agreement or process of law by bidding it in at a foreclosure sale for $23,000. The adjusted basis of the indebtedness at the date of acquisition of the property (increased for costs of acquisition) is $25,000, and this amount becomes the basis of the acquired property. X obtains a deficiency judgment against A for $2,000. Later in 1963, a proper appraisal enables X to establish that the fair market value of the property is $18,000. X is also able to establish (under the rules of section 166 and the regulations thereunder) that due to A's poor financial condition only $1,000 can be collected on the outstanding deficiency judgment. For the year 1963, X may charge its bad debt reserve for $6,000, computed as follows:

Basis of acquired property	$25,000
Less: Fair market value of acquired property	18,000
Excess	7,000
Less: Collectible portion of deficiency judgment	1,000
Portion of excess treated as worthless debt	6,000

(3) **Capital improvements made after date of acquisition not treated as acquired property.** Except as provided in subparagraph (4) of this paragraph, the term "acquired property" does not include capital improvements made after the date of (acquisition within the meaning of paragraph (d) of this section) of the property. Thus, the applicable deduction for exhaustion, wear and tear, obsolescence, amortization, or depletion shall be allowed, if otherwise allowable, for improvements which are made by the creditor with respect to acquired property and which are properly chargeable to the capital account. If the creditor sells or otherwise disposes of the acquired property with such capital improvements, any amount realized by reason of such sale or other disposition shall be allocated in proportion to the respective fair market values of the acquired property and such capital improvements. The portion of the amount realized which is allocable to the acquired property shall be treated in accordance with the rules prescribed in subparagraph (6) of this paragraph. The portion of the amount realized which is allocable to such capital improvements shall be treated under the applicable rules governing the sale or other disposition of such property and without regard to section 595.

(4) **Treatment of minor capital improvements as acquired property.** A creditor may treat any minor capital improvements which it makes to a particular acquired property after the date of acquisition (within the meaning of paragraph (d) of this section) in the same manner as the acquired property, provided such creditor treats all minor capital improvements with respect to that particular acquired property in such manner. For purposes of section 595, a capital improvement shall be considered as "minor" only if the cost of such improvement does not exceed $3,000.

(5) **Records for capital improvements.** For purposes of subparagraphs (3) and (4) of this paragraph, the creditor must maintain such records as are necessary to clearly reflect, with respect to each particular acquired property, the cost of each capital improvement and whether the taxpayer treated minor capital improvements with respect to such property in the same manner as the acquired property.

(6) **Amounts realized with respect to acquired property.** Section 595(b) provides, in part, that any amount realized with respect to acquired property shall be treated as a payment on account of the indebtedness for which such property was security, and any loss with respect thereto shall be treated as a bad debt to which the provisions of section 166 (relating to bad debts) apply. An amount realized with respect to acquired property means an amount representing a recovery of capital, such as proceeds from the sale or other disposition of the property, payments on the original indebtedness made by or on behalf of the debtor (including amounts received under an insurance contract with the Federal Housing Administration or a guarantee by the Veterans' Administration), and collections on a deficiency judgment obtained against the debtor (other than amounts treated as interest under applicable local law). Amounts realized with respect to acquired property include amounts which otherwise would be treated in the manner prescribed in section 351 (relating to transfer to a corporation controlled by transferor), section 354 (relating to exchanges of stock and securities in certain reorganizations), section 453 (relating to installment method), section 1031 (relating to exchange of property held for productive use or for investment), or section 1033 (relating to involuntary conversions). For purposes of section 595(b), if a corporation distributes acquired property in a distribution to which section 311 (relating to taxability of corporation on distribution) or section 336 (relating to nonrecognition of gain or loss to a corporation on distribution of its property in partial or complete liquidation) applies, the fair market value of the acquired property at the time of the distribution shall be treated as an amount realized with respect to such property. However, no amount shall be considered realized by reason of the distribution or transfer of acquired property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, and in the case of such a distribution or transfer the acquired property shall be treated by the distributee or transferee as having the same characteristics as it had in the hands of the distributor or transferor at the time of such distribution

or transfer. The following rules shall apply to amounts realized with respect to acquired property:

(i) Any amount realized shall be applied against and reduce the adjusted basis of the acquired property, and to the extent that such amount exceeds the adjusted basis, it shall, in the case of a creditor using the specific deduction method of accounting for bad debts, be included in gross income as ordinary income, or, in the case of a creditor using the reserve method of accounting for bad debts, be credited to the appropriate bad debt reserve (that is, the reserve for losses on qualifying real property loans or the reserve for losses on nonqualifying loans). Any amounts credited during the taxable year to a reserve for bad debts pursuant to this subdivision shall not be considered as a part of the addition under section 593 for such year, but shall be included in the balance of the reserve for purposes of computing such addition to the reserve for such taxable year. Thus, for example, an amount credited to the reserve for losses on qualifying real property loans during a taxable year shall not be considered as a part of the addition to such reserve computed under the percentage of taxable income method. However, the amount of such credit shall be included in the balance of such reserve for the purpose of determining the amount necessary to increase the balance of such reserve (as of the close of such taxable year) to an amount equal to 3 percent of qualifying real property loans and for the purpose of determining whether such balance exceeds 6 percent of such loans.

(ii) If an amount realized on the sale or other disposition of the acquired property is insufficient to restore to the creditor the adjusted basis of the property, the difference between such adjusted basis and such amount realized shall be treated as a bad debt to which the provisions of section 166 apply. If the creditor subsequently realizes an additional amount with respect to the original indebtedness or the acquired property, such additional amount shall be treated as the recovery of a bad debt.

(7) Treatment of rents, similar amounts, and expenses. Section 595 does not change the treatment of rents, royalties, dividends, interest, or similar amounts received or accrued by the creditor with respect to acquired property, nor does it change the treatment of expenses incurred with respect to such property. (See, however, subparagraph (1) of this paragraph for treatment of depreciation, etc.) Thus, for example, if the acquired property is a governmental obligation within the meaning of section 103 (relating to interest on certain governmental obligations), interest payments received by the creditor with respect to such obligation would not be included in gross income.

(8) Examples. The provisions of subparagraphs (6) and (7) of this paragraph may be illustrated by the following examples:

Example (1)—(i) Facts. X Corporation, a creditor which is an organization described in section 593(a), uses the reserve method of accounting for bad debts. On May 1, 1964, X reduces to ownership or possession by agreement or process of law improved real property which is security for an indebtedness of A which is in default. On the date of acquisition there remains unpaid on the indebtedness $20,000 principal and $700 interest. X has previously included the $700 interest in gross income. Subsequent to acquisition, X incurs expenses totaling $500 for maintenance, and during the period June 1 through September 30, 1964, rents the property for a total rental of $400. Under local law, X is accountable to A for the rents received and A is accountable to X for the expenses incurred. There are no other receipts or expenses until October 1, 1964, at which time X sells the acquired property for $22,000. Under local law, A is not entitled to any portion of the sales proceeds.

(ii) Treatment of rents, expenses, and sales proceeds. X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale	20,800
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,800
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,800)	1,200

(iii) Creditor using specific deduction method. If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,200 portion of the sales proceeds would be treated as ordinary income.

Example (2)—(i) Facts. The facts are the same as in example (1) except that under local law X is not accountable to A for any portion of the rents received and A is not accountable to X for the expenses incurred by X.

(ii) Treatment of rents and expenses. X includes in gross income the total rent receipts of $400 and deducts (if otherwise allowable) the expenses of $500.

(iii) Treatment of sales proceeds. As the result of the sale of the acquired property, X credits $1,300 to the reserve for losses on qualifying real property loans, computed as follows:

Basis of acquired property at acquisition and at date of sale (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Less: Portion of $22,000 sales proceeds applied in reduction of adjusted basis of acquired property	20,700
	0
Portion of sales proceeds credited to reserve for losses on qualifying real property loans ($22,000 minus $20,700)	1,300

(iv) **Creditor using specific deduction method.** If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the $1,300 portion of the sales proceeds would be treated as ordinary income.

Example (3)—(i) Facts. The facts are the same in example (1) except that X sells the acquired property for $15,000.

(ii) **Treatment of rents, expenses, and sales proceeds.** X would treat rents, expenses, and sales proceeds in the following manner:

Basis of acquired property at acquisition (adjusted basis of indebtedness, i.e., $20,000 principal plus $700 interest)	$20,700
Plus: Expenses charged to debtor	500
	21,200
Less: Rents credited to debtor	400
Adjusted basis of acquired property at sale ...	20,800
Less: Portion of $15,000 sales proceeds applied in reduction of adjusted basis of acquired property	15,000
Amount charged to reserve for losses on qualifying real property loans	5,800

(iii) **Creditor using specific deduction method.** If instead of using the reserve method of accounting for bad debts X used the specific deduction method, the excess of $5,800 would be allowed as a specific bad debt deduction.

[T.D. 6814, 30 FR 4473, April 7, 1965]

§ 1.596–1 Limitation on dividends received deduction.

(a) In general. For taxable years beginning after July 11, 1969, in the case of mutual savings banks, domestic building and loan associations, and cooperative banks, if the addition to the reserve for losses on qualifying real property loans for the taxable year is determined under section 593(b)(2) (relating to the percentage of taxable income method), the total amount allowed as a deduction with respect to dividends received under part VIII, subchapter B, chapter 1, subtitle A of the Code (section 241 et seq.) (determined without regard to section 596 and this section) for such taxable year is reduced as provided by this section. In such case, the dividends received deduction otherwise determined under part VIII, subchapter B, chapter 1, subtitle A of the Code, is reduced by an amount equal to the applicable percentage for such year (determined solely under subparagraphs (A) and (B) of section 593(b)(2) and the regulations thereunder) of such total amount. For the rule under which a mutual savings bank, domestic building and loan association, or cooperative bank is deemed to have determined the addition to its reserve for losses on qualifying real property loans for the taxable year under section 593(b)(2), see § 1.593–6A(a)(2).

(b) Example. The provisions of this section may be illustrated by the following example:

Example. X Corporation, a domestic building and loan association, determines the addition to its reserve for losses on qualifying real property loans under section 593(b)(2) for its taxable year beginning in 1971. During that taxable year, X Corporation received a total of $100,000 as dividends from domestic corporations subject to tax under chapter 1 of the Code. X Corporation received no other dividends during the taxable year. Under part VIII, subchapter B, chapter 1, subtitle A of the Code, a deduction, determined without regard to section 596 and this section, of $85,000 would be allowed with respect to the dividends. For the taxable year, the applicable percentage, determined under subparagraphs (A) and (B) of section 593(b)(2), is 54 percent. Under section 596 and this section, the amount allowed as a deduction under section 243 and the regulations thereunder is reduced by $45,900 (54 percent of $85,000) to $39,100 ($85,000 less $45,900).

(c) Dividends received by members of a controlled group. If a thrift institution that computes a deduction under section 593(b)(2) is a member of a controlled group of corporations (within the meaning of section 1563(a), determined by substituting "50 percent" for "80 percent" each place it appears therein) and if the thrift institution, without a bona fide business purpose, transfers stock, directly or indirectly, to another member of the group, the Commissioner may allocate any dividends with respect to the stock to the thrift institution. If the Commissioner allocates a dividend to a thrift institution under this paragraph (c), the Commissioner will also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation, at a time and in a manner consistent with the procedures of § 1.482–1(d)(2). This paragraph (c) applies to taxable years ending on or after August 30, 1975.

[T.D. 7149, 36 FR 20944, Nov. 2, 1971, as amended by T.D. 7631, 44 FR 40496, July 11, 1979]

Bank Affiliates

§ 1.601-1 Special deduction for bank affiliates.

(a) The special deduction described in section 601 is allowed:

(1) To a holding company affiliate of a bank, as defined in section 2 of the Banking Act of 1933 (12 U.S.C. 221a), which holding company affiliate holds, at the end of the taxable year, a general voting permit granted by the Board of Governors of the Federal Reserve System.

(2) In the amount of the earnings or profits of such holding company affiliate which, in compliance with section 5144 of the Revised Statutes (12 U.S.C. 61), has been devoted by it during the taxable year to the acquisition of readily marketable assets other than bank stock.

(3) Upon certification by the Board of Governors of the Federal Reserve System to the Commissioner that such an amount of the earnings or profits has been so devoted by such affiliate during the taxable year.

No deduction is allowable under section 601 for the amount of readily marketable assets in excess of what is required by section 5144 of the Revised Statutes (12 U.S.C. 61) to be acquired by such affiliate, or in excess of the taxable income for the taxable year computed without regard to the special deductions for corporations provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code. Nor may the aggregate of the deductions allowable under section 601 and the credits allowable under the corresponding provision of any prior income tax law for all taxable years exceed the amount required to be devoted under such section 5144 to the acquisition of readily marketable assets other than bank stock.

(b) Every taxpayer claiming a deduction provided for in section 601 shall attach to its return a supplementary statement setting forth all the facts and information upon which the claim is predicated, including such facts and information as the Board of Governors of the Federal Reserve System may prescribe as necessary to enable it, upon the request of the Commissioner subsequent to the filing of the return, to certify to the Commissioner the amount of earnings or profits devoted to the acquisition of such readily marketable assets. A certified copy of such supplementary statement shall be forwarded by the taxpayer to the Board of Governors at the time of the filing of the return. The holding company affiliate shall also furnish the Board of Governors such further information as the Board shall require. For the requirements with respect to the amount of such readily marketable assets which must be acquired and maintained by a holding company affiliate to which a voting permit has been granted, see section 5144(b) and (c) of the Revised Statutes (12 U.S.C. 61).

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

NATURAL RESOURCES

Deductions

§ 1.611-0 Regulatory authority.

Sections 1.611-1 through 1.614-8, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 611(a) of the Code to prescribe regulations under which a reasonable allowance for depletion and depreciation of improvements shall be allowed, according to the peculiar conditions in each case, in the case of mines, oil and gas wells, other natural deposits and timber.

[T.D. 6965, 33 FR 10692, July 26, 1968]

§ 1.611-1 Allowance of deduction for depletion.

(a) Depletion of mines, oil and gas wells, other natural deposits, and timber—(1) In general. Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. In the case of standing timber, the depletion allowance shall be computed solely upon the adjusted basis of the property. In the case of other exhaustible natural resources the allowance for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

(2) See § 1.611–5 for methods of depreciation relating to improvements connected with mineral or timber properties.

(3) See paragraph (d) of this section for definition of terms.

(b) **Economic interest.** (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

(2) No depletion deduction shall be allowed the owner with respect to any timber, coal, or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or iron ore, if such disposal is considered a sale of timber, coal, or domestic iron ore under section 631(b) or (c).

(c) **Special rules—(1) In general.** For the purpose of the equitable apportionment of depletion among the several owners of economic interests in a mineral deposit or standing timber, if the value of any mineral or timber must be ascertained as of any specific date for the determination of the basis for depletion, the values of such several interests therein may be determined separately, but, when determined as of the same date, shall together never exceed the value at that date of the mineral or timber as a whole.

(2) **Leases.** In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interests in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder.

(3) **Life tenant and remainderman.** In the case of property held by one person for life with remainder to another person, the deduction for depletion under section 611 shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(4) **Mineral or timber property held in trust.** If a mineral property or timber property is held in trust, the allowable deduction for depletion is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income from such property allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depletion in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depletion reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(i) If under the trust instrument of local law the income of a trust computed without regard to depletion is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(ii) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depletion in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depletion reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depletion deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument, except as otherwise provided in this paragraph when the

trust instrument or local law requires or permits the trustee to maintain a reserve for depletion.

(5) Mineral or timber property held by estate. In the case of a mineral property or timber property held by an estate the deduction for depletion under section 611 shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of income of the estate from such property which is allocable to each.

(d) Definitions. As used in this part, and the regulations thereunder, the term—

(1) "Property" means—(i) in the case of minerals, each separate economic interest owned in each mineral deposit in each separate tract or parcel of land or an aggregation or combination of such mineral interests permitted under section 614(b), (c), (d), or (e); and (ii) in the case of timber, an economic interest in standing timber in each tract or block representing a separate timber account (see paragraph (d) of § 1.611–3). For rules with respect to waste or residue of prior mining, see paragraph (c) of § 1.614–1. When, in the regulations under this part, either the word "mineral" or "timber" precedes the word "property", such adjectives are used only to classify the type of "property" involved. For further explanation of the term "property", see section 614 and the regulations thereunder.

(2) "Fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

(3) "Mineral enterprise" is the mineral deposit or deposits and improvements, if any, used in mining or in the production of oil and gas, and only so much of the surface of the land as is necessary for purposes of mineral extraction. The value of the mineral enterprise is the combined value of its component parts.

(4) "Mineral deposit" refers to minerals in place. When a mineral enterprise is acquired as a unit, the cost of any interest in the mineral deposit or deposits is that proportion of the total cost of the mineral enterprise which the value of the interest in the deposit or deposits bears to the value of the entire enterprise at the time of its acquisition.

(5) "Minerals" includes ores of the metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits, except minerals derived from sea water, the air, or from similar inexhaustible sources. It includes but is not limited to all of the minerals and other natural deposits subject to depletion based upon a percentage of gross income from the property under section 613 and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7261, 38 FR 5467, March 1, 1973]

§ 1.611–2 Rules applicable to mines, oil and gas wells, and other natural deposits.

(a) Computation of cost depletion of mines, oil and gas wells, and other natural deposits. (1) The basis upon which cost depletion is to be allowed in respect of any mineral property is the basis provided for in section 612 and the regulations thereunder. After the amount of such basis applicable to the mineral property has been determined for the taxable year, the cost depletion for that year shall be computed by dividing such amount by the number of units of mineral remaining as of the taxable year (see subparagraph (3) of this paragraph), and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year (see subparagraph (2) of this paragraph). In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas.

(2) As used in this paragraph, the phrase "number of units sold within the taxable year"—

(i) In the case of a taxpayer reporting income on the cash receipts and disbursements method, includes units for which payments were received within the taxable year although produced or sold prior to the taxable year, and excludes units sold but not paid for in the taxable year, and

(ii) In the case of a taxpayer reporting income on the accrual method, shall be determined from the taxpayer's inventories kept in physical quantities and in a manner consistent with his method of inventory accounting under section 471 or 472.

The phrase does not include units with respect to which depletion deductions were allowed or allowable prior to the taxable year.

(3) "The number of units of mineral remaining as of the taxable year" is the number of units of mineral remaining at the end of the year to be recovered from the property (including units recovered but not sold) plus the "number of units sold within the taxable year" as defined in this section.

(4) In the case of a natural gas well where the annual production is not metered and is not capable of being estimated with reasonable accuracy,

the taxpayer may compute the cost depletion allowance in respect of such property for the taxable year by multiplying the adjusted basis of the property by a fraction, the numerator of which is equal to the decline in rock pressure during the taxable year and the denominator of which is equal to the expected total decline in rock pressure from the beginning of the taxable year to the economic limit of production. Taxpayers computing depletion by this method must keep accurate records of periodical pressure determinations.

(5) If an aggregation of two or more separate mineral properties is made during a taxable year under section 614, cost depletion for each such property shall be computed separately for that portion of the taxable year ending immediately before the effective date of the aggregation. Cost depletion with respect to the aggregated property shall be computed for that portion of the taxable year beginning on such effective date. The allowance for cost depletion for the taxable year shall be the sum of such cost depletion computations. For purposes of this paragraph, each such portion of the taxable year shall be considered as a taxable year. Similar rules shall be applied where a separate mineral property is properly removed from an existing aggregation during a taxable year. See section 614 and the regulations thereunder for rules relating to the effective date of an aggregation of mineral interests and for rules relating to the adjusted basis of an aggregation.

(6) The apportionment of the deduction among the several owners of economic interests in the mineral deposit or deposits will be made as provided in paragraph (c) of § 1.611-1.

(b) Depletion accounts of mineral property. **(1)** Every taxpayer claiming and making a deduction for depletion of mineral property shall keep a separate account in which shall be accurately recorded the cost or other basis provided by section 1012, of such property together with subsequent allowable capital additions to each account and all the other adjustments required by section 1016.

(2) Mineral property accounts shall thereafter be credited annually with the amounts of the depletion so computed in accordance with section 611 or 613 and the regulations thereunder; or the amounts of the depletion computed in shall be credited to depletion reserve accounts. No further deductions for cost depletion shall be allowed when the sum of the credits for depletion equals the cost or other basis of the property, plus allowable capital additions. However, depletion deductions may be allowable thereafter computed upon a percentage of gross income from the property. See section 613 and the regulations thereunder. In no event shall percentage depletion in excess of cost or other basis of the property be credited to the improvements account or the depreciation reserve account.

(c) Determination of mineral contents of deposits. **(1)** If it is necessary to estimate or determine with respect to any mineral deposit as of any specific date the total recoverable units (tons, pounds, ounces, barrels, thousands of cubic feet, or other measure) of mineral products reasonably known, or on good evidence believed, to have existed in place as of that date, the estimate or determination must be made according to the method current in the industry and in the light of the most accurate and reliable information obtainable. In the selection of a unit of estimate, preference shall be given to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the deposit for the purposes of valuation and depletion shall include as to both quantity and grade:

(i) The ores and minerals "in sight", "blocked out", "developed", or "assured", in the usual or conventional meaning of these terms with respect to the type of the deposits, and

(ii) "Probable" or "prospective" ores or minerals (in the corresponding sense), that is, ores or minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development. Such "probable" or "prospective" ores or minerals may be estimated:

(a) As to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological surveys or other evidence to a high degree of probability, and

(b) As to grade, only in accordance with the best indications available as to richness.

(2) If the number of recoverable units of mineral in the deposit has been previously estimated for the prior year or years, and if there has been no known change in the facts upon which the prior estimate was based, the number of recoverable units of mineral in the deposit as of the taxable year will be the number remaining from the prior estimate. However, for any taxable year for which it is ascertained either by the taxpayer or the district director from any source, such as operations or development work prior to the close

of the taxable year, that the remaining recoverable mineral units as of the taxable year are materially greater or less than the number remaining from the prior estimate, then the estimate of the remaining recoverable units shall be revised, and the annual cost depletion allowance with respect to the property for the taxable year and for subsequent taxable years will be based upon the revised estimate until a change in the facts requires another revision. Such revised estimate will not, however, change the adjusted basis for depletion.

(d) Determination of fair market value of mineral properties, and improvements, if any. (1) If the fair market value of the mineral property and improvements at a specified date is to be determined for the purpose of ascertaining the basis, such value must be determined, subject to approval or revision by the district director, by the owner of such property and improvements in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments or subsequent improvements in methods of extraction and treatment of the mineral product. The district director will give due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties and improvements, bona fide offers, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property and improvements was in question, the amount at which the property and improvements may have been inventoried or appraised in probate or similar proceedings, and disinterested appraisals by approved methods.

(2) If the fair market value must be ascertained as of a certain date, analytical appraisal methods of valuation, such as the present value method will not be used:

(i) If the value of a mineral property and improvements, if any, can be determined upon the basis of cost or comparative values and replacement value of equipment, or

(ii) If the fair market value can reasonably be determined by any other method.

(e) Determination of the fair market value of mineral property by the present value method. (1) To determine the fair market value of a mineral property and improvements by the present value method, the essential factors must be determined for each mineral deposit. The essential factors in determining the fair market value of mineral deposits are:

(i) The total quantity of mineral in terms of the principal or customary unit (or units) paid for in the product marketed,

(ii) The quantity of mineral expected to be recovered during each operating period,

(iii) The average quality or grade of the mineral reserves,

(iv) The allocation of the total expected profit to the several processes or operations necessary for the preparation of the mineral for market,

(v) The probable operating life of the deposit in years,

(vi) The development cost,

(vii) The operating cost,

(viii) The total expected profit,

(ix) The rate at which this profit will be obtained, and

(x) The rate of interest commensurate with the risk for the particular deposit.

(2) If the mineral deposit has been sufficiently developed, the valuation factors specified in subparagraph (1) of this paragraph may be determined from past operating experience. In the application of factors derived from past experience, full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of development, production, interest rate, and selling price of the product marketed during the expected operating life of the mineral deposit. Mineral deposits for which these factors cannot be determined with reasonable accuracy from past operating experience may also be valued by the present value method; but the factors must be deduced from concurrent evidence, such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits, the intensity of mineralization, the oil-gas ratio, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the deposit, and any other evidence tending to establish a reasonable estimate of the required factors.

(3) Mineral deposits of different grades, locations, and probable dates of extraction should be valued separately. The mineral content of a deposit shall be determined in accordance with paragraph (c) of this section. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases

or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or reasonably to be expected for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating life of oil and gas wells is also influenced by the natural decline in pressure and flow, and by voluntary or enforced curtailment of production. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions, as described in §§ 1.612–2 and 1.612–4, and deductions for depreciation and depletion, but including cost of repairs. This cost of repairs is not to be confused with the depreciation deduction by which the cost of improvements is returned to the taxpayer free from tax. In general, no estimates of these factors will be approved by the district director which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods.

(4) The value of each mineral deposit is measured by the expected gross income (the number of units of mineral recoverable in marketable form multiplied by the estimated market price per unit) less the estimated operating cost, reduced to a present value as of the date for which the valuation is made at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at that date of the improvements and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral enterprise before the date for which the valuation is made. On the other hand, higher risks ordinarily attach to appraisals upon any other basis.

(f) Revaluation of mineral property not allowed. No revaluation of a mineral property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner.

(g) Statement to be attached to return when valuation, depletion, or depreciation of mineral property or improvements are claimed. (1) For the first taxable year ending before December 31, 1967, for which a taxpayer asserts a value for any mineral property or improvement as of a specific date or claims a deduction for depletion, or depreciation, there shall be attached to the return of the taxpayer for such taxable year a statement setting forth, in complete, summary form, the pertinent information required by this paragraph with respect to each such mineral property or improvement (including oil and gas properties or improvements). The summary statement shall be deemed a part of the income tax return to which it relates. In addition to such summary statement, the taxpayer must assemble, segregate and have readily available at his principal place of business, all the supporting data (listed in subparagraphs (2), (3), and (4) of this paragraph) which is used in compiling the summary statement. For taxable years after such first taxable year, and ending before December 31, 1967, the taxpayer need attach to his return only an explanation of the changes, if any, in the information previously furnished. For example, when a taxpayer has filed adequate maps with the district director he may be relieved of filing further maps of the same area, if all additional information necessary for keeping the maps up-to-date is filed each year. In any case in which any of the information required by this paragraph has been previously filed by the taxpayer (including information furnished in accordance with corresponding provisions of prior regulations), such information need not be filed again, but a statement should be attached to the return of the taxpayer indicating clearly when and in what form such information was previously filed. For provisions relating to the data which shall be submitted with returns for taxable years ending on or after December 31, 1967, see subparagraph (5) of this paragraph.

(2) The information referred to in subparagraph (1) of this paragraph is as follows:

(i) An adequate map showing the name, description, location, date of surveys, and identification of the deposit or deposits;

(ii) A description of the character of the taxpayer's property, accompanied by a copy of the instrument or instruments by which it was acquired;

(iii) The date of acquisition of the property, the exact terms and dates of expiration of all leases involved, and if terminated, the reasons therefor;

(iv) The cost of the mineral property and improvements, stating the amount paid to each vendor, with his name and address;

(v) The date as of which the mineral property and improvements are valued, if a valuation is necessary to establish the basis as provided by section 1012;

(vi) The value of the mineral property and improvements on that date with a statement of the precise method by which it was determined;

(vii) An allocation of the cost or value among the mineral property, improvements and the surface of the land for purposes other than mineral production;

(viii) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(ix) The number of units sold and the number of units for which payment was received or accrued during the year for which the return is made (in the case of newly developed oil and gas deposits it is desirable that this information be furnished by months);

(x) The gross amount received from the sale of mineral;

(xi) The amount of depreciation for the taxable year and the amount of cost depletion for the taxable year;

(xii) The amounts of depletion and depreciation, if any, stated separately, which for each and every prior year:

(a) Were allowed (see section 1016(a)(2)),

(b) Were allowable, and

(c) Would have been allowable without reference to percentage or discovery depletion;

(xiii) The fractions (however measured) of gross production from the deposit or deposits to which the taxpayer and other persons are entitled together with the names and addresses of such other persons; and

(xiv) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deductions claimed.

(3) In the case of oil and gas properties, the following information with respect to each property is required in addition to that information set forth in subparagraph (2) of this paragraph:

(i) The number of acres of producing oil or gas land and, if additional acreage is claimed to be proven, the amount of such acreage and the reasons for believing it to be proven;

(ii) The number of wells producing at the beginning and end of the taxable year;

(iii) The date of completion of each well finished during the taxable year;

(iv) The date of abandonment of each well abandoned during the taxable year;

(v) Maps showing the location of the tracts or leases and of the producing and abandoned wells, dry holes, and proven oil and gas lands (the maps should show depth, initial production, and date of completion of each well, etc., to the extent that these data are available);

(vi) The number of pay sands and average thickness of each pay sand or zone;

(vii) The average depth to the top of each of the different pay sands;

(viii) The annual production of the deposit or of the individual wells, if the latter information is available, from the beginning of its productivity to the end of the taxable year, the average number of wells producing during each year, and the initial daily production of each well (the extent to which oil or gas is used for fuel on the premises should be stated with reasonable accuracy);

(ix) All available data regarding change in operating conditions, such as unit operation, proration, flooding, use of air-gas lift, vacuum, shooting, and similar information, which have a direct effect on the production of the deposit; and

(x) Available geological information having a probable bearing on the oil and gas content; information with respect to edge water, water drive, bottom hole pressures, oil-gas ratio, porosity of reservoir rock, percentage of recovery, expected date of cessation of natural flow, decline in estimated potential, and characteristics similar to characteristics of other known fields.

(4) For rules relating to an additional statement to be attached to the return when the depletion deduction is computed upon a percentage of gross income from the property, see § 1.613–6.

(5) A taxpayer who claims a total deduction of more than $200 for depletion of mines, oil and gas wells, or other natural deposits for the taxable year ending on or after December 31, 1967, and before December 31, 1968, shall submit with his return for such taxable year a filled-out Form M (Mines and Other Natural Deposits—Depletion Data) or Form O (Oil and Gas Depletion Data). See section 6011(a). For the purpose of this subparagraph, the determination under section 631(c) of gain or loss upon the disposition of coal or domestic iron ore with a retained economic interest shall not be regarded as the claiming of a deduction for depletion. Such forms shall be filed for any subsequent taxable year if the Commissioner determines that the forms are required for such year. Where appropriate, both Form M and Form O shall be filed. Forms M and O shall be deemed to be part of the return to which they relate. If a taxpayer mines more than one mineral, a separate Form M shall be filed for each such mineral. If a taxpayer has both domestic and foreign properties, separate forms shall be filed for each country in which a taxpayer's properties are located. All data relating to a taxpayer's domestic oil and gas properties shall be summarized on a single Form O, and data relating to a taxpayer's domestic mineral properties (other than oil and gas properties) shall be summarized on a single Form M for each mineral. Similarly, all data relating to a taxpayer's oil and gas properties in a specific foreign country shall be summarized on a single Form O, and data relating to a taxpayer's mineral properties (other than oil and gas properties) in a specific foreign country shall be summarized on a single Form M for each mineral. In addition, the taxpayer shall assemble, segregate, and have readily available at his principal place of business, the data listed in subparagraphs (2), (3), and (4) of this paragraph.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6938, 32 FR 17518, Dec. 7, 1967; T.D. 7170, 37 FR 5373, March 15, 1972]

§ 1.611–3 Rules applicable to timber.

(a) Capital recoverable through depletion allowance in case of timber. In general, the capital remaining in any year recoverable through depletion allowances is the basis provided by section 612 and the regulations thereunder. For the method of determining fair market value and quantity of timber, see paragraphs (d), (e), and (f) of this section. For capitalization of carrying charges, see section 1016(a)(1)(A). Amounts paid or incurred in connection with the planting of timber (including planting for Christmas tree purposes) shall be capitalized and recoverable through depletion allowances. Such amounts include, for example, expenditures made for the preparation of the timber site for planting or for natural seeding and the cost of seedlings. The apportionment of deductions between the several owners of economic interests in standing timber will be made as provided in paragraph (c) of § 1.611–1.

(b) Computation of allowance for depletion of timber for taxable year. (1) The depletion of timber takes place at the time timber is cut, but the amount of depletion allowable with respect to timber that has been cut may be computed when the quantity of cut timber is first accurately measured in the process of exploitation. To the extent that depletion is allowable in a particular taxable year with respect to timber the products of which are not sold during such year, the depletion so allowable shall be included as an item of cost in the closing inventory of such products for such year.

(2) The depletion unit of the timber for a given timber account in a given year shall be the quotient obtained by dividing (i) the basis provided by section 1012 and adjusted as provided by section 1016, of the timber on hand at the beginning of the year plus the cost of the number of units of timber acquired during the year plus proper additions to capital, by (ii) the total number of units of timber on hand in the given account at the beginning of the year plus the cost of the number of units of timber acquired during the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account. The number of units of timber of a given timber account cut during any taxable year multiplied by the depletion unit of that timber account applicable to such year shall be the amount of depletion allowable for the taxable year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on such basis, in which case the amount allowable on account of depletion for a given month will be determined in the manner outlined herein for a given year. The total amount of the allowance for depletion in any taxable year shall be the sum of the amounts allowable for the several timber accounts. For a description of timber accounts, see paragraphs (c) and (d) of this section.

(3) When a taxpayer has elected to treat the cutting of timber as a sale or exchange of such timber under the provisions of section 631(a), he shall reduce the timber account containing such timber by an amount equal to the adjusted depletion basis of such timber. In computing any further gain or loss on such timber, see paragraph (e) of § 1.631–1.

(c) **Timber depletion accounts on books.** (1) Every taxpayer claiming or expecting to claim a deduction for depletion of timber property shall keep accurate ledger accounts in which shall be recorded the cost or other basis provided by section 1012 of the property and land together with subsequent allowable capital additions in each account and all other adjustments provided by section 1016 and the regulations thereunder.

(2) In such accounts there shall be set up separately the quantity of timber, the quantity of land, and the quantity of other resources, if any, and a proper part of the total cost or value shall be allocated to each after proper provision for immature timber growth. See paragraph (d) of this section. The timber accounts shall be credited each year with the amount of the charges to the depletion accounts computed in accordance with paragraph (b) of this section or the amount of the charges to the depletion accounts shall be credited to depletion reserve accounts. When the sum of the credits for depletion equals the cost or other basis of the timber property, plus subsequent allowable capital additions, no further deduction for depletion will be allowed.

(d) **Aggregating timber and land for purposes of valuation and accounting.** (1) With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block". A block may be an operation unit which includes all the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's timber which would logically be removed by a single logging development. Blocks may also be established by geographical or political boundaries or by logical management areas. Timber acquired under cutting contracts should be carried in separate accounts and shall not constitute part of any block. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the district director on audit, the taxpayer may divide the timber in a given block into two or more accounts. For example, timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts. Individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts. Blocks may be divided into two or more accounts based on the character of the timber or its accessibility, or scattered tracts may be included in separate accounts. If such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(2) The timber accounts mentioned in subparagraph (1) of this paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in subparagraph (1) of this paragraph, the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

(3) The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively. In cases in which immature timber growth is a factor, a reasonable portion of the total value or cost shall be allocated to such immature timber, and when the timber becomes merchantable such value or cost shall be recoverable through depletion allowances.

(4) Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

(5) For good and substantial reasons satisfactory to the district director, or as required by the district director on audit, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts.

(e) **Determination of quantity of timber.** Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board measure, log scale, cords, or

other units) of timber reasonably known, or on good evidence believed, to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, whichever date is applicable in determining the basis for cost depletion. This estimate shall state as nearly as possible the number of units which would have been found present by careful estimate made on the specified date with the object of determining 100 percent of the quantity of timber which the area covered by the specific account would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, or of operations or development work, it is ascertained either by the taxpayer or the district director that there remain on the ground, available for utilization, more or less units of timber at the close of the taxable year (or at the close of the month if the taxpayer keeps his depletion accounts on a monthly basis) than remain in the timber account or accounts on the basis of the original estimate, then the original estimate (but not the basis for depletion) shall be revised. The depletion unit shall be changed when such revision has been made. The annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which the revision is made and all subsequent taxable years until a change in facts requires another revision.

(f) **Determination of fair market value of timber property.** (1) If the fair market value of the property at a specified date is the basis for depletion deductions, such value shall be determined, subject to approval or revision by the district director upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, and methods of exploitation, in degree of utilization, etc. Such factors as the following will be given due consideration:

(i) Character and quality of the timber as determined by species, age, size, condition, etc.;

(ii) The quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber;

(iii) Accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation and the climate and the state of industrial development of the locality); and

(iv) The freight rates by common carrier to important markets.

(2) The timber in each particular case will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned in this paragraph, will be consistent with that of other similar timber in the region. The district director will give weight and consideration to any and all facts and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors.

(g) **Revaluation of timber property not allowed.** No revaluation of a timber property whose value as of any specific date has been determined and approved will be made or allowed during the continuance of the ownership under which the value was so determined and approved, except in the case of misrepresentation or fraud or gross error as to any facts known on the date as of which the valuation was made. Revaluation on account of misrepresentation or fraud or such gross error will be made only with the written approval of the Commissioner. The depletion unit shall be revised when such a revaluation of a timber property has been made and the annual charge to the depletion account with respect to the property shall be computed by using such revised unit for the taxable year for which such revision is made and for all subsequent taxable years.

(h) **Information to be furnished by taxpayer claiming depletion of timber.** A taxpayer claiming a deduction for depletion of timber and for depreciation of plant and other improvements shall attach to his income tax return a filled-out Form T-Timber for the taxable year covered by the

income tax return, including the following information:

(1) A map where necessary to show clearly timber and land acquired, timber cut, and timber and land sold;

(2) Description of, cost of, and terms of purchase of timberland or timber, or cutting rights, including timber or timber rights acquired under any type of contract;

(3) Profit or loss from sale of land, or timber, or both;

(4) Description of timber with respect to which claim for loss, if any, is made;

(5) Record of timber cut;

(6) Changes in each timber account as a result of purchase, sale, cutting, reestimate, or loss;

(7) Changes in improvements accounts as the result of additions to or deductions from capital and depreciation, and computation of profit or loss on sale or other disposition of such improvements;

(8) Operation data with respect to raw and finished material handled and inventoried;

(9) Statement as to application of the election under section 631(a) and pertinent information in support of the fair market value claimed thereunder;

(10) Information with respect to land ownership and capital investment in timberland; and

(11) Any other data which will be helpful in determining the reasonableness of the depletion or depreciation deductions claimed in the return.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.611–4 Depletion as a factor in computing earnings and profits for dividend purposes.

For rules with respect to computation of earnings and profits where depletion is a factor in the case of corporations, see paragraph (c)(1) of § 1.312–6.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.611–5 Depreciation of improvements.

(a) In general. Section 611 provides in the case of mines, oil and gas wells, other natural deposits, and timber that there shall be allowed as a deduction a reasonable allowance for depreciation of improvements. Such allowance shall include exhaustion, wear and tear, and obsolescence. The deduction allowed under section 611 shall be determined under the provisions of section 167 and the regulations thereunder. For purposes of section 167 the unit of production method may, under appropriate circumstances, be considered a reasonable method under section 167(a), and therefore, not subject to the limitations prescribed by section 167(b).

(b) Special rules for mines, oil and gas wells, other natural deposits and timber. (1) For principles governing the apportioning of depreciation allowances under sections 611 and 167 in the case of property held by one person for life with remainder to another or in the case of property held in trust or by an estate, see § 1.167(h)–1.

(2) A reasonable allowance for depreciation on account of obsolescence or decay shall be required in an appropriate case during periods when the improvement is not used in production or is used in producing at a rate below its normal capacity. This rule is applicable whether or not the taxpayer uses the unit of production method.

(3) See sections 615 and 616 and the regulations thereunder for special rules for treatment of allowances for depreciation of improvements with respect to the exploration and development of a mine or other natural deposit (other than oil or gas).

(4) In the case of operating oil or gas properties, the deduction for depreciation shall be allowed for those costs of improvements such as machinery, tools, equipment, pipes, and other similar items and the costs of installation which are not treated as a deductible expense under section 263(c). See § 1.612–4.

(c) Accounting and recordkeeping. See § 1.167(a)–7 for accounting and recordkeeping requirements for taxpayers claiming deductions under section 611 and this section.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, March 24, 1964; T.D. 6836, 30 FR 8902, July 15, 1965]

§ 1.612–1 Basis for allowance of cost depletion.

(a) In general. The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property except as provided in paragraph (b) of this section. The adjusted basis of such property is the cost or other

basis determined under section 1012, relating to the basis of property, adjusted as provided in section 1016, relating to adjustments to basis, and the regulations under such sections. In the case of the sale of a part of such property, the unrecovered basis thereof shall be allocated to the part sold and the part retained.

(b) **Special rules.** (1) The basis for cost depletion of mineral or timber property does not include:

(i) Amounts recoverable through depreciation deductions, through deferred expenses, and through deductions other than depletion, and

(ii) The residual value of land and improvements at the end of operations.

In the case of any mineral property the basis for cost depletion does not include amounts representing the cost or value of land for purposes other than mineral production. Furthermore, in the case of certain mineral properties, such basis does not include exploration or development expenditures which are treated under section 615(b) or 616(b) as deferred expenses to be taken into account as deductions on a ratable basis as the units of minerals benefited thereby are produced and sold. However, there shall be included in the basis for cost depletion of oil and gas property the amounts of capitalized drilling and development costs which, as provided in § 1.612–4, are recoverable through depletion deductions. In the case of timber property, the basis for cost depletion does not include amounts representing the cost or value of land.

(2) Where a taxpayer elects to treat the cutting of timber as a sale or exchange of such timber, the basis for cost depletion shall be the fair market value of such timber as of the first day of the taxable year in which such timber is cut and such value shall be considered for such taxable year and all subsequent taxable years as the cost of such timber for all purposes for which such cost is a necessary factor. See section 631(a).

(c) **Cross references.** In cases where the valuation, revaluation, or mineral content of deposits is a factor, see paragraphs (c), (d), (e), and (f) of § 1.611–2. In cases where the valuation, revaluation, or quantity of timber is a factor, see paragraphs (e), (f), and (g) of § 1.611–3. For definitions of the terms "property", "fair market value", "mineral enterprise", "mineral deposit", and "minerals", see paragraph (d) of § 1.611–1. For rules with respect to treatment of depletion accounts on taxpayers' books, see paragraph (b) of § 1.611–2 in the case of mineral property, and paragraph (c) of § 1.611–3 in the case of timber property.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.612–2 Allowable capital additions in case of mines.

(a) **In general.** Expenditures for improvements and for replacements, not including expenditures for ordinary and necessary maintenance and repairs, shall ordinarily be charged to capital account recoverable through depreciation deductions. Expenditures for equipment (including its installation and housing) and for replacements thereof, which are necessary to maintain the normal output solely because of the recession of the working faces of the mine and which—

(1) Do not increase the value of the mine, or

(2) Do not decrease the cost of production of mineral units, or

(3) Do not represent an amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made shall be deducted as ordinary and necessary business expenses.

(b) **Special rule.** For special provisions applicable to treatment of expenditures for certain exploration and development costs (other than for the acquisition, restoration, or betterment of improvements) with respect to minerals other than oil or gas, see sections 615 and 616 and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.612–3 Depletion; treatment of bonus and advanced royalty.

(a) **Bonus.** (1) If a bonus in addition to royalties is received upon the grant of an economic interest in a mineral deposit, or standing timber, there shall be allowed to the payee as a cost depletion deduction in respect of the bonus an amount equal to that proportion of his basis for depletion as provided in section 612 and § 1.612–1 which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the payee's basis for depletion and the remainder of the basis is recoverable through depletion deductions as the royalties are thereafter received. (But see paragraph (e) of this section.) For example, a taxpayer leases mineral property to another reserving a one-eighth royalty and in addition receives a bonus of $10,000. Assuming that the

taxpayer's basis with respect to the mineral property is $21,000 and that the royalties expected to be received are estimated to total $20,000, the depletion on the bonus would be $7,000:

[$21,000 (basis)×$10,000 (bonus)]÷$30,000 (bonus plus estimated royalties).

The remaining $14,000 of basis will be recovered through depletion as the royalties are received.

(2) If the grant of an economic interest in a mineral deposit or standing timber with respect to which a bonus was received expires, terminates, or is abandoned before there has been any income derived from the extraction of mineral or cutting of timber, the payee shall adjust his capital account by restoring thereto the depletion deduction taken on the bonus and a corresponding amount must be returned as income in the year of such expiration, termination, or abandonment.

(3) In the case of the payor, payment of the bonus constitutes a capital investment made for the acquisition of an economic interest in a mineral deposit or standing timber recoverable through the depletion allowance. See paragraph (c)(5)(ii) of § 1.613–2 in cases in which percentage depletion is used.

(b) Advanced royalties. (1) If the owner of an operating interest in a mineral deposit or standing timber is required to pay royalties on a specified number of units of such mineral or timber annually whether or not extracted or cut within the year, and may apply any amounts paid on account of units not extracted or cut within the year against the royalty on the mineral or timber thereafter extracted or cut, the payee shall compute cost depletion on the number of units so paid for in advance of extraction or cutting and shall treat the amount so determined as an allowable deduction for depletion from the gross income of the year in which such payment or payments are made. No deduction for depletion by such payee shall be claimed or allowed in any subsequent year on account of the extraction or cutting in such year of any mineral or timber so paid for in advance and for which deduction has once been made. (But see paragraph (e) of this section.)

(2) If the right to extract minerals or to cut timber against which the advanced royalties may be applied expires, terminates, or is abandoned before all such minerals or timber have been extracted or cut, the payee shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of any units of mineral or timber paid for in advance but not extracted or cut, and a corresponding amount must be returned as income for the year of such expiration, termination or abandonment. (But see paragraph (e) of this section.)

(3) The payor shall treat the advanced royalties paid or accrued in connection with mineral property as deductions from gross income for the year the mineral product, in respect of which the advanced royalties were paid or accrued, is sold. For purposes of the preceding sentence, in the case of mineral sold before production the mineral product is considered to be sold when the mineral is produced (*i.e.*, when a mineral product first exists). However, in the case of advanced mineral royalties paid or accrued in connection with mineral property as a result of a minimum royalty provision, the payor, at his option, may instead treat the advanced royalties as deductions from gross income for the year in which the advanced royalties are paid or accrued. See section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For purposes of this paragraph, a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. For special rules applicable when the payor is a sublessor of coal or domestic iron ore, see paragraph (b)(3) of § 1.631–3. Every taxpayer who pays or accrues advanced royalties resulting from a minimum royalty provision must make an election as to the treatment of all such advanced royalties in his return for the first taxable year ending after December 31, 1939, in which the advanced royalties are paid or accrued. The taxpayer's treatment of the advanced royalties for the first year shall be deemed to be the exercise of the election. Accordingly, a failure to deduct the advanced royalties for that year will constitute an election to have all the advanced royalties treated as deductions for the year of the sale of the mineral product in respect of which the advanced royalties are paid or accrued. See section 7807(b)(2). For additional rules relating to elections in the case of partners and partnerships, see section 703(b) and the regulations thereunder. The provisions of this subparagraph do not allow as deductions from gross income amounts disallowed as deductions under other provisions of the Code, such as section 461 (relating to general rule for taxable year of deduction), section 465 (relat-

ing to deductions limited to amount at risk in case of certain activities), or section 704(d) (relating to limitation on allowance to partners of partnership losses).

(4) The application of subparagraphs (2) and (3) of this paragraph may be illustrated by the following examples:

Example (1). B leased certain mineral lands from A under a lease in which A reserved a royalty of 10 cents a ton on minerals mined and sold by B. The lease also provided that B had to pay an annual minimum royalty of $10,000 representing the amount due on 100,000 tons of the particular mineral whether or not B mined and sold that amount. It was further provided that, if B did not mine and sell 100,000 tons in any year, he could mine and sell in any subsequent year the amount of mineral on which he had paid the royalty without the payment of any additional royalty. However, this right of recoupment was limited to minerals mined and sold in any later year in excess of the 100,000 tons represented by the $10,000 minimum royalty required to be paid for that later year. Assume that in 1956 B paid A the minimum royalty of $10,000, but mined and sold only 60,000 tons of the mineral and that in 1957 he abandoned the lease without any further production. Since the $10,000 represents royalties on 100,000 tons of mineral and only 60,000 tons were mined and sold, A must restore in 1957 to his capital account the depletion deductions taken in 1956 on $4,000 on account of the 40,000 tons paid for in advance but not mined and sold, and must also return the corresponding amount as income in 1957.

Example (2). Assume that B, under the lease in example (1), paid the $10,000 minimum royalty and mined no minerals in 1956 but that in 1957 B mined and sold 200,000 tons of mineral. If this is B's first such expenditure, B has an option, for the purpose of computing taxable income under section 63, to deduct in 1956 the $10,000 paid in that year although no mineral was mined, or to take the deduction in 1957 when the mineral, for which the $10,000 was paid in 1956, was mined and sold. (For treatment under percentage depletion, see example in paragraph (c)(5)(iii) of § 1.613–2.)

(c) **Delay rental.** (1) A delay rental is an amount paid for the privilege of deferring development of the property and which could have been avoided by abandonment of the lease, or by commencement of development operations, or by obtaining production.

(2) Since a delay rental is in the nature of rent it is ordinary income to the payee and not subject to depletion. The payor may at his election deduct such amount as an expense, or under section 266 and the regulations thereunder, charge it to depletable capital account.

(d) **Percentage depletion deduction with respect to bonus and advanced royalty.** In lieu of the allowance based on cost depletion computed under paragraphs (a) and (b) of this section, the payees referred to therein may be allowed a depletion deduction in respect of any bonus or advanced royalty for the taxable year in an amount computed on the basis of the percentage of gross income from the property as provided in section 613 and the regulations thereunder.

(e) **Cross reference.** In the case of bonuses and advanced royalties received in connection with a contract of disposal of timber covered by section 631(b) or coal or iron ore covered by section 631(c), see that section and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9305, July 27, 1965; T.D. 7523, 42 FR 63641, Dec. 19, 1977]

§ 1.612–4 Charges to capital and to expense in case of oil and gas wells.

(a) **Option with respect to intangible drilling and development costs.** In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of oil and gas properties may at his option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used—

(1) In the drilling, shooting, and cleaning of wells,

(2) In such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do not have a salvage value. For the

purpose of this option, labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of an oil and gas property whether incurred by him prior or subsequent to the formal grant or assignment to him of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(b) Recovery of optional items, if capitalized. (1) Items returnable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are returnable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items specified in subparagraphs (1) and (2) for the purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs, then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made in the return for the first taxable year beginning after December 31, 1942, in which such a nonproductive well is completed. Such election with respect to intangible drilling and development costs of nonproductive wells is a new election, and, when made, shall be binding for all subsequent years. Any taxpayer who incurs optional drilling and development costs in drilling a nonproductive well must make a clear statement of election under this option in the return for the first taxable year beginning after December 31, 1942, in which such nonproductive well is completed. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(c) Nonoptional items distinguished. (1) Capital items: The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the option provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas.

(d) Manner of making election. The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's return for the first taxable year in

which the taxpayer pays or incurs such costs; no formal statement is necessary. If the taxpayer fails to deduct such costs as expenses in such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

(e) **Effect of option and election.** This section does not grant a new option under paragraph (a) of this section or new election under paragraph (b) of this section. Section 3 of the Act of October 23, 1962 (Public Law 87–863, 76 Stat. 1142) granted any taxpayer who had exercised an option to capitalize intangible drilling and development costs under Regulations 111, § 29.23(m)–16 (1939 Code) or Regulations 118, § 39.23(m)–16 (1939 Code) a new option for the first taxable year ending after October 22, 1962, to deduct such costs as expenses. Unless he has exercised the new option granted by such Act, any taxpayer who exercised an option or made an election under the regulations described in the preceding sentence is, by such option or election, bound with respect to all intangible drilling and development costs (whether made before January 1, 1954, or after December 31, 1953) in connection with oil and gas properties. See section 7807(b)(2). Any taxpayer who has not made intangible drilling and development expenditures in any taxable year beginning after December 31, 1942, prior to his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, must exercise the option granted in paragraph (a) of this section in the return for the first taxable year in which the taxpayer pays or incurs such expenditures. If such return is required by law (including extensions thereof) to be filed before November 1, 1965, the option under paragraph (a) of this section, or the election under paragraph (b) of this section, may be exercised or changed not later than November 1, 1965. The exercise of or change in such option or election shall be effective with respect to the earliest taxable year to which the option or election is applicable in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from such exercise or change is not prevented by any law or rule of law on the date such option is exercised or such election is made. Any such option or election shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years.

[T.D. 6836, 30 FR 8902, July 15, 1965]

§ 1.612–5 Charges to capital and to expense in case of geothermal wells.

(a) **Option with respect to intangible drilling and development costs.** In accordance with the provisions of section 263(c), intangible drilling and development costs incurred by an operator (one who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) in the development of a geothermal deposit (as defined in section 613(e)(3) and the regulations thereunder) may at the operator's option be chargeable to capital or to expense. This option applies to all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water. Such expenditures have for convenience been termed intangible drilling and development costs. They include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if such amounts are depletable income to the recipient, and amounts properly allocable to cost of depreciable property) done for them by contractors under any form of contract, including turnkey contracts. Examples of items to which this option applies are all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used:

(1) In the drilling, shooting, and cleaning of wells,

(2) In such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells, and

(3) In the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of geothermal steam or hot water.

In general, this option applies only to expenditures for those drilling and developing items which in themselves do *not* have a salvage value. For the purpose of *this* option, labor, fuel, repairs, hauling, supplies, etc. are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Included in this option are all costs of drilling and development undertaken (directly or through a contract) by an operator of a geothermal property whether incurred by the operator prior or subsequent to the formal grant or assign-

ment of operating rights (a leasehold interest, or other form of operating rights, or working interest); except that in any case where any drilling or development project is undertaken for the grant or assignment of a fraction of the operating rights, only that part of the costs thereof which is attributable to such fractional interest is within this option. In the excepted cases, costs of the project undertaken, including depreciable equipment furnished, to the extent allocable to fractions of the operating rights held by others, must be capitalized as the depletable capital cost of the fractional interest thus acquired.

(b) Recovery of optional items, if capitalized. (1) Items recoverable through depletion: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are recoverable through depletion insofar as they are not represented by physical property. For the purposes of this section the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are recoverable through depletion.

(2) Items recoverable through depreciation: If the taxpayer charges such expenditures as fall within the option to capital account, the amounts so capitalized and not deducted as a loss are recoverable through depreciation insofar as they are represented by physical property. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc. used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract, such costs shall be allocated between the foregoing classes of items specified in paragraphs (b)(1) and (2) of this section for the purpose of determining the depletion and depreciation allowances.

(4) Option with respect to cost of nonproductive wells: If the operator has elected to capitalize intangible drilling and development costs; then an additional option is accorded with respect to intangible drilling and development costs incurred in drilling a nonproductive well. Such costs incurred in drilling a nonproductive well may be deducted by the taxpayer as an ordinary loss provided a proper election is made in the taxpayer's original or amended return for the first taxable year ending on or after October 1, 1978, in which such a nonproductive well is completed. The taxpayer must make a clear statement of election under this option in the return or amended return. The election may be revoked by the filing of an amended return that does not contain such a statement. The absence of a clear indication in such return of an election to deduct as ordinary losses intangible drilling and development costs of nonproductive wells shall be deemed to be an election to recover such costs through depletion to the extent that they are not represented by phy^ical property, and through depreciation to the extent that they are represented by physical property. Upon the expiration of the time for filing a claim for credit or refund of any overpayment of tax imposed by chapter 1 of the Code with respect to the first taxable year ending on or after October 1, 1978 in which a nonproductive well is completed, the taxpayer is bound for all subsequent years by his exercise of the option to deduct intangible drilling and development costs of nonproductive wells as an ordinary loss or his deemed election to recover such costs through depletion or depreciation.

(c) Nonoptional items distinguished—(1) Capital items: The option with respect to intangible drilling and development costs does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a salvage value. Examples of such items are the costs of the actual materials in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The option does not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for treating geothermal steam or hot water. These are capital items and are recoverable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the option provided by this section, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of geothermal steam or hot water.

(d) Manner of making election. The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming intangible drilling and development costs as a deduction on the taxpayer's original or amended return for the first taxable year ending on or after October 1,

1978, in which the taxpayer pays or incurs such costs with respect to a geothermal well commenced on or after that date. No formal statement is necessary. The exercise of the option may be revoked by the filing of an amended return that does not claim such a deduction. If the taxpayer fails to deduct such costs as expenses in any such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property. Upon the expiration of the time for filing a claim for credit or refund of any overpayment of tax imposed by chapter 1 of the Code with respect to the first taxable year ending on or after October 1, 1978, in which the taxpayer pays or incurs intangible drilling and development costs with respect to a geothermal well commenced on or after that date, the taxpayer is bound by his exercise of the option to charge such costs to expense or his deemed election to recover such costs through depletion or depreciation for that year and for all subsequent years.

(e) Effective date. The option granted by paragraph (a) of this section is available only for taxable years ending on or after October 1, 1978, with respect to geothermal wells commenced on or after that date.

[T.D. 7806, 47 FR 4061, Jan. 28, 1982]

§ 1.613–1 Percentage depletion; general rule.

In the case of a taxpayer computing the deduction for depletion under section 611 with respect to minerals on the basis of a percentage of gross income from the property, as defined in section 613(c) and §§ 1.613–3 and 1.613–4, such deduction shall be the percentage of such gross income as specified in section 613(b) and § 1.613–2. The deduction shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). Such taxable income shall be computed in accordance with § 1.613–5. In no case shall the deduction for depletion computed under this section be less than the deduction computed upon the cost or other basis of the property provided in section 612 and the regulations thereunder. The apportionment of the deduction between the several owners of economic interests in a mineral deposit will be made as provided in paragraph (c) of § 1.611–1. For rules with respect to "gross income from the property" and for definition of the term "mining", see §§ 1.613–3 and 1.613–4. For definitions of the terms "property", "mineral deposit", and "minerals", see paragraph (d) of § 1.611–1.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960 as amended by T.D. 7170, 37 FR 5374, March 15, 1972]

§ 1.613–2 Percentage depletion rates.

(a) In general. Subject to the provisions of paragraph (b) of this section and as provided in section 613(b), in the case of mines, wells, or other natural deposits, a taxpayer may deduct as an allowance for depletion under section 611 the percentages of gross income from the property as set forth in subparagraphs (1), (2), and (3) of this paragraph.

(1) Without regard to situs of deposits. The following rates are applicable to the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced:

(i) 27½ percent—Gas wells, oil wells.

(ii) 23 percent—Sulfur, uranium.

(iii) 15 percent—Ball clay, bentonite, china clay, metal mines [1], sagger clay, rock asphalt, vermiculite.

(iv) 10 percent—Asbestos [1], brucite, coal, lignite, perlite, sodium chloride, wollastonite.

(v) 5 percent—Brick and tile clay, gravel, mollusk shells (including clam shells and oyster shells), peat, pumice, sand, scoria, shale, stone (except dimension or ornamental stone). If from brine wells—Bromine, calcium chloride, magnesium chloride.

(2) Production from United States deposits. A rate of 23 percent is applicable to the minerals listed in this subparagraph if produced from deposits within the United States:

Anorthosite.[2]

Asbestos.

Bauxite.

Beryl.[3]

Celestite.

Chromite.

Corundum.

Fluorspar.

Graphite.

Ilmenite.

Kyanite.

[1] Not applicable if the rate prescribed in subparagraph (2) of this paragraph is applicable.

[2] The rate prescribed in this subparagraph does not apply except to the extent that alumina and aluminum compounds are extracted therefrom.

[3] Applicable only for taxable years beginning before January 1, 1964.

Mica.

Olivine.

Quartz crystals (radio grade).

Rutile.

Block Steatite talc.

Zircon.

Ores of the following metals—

Antimony.

Beryllium.[4]

Bismuth.

Cadmium.

Cobalt.

Columbium.

Lead.

Lithium.

Manganese.

Mercury.

Nickel.

Platinum.

Platinum group metals.

Tantalum.

Thorium.

Tin.

Titanium.

Tungsten.

Vanadium.

Zinc.

(3) **Other minerals.** A rate of 15 percent is applicable to the minerals listed in this subparagraph regardless of the situs of the deposits from which the minerals are produced, provided the minerals are not used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. If, however, such minerals are sold or used for the purposes described in the preceding sentence, a rate of 5 percent is applicable to any of such minerals unless sold on bid in direct competition with a bona fide bid to sell any of the minerals listed in subdivision (iii) of subparagraph (1) of this paragraph, in which case the rate is 15 percent. In addition, the provisions of this subparagraph are not applicable with respect to any of the minerals listed herein if the rate prescribed in subparagraph (2) of this paragraph is applicable.

Aplite.

Barite.

Bauxite.

Beryl.[5]

Borax.

Calcium carbonates.

Clay, refractory and fire.[6]

Diatomaceous earth.

Dolomite.

Feldspar.

Flake Graphite.

(4) For purposes of this section, the term "all other minerals" does not include (i) soil, sod, dirt, turf, water, or mosses; or (ii) minerals from sea water, the air, or similar inexhaustible sources. However, the term "all other minerals" is not limited in meaning to the minerals listed in section 613(b), but includes all other minerals (except those to which a specific percentage rate applies under subparagraphs (1), (2), (3), (4), and (5), of section 613(b)): For example, gypsum, novaculite, natural mineral pigments, quartz sand and quartz pebbles, graphite and kyanite (if section 613(b)(2)(B) does not apply), and anorthosite to the extent that alumina and aluminum compounds are not extracted therefrom. The 15 percent rate applies to such "all other minerals" when used or sold for use by the mine owner or operator for purposes other than as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes. When any such minerals are used or sold for use by the mine owner or operator as rip rap, ballast, road material, rubble, concrete aggregates, or for similar purposes, the 5 percent rate applies except that, when sold for such use by the mine owner or operator on a bid in direct competition with a bona fide bid to sell a mineral listed in section 613(b)(3), the 15 percent rate applies. For example, limestone sold on a bid in direct competition with a bona fide bid to sell rock asphalt for road building purposes may be entitled to a 15 percent rate. In every case the taxpayer must establish to the satisfaction of the district director that there was a bona fide bid to sell a mineral listed under section 613(b)(3) by a person other than the taxpayer, and that the mineral sold by the taxpayer was sold on a bid in direct competition with such bona fide bid to sell such other material.

Fluorspar.

Fullers earth.

Barnet.

Gilsonite.

Granite.

Lepidolite.

Limestone.

[4] Applicable only for taxable years beginning after December 31, 1963.

[5] Applicable only for taxable years beginning before January 1, 1964.

[6] Not applicable for taxable years beginning after December 31, 1960.

Magnesite.
Magnesium carbonates.
Marble.
Mica.
Phosphate rock.
Potash.
Quartzite.
Slate.
Soapstone.
Spodumene.
Stone (dimension or[7] ornamental).
Talc (including pyrophyllite).
Thernardite.
Tripoli.
Trona.
All other minerals.[7]

(b) Definition of terms. (1) For purposes of this section, the minerals indicated below shall have the following meanings:

(i) Clay, brick and tile—Clay used or sold for use in the manufacture of common brick, drain and roofing tile, sewer pipe, flower pots, and kindred products (other than clay specifically identified as a clay for which a 15 percent rate of percentage allowance is provided).

(ii) Clay, refractory and fire—Clay which has a pyrometric cone equivalent of 19 or higher.

(iii) Pumice—All pumice including pumicite.

(iv) Scoria—Only scoria produced from natural deposits.

(2) For purposes of this section, the term "United States" means the States and the District of Columbia. See section 7701(a)(9).

(3) For purposes of this section, the term "dimension stone" means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for such uses as building stone (excluding rubble), monumental stone, paving blocks, curbing and flagging. For purposes of this section, "ornamental stone" means blocks and slabs of natural stone, subsequently cut to definite shapes and sizes and used or sold for use for making ornaments or statues.

(c) Rules for application of paragraph (a) of this section. (1) In no case may the allowance for depletion computed upon the basis of a percentage of gross income from the property exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For rules relating to the computation of such taxable income, see § 1.613–5.

(2) In cases in which there are produced from a mineral property two or more minerals, each entitled to a different percentage depletion rate under section 613(b) and this section or any of which is entitled to cost depletion only, the percentage depletion allowance is the sum of the results obtained by applying the percentage applicable to each mineral (zero, if not entitled to percentage depletion) to the "gross income from the property" attributable to such mineral. The sum so computed is subject to the limitation provided in section 613(a) and § 1.613–1, that is, 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). Such taxable income (computed in accordance with § 1.613–4) is the total taxable income resulting from the sale of all minerals produced from the mineral property (as defined in section 614 and the regulations thereunder). The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Pyrite, an iron sulfide, may be sold for either its sulfur content or its iron content, or both. Sulfur is entitled to a percentage depletion deduction based on 23 percent of gross income from the property whereas the percentage depletion deduction for iron is based on 15 percent of such gross income. Therefore, in the case of a taxpayer who sells pyrite for both its sulfur and iron content, 23 percent of his gross income from sulfur plus 15 percent of his gross income from iron would be his maximum allowable percentage depletion deduction. However, this maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.*, 50 percent of "taxable income from the property (computed without allowance for depletion)", such taxable income being the overall taxable income resulting from the sale of both minerals contained in the deposit.

Example (2). Oil and gas are produced from a single mineral property of a taxpayer who operates a retail outlet for the sale of oil products within the meaning of section 613A(d)(2). The taxpayer is not entitled to percentage depletion on the gross income attributable to the oil, but is entitled to percentage depletion on the gross income attributable to gas which is regulated gas under section 613A(b)(2)(B). Accordingly, the taxpayer's maximum allowable percentage depletion deduction would be zero percent of gross income from the property with respect to oil, plus 22 percent (see section 613A(b)(1)) of gross income from the property with respect to gas. This maximum deduction would be subject to the limitation provided for in section 613(a), *i.e.*, 50 percent of "taxable income from the property (computed without allowance for depletion)," such taxable income being the overall taxable income resulting from the sale of both oil and gas. However, in the case of oil or gas production which qualifies for percentage depletion under section 613A(c), see the special allocation rules contained in section 613A(c)(7)(C) and (E) and § 1.613A–4.

[7] The 15-percent rate is applicable only to stone used or sold for use by the mine owner or operator as dimension stone or ornamental stone.

(3) Except as provided in section 613(d) and the regulations thereunder relating to special rules for determining rates of depletion for taxable years ending after December 31, 1953, to which the Internal Revenue Code of 1939 applies—

(i) The percentage rates set forth in this section are applicable only for taxable years beginning after December 31, 1953, and ending after August 16, 1954; and

(ii) The percentage rates set forth in 26 CFR (1939) 39.23(m)–5 (Regulations 118) are applicable for taxable years beginning before January 1, 1954, or ending before August 17, 1954.

(4) Percentage depletion is not allowable with respect to the income from a disposal of coal (including lignite) or domestic iron ore (as defined in paragraph (e) of § 1.631–3) with a retained economic interest to the extent that such income is treated as from a sale of coal or iron ore under section 631(c) and § 1.631–3. Rents or royalties paid or incurred by a taxpayer with respect to coal (including lignite) or domestic iron ore shall be excluded by such taxpayer in determining "gross income from the property" without regard to the treatment under section 631(c) of such rents and royalties in the hands of the recipient.

(5)(i) In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties (which are depletable income to the payee) which are paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from "gross income from the property". The following example illustrates this rule:

Example. A leases coal-bearing lands to B on condition that B will annually pay a royalty of 25 cents a ton on coal mined and sold by B. During the year 1956, B mines and sells f.o.b. mine 100,000 tons of coal for $600,000. In computing "gross income from the property" for the year 1956, B will exclude $25,000 (100,000 tons×$0.25) in computing his allowable percentage depletion deduction. B's allowable percentage depletion deduction (without reference to the limitation based on taxable income from the property) for the year 1956 will be $57,500 (($600,000–$25,000)×10 percent).

(ii) If bonus payments have been paid in respect of the property in any taxable year or any prior taxable years, there shall be excluded in determining the "gross income from the property", an amount equal to that part of such payments which is allocable to the product sold (or otherwise giving rise to gross income) for the taxable year. For purposes of the preceding sentence, bonus payments include payments by the lessee with respect to a production payment which is treated as a bonus under section 636(c). Such a production payment is equally allocable to all mineral from the mineral property burdened thereby. The following examples illustrate the provisions of this subdivision:

Example (1). In 1956, A leases oil bearing lands to B, receiving $200,000 as a bonus and reserving a royalty of one-eighth of the proceeds of all oil produced and sold. It is estimated at the time the lease is entered into that there are 1,000,000 barrels of oil recoverable. In 1956, B produces and sells 100,000 barrels for $240,000. In computing his "gross income from the property" for the year 1956, B will exclude $30,000 (⅛ of $240,000), the royalty paid to A, and $20,000 (100,000 bbls. sold/1,000,000 bbls. estimated to be available × $200,000 bonus), the portion of the bonus allocable to the oil produced and sold during the year. However, in computing B's taxable income under section 63, the $20,000 attributable to the bonus payment shall not be either excluded or deducted from B's gross income computed under section 61. (See paragraph (a)(3) of § 1.612–3.)

Example (2). In 1971, C leases to D oil bearing lands estimated to contain 1,000,000 barrels of oil, reserving a royalty of one-eighth of the proceeds of all oil produced and sold and a $500,000 production payment payable out of 50 percent of the first oil produced and sold attributable to the seven-eighths operating interest. In 1972, D produces and sells 100,000 barrels of oil. In computing his "gross income from the property" for the year 1972, D will exclude, in addition to the royalty paid to C, $50,000 (100,000 bbls. sold/1,000,000 bbls. estimated to be available × $500,000 treated under section 636(c) as a bonus), the portion of the production payment allocable to the oil produced and sold during the taxable year. However, in computing D's taxable income under section 63, the $50,000 attributable to the retained production payment shall not be either excluded or deducted from D's gross income computed under section 61.

(iii) If advanced royalties have been paid in respect of the property in any taxable year, the amount excluded from "gross income from the property" of the payor for the current taxable year on account of such payment, shall be an amount equal to the deduction for such taxable year taken on account of such payment pursuant to paragraph (b)(3) of § 1.612–3.

Example. If B in example (2) in paragraph (b)(4) of § 1.612–3, elects to deduct in 1956 the $10,000 paid to A in that year, he must exclude the same amount from "gross income from the property" in 1956; however, if B elects to defer the deduction until 1957 when he mined and sold the mineral, he must exclude the $10,000 from "gross income from the property" in 1957.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9306, July 27, 1965; T.D. 7170, 37 FR 5374, March 15, 1972; T.D. 7261, 38 FR 5467, March 1, 1973; T.D. 7487, 42 FR 24263, May 13, 1977]

§ 1.613–3 Gross income from the property.

(a) **Oil and gas wells.** In the case of oil and gas wells, "gross income from the property", as used in section 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on

the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or filed price of the oil or gas before conversion or transportation.

(b) Minerals other than oil and gas—(1) In general. The term "gross income from the property," as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. "Gross income from mining" is that amount of income which is attributable to the processes of extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. For the purpose of this section, "ordinary treatment processes" (applicable to the taxable years beginning before January 1, 1961) and "treatment processes considered as mining" (applicable to the taxable years beginning after December 31, 1960) will be referred to as "mining processes." Processes, including packaging and transportation, which do not qualify as mining will be referred to as "nonmining processes." Also for the purpose of this section, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "nonmining transportation." See paragraph (f) of this section for the definition of the term "mining" and paragraph (g) of this section for rules relating to nonmining processes.

(2) Sales prior to the application of nonmining processes including nonmining transportation. (i) Subject to the adjustments required by paragraph (e)(1) of this section, gross income from mining means (except as provided in subdivision (ii) of this subparagraph) the actual amount for which the ore or mineral is sold if the taxpayer sells the ore or mineral—

(a) As it emerges from the mine, prior to the application of any process other than a mining process or any transportation, or

(b) After application of only mining processes, including mining transportation, and before any nonmining transportation.

If the taxpayer sells his ore or mineral in more than one form, and if only mining processes are applied to the ore or mineral, gross income from mining is the actual amount for which the various forms of the ore or mineral are sold, after any adjustments required by paragraph (e)(1) of this section. For example, if, at his mine or quarry, a taxpayer sells several sizes of crushed gypsum and also sells gypsum fines produced as an incidental by-product of his crushing operations, without applying any nonmining processes, gross income from mining will ordinarily be the total amount for which such crushed gypsum and fines are actually sold. See paragraphs (f) and (g) of this section for provisions defining mining and nonmining processes for various minerals.

(ii) [Reserved]

(c) Sales after the application of nonmining processes including nonmining transportation where a representative market or field price for the taxpayer's ore or mineral can be ascertained—(1) General rule. If the taxpayer processes the ore or mineral before sale by the application of nonmining processes (including nonmining transportation), gross income from the property shall be computed by use of the representative market or field price of an ore or mineral of like kind and grade as the taxpayer's ore or mineral after the application of the mining processes (if any) actually applied and before any nonmining transportation, subject to any adjustments required by paragraph (e) of this section. The objective in computing gross income from the property by the representative market or field price method is to ascertain, on the basis of a study of actual competitive sales by the taxpayer or others, the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if, prior to the application of nonmining processes, the taxpayer had sold the quantities and types of ores and minerals to which he applied nonmining processes. If it is possible to determine a market or field price under the provisions of this paragraph, and if such price is determined to be representative, the taxpayer's gross income from the property shall be determined on the basis of such price and not under the provisions of paragraph (d) of this section. The taxpayer's own actual sales prices for ores or minerals of like kind and grade shall be taken into account when establishing market or field prices, provided that such sales are determined to be representative.

(2) Criteria for determining whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral. An ore or mineral will be considered to be of like kind and grade as the taxpayer's ore or mineral if, in common commercial practice, it is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer's ore or mineral so that it is used or is economically suitable for use for essentially the same purposes as the uses to which the taxpayer's

ore or mineral is put. Whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral will generally be determined by reference to industrial specifications and by consideration of chemical and physical data relating to the minerals and deposits in question. An ore or mineral may be considered to be of like kind and grade as the taxpayer's ore or mineral even though the chemical, mineralogical, or physical characteristics (including size, mineral content, structure, and impurities) of such ore or mineral are not precisely identical to those of the taxpayer's ore or mineral. Similarly, the fact that the taxpayer applies slightly different size reduction processes, the fact that the taxpayer uses slightly different benefication processes, or the fact that the taxpayer sells his ore or mineral for different purposes, will not in itself, prevent another person's ore or mineral from being considered to be of like kind and grade as the taxpayer's ore or mineral. On the other hand, the fact that the taxpayer's ore or mineral is suitable for the same general commercial use as another person's ore or mineral will not cause the two ores or minerals to be considered to be of like kind and grade if the desirable natural constituents of the two ores or minerals are markedly different substances. For example, anthracite coal will not be considered to be of like kind as bituminous coal merely because both types of coal can be used as fuel. Similarly, bituminous coal which does not possess coking qualities will not be considered to be of like grade as bituminous coking coal. However, in the case of a taxpayer who mines and uses his bituminous coal in the production of coke, all bituminous coals in the same marketing area will be considered to be of like kind, and all such bituminous coals having the same or similar coking quality suitable for commercial use by coke producers will be considered to be of like grade as the coal mined and used by the taxpayer.

(3) Factors to be considered in determining the representative market or field price for the taxpayer's ore or mineral. In determining the representative market or field price for the taxpayer's ore or mineral, consideration shall be given only to prices of ores or minerals of like kind and grade as the taxpayer's ore or mineral and with which, under commercially accepted standards, the taxpayer's ore or mineral would be considered to be in competition if it were sold under the conditions described in paragraph (b)(2)(i) of this section. A weighted average of the selling prices of ores or minerals of like kind and grade as the taxpayer's, beneficiated only by mining processes, in the taxpayer's actual or potential lines of commerce, and in the marketing area of the taxpayer's mine, although not a prerequisite to the determination of the representative market or field price, is an important factor in the determination of such price. The taxpayer's own competitive sales prices for minerals which have been subjected only to mining processes shall be taken into account in computing such a weighted average. The identity of the taxpayer's actual or potential lines of commerce, the geographical extent of the relevant markets, and the price within such markets which is the representative market or field price, are necessarily factual determinations to be made on the basis of the facts and circumstances of each individual case. These facts and circumstances include the similarity of the taxpayer's ore or mineral to the ores or minerals marketed by others, the location of the mines or quarries at which sales of ores or minerals take place, the frequency and volume of such sales, the functional product markets in which miners' ores or minerals are sold, the amount of competition within the relevant markets, the date or dates at which sales take place, the prices paid by the taxpayer and by others when purchasing similar ores or minerals, and all other relevant factors.

(4) Type of sales which may be considered in determining the representative market or field price for the taxpayer's ore or mineral. Sales or purchases, including the taxpayer's, of ores or minerals of like kind and grade as the taxpayer's will be taken into consideration in determining the representative market or field price for the taxpayer's ore or mineral only if such sales or purchases are the result of competitive transactions. Accordingly, primary consideration will be given to sales in markets characterized by a substantial number of unrelated buyers and sellers, no one of whom controls a substantial portion of the sales or purchases in the market. For the purpose of determining the representative market or field price for the taxpayer's ore or mineral, exceptional, insignificant, unusual, tie-in, or accommodation sales shall be disregarded. Representative market or field prices shall not be determined by reference to prices established in transactions between members of a controlled group. See paragraph (a) of section 1.482–1 for the definitions of the terms "controlled" and "group".

(5) Information to be furnished by a taxpayer computing gross income from the property by use of a representative market or field price. A taxpayer who computes his gross income from the property pursuant to the provisions of this paragraph shall attach to his return a statement indicating the price or prices used by him in comput-

ing gross income from mining under this paragraph and the source of his information as to such price or prices.

(6) **Limitation on gross income from the property computed under the provisions of this paragraph.** It shall be presumed that a price is not a representative market or field price for the taxpayer's ore or mineral if the sum of such price plus the total of all costs of the nonmining processes (including nonmining transportation) which the taxpayer applies to his ore or mineral regularly exceeds the taxpayer's actual sales price of his first marketable product or group of products. See paragraph (d)(1)(iv) of this section for the definition of the term "first marketable product or group of products". For example, if the total of all costs of nonmining processes applied by the taxpayer to coal for the purpose of making coke is $12 per ton, and if the taxpayer's actual sale price for such coke is $18 per ton, a price of $7 per ton would not be a representative market or field price for the taxpayer's coal. In order to rebut the presumption set forth in the first sentence of this subparagraph, evidence must be produced to establish to the satisfaction of the district director that the loss on nonmining operations is directly attributable to unusual, peculiar, and nonrecurring factors rather than to the use of a market or field price which is not representative. For example, the first sentence of this subparagraph shall not apply if the taxpayer establishes in an appropriate case that the loss on nonmining operations is directly attributable to unusual, peculiar, and nonrecurring events such as a fire, flood, explosion, earthquake, strike, or a similar event which is not a normal part of the operations of the taxpayer.

(d) **Sales after the application of nonmining processes where a representative market or field price cannot be ascertained—(1) Computation of gross income from the property by use of the proportionate profits method.** (i) If it is impossible to determine a representative market or field price as described in paragraph (c) of this section, then, except as provided in subparagraph (2) of this paragraph, gross income from the property shall be computed by use of the proportionate profits method. See § 1.611–0. The objective of the proportionate profits method of computation is to ascertain gross income from the property by applying the principle that each dollar of the total costs paid or incurred to produce, transport and sell the first marketable product or group of products earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell and transport the first marketable product or group of products. See subdivision (iv) of this subparagraph for the definition of the term "first marketable product or group of products".

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). See subdivisions (iv) and (v) of this subparagraph for the definitions of the terms "first marketable product or group of products" and "gross sales (actual or constructive)", respectively. The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, § 39.23(m)–1(e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

Mining costs ÷ Total costs × Gross sales = Gross income from mining.

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall be properly apportioned to mining and to nonmining. In the absence of any specific provision of this section providing an apportionment method, such costs shall be apportioned by use of a method which is reasonable in the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which would normally be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c) of § 1.613–4.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. The first marketable product or group of products does not include a product or group of products additionally refined, beneficiated, altered, or manufactured as a result of the application of additional nonmining processes. For example, if a cement manufacturer sells his own finished cement of various types in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement of various types, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v) As used in this paragraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations. The prices at which actual or constructive sales are made are to be determined in accordance with the principles set forth in this paragraph and in paragraphs (b), (c), and (e) of this section, as appropriate. In the case of constructive sales of the taxpayer's first marketable product or group of products, the taxpayer shall attach to his return a statement indicating the price or prices used by him in computing the representative market or field price for such product or products, and the source of his information as to such price or prices. The prices at which actual or constructive sales are made shall not be determined by reference to prices established in transactions between members of a controlled group. See paragraph (a) of § 1.482–1 for the definitions of the terms "controlled" and "group".

(vi) The provisions of this subparagraph may be illustrated by the following example:

Example.—(a) Facts. A is engaged in the mining of a mineral to which section 613 applies, and in the application thereto of nonmining processes. During 1968, A incurred extraction costs of $35,000; other mining costs of $56,000; $150,000 for manufacturing costs; $46,000 for other nonmining processes; and $14,000 for the company president's salary and similar costs. The actual gross sales price of A's first marketable group of products (after the adjustments required by paragraph (e) of this section) was $6 per ton for all products. During 1968, A sold 70,000 tons of these manufactured products. It is not possible to establish a representative market or field price for A's mineral before the application of nonmining processes.

(b) Computation. (1) The computation of A's gross income from mining by use of the proportionate profits method involves two steps. The first step is to apportion A's costs to mining and to nonmining. A apportions the company president's salary and similar costs to mining and to nonmining in the manner described in the third and fourth sentences of subdivision (iii) of this subparagraph, and apportions his remaining costs as follows:

Cost	Mining	Nonmining	Total
Extraction	$35,000	....	$35,000
Other mining processes	56,000	56,000	
Manufacturing	....	$150,000	150,000
Other nonmining processes	....	46,000	46,000
Subtotal	91,000	196,000	287,000
President's salary and similar costs	4,439	9,561	14,000
Total costs	95,439	205,561	301,000

(2) The second step is to apply the proportionate profits fraction so as to compute A's gross income from mining. To do this, A first computes his gross sales of his first marketable group of products. In this case, the actual gross sales price of A's first marketable group of products (after the adjustments required by paragraph (e) of this section) was $6 per ton for all products. Since 70,000 tons of these products were sold, A's actual gross sales were $420,000. Next, A multiplies his actual gross sales of $420,000 by the proportionate profits fraction, whose numerator consists of his total mining costs ($95,439) and whose denominator consists of his total costs ($301,000). This procedure indicates that A's gross income from mining is $133,170 (*i.e.*, 95,439/301,000ths of A's actual gross sales of $420,000).

(2) [Reserved]

(3) Costs to be used in computing gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs. In determining the taxpayer's gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs, only costs actually paid or incurred shall be taken into consideration. In general, if the taxpayer has consistently employed a reasonable method of determining the costs of the various individual phas-

es of his mining and nonmining processes (such as extraction, loading for shipment, calcining, packaging, etc.), such method shall not be disturbed. The amount of any particular item to be taken into account shall, for taxable years beginning after November 30, 1968, be the amount used in determining the taxpayer's income for tax purposes. For example, the depreciation lives, methods, and records used for tax purposes, if different from those used for book purposes, shall be the basis for determining the amount of depreciation to be used in the proportionate profits computation of gross income from mining.

(4) **Treatment of particular items in computing gross income from the property by use of the proportionate profits method or another approved method based on the taxpayer's costs.** (i) Except as specifically provided elsewhere in this section, when determining gross income from the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer, and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which the district director determines will clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. Where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to such plants or mills in excess of 50 miles (or of such greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to such excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

(ii) In determining gross income from the property by use of the proportionate profits method or any other approved method which is based on the taxpayer's costs, a process shall not be considered as a mining process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nonmining costs in determining gross income from mining. If a mining process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining gross income from mining. Accordingly, all profits attributable thereto are treated as nonmining profits. In the absence of methods which will more clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, the cost attributable thereto shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining gross income from the property by use of the proportionate profits method (or any other approved method which is based on the taxpayer's costs)—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from the property by means of the proportionate profits method or any other approved method based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613–4 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

(v) In computing gross income from the property by means of the proportionate profits method or any other approved method based on the taxpayer's costs, allowances to customers which are determined to have the effect of trade or cash discounts under the provisions of paragraph (e)(1)(ii) of this section, shall (if not otherwise taken into account) be excluded from the denominator of the proportionate profits fraction. See paragraph (e)(1)(i) of this section for provisions excluding such allowances from the taxpayer's gross sales of his first marketable product or group of products.

(e) Reductions of sales price in computing gross income from the property—(1) Discounts. (i) The amount of any trade or (for taxable years beginning after November 30, 1968) cash discounts actually allowed by a taxpayer computing gross income from the property under the provisions of paragraph (b)(2) of this section shall be subtracted from the sale price of the taxpayer's ore or mineral. In the case of a taxpayer computing gross income from the property under the provisions of paragraph (c) of this section, any such discounts actually allowed (if not otherwise taken into account) by the person or persons making the sales on the basis of which the representative market or field price for the taxpayer's ore or mineral is to be determined shall be subtracted from the sale price in computing such representative market or field price. In the case of a taxpayer computing gross income from the property under the provisions of paragraph (d) of this section, such discounts (if not otherwise taken into account) shall be subtracted from the gross sales (actual or constructive) of the first marketable product or group of products.

(ii) The provisions of subdivision (i) of this subparagraph apply even though a trade or cash discount is allowed in some form other than a direct reduction in sale price. Accordingly, allowances (no matter how designated) which are determined to have the same effect as trade or cash discounts shall be subject to such subdivision. For example, in a particular case freight absorption and special services to customers may in effect constitute trade or cash discounts. Further, interlocking sale and purchase arrangements may in effect constitute trade or cash discounts in instances in which a miner sells his mineral product to a vendee at an excessive price, in return for an agreement to purchase the vendee's product at a price which is also excessive. The dollar amount of an allowance having the same effect as a trade or cash discount shall be determined in light of all the facts and circumstances; and shall include an appropriate share of the taxpayer's overhead and profit in instances which a service is rendered by the taxpayer or his employees. For example, in instances in which gross income from mining is computed under paragraph (d)(1) of this section, the dollar amount attributable to services performed by the taxpayer or his employees shall include a proportionate share of the taxpayer's overhead and profit.

(2) Purchased transportation to the customer. (i) A taxpayer who computes gross income from mining under the provisions of paragraph (c) of this section and who sells his ore or mineral after the application of only mining processes but after nonmining transportation shall use as the representative market or field price (as described in paragraph (c) of this section) his delivered price (if otherwise representative) reduced by costs paid or incurred by him for purchased transportation to the customer as defined in subdivision (iii) of this subparagraph. If the transportation by the taxpayer is not purchased transportation to the customer, and if other producers in the taxpayer's marketing area sell significant quantities of the ore or mineral of like kind and grade after the application of only mining processes but after purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph), the delivered price at which the ore or mineral is sold by such other producers (if otherwise representative) re-

duced by the costs of purchased transportation to the customer paid or incurred by such producers shall be used by the taxpayer as the representative market or field price for his ore or mineral. When applying the preceding sentence, appropriate adjustments shall be made to take into account differences in mode of transportation and distance. For purposes of this subdivision, any delivered price shall be adjusted as provided in subparagraph (1) of this paragraph.

(ii) In the case of a taxpayer computing gross income from mining under the provisions of paragraph (d)(1) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the taxpayer's gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph) and from the denominator of the proportionate profits fraction, without attributing profits to the cost of such transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of methods of computation which are approved under paragraph (d)(2) of this section and which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which does not meet the requirements of subdivision (iii) of this subparagraph, see paragraph (d)(4)(i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation from the taxpayer's mine or plant to the customer—

(a) Which is performed in conveyances owned or leased by persons other than the taxpayer, rather than in conveyances owned or leased by the taxpayer;

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling); and

(c) Which is charged to the customer in such a way that the taxpayer ordinarily does not earn any profit with respect to such transportation.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (a)(3) of § 1.482-1) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482-1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. The taxpayer must demonstrate the nonprofit character of the transportation services, as described in (c) of this subdivision, in light of all the facts and circumstances. It shall be presumed that the requirements set forth in either (a) or (c) of this subdivision (relating, respectively, to conveyance ownership and profits) are not satisfied if the taxpayer requires customers to purchase minerals or mineral products only on a delivered basis, by failing to offer such minerals or products for sale on the basis of a price f.o.b. the taxpayer's mine or plant, or by other means. In the case of taxpayers computing gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms with the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(1)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A is engaged in the mining of an ore of mineral M and in the production and sale of M concentrate. A retains a portion of his concentrate for use in his own nonmining operations. During 1968, A sold 100,000 tons of M concentrate of ore mined and processed by him. Such sales constituted a significant portion of his total production. 80,000 tons of such concentrate were sold by A on the basis of a representative price (after adjustments required by subparagraph (1) of this paragraph) of $30 per ton f.o.b. mine or plant. The remaining 20,000 tons were sold by A, both directly and through terminals, on the basis of a delivered price (after adjustments required by subparagraph (1) of this paragraph) at City X of $40 per ton. The delivered price included the $15 per ton cost of purchased transportation from the mine or plant to customers in City X. The representative market or field price of the concentrate sold by A on the basis of a delivered price is $25 per ton, determined by subtracting the cost of the purchased transportation to the customer ($15 per ton) from the delivered price for the concentrate ($40 per ton). Accordingly, A's gross income from mining with respect to the 20,000 tons of M concentrate sold on a delivered basis is $500,000. The representative market or field price for the concentrate retained by A and used in his own nonmining operations may be computed by reference to the weighted average price for both A's f.o.b. mine and A's delivered sales of concentrate, with the delivered sales prices reduced in the manner described

above. On this basis, the representative market or field price for the retained concentrate is $29 per ton.

Example (2). B is engaged in the mining of an ore of mineral N and in the production of its concentrate. B retains all but an insignificant amount of his concentrate for use in his own nonmining operations. Other producers in B's marketing area sell significant amounts of N concentrate of like kind and grade, both on an f.o.b. mine or plant basis and on a delivered basis. In this case, the prices for both the f.o.b. and the delivered sales made by other producers (after any adjustments required by subparagraph (1) of this paragraph), with the delivered prices reduced by the cost of purchased transportation to the customer, shall, if such prices are otherwise representative, be taken into account when establishing the representative market or field price for the N concentrate produced and used by B.

(f) Definition of mining—(1) In general. The term "mining" includes only—

(i) The extraction of ores or minerals from the ground;

(ii) Mining processes, as described in subparagraphs (2) through (5) of this paragraph; and

(iii) So much of the transportation (whether or not by common carrier) of ores or minerals from the point of extraction of the ores or minerals from the ground to the plants or mills in which the processes referred to in subdivision (ii) of this subparagraph are applied thereto as is not in excess of 50 miles, and, if the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over such greater distance as the Commissioner authorizes. See paragraph (h) of this section for rules relating to the filing of applications to treat as mining any transportation in excess of 50 miles.

(2) Definition of mining processes. (i) As used in subparagraph (1)(ii) of this paragraph, the term "mining processes" means, for taxable years beginning before January 1, 1961, the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, including the following processes (and the processes necessary or incidental thereto), and, for taxable years beginning after December 31, 1960, means the following processes (and the processes necessary or incidental thereto):

(a) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(b) In the case of sulfur recovered by the Frasch process—cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(c) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product (as defined in subparagraph (3)(iv) of this paragraph)—

(1) Where applied for the purpose of bringing to shipping grade and form (as defined in paragraph (f)(3)(iii) of this section)—sorting, concentrating, sintering, and substantially equivalent processes, and

(2) Loading for shipment.

(d) In the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit; and

(e) In the case of the following ores or minerals—

(1) The furnacing of quicksilver ores,

(2) The pulverization of talc,

(3) The burning of magnesite, and

(4) The sintering and nodulizing of phosphate rock.

(ii) For taxable years beginning after December 31, 1960, the term "mining processes" also includes:

(a) In the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process; and

(b) In the case of clay to which section 613(b)(5)(B) applies—crushing, grinding, and separating the clay from waste, but not including any subsequent process.

(iii) A process is "necessary" to another related process if it is essential to the performance of the other process. For example, if the concentrating of low-grade iron ores to bring to shipping grade and form cannot be effectively accomplished with-

out fine pulverization, such pulverization may be treated as a process which is "necessary" to the concentration process. Accordingly, because concentration is a mining process, such pulverization is also a mining process. Furthermore, if mining processes cannot be effectively applied to a mineral without storage of the mineral while awaiting the application of such processes, such storage may be treated as a process which is "necessary" to the accomplishment of such mining processes. A process is "incidental" to another related process if the cost thereof is insubstantial in relation to the cost of the other process or if the process is merely the coincidental result of the application of the other process. For example, the use of thawing equipment to unload frozen ore cars at concentration plants will be considered incidental to concentration, where the cost of using such equipment is insubstantial in relation to the cost of the concentration process. Further, where crushing of a crude mineral is treated as a mining process, the production of fines as a by-product is ordinarily the coincidental result of the application of a mining process. If a taxpayer demonstrates that a particular process is necessary or incidental solely to a process named as a mining process in section 613(c)(4) or this paragraph, the necessary or incidental process will also be considered a mining process.

(iv) The term "mining" does not include purchasing minerals from another. Accordingly, the processes listed in this paragraph shall be considered as mining processes only to the extent that they are applied by a mine owner or operator to an ore or mineral in respect of which he is entitled to a deduction for depletion under section 611. The application of these processes to purchased ores, minerals, or materials does not constitute mining.

(3) Processes recognized as mining for ores or minerals covered by section 613(c)(4)(C). (i) As used in section 613(c)(4)(C) and subparagraph (2)(i)(c) of this paragraph, the terms "sorting" and "concentrating" mean the process of eliminating waste, separating the valuable mineral from the valueless, or separating two or more valuable minerals or ores. Examples of sorting and concentrating processes are hand or mechanical sorting, magnetic separation, gravity concentration, jigging, the use of shaking or concentrating tables, the use of spiral concentrators, the use of sluices or sluice boxes, sink-and-float processes, and floatation processes such as bubble, skin, and froth flotation. Under section 613(c)(4)(C), concentration will be considered a mining process only where it is applied to bring an ore or mineral to shipping grade and form.

(ii) As used in section 613(c)(4)(C) and subparagraph (2)(i)(c) of this paragraph, the term "sintering" means the agglomeration of fine particles by heating to a temperature at which incipient, but not complete, fusion occurs. Sintering will be considered a mining process only where it is applied to an ore or mineral, or a concentrate of an ore or mineral, as an auxiliary process necessary to bring the ore or mineral to shipping grade and form. A thermal action which is applied in the manufacture of a finished product will not be considered to be a mining process, even though such thermal action may cause the agglomeration of fine particles by incipient fusion, and even though such action does not cause a chemical change in the agglomerated particles. For example, the sintering of finely ground iron ore concentrate prior to shipment from the concentration plant for the purpose of preventing the risk of loss of the finely divided particles is considered a mining process. On the other hand, for example, a heating process applied to expand or harden clay, shale, perlite, vermiculite, or other materials in the course of the manufacture of lightweight aggregate or other building materials is not considered to be a mining process.

(iii) As used in section 613(c)(4)(C) and this section, to "bring to shipping grade and form" means to bring (by the application of mining processes at the mine or concentration plant) the quality or size of an ore or mineral to the initial condition at which a significant portion thereof customarily is shipped by ordinary miners for sale or for use in a manufacturing process. The determination as to when an ore or mineral reaches shipping grade and form shall be made on the basis of U.S. nationwide mining practice, except that, in the case of a mineral industry in which the U.S. practice is shown to be unrepresentative of the mining practices of U.S. taxpayers in such industry, the determination shall be made in light of worldwide mining practice by U.S. taxpayers in such industry. A process will not be recognized as a process applied to bring a mineral to shipping grade and form if the process is applied following shipment to a facility at which processes described in paragraph (g) of this section are applied, or if such process (wherever applied) beneficiates the ore or mineral to the degree that such process constitutes smelting or refining, or any other nonmining process within the meaning of paragraph (g) of this section.

(iv) An ore or mineral is "customarily sold in the form of a crude mineral product," within the

meaning of section 613(c)(4)(C), if a significant portion of the production thereof is sold or used in a nonmining process prior to the alteration of its inherent mineral content by some form of beneficiation, concentration, or ore dressing. An ore or mineral does not lose its classification as a crude mineral product by reason of the fact that, before sale or use in a nonmining process, the ore or mineral may be crushed or subjected to other processes which do not alter its inherent mineral content. Whether the portion of production sold or used in the form of a crude mineral product is a significant portion of the total production of an ore or mineral is a question of fact, to be determined by reference to the U.S. nationwide pattern of sales and uses for such ore or mineral, except that, in the case of a mineral industry in which the U.S. pattern of sales and uses is shown to be unrepresentative of the pattern of sales and uses of U.S. taxpayers in such industry, the determination shall be made in light of the worldwide pattern of sales and uses by U.S. taxpayers in such industry.

(4) Type of processes recognized as mining for ores or minerals covered by section 613(c)(4)(D). Cyanidation, leaching, crystallization, and precipitation, which are listed in section 613(c)(4)(D) as treatment processes considered as mining, and the processes (or combination of processes) which are substantially equivalent thereto, will be recognized as mining only to the extent that they are applied to the taxpayer's ore or mineral for the purpose of separation or extraction of the valuable mineral product or products from the ore, or for the purpose of separation or extraction of the mineral or minerals from other material extracted from the mine or other natural deposit. A process, no matter how denominated, will not be recognized as mining if the process beneficiates the ore or mineral to the degree that such process, in effect, constitutes smelting, refining, or any other nonmining process within the meaning of paragraph (g) of this section. As used in section 613(c)(4)(D) and subparagraph (2)(i)(d) of this paragraph, the term "concentration" has the meaning set forth in the first two sentences of subparagraph (3)(i) of this paragraph.

(g) Nonmining processes—(1) General rule. Unless they are otherwise provided for in paragraph (f) of this section as mining processes (or are necessary or incidental to processes listed therein), the following processes are not considered to be mining processes—electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping. See subparagraph (6) of this paragraph for definitions of certain of these terms.

(2) Necessary or incidental processes; sequence. (i) A process (even though otherwise nominally specified as a mining process in section 613(c) or this section) shall not be considered as mining if it functions in any significant degree as a necessary or incidental part of such nonmining processes as refining, smelting, roasting, manufacturing, or packaging, or any other nonmining activity. For example, the crushing and grinding or the loading for shipment of products which have been molded, shaped, or fired shall not be considered as mining. See paragraph (f)(2)(iii) of this section for the definitions of the terms "necessary" and "incidental".

(ii) Ordinarily, a process applied subsequent to a nonmining process shall also be considered to be a nonmining process. However, exceptions to this rule shall be made in those instances in which the rule would discriminate between similarly situated producers of the same mineral. For example, roasting is specifically designated in subdivision (i) of this subparagraph as a nonmining process, but in the case of minerals referred to in section 613(c)(4)(C) sintering is recognized as a mining process. However, if certain impurities in an ore can only be removed by roasting in order to bring it to the same shipping grade and form as a competitive sintered ore of the same kind which requires no roasting, the subsequent sintering of the roasted ore will be treated as a mining process, although the roasting of the ore is a nonmining process and will be treated as such. The test of nondiscrimination shall be applied by reference to the U.S. nationwide pattern of production in the particular mineral industry, except that, in the case of a mineral industry in which the U.S. pattern of production is shown to be unrepresentative of the pattern of production of U.S. taxpayers in such industry, the determination shall be made in light of the worldwide pattern of production by U.S. taxpayers in such industry. In addition, exceptions to the rule set forth in the first sentence of this subdivision shall be made in cases in which a nonmining process is incidental to a process specified as mining. See paragraph (f)(2)(iii) of this section for the definition of the term "incidental." For example, the sprinkling of coal with dots of paper to identify the coal for trade name purposes prior to loading for shipment shall not prevent the loading for shipment from being considered as mining.

(3) **Transportation for the purpose of marketing or distribution; storage.** Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

(h) **Application to treat, as mining, transportation in excess of 50 miles.** If a taxpayer desires to include in the computation of his gross income from mining transportation in excess of 50 miles from the point of extraction of the minerals from the ground, he shall file an original and one copy of an application for the inclusion of such greater distance with the Commissioner of Internal Revenue, Washington, D.C. 20224. The application must include a statement setting forth in detail the facts concerning the physical and other requirements which prevented the construction and operation of the plant (in which mining processes, as defined in paragraph (f) of this section, are applied) at a place nearer to the point of extraction from the ground. These facts must be sufficient to apprise the Commissioner of the exact basis of the application. If the taxpayer's return is filed prior to receipt of notice of the Commissioner's action upon the application, a copy of such application shall be attached to the return. If, after an application is approved by the Commissioner, there is a material change in any of the facts relied upon in such application, a new application must be submitted by the taxpayer.

(i) **Extraction from waste or residue.** "Extraction of ores or minerals from the ground" means not only the extraction of ores or minerals from a deposit, but also the extraction by mine owners or operators of ores or minerals from waste or residue of their prior mining. The preceding sentence does not apply to any such extraction of ores or minerals by the purchaser of such waste or residue or the purchaser of the rights to extract ores or minerals from such waste or residue. The term "purchaser" does not apply to any person who acquires a mineral property, including such waste or residue, in a tax-free exchange, such as a corporate reorganization, from a person who was entitled to a depletion allowance upon ores or minerals produced from such waste or residue, or from a person who would have been entitled to such depletion allowance had section 613(c)(3) been in effect at the time of the transfer. The term "purchaser" also does not apply to a lessee who has renewed a mineral lease if the lessee was entitled to a depletion allowance (or would have been so entitled had section 613(c)(3) been in effect at the time of the renewal) upon ores or minerals produced from such waste or residue before renewal of the lease. It is not necessary, for purposes of the preceding sentence, that the mineral lease contain an option for renewal. The term "purchaser" does include a person who acquires such waste or residue in a taxable transaction, even though such waste or residue is acquired merely as an incidental part of the entire mineral enterprise. It is immaterial whether the waste or residue results from the process of extraction from the ground or from application of mining processes, as defined in paragraph (f) of this section. However, extraction of ores or minerals from waste or residue which results from processes which are not allowable as mining processes is not treated as mining. For special rules with respect to certain corporate acquisitions referred to in section 381(a), see section 381(c)(18) and the regulations thereunder.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6965, 33 FR 10692, July 26, 1968]

§ 1.613–4 Gross income from the property in the case of minerals other than oil and gas.

(a) **In general.** The rules contained in this section are applicable to the determination of gross income from the property in the case of minerals other than oil and gas and the rules contained in § 1.613–3 are not applicable to such determination, notwithstanding provisions to the contrary in § 1.613–3. The term "gross income from the property," as used in section 613(c)(1), means, in the case of a mineral property other than an oil or gas property, gross income from mining. "Gross income from mining" is that amount of income which is attributable to the extraction of the ores or minerals from the ground and the application of mining processes, including mining transportation. For the purpose of this section, "ordinary treatment processes" (applicable to the taxable years beginning before January 1, 1961) and "treatment processes considered as mining" (applicable to the taxable years beginning after December 31, 1960) will be referred to as "mining processes." Processes, including packaging and transportation,

which do not qualify as mining will be referred to as "nonmining processes." Also for the purpose of this section, transportation which qualifies as "mining" will be referred to as "mining transportation" and transportation which does not qualify as "mining" will be referred to as "nonmining transportation." See paragraph (f) of this section for the definition of the term "mining" and paragraph (g) of this section for rules relating to nonmining processes.

(b) Sales prior to the application of nonmining processes including nonmining transportation. **(1)** Subject to the adjustments required by paragraph (e)(1) of this section, gross income from mining means (except as provided in subparagraph (2) of this paragraph) the actual amount for which the ore or mineral is sold if the taxpayer sells the ore or mineral—

(i) As it emerges from the mine, prior to the application of any process other than a mining process or any transportation, or

(ii) After application of only mining processes, including mining transportation, and before any nonmining transportation.

If the taxpayer sells his ore or mineral in more than one form, and if only mining processes are applied to the ore or mineral, gross income from mining is the actual amount for which the various forms of the ore or mineral are sold, after any adjustments required by paragraph (e)(1) of this section. For example, if, at his mine or quarry, a taxpayer sells several sizes of crushed gypsum and also sells gypsum fines produced as an incidental by-product of his crushing operations, without applying any nonmining processes, gross income from mining will ordinarily be the total amount for which such crushed gypsum and fines are actually sold. See paragraphs (f) and (g) of this section for provisions defining mining and nonmining processes for various minerals.

(2) In the case of sales between members of a controlled group (including sales as to which the district director exercises his authority under section 482 and the regulations thereunder), the prices for such sales (which shall be deemed to be the actual amount for which the ore or mineral is sold) shall be determined, if possible, by use of the representative market or field price method, as described in paragraph (c) of this section; otherwise such prices shall be determined by the appropriate pricing method as provided in paragraph (d)(1) of this section. For the definitions of the terms "controlled" and "group", see paragraph (j)(1) and (2) of this section.

(c) Cases where a representative market or field price for the taxpayer's ore or mineral can be ascertained—(1) General rule. If the taxpayer processes the ore or mineral before sale by the application of nonmining processes (including nonmining transportation), or uses it in his operations, gross income from mining shall be computed by use of the representative market or field price of an ore or mineral of like kind and grade as the taxpayer's ore or mineral after the application of the mining processes actually applied (if any), including mining transportation (if any), and before any nonmining transportation, subject to any adjustments required by paragraph (e)(1) of this section. See paragraph (e)(2)(i) of this section for certain other situations in which this paragraph shall apply. The objective in computing gross income from mining by the representative market or field price method is to ascertain, on the basis of an analysis of actual competitive sales by the taxpayer or others, the dollar figure or amount which most nearly represents the approximate price at which the taxpayer, in light of market conditions, could have sold his ores or minerals if, prior to the application of nonmining processes, the taxpayer had sold the quantities and types of ores and minerals to which he applied nonmining processes. If it is possible to determine a market or field price under the provisions of this paragraph, and if that price is determined to be representative, the taxpayer's gross income from mining shall be determined on the basis of that price and not under the provisions of paragraph (d) of this section. The taxpayer's own actual sales prices for ores or minerals of like kind and grade shall be taken into account when establishing market or field prices, provided that those sales are determined to be representative.

(2) Criteria for determining whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral. An ore or mineral will be considered to be of like kind and grade as the taxpayer's ore or mineral if, in common commercial practice, it is sufficiently similar in chemical, mineralogical, or physical characteristics to the taxpayer's ore or mineral that it is used, or is commercially suitable for use, for essentially the same purposes as the uses to which the taxpayer's ore or mineral is put. Whether an ore or mineral is of like kind and grade as the taxpayer's ore or mineral will generally be determined by reference to industrial or commercial specifications and by consideration of chemical and physical data relating to the minerals and deposits in question. The fact that the taxpayer applies slightly different size

reduction processes, or the fact that the taxpayer uses slightly different beneficiation processes, or the fact that the taxpayer sells his ore or mineral for different purposes, will not, in itself, prevent another person's ore or mineral from being considered to be of like kind and grade as the taxpayer's ore or mineral. On the other hand, the fact that the taxpayer's ore or mineral is suitable for the same general commercial use as another person's ore or mineral will not cause the two ores or minerals to be considered to be of like kind and grade if the desirable natural constituents of the two ores or minerals are markedly different substances. For example, anthracite coal will not be considered to be of like kind as bituminous coal merely because both types of coal can be used as fuel. Similarly, bituminous coal which does not possess coking qualities will not be considered to be of like grade as bituminous coking coal. However, in the case of a taxpayer who mines and uses his bituminous coal in the production of coke, all bituminous coals in the same marketing area will be considered to be of like kind, and all such bituminous coals having the same or similar coking quality suitable for commercial use by coke producers will be considered to be of like grade as the coal mined and used by the taxpayer.

Fine distinctions between various grades of minerals are to be avoided unless those distinctions are clearly shown to have genuine commercial significance.

(3) **Factors to be considered in determining the representative market or field price for the taxpayer's ore or mineral.** In determining the representative market or field price for the taxpayer's ore or mineral, consideration shall be given only to prices of ores or minerals of like kind and grade as the taxpayer's ore or mineral and with which, under commercially accepted standards, the taxpayer's ore or mineral would be considered to be in competition if it were sold under the conditions described in paragraph (b)(1) of this section. A weighted average of the competitive selling prices of ores or minerals of like kind and grade as the taxpayer's, beneficiated only by mining processes, if any, in the relevant markets, although not determinative of the representative market or field price, is an important factor in the determination of that price. The taxpayer's own competitive sales prices for minerals which have been subjected only to mining processes shall be taken into account in computing such a weighted average. For purposes of the preceding sentence, if the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions by the taxpayer, that price shall be deemed to be a competitive sales price for those transactions. Sales or purchases, including the taxpayer's, of ores or minerals of like kind and grade as the taxpayer's, will be taken into consideration in determining the representative market or field price for the taxpayer's ore or mineral only if those sales or purchases are the result of competitive transactions. The identity of the taxpayer's relevant markets (including their accessibility to the taxpayer), and the representative market or field price within those markets, are necessarily factual determinations to be made on the basis of the facts and circumstances of each individual case. For the purpose of determining the representative market or field price for the taxpayer's ore or mineral, exceptional, insignificant, unusual, tie-in, or accommodation sales shall be disregarded. Except as provided above, representative market or field prices shall not be determined by reference to prices established between members of a controlled group. See paragraph (j) of this section for the definitions of the terms "controlled" and "group".

(4) **Use of prices of mineral of different grade.** If there is no representative market or field price for a mineral of like kind and grade as the taxpayer's, representative market or field prices for an ore or mineral which is of like kind but which is not of like grade as his ore or mineral may be used, with appropriate adjustments for differences in mineral content. Representative market or field prices of an ore or mineral of like kind but not of like grade may be used only if such adjustments are readily ascertainable. For example, it may be appropriate in a particular case to establish the representative market or field price for an ore having 50 percent X mineral content by reference to the representative market or field price for the same kind of ore having 60 percent X mineral content with an appropriate adjustment for the differences in the valuable mineral content of the two ores, any differences in processing costs attributable to impurities, and any other relevant factors.

(5) **Information to be furnished by a taxpayer computing gross income from mining by use of a representative market or field price.** A taxpayer who computes his gross income from mining pursuant to the provisions of this paragraph shall attach to his return a summary statement indicating the prices used by him in computing gross income from mining under this paragraph and the source of his information as to those prices, and the relevant supporting data shall be assembled,

segregated, and made readily available at the taxpayer's principal place of business.

(6) Limitation on gross income from mining computed under the provisions of this paragraph. It shall be presumed that a price is not a representative market or field price for the taxpayer's ore or mineral if the sum of such price plus the total of all costs of the nonmining processes (including nonmining transportation) which the taxpayer applies to his ore or mineral regularly exceeds the taxpayer's actual sales price of his product. For example, if on a regular basis the total of all costs of nonmining processes applied by the taxpayer to coal for the purpose of making coke is $12 per ton, and if the taxpayer's actual sale price for such coke is $18 per ton, a price of $7 per ton would not be a representative market or field price for the taxpayer's coal which is used for making coke. In order to rebut the presumption set forth in the first sentence of this subparagraph, it must be established that the loss on nonmining operations is directly attributable to unusual, peculiar and nonrecurring factors rather than to the use of a market or field price which is not representative. For example, the first sentence of this subparagraph shall not apply if the taxpayer establishes in an appropriate case that the loss on nonmining operations is directly attributable to an event such as a fire, flood, explosion, earthquake, or strike.

(d) Cases where a representative market or field price cannot be ascertained—(1) General rule. (i) If it is impossible to determine a representative market or field price as described in paragraph (c) of this section then, except as provided in subdivision (ii) of this subparagraph, gross income from mining shall be computed by use of the proportionate profits method as set forth in subparagraph (4) of this paragraph. A method of computing gross income from mining under the provisions of this paragraph shall not be deemed to be a method of accounting for purposes of paragraph (e) of § 1.446-1.

(ii)(a) The Office of the Assistant Commissioner (Technical) may determine that a method of computation is more appropriate than the proportionate profits method or the method being used by the taxpayer. The taxpayer may request such a determination (see (d) of this subdivision (ii)). If the taxpayer is using a method of computation which has been determined by the Office of Assistant Commissioner (Technical) to be more appropriate than the proportionate profits method, such method shall continue to be used until it is determined by the Office of Assistant Commissioner (Technical) that either the proportionate profits method or another method is more appropriate.

(b) The proportionate profits method is more appropriate than the method being used under (a) if, under the particular facts and circumstances, the method being used under (a) consistently fails to clearly reflect gross income from mining and the proportionate profits method more clearly reflects gross income from mining for the taxable year.

(c) An alternative method (a method other than the method being used under (a) (if any) and the proportionate profits method) is more appropriate than the method being used under (a) (if any) and the proportionate profits method if, under the particular facts and circumstances, the latter methods consistently fail to clearly reflect gross income from mining, and the alternative method being considered more clearly reflects gross income from mining on a consistent basis than the method being used under (a) (if any) and the proportionate profits method. When determining whether a method of computation clearly reflects gross income from mining, it is relevant to compare the gross income from mining produced by such method with the gross income from mining, on an equivalent amount of production, which results from the computation methods used by competitors. When determining the acceptability of proposed alternative methods, primary consideration will be given to computation methods based upon representative charges for ores, minerals, products, or services. See paragraph (c) of this section for principles determining the representative character of a charge.

(d) Application for permission to compute gross income from mining by use of an alternative method shall be made by submitting a request to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Technical), Washington, D.C. 20224.

(e) Among the alternative methods of computation to which consideration will be given, provided that the requirements of this subdivision (ii) are met, are the methods listed in subparagraphs (5), (6), and (7) of this paragraph. The order in which these methods are listed is not significant, and the listing of these methods does not preclude a request to make use of a method which is not listed.

(iii) Approval and continued use of any method of computation under this paragraph depends upon all the facts and circumstances in each case, and shall be subject to such terms and conditions as may be necessary in the opinion of the Commis-

sioner to reflect clearly the gross income from mining. Accordingly, the use of such a method for any taxable year shall be subject to review and change.

(2) **Costs to be used in computing gross income from mining by use of methods based on the taxpayer's costs.** In determining the taxpayer's gross income from mining by use of methods based on the taxpayer's costs, only costs actually paid or incurred shall be taken into consideration. In general, if the taxpayer has consistently employed a reasonable method of determining the costs of the various individual phases of his mining and nonmining processes (such as extraction, loading for shipment, calcining, packaging, etc.), such method shall not be disturbed. The amount of any particular item to be taken into account shall, for taxable years beginning after November 30, 1968, be the amount used in determining the taxpayer's income for tax purposes. For example, the depreciation lives, methods, and records used for tax purposes, if different from those used for book purposes, shall be the basis for determining the amount of depreciation to be used. However, a taxpayer may continue to use a reasonable method for determining those costs on the basis of the amounts computed for cost control or similar financial or accounting books and records if that method has been used consistently and is applied to the determination of all those costs.

(3) **Treatment of particular items in computing gross income from the mining by use of methods based on the taxpayer's costs.** (i) Except as specifically provided elsewhere in this section, when determining gross income from mining by use of methods based on the taxpayer's costs, the costs attributable to mining transportation shall be treated as mining costs, and the costs attributable to nonmining transportation shall be treated as nonmining costs. Accordingly, except as specifically provided elsewhere in this section, all profits attributable to mining transportation shall be treated as mining profits, and all profits attributable to nonmining transportation shall be treated as nonmining profits. For this purpose, mining transportation means so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to plants or mills in which other mining processes are applied thereto as is not in excess of 50 miles or, if the taxpayer files an application pursuant to paragraph (h) of this section and the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over the greater distance. Further, for this purpose, nonmining transportation includes the transportation (whether or not by common carrier) of ores, minerals, or the products produced therefrom, from the point of extraction from the ground to nonmining facilities, or from a mining facility to a nonmining facility, or from one nonmining facility to another, or from a nonmining facility to the customers who purchase the taxpayer's first marketable product or group of products. See paragraph (e)(2) of this section for provisions relating to purchased transportation to the customer and paragraph (g)(3) of this section for provisions relating to transportation the primary purpose of which is marketing or distribution. In the absence of other methods which clearly reflect the costs of the various phases of transportation, the cost attributable to nonmining transportation shall be an amount which is in the same ratio to the costs incurred for the total transportation as the distance of the nonmining transportation is to the distance of the total transportation. As an example, where the plants or mills in which mining processes are applied to ores or minerals are in excess of 50 miles from the point of extraction from the ground (or in excess of a greater distance approved by the Commissioner), the costs incurred for transportation to those plants or mills in excess of 50 miles (or of that greater distance) shall be treated as nonmining costs in determining gross income from mining. Accordingly, all profits attributable to that excess transportation are treated as nonmining profits. However, except in the case of transportation performed in conveyances owned or leased by the taxpayer, the preceding sentence shall apply only to taxable years beginning after November 30, 1968.

(ii) In determining gross income from mining by use of methods based on the taxpayer's costs, a process shall not be considered as a mining process to the extent it is applied to ores, minerals, or other materials with respect to which the taxpayer is not entitled to a deduction for depletion under section 611. The costs of such nondepletable ores, minerals, or materials; the costs of the processes (including blending, size reduction, etc.) applied thereto; and the transportation costs thereof, if any, shall be considered as nominating costs in determining gross income from mining. If a mining process is applied to an admixture of depletable and nondepletable material, the cost of the process and the cost of transportation, if any, attributable to the nondepletable material shall be considered as nonmining costs in determining gross income from mining. Accordingly, all prof-

its attributable thereto are treated as nonmining profits. In the absence of other methods which clearly reflect the cost attributable to the processing and transportation, if any, of the nondepletable admixed material, that cost shall be deemed to be that proportion of the costs which the tonnage of nondepletable material bears to the total tonnage of both depletable and nondepletable material.

(iii) In determining gross income from mining by use of methods based on the taxpayer's costs—

(a) The costs attributable to containers, bags, packages, pallets, and similar items as well as the costs of materials and labor attributable to bagging, packaging, palletizing, or similar operations shall be considered as nonmining costs.

(b) The costs attributable to the bulk loading of manufactured products shall be considered as nonmining costs.

(c) The costs attributable to the operation of warehouses or distribution terminals for manufactured products shall be considered as nonmining costs.

Accordingly, all profits attributable thereto are treated as nonmining profits.

(iv) In computing gross income from mining by the use of methods based on the taxpayer's costs, the principles set forth in paragraph (c) of § 1.613-5 shall apply when determining whether selling expenses and trade association dues are to be treated, in whole or in part, as mining costs or as nonmining costs. To the extent that selling expenses and trade association dues are treated as nonmining costs, all profits attributable thereto are treated as nonmining profits.

(v) See paragraph (e)(1) of this section for provisions excluding certain allowances from the taxpayer's gross sales and costs of his first marketable product or group of products.

(4) Proportionate profits method. (i) The objective of the "proportionate profits method" of computation is to ascertain gross income from mining by applying the principle that each dollar of the total costs paid or incurred to produce, sell, and transport the first marketable product or group of products (as defined in subdivision (iv) of this subparagraph) earns the same percentage of profit. Accordingly, in the proportionate profits method no ranking of costs is permissible which results in excluding or minimizing the effect of any costs incurred to produce, sell, and transport the first marketable product or group of products. For purposes of this subparagraph, members of a controlled group shall be treated as divisions of a single taxpayer. See paragraph (j) of this section for the definitions of the terms "controlled" and "group".

(ii) The proportionate profits method of computation is applied by multiplying the taxpayer's gross sales (actual or constructive) of his first marketable product or group of products (after making the adjustments required by paragraph (e) of this section) by a fraction whose numerator is the sum of all the costs allocable to those mining processes which are applied to produce, sell, and transport the first marketable product or group of products, and whose denominator is the total of all the mining and nonmining costs paid or incurred to produce, sell, and transport the first marketable product or group of products (after making the adjustments required by this paragraph and paragraph (e) of this section). The method as described herein is merely a restatement of the method formerly set forth in the second sentence of Regulations 118, section 39.23(m)–1 (e)(3) (1939 Code). The proportionate profits method of computation may be illustrated by the following equation:

Mining Costs $\div$ Total Costs $\times$ Gross Sales = Gross Income from Mining

(iii) Those costs which are paid or incurred by the taxpayer to produce, sell, and transport the first marketable product or group of products, and which are not directly identifiable with either a particular mining process or a particular nonmining process shall, in the absence of a specific provision of this section providing an apportionment method, be apportioned to mining and to nonmining by use of a method which is reasonable under the circumstances. One method which may be reasonable in a particular case is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes bear to each other. For example, the salary of a corporate officer engaged in overseeing all of the taxpayer's processes is an expense which may reasonably be apportioned on the basis of the ratio between the direct costs of mining and nonmining processes. On the other hand, an expense such as workmen's compensation premiums would normally be apportioned on the basis of direct labor costs. For the rule relating to selling expenses, see paragraph (c)(4) of § 1.613–5.

(iv) As used in this section, the term "first marketable product or group of products" means the product (or group of essentially the same products) produced by the taxpayer as a result of the application of nonmining processes, in the

form or condition in which such product or products are first marketed in significant quantities by the taxpayer or by others in the taxpayer's marketing area. For this purpose, bulk and packaged products are considered to be essentially the same product. Sales between members of a controlled group (as defined in paragraph (j) of this section) shall not be considered in making a determination under this subdivision. The first marketable product or group of products does not include any product which results from additional manufacturing or other nonmining processes applied to the product or products first marketed in significant quantities by the taxpayer or others in the taxpayer's marketing area. For example, if a cement manufacturer sells his own finished cement in bulk and bags and also sells concrete blocks or dry ready-mix aggregates containing additives, the finished cement, in bulk and bags, constitutes the first marketable product or group of products produced by him. Similarly, if an integrated iron ore and steel producer sells both pig iron in various sizes and rolled sheet iron or shapes, his first marketable product is the pig iron in its various sizes. Further, if an integrated clay and brick producer sells both unglazed bricks and tiles of various shapes and sizes and additionally manufactured bricks and tiles which are specially glazed, the unglazed products, both packaged and unpackaged, constitute his first marketable product or group of products.

(v)(a) As used in this subparagraph, the term "gross sales (actual or constructive)" means the total of the taxpayer's actual competitive sales to others of the first marketable product or group of products, plus the taxpayer's constructive sales of the first marketable product or group of products used or retained for use in his own subsequent operations, subject to the adjustments required by paragraph (e) of this section. See (b) of this subdivision in the case of actual sales between members of controlled groups and in the case of constructive sales. A "constructive sale" occurs when a miner-manufacturer is deemed, for percentage depletion purposes, to be selling the first marketable product or group of products to himself.

(b) In the case of sales between members of a controlled group as to which the district director has exercised his authority under section 482 and the regulations thereunder and has determined the appropriate price with respect to specific sales transactions, that price shall be deemed, for those transactions, to be the actual amount for which the first marketable product or group of products is sold for purposes of this subdivision (v). In the case of all other sales between members of a controlled group, and in the case of constructive sales, the prices for such sales shall be determined by use of the principles set forth in paragraph (c) of this section, subject to the adjustments required by paragraph (e) of this section. In the case of constructive sales, see paragraph (c)(4) of this section for rules relating to information to be furnished by the taxpayer.

(vi) The provisions of this subparagraph may be illustrated by the following examples:

Example (1)—(a) Facts. A is engaged in the mining of a mineral to which section 613 applies and in the application thereto of nonmining processes. During 1968, A incurred extraction costs of $35,000; other mining costs of $56,000; $150,000 for manufacturing costs; $46,000 for other nonmining processes; and $14,000 for the company president's salary and similar costs resulting from both nonmining and mining processes. During that year, A produced and sold 70,000 tons of his first marketable product for an actual gross sales price of $420,000, after the adjustments required by paragraph (e) of this section. A representative market or field price for A's mineral before the application of nonmining processes cannot be established.

(b) Computation. (1) The computation of A's gross income from mining by use of the proportionate profits method involves two steps. The first step is to apportion A's costs to mining and to nonmining. A apportions the company president's salary and similar costs to mining and to nonmining in the manner described in the second and third sentences of subdivision (iii) of this subparagraph, and apportions his remaining costs as follows:

Cost	Mining	Nonmining	Total
Extraction	$35,000	....	$35,000
Other mining processes	56,000	....	56,000
Manufacturing	....	$150,000	150,000
Other nonmining processes	....	46,000	46,000
Subtotal	91,000	196,000	287,000
President's salary and similar costs	4,439	9,561	14,000
Total costs	95,439	205,561	301,000

(2) The second step is to apply the proportionate profits fraction so as to compute A's gross income from mining. To do this, A first computes his gross sales of his first marketable group of products, in this case $420,000. A multiplies his actual gross sales of $420,000 by the proportionate profits fraction, whose numerator consists of his total mining costs ($95,439) and whose denominator consists of his total costs ($301,000). Thus, A's gross income from mining is $133,170 (*i.e.*, 95,439/301,000ths of A's actual gross sales of $420,000).

Example (2). B, who leases a mineral property from C, is engaged in the mining of a mineral to which section 613 applies and in the application thereto of nonmining processes. Pursuant to the terms of the lease, B is required to pay C 10 cents for each ton of mineral which B mines. During 1971, B extracted 100,000 tons of mineral. He sold his first marketable product for an actual gross sales price of $225,000 after the adjustments required by paragraph (e) of this section. A representative

market or field price for B's mineral before the application of nonmining processes cannot be established. During 1971, with respect to the 100,000 tons of mineral extracted, B incurred mining costs of $50,000 and nonmining costs of $100,000, and paid $10,000 to C as C's royalty. Since the royalty payment is considered to be C's share of the gross income from mining under section 613(a), it is not considered to be either a mining cost or a nonmining cost of B. B's gross income from mining is $65,000 under the proportionate profits method, determined as follows: The $225,000 gross receipts must be multiplied by the proportionate profits fraction which is $50,000 mining costs over $150,000 total costs ($50,000 + $100,000 nonmining costs). Since the resulting $75,000 is the total gross income from mining with respect to the property, it must be allocated between B's lease interest and C's royalty interest. The $10,000 paid to C must be subtracted from the $75,000 leaving $65,000 which represents B's gross income from mining. C's gross income from mining is the royalty he received or $10,000.

(5) Representative schedule method. The "representative schedule method" is a pricing formula which uses representative finished product prices, penalties, charges and adjustments, established in arms-length transactions between unrelated parties, to determine the market or field price for a crude mineral product. The representative character of a price, penalty, charge, or adjustment shall be determined by applying the principles set forth in paragraph (c) of this section. The representative schedule method is principally intended for use in those industries in which such a schedule-type pricing method is in general use to determine the price paid to unintegrated mineral producers for their crude mineral product. For example, if unintegrated producers of copper concentrate in a particular field or market customarily sell their product at prices which are determined in accordance with a schedule-type pricing formula, consideration will be given to the determination of concentrate prices for integrated copper producers in accordance with the same pricing formula. The representative schedule method shall not be used if it is impossible to determine one or more of the elements in the representative schedule formula by reference to prices, penalties, charges, or adjustments established in representative transactions between unrelated parties. See paragraph (c) of this section for principles determining the representative character of a charge.

(6) Method using prices outside the taxpayer's market. Under the "other market method" the taxpayer uses representative market or field prices established outside his markets, provided that conditions there are substantially the same as in his markets. For example, it may be appropriate in a particular case to establish the representative market or field price for pellets containing 60 percent iron which are produced and used in market area X by reference to the representative market or field price for pellets containing 60 percent iron which are produced and sold in adjacent market area Y, provided that conditions in the two marketing areas are shown to be substantially the same.

(7) Rate of return on investment method. [Reserved]

(e) Reductions of sales price in computing gross income from mining—(1) Discounts. If a taxpayer computes gross income from mining under the provisions of paragraph (b)(1) of this section, trade discounts and, for taxable years beginning after November 30, 1968, cash discounts actually allowed by the taxpayer shall be subtracted from the sale price of the taxpayer's ore or mineral. If a taxpayer computes gross income from mining under the provisions of paragraph (c) of this section, any such discounts actually allowed (if not otherwise taken into account) by the person or persons making the sales on the basis of which the representative market or field price for the taxpayer's ore or mineral is to be determined shall be subtracted from the sale price in computing such representative market or field price. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, such discounts actually allowed (if not otherwise taken into account) shall be subtracted from the gross sales (actual or constructive), and shall not be considered a cost, of the first marketable product or group of products. The provisions of this subparagraph shall apply to arrangements which have the same effect as trade or cash discounts, regardless of the form of the arrangements.

(2) Purchased transportation to the customer. (i) A taxpayer who computes gross income from mining under the provisions of paragraph (c) of this section and who sells his ore or mineral after the application of only mining processes but after nonmining transportation shall use as the representative market or field price his delivered price (if otherwise representative) reduced by costs paid or incurred by him for purchased transportation to the customer as defined in subdivision (iii) of this subparagraph. If the transportation by the taxpayer is not purchased transportation to the customer, or if the taxpayer does not sell the ore or mineral until after the application of nonmining processes, and if other producers in the taxpayer's marketing area sell significant quantities of an ore or mineral of like kind and grade after the application of only mining processes but after purchased transportation to the customer, the representative delivered price at which the ore or mineral is sold by those other producers reduced by representative costs of purchased transportation to the customer

paid or incurred by those producers shall be used by the taxpayer as the representative market or field price for his ore or mineral in applying paragraph (c) of this section. Furthermore, appropriate adjustments shall be made to take into account differences in mode of transportation and distance. When applying this subdivision, the representative market or field price so computed shall not exceed the taxpayer's delivered price less his actual costs of transportation to the customer. For purposes of this subdivision, any delivered price shall be adjusted as provided in subparagraph (1) of this paragraph.

(ii) If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the cost of purchased transportation to the customer (as defined in subdivision (iii) of this subparagraph) shall be excluded from the gross sales of his first marketable product or group of products (after any adjustments required by subparagraph (1) of this paragraph), and from the denominator of the proportionate profits fraction, so as not to attribute profits to the cost of that transportation. Similar transportation cost adjustments may be made, if appropriate, in the case of other methods of computation which are based on the taxpayer's costs. For the treatment of costs and profits attributable to transportation which is not purchased transportation to the customer as defined in subdivision (iii) of this subparagraph, see paragraph (d)(3)(i) of this section.

(iii) For purposes of this section, the term "purchased transportation to the customer" means, in general, nonmining transportation of the taxpayer's minerals or mineral products to the customer—

(a) Which is not performed in conveyances owned or leased directly or indirectly, in whole or in part, by the taxpayer,

(b) Which is performed solely to deliver the taxpayer's minerals or mineral products to the customer, rather than to transport such minerals or products for packaging or other additional processing by the taxpayer (other than incidental storage or handling), and

(c) With respect to which the taxpayer ordinarily does not earn any profit.

For purposes of the preceding sentence, transportation which is performed by a person controlling or controlled by the taxpayer (within the meaning of paragraph (j)(1) of this section) shall be deemed to have been performed in conveyances owned or leased by the taxpayer unless it is established by the taxpayer that the price charged by the controlling or controlled person for such transportation constitutes an arm's-length charge (under the standard described in paragraph (b)(1) of § 1.482–1). The term "purchased transportation to the customer" includes transportation to a warehouse, terminal, or distribution facility owned or operated by the taxpayer, provided that such transportation is performed under the conditions described in the first sentence of this subdivision. A taxpayer will not be deemed ordinarily to earn a profit on transportation merely because charges for the transportation are included in the stated selling price, rather than being separately stated or segregated from other billing. A taxpayer will not be deemed ordinarily to earn a profit on transportation if the rates for the transportation constitute an arm's-length charge ordinarily paid by shippers of the same product in similar circumstances. If a taxpayer computes gross income from mining under the provisions of paragraph (d) of this section, the term "purchased transportation to the customer" refers to transportation which conforms to the other requirements of this subdivision and which is performed to transport the taxpayer's first marketable product or group of products (as defined in paragraph (d)(4)(iv) of this section) rather than to transport minerals or mineral products which do not yet constitute the taxpayer's first marketable product or group of products.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A is engaged in the mining of an ore of mineral M and in the production and sale of M concentrate. A retains a portion of his concentrate for use in his own nonmining operations. During 1968, A sold 100,000 tons of M concentrate of ore mined and processed by him, which sales constituted a significant portion of his total production. Eighty thousand tons of that concentrate were sold by A on the basis of a representative price (after adjustments required by subparagraph (1) of this paragraph) of $30 per ton f.o.b. mine or plant, resulting in gross income from mining of $2,400,000. The remaining 20,000 tons were sold by A, both directly and through terminals, on the basis of a delivered price (after adjustments required by subparagraph (1) of this paragraph) at City X of $40 per ton. The delivered price included $15 per ton cost of purchased transportation from the mine or plant to customers in City X. The representative market or field price of the concentrate sold by A on the basis of a delivered price is $25 per ton, determined by subtracting the cost of the purchased transportation to the customer ($15 per ton) from the delivered price for the concentrate ($40 per ton). Accordingly, A's gross income from mining with respect to the 20,000 tons of M concentrate sold on a delivered basis is $500,000. The representative market or field price for the concentrate retained by A and used in his own nonmining operations may be computed by reference to the weighted average price for both A's f.o.b. mine and A's delivered sales of concentrate, with the delivered sales prices reduced in the manner described above. On this basis, the representative market or field price for the retained concentrate is $29 per ton.

Example (2). B is engaged in the mining of an ore of mineral N and in the production of N concentrate. B retained all but an insignificant amount of his concentrate for use in his own nonmining operations. Other producers in B's marketing area sell significant amounts of N concentrate of like kind and grade, both on an f.o.b. mine or plant basis and on a delivered basis. In this case, the prices for both the f.o.b. and the delivered sales made by other producers (after any adjustments required by subparagraph (1) of this paragraph), after reduction of the delivered prices by the cost of purchased transportation to the customer, shall, if such prices are otherwise representative, be taken into account in establishing the representative market or field price for the N concentrate produced and used by B.

(f) Definition of mining—(1) In general. The term "mining" includes only—

(i) The extraction of ores or minerals from the ground;

(ii) Mining processes, as described in subparagraphs (2) through (6) of this paragraph; and

(iii) So much of the transportation (whether or not by common carrier) of ores or minerals from the point of extraction of the ores or minerals from the ground to the plants or mills in which the processes referred to in subdivision (ii) of this subparagraph are applied thereto as is not in excess of 50 miles, and, if the Commissioner finds that both the physical and other requirements are such that the ores or minerals must be transported a greater distance to such plants or mills, the transportation over such greater distance as the Commissioner authorizes. See paragraph (h) of this section for rules relating to the filing of applications to treat as mining any transportation in excess of 50 miles.

(2) Definition of mining processes. (i) As used in subparagraph (1)(ii) of this paragraph, the term "mining processes" means, for taxable years beginning before January 1, 1961, the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products, including the following processes (and the processes necessary or incidental thereto), and, for taxable years beginning after December 31, 1960, the following processes (and the processes necessary or incidental thereto):

(a) In the case of coal—cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment;

(b) In the case of sulfur recovered by the Frasch process—cleaning, pumping to vats, cooling, breaking, and loading for shipment;

(c) In the case of iron ore, bauxite, ball and sagger clay, rock asphalt, and ores or minerals which are customarily sold in the form of a crude mineral product (as defined in subparagraph (3)(iv) of this paragraph)—

(1) Where applied for the purpose of bringing to shipping grade and form (as defined in subparagraph (3)(iii) of this paragraph)—sorting, concentrating, sintering, and substantially equivalent processes, and

(2) Loading for shipment.

(d) In the case of lead, zinc, copper, gold, silver, uranium, or fluorspar ores, potash, and ores or minerals which are not customarily sold in the form of the crude mineral product—crushing, grinding, and beneficiation by concentration (gravity, flotation, amalgamation, electrostatic, or magnetic), cyanidation, leaching, crystallization, precipitation (but not including electrolytic deposition, roasting, thermal or electric smelting, or refining), or by substantially equivalent processes or combination of processes used in the separation or extraction of the product or products from the ore or the mineral or minerals from other material from the mine or other natural deposit; and

(e) In the case of the following ores or minerals—

(1) The furnacing of quicksilver ores,

(2) The pulverization of talc,

(3) The burning of magnesite, and

(4) The sintering and nodulizing of phosphate rock.

(ii) The term "mining processes" also includes the following processes (and, except as otherwise provided in this subdivision, the processes necessary or incidental thereto):

(a) For taxable years beginning after December 31, 1960, in the case of calcium carbonates and other minerals when used in making cement—all processes (other than preheating the kiln feed) applied prior to the introduction of the kiln feed into the kiln, but not including any subsequent process;

(b) For taxable years beginning after December 31, 1960, and before November 14, 1966, in the case of clay to which former section 613(b)(5)(B) applied, and for taxable years beginning after November 13, 1966, in the case of clay to which section 613(b)(5) or (6)(B) applies—crushing, grinding, and separating the clay from waste, but not including any subsequent process;

(c) For taxable years beginning after October 9, 1969, in the case of minerals (other than sodium chloride) extracted from brines pumped from a saline perennial lake (as defined in paragraph (b) of § 1.613–2)—the extraction of such minerals from the brines, but in no case including any further processing or refining of such extracted minerals; and

(d) For taxable years beginning after December 30, 1969, in the case of oil shale (as defined in paragraph (b) of § 1.613–2)—extraction from the ground, crushing, loading into the retort, and retorting, but in no case hydrogenation, refining, or any other process subsequent to retorting.

(iii) A process is "necessary" to another related process if it is prerequisite to the performance of the other process. For example, if the concentrating of low-grade iron ores to bring to shipping grade and form cannot be effectively accomplished without fine pulverization, such pulverization shall be treated as a process which is "necessary" to the concentration process. Accordingly, because concentration is a mining process, such pulverization is also a mining process. Furthermore, if mining processes cannot be effectively applied to a mineral without storage of the mineral while awaiting the application of such processes, such storage shall be treated as a process which is "necessary" to the accomplishment of such mining processes. A process is "incidental" to another related process if the cost thereof is insubstantial in relation to the cost of the other process, or if the process is merely the coincidental result of the application of the other process. For example, the sprinkling of coal, prior to loading for shipment, with dots of paper to identify the coal for trade-name purposes will be considered incidental to the loading where the cost of that sprinkling is insubstantial in relation to the cost of the loading process. Also, where crushing of a crude mineral is treated as a mining process, the production of fines as a by-product is ordinarily the coincidental result of the application of a mining process. If a taxpayer demonstrates that, as a factual matter, a particular process is necessary or incidental to a process named as a mining process in section 613(c)(4) of this paragraph, the necessary or incidental process will also be considered a mining process.

(iv) The term "mining" does not include purchasing minerals from another. Accordingly, the processes listed in this paragraph shall be considered as mining processes only to the extent that they are applied by a mine owner or operator to an ore or mineral in respect of which he is entitled to a deduction for depletion under section 611. The application of these processes to purchased ores, minerals, or materials does not constitute mining.

(3) **Processes recognized as mining for ores or minerals covered by section 613(c)(4)(C).** (i) As used in section 613(c)(4)(C) and subparagraph (2)(i)(c) of this paragraph, the terms "sorting" and "concentrating" mean the process of eliminating substantial amounts of the impurities or foreign matter associated with the ores or minerals in their natural state, or of separating two or more valuable minerals or ores, without changing the physical or chemical identity of the ores or minerals. Examples of sorting and concentrating processes are hand or mechanical sorting, magnetic separation, gravity concentration, jigging, the use of shaking or concentrating tables, the use of spiral concentrators, the use of sluices or sluice boxes, sink-and-float processes, classifiers, hydrotators and flotation processes. Under section 613(c)(4)(C), sorting and concentration will be considered mining processes only where they are applied to bring an ore or mineral to shipping grade and form.

(ii) As used in section 613(c)(4)(C) and subparagraph (2)(i)(c) of this paragraph, the term "sintering" means the agglomeration of fine particles by heating to a temperature at which incipient, but not complete, fusion occurs. Sintering will be considered a mining process only where it is applied to an ore or mineral, or a concentrate of an ore or mineral, as an auxiliary process necessary to bring the ore or mineral to shipping form. A thermal action which is applied in the manufacture of a finished product will not be considered to be a mining process even though such thermal action may cause the agglomeration of fine particles by incipient fusion, and even though such action does not cause a chemical change in the agglomerated particles. For example, the sintering of finely ground iron ore concentrate, prior to shipment from the concentration plant, for the purpose of preventing the risk of loss of the finely divided particles during shipment is considered a mining process. On the other hand, for example, a heating process applied to expand or harden clay, shale, perlite, vermiculite, or other materials in the course of the manufacture of lightweight aggregate or other building materials is not considered to be a mining process.

(iii) As used in section 613(c)(4)(C) and this section, to "bring to shipping grade and form" means, with respect to taxable years beginning after December 31, 1960, to bring (by the application of mining processes at the mine or concentration plant) the quality or size of an ore or mineral

to the stage or stages at which the ore or mineral is shipped to customers or used in nonmining processes (as defined in paragraph (g) of this section) by the taxpayer.

(iv) An ore or mineral is "customarily sold in the form of a crude mineral product", within the meaning of section 613(c)(4)(C), if a significant portion of the production thereof is sold or used in a nonmining process prior to the alteration of its inherent mineral content by some form of beneficiation, concentration, or ore dressing. An ore or mineral does not lose its classification as a crude mineral product by reason of the fact that, before sale or use in a nonmining process, the ore or mineral may be crushed or subjected to other processes which do not alter its inherent mineral content. Whether the portion of production sold or used in the form of a crude mineral product is a significant portion of the total production of an ore or mineral is a question of fact.

(4) Type of processes recognized as mining for ores or minerals covered by section 613(c)(4)(D). Cyanidation, leaching, crystallization, and precipitation, which are listed in section 613(c)(4)(D) as treatment processes considered as mining, and the processes (or combination of processes) which are substantially equivalent thereto, will be recognized as mining only to the extent that they are applied to the taxpayer's ore or mineral for the purpose of separation or extraction of the valuable mineral product or products from the ore, or for the purpose of separation or extraction of the mineral or minerals from other material extracted from the mine or other natural deposit. A process, no matter how denominated, will not be recognized as mining if the process beneficiates the ore or mineral to the degree that such process, in effect, constitutes smelting, refining, or any other nonmining process within the meaning of paragraph (g) of this section. As used in section 613(c)(4)(D) and subparagraph (2)(i)(d) of this paragraph, the term "concentration" has the meaning set forth in the first two sentences of subparagraph (3)(i) of this paragraph.

(5) Processes recognized as mining under section 613(c)(4)(I). Under the authority granted the Secretary or his delegate in section 613(c)(4)(I), the processes which are described in subdivisions (i) through (iv) of this subparagraph, and the processes necessary or incidental thereto, are recognized as mining processes for taxable years beginning after December 31, 1960. The processes described in subdivisions (i) through (iv) of this subparagraph are in addition to the specific processes recognized as mining under section 613(c)(4). Such additional processes are:

(i) Crushing and grinding, but not fine pulverization (as defined in paragraph (g)(6)(v) of this section);

(ii) Size classification processes applied to the products of an allowable mining process;

(iii) Drying to remove free water, provided that such drying does not change the physical or chemical identity or composition of the mineral; and

(iv) Washing or cleaning the surface of mineral particles (including the washing of sand and gravel and the treatment of kaolin particles to remove surface stains), provided that such washing or cleaning does not activate or otherwise change the physical or chemical structure of the mineral particles.

(6) In the case of a process applied subsequent to a nonmining process, see paragraph (g)(2) of this section.

(g) Nonmining processes—(1) General rule. Unless they are otherwise provided for in paragraph (f) of this section as mining processes (or are necessary or incidental to processes listed therein), the following processes are not considered to be mining processes—electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping. See subparagraph (6) of this paragraph for definitions of certain of these terms.

(2) Processes subsequent to nonmining processes. Notwithstanding any other provision of this section, a process applied subsequent to a nonmining process (other than nonmining transportation) shall also be considered to be a nonmining process. Exceptions to this rule shall be made, however, in those instances in which the rule would discriminate between similarly situated producers of the same mineral. For example, roasting is specifically designated in subparagraph (1) of this paragraph as a nonmining process, but in the case of minerals referred to in section 613(c)(4)(C) sintering is recognized as a mining process. If certain impurities in an ore can only be removed by roasting in order to bring it to the same shipping grade and form as a competitive sintered ore of the same kind which requires no roasting, the subsequent sintering of the roasted ore will be treated as a mining process. In that case, however, the roasting of the ore will none-

theless continue to be treated as a nonmining process.

(3) **Transportation for the purpose of marketing or distribution; storage.** Transportation the primary purpose of which is marketing, distribution, or delivery for the application of only nonmining processes shall not be considered as mining. Nor shall transportation be considered as mining merely because, during the course of such transportation, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow. Similarly, storage or warehousing of manufactured products shall not be considered as mining. The preceding sentence shall apply even though, during the course of such storage or warehousing, some extraneous matter is removed from the ore or mineral by the operation of forces of nature, such as evaporation, drainage, or gravity flow.

(4) **Manufacturing, etc.** The production, packaging, distribution, and marketing of manufactured products, and the processes necessary or incidental thereto, are nonmining processes.

(5) **Transformation processes.** Processes which effect a substantial physical or chemical change in a crude mineral product, or which transform a crude mineral product into new or different mineral products, or into refined or manufactured products, are nonmining processes except to the extent that such processes are allowed as mining processes under section 613(c) or under paragraph (f) of this section.

(6) **Definitions.** As used in section 613(c)(5) and this section—

(i) The term "calcining" refers to processes used to expel the volatile portions of a mineral by the application of heat, as, for example, the burning of carbonate rock to produce lime, the heating of gypsum to produce calcined gypsum or plaster of Paris, or the heating of clays to reduce water of crystallization.

(ii) The term "thermal smelting" refers to processes which reduce, separate, or remove impurities from ores or minerals by the application of heat, as, for example, the furnacing of copper concentrates, the heating of iron ores, concentrates, or pellets in a blast furnace to produce pig iron, or the heating of iron ores or concentrates in a direct reduction kiln to produce a feed for direct conversion into steel.

(iii) The term "refining" refers to processes (other than mining processes designated in section 613(c)(4) or this section) used to eliminate impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as, for example, the refining of blister copper. In general, a refining process is designed to achieve a high degree of purity by removing relatively small amounts of impurities or foreign matter from smelted or partially processed ores or minerals.

(iv) The term "polishing" refers to processes used to smooth the surface of minerals, as, for example, sawing applied to finish rough cut blocks of stone, sand finishing, buffing, or otherwise smoothing blocks of stone.

(v) The term "fine pulverization" refers to any grinding or other size reduction process applied to reduce the normal topsize of a mineral product to less than .0331 inches, which is the size opening in a No. 20 Screen (U.S. Standard Sieve Series). A mineral product will be considered to have a normal topsize of .0331 inches if at least 98 percent of the product will pass through a No. 20 Screen (U.S. Standard Sieve Series), provided that at least 5 percent of the product is retained on a No. 45 Screen (U.S. Standard Sieve Series). Compliance with the normal topsize test may also be demonstrated by other tests which are shown to be reasonable in the circumstances. The normal topsize test shall be applied to the product of the operation of each separate and distinct piece of size reduction equipment utilized (such as a roller mill), rather than to the final products for sale. Fine pulverization includes the repeated recirculation of material through crushing or grinding equipment to accomplish fine pulverization. Separating or screening the product of a fine pulverization process (including separation by air or water flotation) shall be treated as a nonmining process.

(vi) The term "blending with other materials" refers to processes used to blend different kinds of minerals with one another, as, for example, blending iodine with common salt for the purpose of producing iodized table salt.

(vii) The term "treatment effecting a chemical change" refers to processes which transform or modify the chemical composition of a crude mineral, as, for example, the coking of coal. The term does not include the use of chemicals to clean the surface of mineral particles provided that such cleaning does not make any change in the physical or chemical structure of the mineral particles.

(viii) The term "thermal action" refers to processes which involve the application of artificial heat to ores or minerals, such as, for example, the

burning of bricks, the coking of coal, the expansion or popping of perlite, the exfoliation of vermiculite, the heat treatment of garnet, and the heating of shale, clay, or slate to produce lightweight aggregates. The term does not include drying to remove free water.

(h) Application to treat, as mining, transportation in excess of 50 miles. If a taxpayer desires to include in the computation of his gross income from mining transportation in excess of 50 miles from the point of extraction of the minerals from the ground, he shall file an original and one copy of an application for the inclusion of such greater distance with the Commissioner of Internal Revenue, Washington, D.C. 20224. The application must include a statement setting forth in detail the facts concerning the physical and other requirements which prevented the construction and operation of the plant (in which mining processes, as defined in paragraph (f) of this section, are applied) at a place nearer to the point of extraction from the ground. These facts must be sufficient to apprise the Commissioner of the exact basis of the application. If the taxpayer's return is filed prior to receipt of notice of the Commissioner's action upon the application, a copy of such application shall be attached to the return. If, after an application is approved by the Commissioner, there is a material change in any of the facts relied upon in such application, a new application must be submitted by the taxpayer.

(i) Extraction from waste or residue. "Extraction of ores or minerals from the ground" means not only the extraction of ores or minerals from a deposit, but also the extraction by mine owners or operators of ores or minerals from waste or residue of their prior mining. It is immaterial whether the waste or residue results from the process of extraction from the ground or from application of mining processes as defined in paragraph (f) of this section. However, extraction of ores or minerals from waste or residue which results from processes which are not allowable as mining processes is not treated as mining. "Extraction of ores or minerals from the ground" does not include extraction of ores or minerals by the purchaser of waste or residue or the purchaser of the rights to extract ores or minerals from waste or residue. The term "purchaser" does not apply to any person who acquires a mineral property, including waste or residue, in a tax-free exchange, such as a corporate reorganization, from a person who was entitled to a depletion allowance upon ores or minerals produced from such waste or residue, or from a person who would have been entitled to such depletion allowance had section 613(c)(3) been in effect at the time of the transfer. The term "purchaser" also does not apply to a lessee who has renewed a mineral lease if the lessee was entitled to a depletion allowance (or would have been so entitled had section 613(c)(3) been in effect at the time of the renewal) upon ores or minerals produced from waste or residue before renewal of the lease. It is not necessary, for purposes of the preceding sentence, that the mineral lease contain an option for renewal. The term "purchaser" does include a person who acquires waste or residue in a taxable transaction, even though such waste or residue is acquired merely as an incidental part of the entire mineral enterprise. For special rules with respect to certain corporate acquisitions referred to in section 381(a), see section 381(c)(18) and the regulations thereunder.

(j) Definition of controlled group. When used in this section—

(1) The term "controlled" includes any kind of control, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(2) The term "group" means the organizations, trades, or businesses owned or controlled by the same interests.

[T.D. 7170, 37 FR 5374, March 15, 1972]

§ 1.613–5 Taxable income from the property.

(a) General rule. The term "taxable income from the property (computed without allowance for depletion)", as used in section 613 and this part, means "gross income from the property" as defined in section 613(c) and §§ 1.613–3 and 1.613–4, less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. These deductible items include operating expenses, certain selling expenses, administrative and financial overhead, depreciation, taxes deductible under section 162 or 164, losses sustained, intangible drilling and development costs, exploration and development expenditures, etc. See paragraph (c) of this section for special rules relating to discounts and to certain of these deductible items. Expenditures which may be attributable both to the mineral property upon which depletion is claimed and to other activities shall be properly

apportioned to the mineral property and to such other activities. Furthermore, where a taxpayer has more than one mineral property, deductions which are not directly attributable to a specific mineral property shall be properly apportioned among the several properties. In determining the taxpayer's taxable income from the property, the amount of any particular item to be taken into account shall be determined in accordance with the principles set forth in paragraph (d)(2) and (3) of § 1.613–4.

(b) Special rule; decrease in mining expenses resulting from gain recognized under section 1245(a)(1). (1) If during any taxable year beginning after December 31, 1962, the taxpayer disposes of an item of section 1245 property (as defined in section 1245(a)(3)) which has been used in connection with a mineral property, then for the purpose of computing the taxable income from such mineral property for such taxable year, the allowable deductions taken into account with respect to expenses of mining (that is, expenses attributable to a mineral property other than an oil and gas property) shall be decreased by an amount equal to the portion of any gain recognized under section 1245(a)(1)(relating to treatment of gain from dispositions of certain depreciable property as ordinary income) which is properly allocable to such mineral property in respect of which the taxable income is being computed. The portion of such gain which is properly allocable to such mineral property shall bear the same ratio to the total of such gain as—

(i) The portion of the "adjustments reflected in the adjusted basis" (as such term is defined in paragraph (a)(2) of § 1.1245–2, relating to definition of recomputed basis) of such section 1245 property, which were allowable as deductions from the "gross income from the property" (as defined in section 613(c) and § 1.613–3) in computing the taxable income from such mineral property, bears to

(ii) The total of the "adjustments reflected in the adjusted basis" of such section 1245 property.

(2) For the purposes of this paragraph, the adjustments reflected in the adjusted basis of the section 1245 property disposed of shall be deemed to have been taken into account in computing the taxable income from the mineral property for any taxable year notwithstanding that for the taxable year the allowance for depletion was determined without reference to percentage depletion under section 613.

(3) If the amount of gain described in subparagraph (1) of this paragraph allocable to a mineral property for a taxable year exceeds the allowable deductions otherwise taken into account in computing the taxable income from the mineral property for the taxable year, the excess may not be taken into account in computing the taxable income from the mineral property for any other taxable year.

(4) To the extent that the adjustments reflected in the adjusted basis of the section 1245 property are allocable to mineral property which the taxpayer no longer owns in the taxable year in which he disposes of the section 1245 property, the gain recognized under section 1245(a)(1) does not result in any tax benefit to the taxpayer under this paragraph since he has no taxable income from the mineral property for such year. However, if a taxpayer has, in the taxable year in which he disposes of an item of section 1245 property, only a portion of the original mineral property to which gain described in subparagraph (1) of this paragraph with respect to the section 1245 property is properly allocable, the entire amount of that gain shall nevertheless be taken into account in computing the taxable income of the remaining portion of the mineral property. Furthermore, the fact that a mineral property to which section 1245 gain is properly allocable is (in the taxable year in which the taxpayer disposes of an item of section 1245 property) no longer in existence merely because the mineral property has been made a part of an aggregation or has been deaggregated will not result in the loss of tax benefits under this section. Accordingly,

(i) If a taxpayer has made an aggregation of mineral properties (see section 614 and the regulations thereunder), the amount of any gain described in subparagraph (1) of this paragraph which is properly allocable to the aggregation shall include the portion of any gain which would be properly allocable to the mineral properties which existed separately prior to the aggregation and of which the aggregation is or was composed, if the prior mineral properties had not been aggregated; and

(ii) If a taxpayer has deaggregated a mineral property, the amount of any gain described in subparagraph (1) of this paragraph which is properly allocable to each of the resulting mineral properties shall include a part of the portion of any gain which would be properly allocable to the prior aggregation if the aggregation had not been deaggregated, the part properly allocable to each of the resulting properties being determined by

allocating the gain between the resulting properties in the same manner as basis is allocated between them for tax purposes (see paragraph (a)(2) of § 1.614–6 and example (5) of subparagraph (7) of this paragraph).

(5) In any case in which it is necessary to determine the portion of any gain recognized under section 1245(a)(1) which is properly allocable to the mineral property in respect of which the taxable income is being computed, the taxpayer shall have available permanent records of all the facts necessary to determine with reasonable accuracy the amount of such portion. In the absence of such records, none of the gain recognized under section 1245(a)(1) shall be allocable to such mineral property.

(6) As used in this paragraph, the term "mineral property" has the meaning assigned to it by section 614 and § 1.614–1.

(7) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A, who uses the calendar year as his taxable year, operated and treated as separate properties mines Nos. 1 and 2. On January 1, 1963, A acquired a truck which was section 1245 property. During 1963 and 1964 the truck was used 25 percent of the time at mine No. 1 and 75 percent of the time at mine No. 2. For each such year the depreciation adjustments allowed in respect of the truck were $800 (the amount allowable). In computing the taxable income from mines Nos. 1 and 2 for each such year, $200 (25 percent of $800) of the depreciation adjustments was allocated by A to mine No. 1 and $600 (75 percent of $800) to mine No. 2. Thus, for the 2 years, the total of the depreciation adjustments on the truck was $1,600, of which $400 was allocated to mine No. 1 and $1,200 to mine No. 2. On January 1, 1965, A recognized upon sale of the truck a gain of $500 to which section 1245(a)(1) applied. During 1965, A did not recognize any other gain to which section 1245(a)(1) applied. In computing taxable income from the mines for 1965, the expenses otherwise required to be taken into account are reduced by $125 (that is $400/$1,600 of $500) for mine No. 1 and by $375 (that is $1,200/$1,600 of $500) for mine No. 2.

Example (2). The situation is the same as in example (1), except that the truck in question is used 25 percent of the time at mine No. 1, and 75 percent of the time in a nonmining business owned by A. Accordingly, in computing taxable income from A's mines for 1965, the expenses for mine No. 1 otherwise required to be taken into account are reduced by $125 (that is $400/$1,600 of $500), but no reduction is made in the expenses for mine No. 2, since the truck in question was not used in connection with that mineral property.

Example (3). The situation is the same as in example (1), except that the truck in question was used exclusively at mine No. 1 in 1963. On January 1, 1964, the truck was transferred to mine No. 2, and was used exclusively at mine No. 2 during the remaining period prior to its sale. However, A continued to own and operate mine No. 1. For the 2 years 1963 and 1964, the total of the depreciation adjustments on the truck was $1,600, of which $800 was allocated to mine No. 1 and $800 to mine No. 2. In computing taxable income from A's mines for 1965, the expenses for mines Nos. 1 and 2 otherwise required to be taken into account are reduced by $250 each (that is $800/$1,600 of $500). If A had sold mine No. 1 on January 1, 1964, no reduction in expenses would be allowable as a result of the operation of the truck at mine No. 1, since A would no longer have owned mine No. 1 in the year in which the truck was sold.

Example (4). On January 1, 1963, B, who uses the calendar year as his taxable year and who normally allocates depreciation costs to mines according to the percentage of time which the depreciable asset is used with respect to the mines, acquired a truck which was section 1245 property. During 1963 the truck was used exclusively on mine No. 1, which B operated and treated as a separate property. The depreciation adjustments allowed in respect of the truck for 1963 were $1,000 (the amount allowable), which amount was allocated to mine No. 1 in computing the taxable income therefrom. On January 1, 1964, B acquired and began operating mine No. 2 and elected under section 614(c) to aggregate and treat as one property mines Nos. 1 and 2. During 1964 B used the truck 60 percent of the time for mine No. 1 and 40 percent of the time for mine No. 2. For 1964 the depreciation adjustments allowed in respect of the truck were $1,000 (the amount allowable), which amount was allocated to the aggregation of mines Nos. 1 and 2 in computing the taxable income therefrom. On December 31, 1964, B sold mine No. 2. For 1965 the depreciation adjustments allowed in respect to the truck were $1,000 (the amount allowable), which amount was allocated to mine No. 1 in computing the taxable income therefrom. On January 1, 1966, B recognized gain upon sale of the truck of $600 to which section 1245(a)(1) applied. In computing the taxable income from mine No. 1 for 1966, the expenses otherwise required to be taken into account are reduced by $600, since all the depreciation adjustments allowed with respect to the truck, including those allowed with respect to the use of the truck at mine No. 2 ($400 for 1964), relate to the same mineral property from which B had taxable income in 1966, the taxable year in which he sold the truck.

Example (5). On January 1, 1962, A, who uses the calendar year as his taxable year, elected under section 614(c) to aggregate and treat as one mineral property his operating mineral interests in mines Nos. 1 and 2. On January 1, 1963, A acquired a truck which was section 1245 property, to be used at both mine No. 1 and mine No. 2. A later elected (with the consent of the Commissioner) to deaggregate mines Nos. 1 and 2, and this deaggregation became effective on January 1, 1964. At the time of deaggregation, half of the tax basis of the aggregated property was allocated to mine No. 1, and the other half to mine No. 2. During each of the years 1963 and 1964, the truck was used 25 percent of the time on mine No. 1 and 75 percent of the time on mine No. 2, and the depreciation adjustments allowed in respect of the truck were $800 (the amount allowable). On January 1, 1965, A recognized upon sale of the truck a gain of $500 to which section 1245(a)(1) applied. In computing taxable income from A's mines for 1965, the expenses otherwise required to be taken into account are reduced by $187.50 (that is half of $250 for 1963 and $200/$800 of $250 for 1964) for mine No. 1 and by $312.50 (that is half of $250 for 1963 and $600/$800 of $250 for 1964) for mine No. 2.

(c) Treatment of particular items in computing taxable income from the property. In determining taxable income from the property under the provisions of paragraph (a) of this section—

(1) Trade or cash discounts (or allowances determined to have the same effect as trade or cash discounts) which are actually allowed to the tax-

payer in connection with the acquisition of property, supplies, or services shall not be included in the cost of such property, supplies, or services.

(2) Intangible drilling and development costs which are deducted under section 263(c) and § 1.612-4 shall be subtracted from the gross income from the property.

(3) Exploration and development expenditures which are deducted for the taxable year under sections 615, 616, or 617 shall be subtracted from the gross income from the property.

(4)(i) Selling expenses, if any, paid or incurred with respect to a raw mineral product shall be subtracted from gross income from the property. See subdivision (iii) of this subparagraph for the definition of the term "raw mineral product." For example, the selling expenses paid or incurred by a producer of raw mineral products with respect to products such as crude oil, raw gas, coal, iron ore, or crushed dolomite shall be subtracted from gross income from the property.

(ii) A reasonable portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property. Such reasonable portion shall be equivalent to the typical selling expenses which are incurred by unintegrated miners or producers in the same mineral industry so as to maintain equality in the tax treatment of unintegrated miners or producers in comparison with integrated miner-manufacturers or producer-manufacturers. If unintegrated miners or producers in the same mineral industry do not typically incur any selling expenses, then no portion of the expenses of selling a refined, manufactured, or fabricated product shall be subtracted from gross income from the property when determining the taxpayer's taxable income from the property.

(iii) For purposes of this subparagraph, a product will be considered to be a raw mineral product if (in the case of oil and gas) it is sold in the immediate vicinity of the well or if (in the case of minerals other than oil and gas) it is sold under the conditions described in paragraph (b)(1) of § 1.613-4. In addition, a product will be considered to be a raw mineral product if only insubstantial value is added to the product by nonmining processes (or, in the case of oil and gas, by conversion or transportation processes). For example, in the case of a producer of crushed granite poultry grit, both bulk and bagged grit will be deemed to be a raw mineral product for purposes of the selling expense rule set forth in this subparagraph.

(iv) The term "selling expenses", for purposes of this subparagraph, includes sales management salaries, rent of sales offices, sales clerical expenses, salesmen's salaries, sales commissions and bonuses, advertising expenses, sales traveling expenses, and similar expenses, together with an allocable share of the costs of supporting services, but the term does not include delivery expenses.

(5) Taxes which are taken as a credit rather than as a deduction or which are capitalized shall not be subtracted from the gross income from the property.

(6) Trade association dues paid or incurred by a producer of crude oil or gas or a raw mineral product shall be subtracted from the gross income from the property. See subparagraph (4)(iii) of this paragraph for the definition of the term "raw mineral product". In addition, a reasonable portion of the trade association dues incurred by a producer of a refined, manufactured, or fabricated product shall also be subtracted from gross income from the property if the activities of the association relate to production, treatment and marketing of the crude oil or gas or raw mineral product. One reasonable method of allocating the trade association dues described in the preceding sentence is an allocation based on the proportion that the direct costs of mining processes and the direct costs of nonmining processes (or in the case of oil and gas, conversion and transportation processes) bear to each other. The foregoing rules shall apply even though one of the principal purposes of an association is to advise, promote, or assist in the production, marketing, or sale of refined, manufactured, or fabricated products. For example, a reasonable portion of the trade association dues paid to an association which promotes the sale of cement, refined petroleum, or copper products shall be subtracted from gross income from the property.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6955, 33 FR 6968, May 9, 1968. Redesignated by T.D. 7170, 37 FR 5374, March 15, 1972, as amended by T.D. 7170, 37 FR 5381, March 15, 1972]

§ 1.613-6 Statement to be attached to return when depletion is claimed on percentage basis.

In addition to the requirements set forth in paragraph (g) of § 1.611-2, a taxpayer who claims the percentage depletion deduction under section 613 for any taxable year shall attach to his return for such year a statement setting forth in complete, summary form, with respect to each property for

which such deduction is allowable, the following information:

(a) All data necessary for the determination of the "gross income from the property", as defined in §§ 1.613-3 from 1.613-4, including—

(1) Amounts paid as rents or royalties including amounts which the recipient treats under section 631(c),

(2) Proportion and amount of bonus excluded, and

(3) Amounts paid to holders of other interests in the mineral deposit.

(b) All additional data necessary for the determination of the "taxable income from the property (computed without the allowance for depletion)", as defined in § 1.613-5.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7170, 37 FR 5374, 5382, March 15, 1972]

§ 1.613-7 Application of percentage depletion rates provided in section 613 (b) to certain taxable years ending in 1954.

(a) Election of taxpayer. In the case of any taxable year ending after December 31, 1953, to which the Internal Revenue Code of 1939 is applicable, the taxpayer may elect in accordance with section 613(d) and this section to apply the appropriate percentage depletion rate specified in section 613 in respect of any mineral property (within the meaning of the 1939 Code). In the case of mines, wells, or other natural deposits listed in section 613(b), the election may be made by the taxpayer irrespective of whether his depletion allowance with respect to the property for the taxable year was computed upon the basis of cost, discovery value, or upon a percentage of gross income from the property. Once made, the election shall be irrevocable with respect to the property for which it is exercised. The election may be made for any mineral property of the taxpayer and need not be made for all such properties. "Gross income from the property" and "net income from the property" shall have the same meaning as those terms are used in 26 CFR (1939) 39.23(m)-1 (Regulations 118).

(b) Computation of depletion allowance. The depletion allowance for any taxable year with respect to any property for which the taxpayer makes the election under section 613(d) shall be an amount equal to the sum of—

(1) That portion of a tentative allowance, computed under the provisions of the Internal Revenue Code of 1939 (without regard to paragraph (1) of section 613(d)), which the number of days in the taxable year prior to January 1, 1954, bears to the total number of days in such taxable year; plus

(2) That portion of a tentative allowance, computed by using the appropriate percentage depletion rate specified in section 613(b) (but otherwise computed under the provisions of the Internal Revenue Code of 1939), which the number of days in the taxable year after December 31, 1953, bears to the total number of days in such taxable year.

In the case of any taxable year beginning after December 31, 1953, and ending before August 17, 1954, the depletion allowance with respect to any property for which the taxpayer makes the election under section 613(d) shall be computed under the provisions of the Internal Revenue Code of 1939, except that the appropriate percentage depletion rate specified in section 613(b) shall be used. In making such computation, "gross income from the property" and "net income from the property" shall be determined in the same manner as specified in paragraph (a) of this section.

(c) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). A is a taxpayer who reports income on the basis of a taxable year ending June 30. For the taxable year ended June 30, 1954, A had gross income from a uranium property in the amount of $100,000 and his depletion allowance was computed with reference to percentage depletion. His net income from this property, for purposes of limiting the depletion allowance, was $40,000. The 15-percent rate of depletion provided for in the Internal Revenue Code of 1939 for metal mines resulted in a depletion allowance for the taxable year of $15,000. Percentage depletion computed with reference to the 23-percent rate provided for uranium under section 613(b) is $23,000 ($100,000 times 23 percent). However, the allowance computed on this basis is limited to $20,000 (50 percent of A's net income from the property). If A exercises the election provided for in section 613(d) his depletion allowance for the taxable year is the aggregate of $7,561.64 (184/365 times $15,000) plus $9,917.80 (181/365 times $20,000) or $17,479.44.

Example (2). Assume the same facts as in example (1) except that A's depletion allowance was computed on the basis of cost and amounted to $17,500. If the election is made, A's allowance for the taxable year is the aggregate of $8,821.92 (184/365 times $17,500) plus $9,917.80 (181/365 times $20,-000) or $18,739.72.

(d) Requirement for making election. **(1)** The election under section 613(d) shall be made by filing a statement with the district director with whom the income tax return was filed for the taxable year to which the election is applicable. Such statement shall indicate that an election is being made under section 613(d), shall contain a recomputation of the depletion allowance and the tax liability for all taxable years affected by the exercise of the election, and shall be accompanied

either by a claim for refund or credit or by an amended return or returns, whichever is appropriate.

(2) If the treatment of any item upon which a tax previously determined was based, or if the application of any provisions of the internal revenue laws with respect to such tax, depends upon the amount of income (e.g., charitable contributions, foreign tax credit, dividends received credit, and medical expenses), readjustment in these particulars will be necessary as part of any recomputation in conformity with the change in the amount of the income which results solely from the making of the election under section 613(d).

(e) **Administrative provisions; etc.** (1) Section 36(b) of the Technical Amendments Act of 1958 (72 Stat. 1633) provides as follows:

Sec. 36. Percentage depletion rates for certain taxable years ending in 1954. * * *

(b) **Statute of limitations, etc.; Interest.** If refund or credit of any overpayment resulting from the application of the amendment made by subsection (a) of this section is prevented on the date of the enactment of this Act, or within 6 months from such date, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed within 6 months from such date. No interest shall be paid on any overpayment resulting from the application of the amendment made by subsection (a) of this section.

(2) If refund or credit of any overpayment resulting from the application of section 613(d) is prevented on September 2, 1958, or on or before March 2, 1959, by the operation of any law or rule of law (other than section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such overpayment may, nevertheless, be made or allowed if claim therefor is filed on or before March 2, 1959. If such refund or credit is not prevented on or before March 2, 1959, the time for filing claim therefor shall be governed by the rules of law generally applicable to credits and refunds.

(3) The amount of any refund or credit which is allowable by reason of section 613(d) shall not exceed the decrease in income tax liability resulting solely from the application of the percentage rates specified in section 613(b). No interest shall be allowed or paid on any overpayment resulting from the application of section 613(d).

(4) For purposes of this section the "decrease in income tax liability" shall be the amount by which the tax previously determined (as defined in section 3801(d) of the Internal Revenue Code of 1939) exceeds the tax as recomputed under section 613(d) and this section.

(f) **Adjustment to basis.** Proper adjustment shall be made to the basis of any property as required by section 113(b)(1) of the Internal Revenue Code of 1939 and 26 CFR (1939) 39.-113(b)(1)–1(c) (Regulations 118) to reflect any change in the depletion allowance resulting from the application of section 613(d) of the Internal Revenue Code of 1954.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960. Redesignated by T.D. 7170, 37 FR 5374, March 15, 1972]

§ 1.613A–1 Post-1974 limitations on percentage depletion in case of oil and gas wells; general rule.

Except as otherwise provided in section 613A and the regulations thereunder, in the case of oil or gas which is produced after December 31, 1974, and to which gross income from the property is attributable after such year, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613. In the case of a taxable year beginning before January 1, 1975, and ending after that date, the percentage depletion allowance (but not the cost depletion allowance) with respect to oil and gas wells for such taxable year shall be determined by treating the portion thereof in 1974 as if it were a short taxable year for purposes of section 613 and the portion thereof in 1975 as if it were a short taxable year for purposes of section 613A.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–2 Exemption for certain domestic gas wells. [Reserved]

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–3 Exemption for independent producers and royalty owners. [Reserved]

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–4 Limitations on application of § 1.613A–3 exemption. [Reserved]

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–5 Election under section 613A(c)(4).

The election under section 613A(c)(4) is an annual election which the taxpayer may make by claiming percentage depletion deductions for the taxable year based upon such election. The election may be made, on an original or amended tax return or a claim for credit or refund, at any time prior to the expiration of the statutory period (including any extensions thereof) for the filing of a claim for credit or refund by the taxpayer. The election may be changed by the taxpayer by filing an amended return or a claim for credit or refund. The election allows the taxpayer to treat as his depletable natural gas quantity an amount equal to 6,000 cubic feet multiplied by the number of barrels of the taxpayer's depletable oil quantity to which the election applies. The election applies to secondary or tertiary production, as well as primary production, but in determining the taxpayer's depletable natural gas quantity with respect to secondary or tertiary production the taxpayer's depletable oil quantity shall be determined without regard to section 613A(c)(3)(A)(ii) with respect to production from secondary or tertiary processes.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–6 Recordkeeping requirements.

(a) Principal value of property demonstrated. In the case of a transfer (as defined in § 1.613A–7(n)) after December 31, 1974, of an interest in an oil or gas property (as defined in § 1.613A–7(p)), the transferee (as defined in section 1.613A–7(*o*)) shall keep records showing the terms of the transfer, any geological and geophysical data in the possession of the transferee or other exploratory data with respect to the property transferred, and any other information which bears upon the question of whether at the time of the transfer the principal value of the property transferred had been demonstrated by prospecting, exploration, and discovery work.

(b) Production from secondary or tertiary processes. Every taxpayer who claims depletion with respect to oil or gas produced by secondary or tertiary processes (as defined in § 1.613A–7(k)) shall keep records of the secondary and tertiary processes applied and maintain records of the amount of production so resulting.

(c) Retention of records. The records required by this section shall be kept at all times available for inspection by authorized Internal Revenue officers or employees, and shall be retained so long as the contents may become material in the administration of any Internal Revenue law.

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.613A–7 Definitions. [Reserved]

[T.D. 7487, 42 FR 24264, May 13, 1977]

§ 1.614–0 Introduction.

Section 614 relates to the definition of property and to the various special rules by means of which taxpayers are permitted to aggregate or combine separate properties or to treat such properties as separate. These rules are set forth in detail in §§ 1.614–1 through 1.614–8. Section 1.614–1 sets forth rules under section 614(a) relating to the definition of the term "property." Section 1.614–2 contains the rules relating to the election under section 614(b), as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964, to aggregate operating mineral interests. In the case of mines, the rules contained in § 1.614–2 are applicable only to taxable years beginning before January 1, 1958, to which the Internal Revenue Code of 1954 applies. In the case of oil and gas wells, the rules contained in § 1.614–2 are applicable only to taxable years beginning before January 1, 1964, to which the Internal Revenue Code of 1954 applies. In the case of oil and gas wells, the taxpayer may, however, for taxable years beginning before January 1, 1964, treat any operating mineral interests as if section 614(a) and (b) (as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964) had not been enacted. If any operating mineral interests are so treated, the rules contained in § 1.614–2 are not applicable to such interests and such interests are, in respect of taxable years beginning before January 1, 1964, subject to the rules set forth in § 1.614–4 relating to the Internal Revenue Code of 1939 treatment of separate operating mineral interests in the case of oil and gas wells. Section 1.614–3 prescribes the rules relating to the election under section 614(c)(1) permitting the aggregation of operating mineral interests in the cases of mines for taxable years beginning after December 31, 1957. Section 1.614–3 also sets forth rules relating to the election under section 614(c)(2) in the case of mines by means of which a taxpayer is permitted to treat a single operating mineral interest as more than one such interest for taxable years beginning after December 31, 1957. At the election of the taxpayer with respect to an operating unit, the rules contained in § 1.614–3 are also applicable to taxable years beginning before January 1, 1958, to which the Internal Revenue Code of 1954 applies. If the

taxpayer makes such an election, the rules contained in § 1.614–2 are not applicable to any of the operating mineral interests which are part of the operating unit with respect to which the election described in § 1.614–3 is made. Section 1.614–5 sets forth the rules relating to the aggregation of nonoperating mineral interests. Section 1.614–6 contains the rules relating to basis, holding period, and abandonment and casualty losses where properties have been aggregated or combined. Section 1.614–7 relates to the extension of time for performing certain acts. Section 1.614–8 contains the rules relating to the elections under section 614(b) as amended by section 226(a) of the Revenue Act of 1964 to treat separate operating mineral interests in the case of oil and gas wells as separate properties or in combination for taxable years beginning after December 31, 1963.

[T.D. 6524, 26 FR 145, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13699, Oct. 28, 1965]

§ 1.614–1 Definition of property.

(a) General rule. **(1)** For purposes of subtitle A of the Code, in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

(2) The term "interest" means an economic interest in a mineral deposit. See paragraph (b) of § 1.611–1. The term includes working or operating interests, royalties, overriding royalties, net profits interests, and, to the extent not treated as loans under section 636, production payments.

(3) The term "tract or parcel of land" is merely descriptive of the physical scope of the land to which the taxpayer's interest relates. It is not descriptive of the nature of his rights or interests in the land. All contiguous areas (even though separately described) included in a single conveyance or grant or in separate conveyances or grants at the same time from the same owner constitute a single separate tract or parcel of land. Areas included in separate conveyances or grants (whether or not at the same time) from separate owners are separate tracts or parcels of land even though the areas described may be contiguous. If the taxpayer's rights or interests within the same tract or parcel of land are dissimilar, then each such dissimilar interest constitutes a separate property. If the taxpayer's rights or interests (whether or not dissimilar) within the same tract or parcel of land relate to more than one separate mineral deposit, then his interest with respect to each such separate deposit is a separate property.

(4) Upon the transfer of a "property" in any transaction in which the basis of such property in the hands of the transferee is determined by reference to the basis of such property in the hands of the transferor, such property shall, notwithstanding the provisions of subparagraph (3) of this paragraph, retain the same status and identity in the hands of the transferee as it had in the hands of the transferor. See paragraph (c) of § 1.614–6 if the transferor has made a binding election to treat a separate mineral interest as a separate property, to treat a separate mineral interest as more than one property under section 614(c), or to treat two or more separate mineral interests as an aggregated or combined property under section 614(b) (as it existed either before or after its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e).

(5) The provisions of this paragraph may be illustrated by the following examples:

Example (1). A taxpayer owns one tract of land under which lie three separate and distinct seams of coal. Therefore, the taxpayer owns three separate mineral interests each of which constitutes a separate property.

Example (2). A taxpayer conducts mining operations on eight tracts of land as a single unit. He acquired his interests in each of the eight tracts from separate owners. Even if each tract of land contains part of the same mineral deposit, the taxpayer owns eight separate mineral interests each of which constitutes a separate property.

Example (3). A taxpayer owns a tract of land under which lies one mineral deposit. The taxpayer operates a well on part of the tract and leases to another operator the mineral rights in the remainder retaining a royalty interest therein. The taxpayer thereafter owns two separate mineral interests each of which constitutes a separate property.

Example (4). In 1954, a taxpayer acquires from a single owner, in a single deed, three noncontiguous tracts of mineral land for a single consideration. Even if each tract contains part of the same mineral deposit, the taxpayer owns three separate mineral interests each of which constitutes a separate property.

Example (5). In 1954, taxpayer A simultaneously acquires in fee two contiguous tracts of mineral land from two separate owners. The same mineral deposit underlies both tracts. Thereafter, taxpayer A owns two separate mineral interests each of which constitutes a separate property.

Example (6). Assume that in 1955, taxpayer A, in example (5), leases the two contiguous tracts of mineral land that he acquired in 1954 to taxpayer B by means of a single lease. Thereafter, taxpayer B owns one mineral interest which constitutes a separate property for such time as the lease continues in existence.

Example (7). Assume that in 1955, taxpayer A, in example (5), sells at the same time all the mineral land he acquired in 1954 to taxpayer B. Thereafter, taxpayer B owns one mineral interest which constitutes a separate property. If taxpayer B acquires the mineral land in a transaction in which the basis of such mineral land in his hands is determined by reference to the basis of such mineral land in the hands of taxpayer A, then

taxpayer B owns two separate mineral interests each of which constitutes a separate property.

Example (8). In 1954, taxpayer A simultaneously acquires two contiguous leasehold interests from two separate owners. The same mineral deposit underlies both tracts. Thereafter, taxpayer A owns two separate mineral interests each of which constitutes a separate property.

Example (9). In 1955, taxpayer A, in example (8), simultaneously assigns the two leases to taxpayer B. Thereafter, taxpayer B owns two separate mineral interests each of which constitutes a separate property.

(b) Separation of interests treated as "single property" under prior regulations. Each separate mineral interest which, in accordance with paragraph (a) of this section, is a separate property shall be so treated, notwithstanding the fact that the taxpayer under paragraph (i) of § 39.23(m)–1 of this chapter (Regulations 118) and corresponding provisions of prior regulations may have treated more than one of such interests as a "single property." The basis of each such separate property must be established by a reasonable method. See, however, section 614(b) and (d) (as they existed prior to amendment by section 226 of the Revenue Act of 1964), section 614(c) and (e), and §§ 1.614–2, 1.614–3, 1.614–4, and 1.614–5 for special rules relating to the treatment of two or more separate mineral interests as a single property.

(c) Treatment of a waste bank or residue. A waste bank or residue of prior mining, the extraction of ores or minerals from which is treated as mining under section 613(c)(3), shall not be considered to be a separate mineral deposit but is a part of the mineral deposit from which it was extracted. However, if the owner of such waste bank or residue has disposed of the deposit from which the waste bank or residue was accumulated, or if the waste bank or residue cannot practicably be attributed to a particular deposit of the owner, the waste bank or residue will be regarded as a separate deposit.

[T.D. 6524, 26 FR 147, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13699, Oct. 28, 1965; T.D. 7261, 38 FR 5467, March 1, 1973]

§ 1.614–2 Election to aggregate separate operating mineral interests under section 614(b) prior to its amendment by Revenue Act of 1964.

(a) General rule. (1) The provisions of this section relate to the election, under section 614(b) prior to its amendment by section 226(a) of the Revenue Act of 1964, to aggregate separate operating mineral interests, and, unless otherwise indicated, all references in this section to section 614(b) or any paragraph or subparagraph thereof are references to section 614(b) or a paragraph or subparagraph thereof as it existed prior to such amendment. Notwithstanding the preceding sentence, the definitions contained in paragraphs (b) and (c) of this section shall apply both before and after such amendment. All references in this section to section 614(d) are references to section 614(d) as it existed prior to its amendment by section 226(b)(3) of the Revenue Act of 1964.

(2) A taxpayer who owns two or more separate operating mineral interests, which constitute part or all of an operating unit, may elect under section 614(b) and this section to form one aggregation of any two or more of such operating mineral interests and to treat such aggregation as one property. Any operating mineral interest which the taxpayer does not elect to include within the aggregation within the time prescribed in paragraph (d) of this section shall be treated as a separate property. The aggregation of separate properties which results from exercising the election shall be considered as one property for all purposes of subtitle A of the Code. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made with respect to the separate properties aggregated may be continued in accordance with section 167 and the regulations thereunder. Operating interests in different minerals which comprise part or all of the same operating unit may be included in the aggregation. It is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land or in contiguous tracts or parcels of land so long as such interests are a part of the same operating unit. Under section 614(b), a taxpayer cannot elect to form more than one aggregation of separate operating mineral interests within one operating unit. For definitions of "operating mineral interest" and "operating unit" see respectively paragraphs (b) and (c) of this section.

(b) Operating mineral interest defined. The term "operating mineral interest" means a separate mineral interest as described in section 614(a), in respect of which the costs of production are required to be taken into account by the taxpayer for purposes of computing the limitation of 50 percent of the taxable income from the property in determining the deduction for percentage depletion computed under section 613, or such costs would be so required to be taken into account if the mine,

well, or other natural deposit were in the production stage. The term does not include royalty interests or similar interests, such as production payments or net profits interests. For the purpose of determining whether a mineral interest is an operating mineral interest, "costs of production" do not include intangible drilling and development costs, exploration expenditures under section 615, or development expenditures under section 616. Taxes, such as production taxes, payable by holders of nonoperating interests are not considered costs of production for this purpose. A taxpayer may not aggregate operating mineral interests and nonoperating mineral interests such as royalty interests.

(c) Operating unit defined. **(1)** The term "operating unit" refers to the operating mineral interests which are operated together for the purpose of producing minerals. An "operating unit" of a particular taxpayer must be determined on the basis of his own operations. It is recognized that operating units may not be uniform in the various natural resources industries or in any one of the natural resources industries, such as coal, oil and gas, and the like. As to a particular taxpayer, business reasons may require the formation of operating units that vary in size and content. The term "operating unit" refers to a producing unit, and not to an administrative or sales organization. Among the factors which indicate that mineral interests are operated together as a unit are—

(i) Common field or operating personnel,

(ii) Common supply and maintenance facilities,

(iii) Common processing or treatment plants, and

(iv) Common storage facilities.

However, operating mineral interests which are geographically widespread may not be treated as parts of the same operating unit merely because a single set of accounting records, a single executive organization, or a single sales force is maintained by the taxpayer with respect to such interests, or merely because the products of such interests are processed at the same treatment plant.

(2) If aggregated, an undeveloped operating mineral interest shall be aggregated only with those interests with which it will be operated as a unit when it reaches the production stage.

(3) While a taxpayer may operate an operating mineral interest through an agent, a coowner may aggregate only his operating mineral interests that are actually operated as a unit. For example, if A owned and actually operated the entire working interest in lease X and also owned an undivided fraction of lease Y in which B owned the remaining interest and which B actually operated as a unit with lease Z, A may not aggregate his interest in lease X with his undivided interest in lease Y, since they are not actually operated as a unit.

(4) The determination of the taxpayer as to what constitutes an operating unit is to be accepted unless there is a clear and convincing basis for a change in such determination.

(d) Manner and scope of election—(1) Election; when made. (i) Except as provided in subparagraph (2)(ii) of this paragraph, the election under section 614(b) and paragraph (a) of this section to treat a mineral interest as part of an aggregation shall be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof), for whichever of the following taxable years is the later:

(a) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, or

(b) The first taxable year in which any expenditure for exploration, development, or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest.

See, however, paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor. The election under section 614(b) may not be made with respect to any taxable year beginning after December 31, 1957, except in the case of oil and gas wells. See paragraph (e) of this section for rules with respect to the termination of the election under section 614(b) except in the case of oil and gas wells. If an expenditure has been made in respect of a separate operating mineral interest, it is immaterial whether or not any proven deposit has been discovered with respect to such interest when such expenditure has been made. The provisions of this subdivision may be illustrated by the following example:

Example. Taxpayer A is producing from an oil and gas horizon and in 1958 he drills for the purpose of locating a deeper horizon which will be operated in the same operating unit as the upper producing horizon. At the end of the taxable year 1958 he has expended $50,000 drilling for the purpose of locating a deeper horizon although at such time there is no assurance that such a horizon will be found. If taxpayer A desires to aggregate the deeper horizon, if found, with the upper horizon under section 614(b), he must elect to do so in his return for 1958. If the election to aggregate the upper and

lower horizons as one property is made, the drilling expenditures with respect to the prospective lower horizon must be taken into account along with the income and expenses with respect to the upper producing horizon in computing the depletion allowance on the aggregated property.

However, where expenditures for development of, or production from, a particular mineral deposit result in the discovery of another mineral deposit, the election with respect to such other deposit shall be made for the taxable year in which it is discovered and not for the taxable year in which the expenditures were first made which resulted in such discovery.

(ii) Except in the case of oil and gas wells, if a taxpayer fails to make an election under section 614(b) to aggregate a particular operating mineral interest on or before the time prescribed for the making of such election, such interest will be treated as if an election had been made under section 614(b) to treat it as a separate property and it cannot be included in any aggregation within the operating unit of which it is a part unless the taxpayer obtains the consent of the Commissioner. However, where the taxpayer owns more than one property within an operating unit, but has elected to treat such properties separately and one or more additional operating mineral interests are subsequently acquired, any one or more of the latter may be aggregated with one of the existing separate properties within the operating unit but not with more than one of them since they cannot be validly aggregated with each other.

(iii) In the case of oil and gas wells, if the taxpayer fails to make an election under section 614(b) with respect to a particular operating mineral interest on or before the time prescribed for the making of such election, the taxpayer shall be deemed to have treated such interest under the provisions of section 614(d). See section 614(d) and § 1.614–4.

(iv) For purposes of section 614(b), the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest. Thus, a taxpayer who makes expenditures for the exploration of minerals on a particular tract under an option to acquire an economic interest in minerals in place is not required to make an election with respect to such interest at that time. Furthermore, the election need not be made in the taxable year in which payments are made for the acquisition of a lease, such as the payment of a bonus, unless exploratory, development, or operation expenditures are made thereafter with respect to the property in that year.

(2) *Election; how made.* (i) The election under section 614(b) must be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. This statement shall indicate that the taxpayer is making an aggregation of separate operating mineral interests within an operating unit under section 614(b) and shall contain a description of the aggregation and describe the operating mineral interests within the operating unit which are to be treated as separate properties apart from the aggregation. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and identifies the properties which are to be treated separately will be sufficient. The statement shall also contain a description of the operating unit in sufficient detail to show that the aggregated operating mineral interests are properly within a single operating unit. See paragraph (c) of this section. The taxpayer shall maintain adequate records and maps in support of the above information. In the event expenditures are first made on an operating mineral interest within an operating unit after an election with respect to the aggregation of interests in that operating unit has been made, the taxpayer shall furnish only information describing such operating mineral interest, its location in the operating unit, and whether it is to be included within the aggregation.

(ii) If the taxpayer made or did not make the election under section 614(b) with respect to a particular operating mineral interest and the last day prescribed by law for filing the return (including extensions of time therefor) on which the election was required to be made falls on or before May 1, 1961, consent is hereby given to the taxpayer to make or change the election not later than May 1, 1961. Any such election or change of such election shall be effective with respect to the earliest taxable year to which the election is applicable in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from such election or change is not prevented by any law or rule of law on the date such election or change is made. An election or change of election made pursuant to this subdivision shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years unless consent to a different treatment is obtained from the Commissioner. (See, however, paragraph (e) of this section for rules relating to the termination and nonapplicability of the election under section 614(b) except in the case of oil and gas wells.) Such election or change shall be made in the form

of a statement setting forth the nature of the election or change, including information substantially the same as that required by subdivision (i) of this subparagraph, and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for refund or credit. The appropriate documents must be filed on or before May 1, 1961 with the district director for the district in which the original return was filed.

(3) **Election; when effective.** If a taxpayer has elected to aggregate an operating mineral interest, the date on which the aggregation becomes effective is the earliest date within the taxable year affected, on which the taxpayer incurred any expenditure for exploration, development, or operation of such interest. The application of this rule may be illustrated by the following examples:

Example (1). In 1953, a taxpayer owned and operated mineral interests Nos. 1, 2, and 3. All three interests form one operating unit. The taxpayer, who files his return on a calendar year basis, continued to own and operate these interests during the year 1954, and in his return for that year, filed on April 15, 1955, elected to aggregate these three interests. As the result of this election, the aggregation was effective for all purposes of subtitle A of the Code as of January 1, 1954.

Example (2). Assume that, on March 1, 1955, the taxpayer described in example (1) acquired operating mineral interest No. 4 which was also a part of the operating unit composed of operating mineral interests Nos. 1, 2, and 3, that he made his first expenditure for exploration with respect to operating mineral interest No. 4 on September 1, 1955, and that, in his return filed on April 15, 1956, he elected to aggregate operating mineral interest No. 4 with the aggregation consisting of Nos. 1, 2, and 3. As the result of that election, operating mineral interest No. 4 became a part of the aggregation for all purposes of subtitle of the Code on September 1, 1955.

(4) **Election; binding effect.** A valid election made under section 614(b) and this section shall be binding upon the taxpayer for the taxable year for which made and all subsequent taxable years unless consent to make a change is obtained from the Commissioner. However, see paragraph (e) of this section for rules with respect to the termination of the election under section 614(b) except in the case of oil and gas wells. For rules relating to the binding effect of an election where the basis of a separate or an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6. A taxpayer can neither include within the aggregation a separate operating mineral interest which he had previously elected to treat separately, nor exclude from the aggregation a separate operating mineral interest previously included therein unless consent to do so is obtained from the Commissioner. A change in tax consequences alone is not sufficient to obtain consent to change the treatment of an operating mineral interest. However, consent may be appropriate where, for example, there has been a substantial change in the taxpayer's operations so that a major part of an aggregation becomes a part of another operating unit. Applications for consent shall be made in writing to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application must be accompanied by a statement indicating the reason or reasons for the change and furnishing the information required under subdivision (i) of subparagraph (2) of this paragraph, unless such information has been previously filed and is current.

(5) **Invalid aggregations—(i) In general.** In addition to aggregations which are invalid under section 614(b) because of the failure to make timely elections, aggregations may be invalid under such section in situations which may be divided into two general categories. The first category involves basic aggregations which were timely but otherwise initially invalid. The second category involves invalid additions of operating mineral interests to basic aggregations which additions became subject to the election in years subsequent to the year in which the initial basic aggregation or aggregations were formed.

(ii) **Invalid basic aggregations.** The term "invalid basic aggregations" refers to those aggregations which are initially invalid. Generally, such basic aggregations will be invalid because more than one aggregation has been formed within an operating unit or because operating mineral interests in two or more operating units have been improperly aggregated. For any year in which an invalid basic aggregation exists, each operating mineral interest included in such aggregation shall be treated for all purposes as a separate property unless consent is obtained from the Commissioner to treat any such interest in a different manner. Consent will be granted in appropriate cases as, for example, where the taxpayer demonstrates that he inadvertently formed an invalid basic aggregation. The provisions of this subdivision may be illustrated by the following examples:

Example (1). In 1953, taxpayer A owned six operating mineral interests, designated No. 1 through No. 6, and he continued to own and operate such interests during 1954. He acquired no other operating mineral interests during such year. All six of these operating mineral interests form one operating unit. Assume that A elected under section 614(b) to aggregate operating mineral interests Nos. 1 through 3 into one aggregation and Nos. 4 through 6 into another aggregation. Since A has formed two aggregations in one operating unit, they are invalid basic aggregations. Therefore, interests Nos. 1 through 6 must be treated as separate properties for 1954 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

Example (2). Assume the same facts as in example (1) and assume also that, in his return for 1954, A correctly elected to aggregate all six operating mineral interests into one aggregation under section 614(b). Assume further that all these operating mineral interests continued to be in one operating unit for the years 1954, 1955, and 1956 but that, because of changes in the facts and circumstances of A's operations, in 1957 operating mineral interests Nos. 1, 2, and 3 became a part of one operating unit and Nos. 4, 5, and 6 became a part of another operating unit. Notwithstanding the change in operations, the election made by A shall continue to be binding unless consent to change such election is obtained from the Commissioner.

(iii) Invalid additions. The term "additions" refers to the additions that a taxpayer makes by electing to aggregate an operating mineral interest with an aggregation formed in a previous year. Such additions will be invalid where the taxpayer either elected to aggregate an operating mineral interest with an invalid basic aggregation or elected to aggregate an operating mineral interest which is part of one operating unit with an aggregation of operating mineral interests which is a part of another operating unit. An operating mineral interest which is invalidly added to either a valid basic aggregation or to an invalid basic aggregation shall be considered as a separate property unless consent is obtained from the Commissioner to treat such interest in a different manner. The following are examples of invalid additions:

Example (1). In 1953, taxpayer A owned six operating mineral interests designated No. 1 through No. 6 and he continued to own and operate such interests during 1954. He acquired no other operating mineral interests during that year. Nos. 1 through 3 formed one operating unit and Nos. 4 through 6 formed another operating unit. In his return for 1954, A incorrectly elected to aggregate all six operating mineral interests into one aggregation under section 614(b). In 1955, A acquired and commenced development of operating mineral interest No. 7 which is correctly a part of the operating unit of which operating mineral interests Nos. 1, 2, and 3 are a part. A elected under section 614(b), for the year 1955, to aggregate operating mineral interest No. 7 with the invalid basic aggregation composed of Nos. 1 through 6. Since operating mineral interest No. 7 was aggregated with an invalid basic aggregation, it is an invalid addition and must be treated as a separate property unless consent is obtained from the Commissioner to treat it in a different manner.

Example (2). In 1953, taxpayer A owned nine operating mineral interests designated No. 1 through No. 9. During 1954, he continued to own and operate such interests and acquired no other operating mineral interest. Interests No. 1 through No. 3 form one operating unit, Nos. 4 through 6 form another operating unit, and Nos. 7 through 9 form a third operating unit. For the year 1954, A elected under section 614(b) to aggregate operating mineral interests Nos. 1, 2, 3, and 4 into one aggregation, to treat Nos. 5 and 6 as separate properties, and to aggregate Nos. 7, 8, and 9 into another aggregation. Assume that in 1955 A acquired and commenced development of operating mineral interest No. 10 which was a part of the operating unit composed of Nos. 1, 2, and 3. Assume further that he elected under section 614(b) to aggregate No. 10 with the aggregation composed of Nos. 7, 8, and 9. This would be an invalid addition to a valid basic aggregation since operating mineral interest No. 10 was not properly a part of the operating unit formed by Nos. 7, 8, and 9. Therefore, interest No. 10 must be treated as a separate property for 1955 and all subsequent taxable years unless consent is obtained from the Commissioner to treat it in a different manner. However, the valid basic aggregation composed of interests Nos. 7 through 9 is not affected by the invalid addition of interest No. 10.

Example (3). Assume the same facts as in example (2) except that A elected under section 614(b) in 1955 to aggregate No. 10 with the aggregation of Nos. 1 through 4. This would also be an invalid addition because the aggregation composed of Nos. 1 through 4 is an invalid basic aggregation since operating mineral interest No. 4 is not a part of the operating unit consisting of Nos. 1, 2, and 3. Therefore, interest No. 10 must be treated as a separate property for 1955 and all subsequent taxable years unless consent is obtained from the Commissioner to treat such interest in a different manner.

(e) **Termination of election—(1) Taxable years beginning after December 31, 1963, in the case of oil and gas wells.** In the case of oil and gas wells, the election provided for under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests shall not apply with respect to any taxable year beginning after December 31, 1963. In addition, if a taxpayer treated certain separate operating mineral interests in a single tract or parcel of land as separate rather than as an aggregation and decides to continue such treatment for taxable years beginning after December 31, 1963, he must make an appropriate election under section 614(b) as amended by the Revenue Act of 1964. See § 1.614–8.

(2) Taxable years beginning after December 31, 1957, in the case of mines. Except in the case of oil and gas wells, the election provided for under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests shall not apply with respect to any taxable year beginning after December 31, 1957. Thus, if a taxpayer makes a binding election under section 614(b) to form an aggregation of separate operating mineral interests within an operating unit for taxable years beginning before January 1, 1958, he must make a new election for the first taxable year beginning after December 31, 1957, under section 614(c) within the time prescribed in § 1.614–3 if he wishes to aggregate any separate operating mineral interests within such operating unit. A new election must be made under section 614(c) notwithstanding the fact that the aggregation formed under section 614(b) would constitute a valid aggregation under section 614(c). Failure to make such an election within the time prescribed shall constitute an election to treat each separate operating mineral interest within the operating unit as a separate property for taxable years beginning after December 31, 1957.

(3) Taxable years beginning before January 1, 1958, in the case of mines. An election made under section 614(b) and paragraph (a) of this section to form an aggregation of separate operating mineral interests within a particular operating unit shall not apply with respect to any taxable year beginning prior to January 1, 1958, for which the taxpayer makes an election under section 614(c)(3)(B) and paragraph (f)(2) of § 1.614–3 which is applicable to any separate operating mineral interest within the same operating unit. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). In 1953, taxpayer A owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 5 comprise a mine, and operating mineral interest No. 6 represents one mineral deposit in a single tract of land which is being extracted by means of two mines. Taxpayer A previously made a binding election under section 614(b) to aggregate operating mineral interests Nos. 1 through 5 and to treat operating mineral interest No. 6 as a separate property. Under section 614(c)(2) and (3)(B) taxpayer A makes an election which is applicable for the taxable year 1954 and all subsequent taxable years to treat operating mineral interest No. 6 as two separate operating mineral interests. Therefore, the previous election of taxpayer A to aggregate operating mineral interests Nos. 1 through 5 under section 614(b) does not apply. Unless taxpayer A also makes an election to aggregate operating mineral interests Nos. 1 through 5 as one property under section 614(c)(1) and (3)(B) within the time prescribed in paragraph (f)(2) of § 1.614–3, he shall be deemed to have made an election to treat each of such interests as a separate property for 1954 and all subsequent taxable years.

Example (2). In 1953, taxpayer B owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 3 comprise a mine and Nos. 4 through 6 comprise a second mine. Taxpayer B previously made a binding election under section 614(b) to aggregate operating mineral interests Nos. 1 through 8 and to treat Nos. 4 through 6 as separate properties. Under section 614(c)(1) and (3)(B) taxpayer B makes an election which is applicable for the taxable year 1954 and all subsequent taxable years to aggregate operating mineral interests Nos. 4 through 6 as one property. The previous election of the taxpayer under section 614(b) to aggregate operating mineral interests Nos. 1 through 3 does not apply even though such aggregation would constitute a valid aggregation if formed under section 614(c)(1). Therefore, if taxpayer B wishes to continue to treat operating mineral interests Nos. 1 through 3 as one property, he must also make an election to do so under section 614(c)(1) and (3)(B) within the time prescribed in paragraph (f)(2) of § 1.614–3.

(4) Bases of separate operating mineral interests. If an aggregation formed under section 614(b) is terminated by reason of the provisions of section 614(b)(4)(A), is terminated under section 614(b)(4)(B) for any taxable year after the first taxable year to which the election under section 614(b) applies, or is terminated by reason of the provisions of section 614(b) as amended by the Revenue Act of 1964, the bases of the separate operating mineral interests (and combinations thereof) included in such aggregation shall be determined in accordance with the rules contained in paragraph (a)(2) of § 1.614–6 as of the first day of the first taxable year for which the termination is effective. However, if by reason of the provisions of section 614(b)(4)(B), an election to aggregate under section 614(b) does not apply for any taxable year for which such election was made, the bases of the separate operating mineral interests included in the aggregation formed under section 614(b) shall be determined without regard to the election under section 614(b).

(f) Alternative treatment of separate operating mineral interests in the case of oil and gas wells. For rules relating to an alternative treatment of separate operating mineral interests in the case of oil and gas wells, see § 1.614–4.

[T.D. 6524, 26 FR 147, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13700, Oct. 28, 1965]

§ 1.614–3 Rules relating to separate operating mineral interests in the case of mines.

(a) Election to aggregate separate operating mineral interests—(1) General rule. Except in the case of oil and gas wells, a taxpayer who owns two or more separate operating mineral interests, which constitute part or all of the same operating unit, may elect under section 614(c)(1) and this paragraph to form an aggregation of all such operating mineral interests which comprise any one mine or any two or more mines and to treat such aggregation as one property. The aggregated property which results from the exercise of such election shall be considered as one property for all purposes of subtitle A of the Code. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improvements made with respect to the separate properties aggregated may be continued in accordance with section 167 and the regulations thereunder. It is not necessary for purposes of the aggregation that the separate operating mineral interests be included in a single tract or parcel of land or in contiguous tracts or parcels of land so long as such interests constitute part or all of the same operating unit. A taxpayer may elect to form more than one aggregation of separate operating mineral interests within one operating unit so long as each aggregation consists of all the separate operating mineral interests which comprise

any one mine or any two or more mines. Thus, no aggregation may include any separate operating mineral interest which is a part of a mine without including all of the separate operating mineral interests which comprise such mine in the first taxable year for which the election to aggregate is effective. Any separate operating mineral interest which becomes a part of such mine in a subsequent taxable year must also be included in such aggregation as of the taxable year that such interest becomes a part of such mine. The taxable year in which such interest becomes a part of such mine shall be determined upon the basis of the facts and circumstances of the particular case. If a taxpayer fails to make an election under this paragraph to aggregate a particular operating mineral interest (other than an interest which becomes a part of a mine with respect to which the interests have been aggregated in a prior taxable year) on or before the last day prescribed for making such an election, such interest shall be treated as if an election had been made to treat it as a separate property. A taxpayer may not aggregate operating mineral interests and nonoperating mineral interests such as royalty interests. For definitions of the terms "operating mineral interest", "operating unit", and "mine", see respectively paragraphs (c), (d), and (e) of this section.

(2) Aggregation in subsequent taxable years. If the taxpayer has made an election under section 614(c)(1) for a particular taxable year with respect to any operating mineral interest or interests within a particular operating unit, and if, for a subsequent taxable year, the taxpayer desires to make an election with respect to an additional operating mineral interest within the same operating unit, then whether or not the taxpayer may elect to include such additional interest in an aggregation or treat it as a separate property depends upon the nature of such additional interest and of the taxpayer's previous elections. If the additional interest is a part of a mine with respect to which the other interests have been aggregated, the additional interest must be included in such aggregation. If the additional interest is a part of a mine with respect to which the other interests have been treated as separate properties, the additional interest must be treated as a separate property. If the additional interest is part of a mine which previously consisted of only a single interest which has not been aggregated with any other mine, such additional interest may be aggregated or treated as a separate property. If the additional interest is an entire mine, it may, at the election of the taxpayer, (i) be added to any aggregation within the same operating unit, (ii) be aggregated with any other single interest which is an entire mine provided both interests are within the same operating unit even though such single interest has previously been treated as a separate property, or (iii) be treated as a separate property.

(b) Election to treat a single operating mineral interest as more than one property—(1) General rule. Except in the case of oil and gas wells, a taxpayer who owns a separate operating mineral interest in a mineral deposit in a single tract or parcel of land may elect under section 614(c)(2) and this paragraph to treat such interest as two or more separate operating mineral interests if such mineral deposit is being developed or extracted by means of two or more mines. In order for this election to be applicable, there must be at least two mines with respect to each of which an expenditure for development or operation has been made by the taxpayer. The election under section 614(c)(2) may also be made with respect to a separate operating mineral interest formed by a previous election under section 614(c)(2) at such time as the mineral deposit previously allocated to such interest is being developed or extracted by means of two or more mines. If there is more than one mineral deposit in a single tract or parcel of land, an election under section 614(c)(2) with respect to any one of such mineral deposits has no application to the other mineral deposits. The election under section 614(c)(2) may not be made with respect to an aggregated property or with respect to any operating mineral interest which is a part of any aggregation formed by the taxpayer unless the taxpayer obtains consent from the Commissioner. Such consent will not be granted where the principal purpose for the request to make the election is based on tax consequences. Application for such consent shall be made in writing to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application must be accompanied by a statement setting forth in detail the reason or reasons for the request to exercise the election with respect to an aggregated property.

(2) Allocation of mineral deposit. If the taxpayer elects to treat a separate operating mineral interest in a mineral deposit in a single tract or parcel of land as more than one separate operating mineral interest, then all of such mineral deposit therein and all of the portion of the tract or parcel of land allocated thereto must be allocated to the newly formed separate operating mineral interests. A portion of such mineral deposit and such tract or parcel of land must be allocated to each such newly formed separate operating mineral interest.

There must be at least one mine, with respect to which an expenditure for development or operation has been made by the taxpayer, with respect to each such portion. The extent of the portion to be allocated to each newly formed separate operating mineral interest is to be determined upon the basis of the facts and circumstances of the particular case.

(3) **Basis of newly formed separate operating mineral interests.** The adjusted basis of each of the separate operating mineral interests formed by the making of the election under section 614(c)(2) shall be determined by apportioning the adjusted basis of the separate operating mineral interest with respect to which such election was made between (or among) the newly formed separate operating mineral interests in the same proportion as the fair market value of each such newly formed interest (as of the date on which the election becomes effective) bears to the total fair market value of the interest with respect to which the election was made as of such date.

(4) **Aggregation of newly formed separate operating mineral interests.** Any separate operating mineral interest formed by the making of the election under section 614(c)(2) may be included as a part of an aggregation subject to the requirements of paragraph (a) of this section, provided that the time for making the election under section 614(c)(1) to include such separate operating mineral interest in such aggregation has not expired. See paragraph (f) of this section. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1958, taxpayer A acquired two separate operating mineral interests designated No. 1 and No. 2. Each is an interest in a single mineral deposit in a single tract of land. In the same year, taxpayer A made his first development expenditure with respect to a mine on operating mineral interest No. 1 and a mine on operating mineral interest No. 2. Operating mineral interests Nos. 1 and 2 are operated as a unit. Taxpayer A did not elect to aggregate operating mineral interests Nos. 1 and 2 under section 614(c)(1) within the time prescribed for making such an election. In 1960 taxpayer A made his first development expenditure with respect to a second mine on operating mineral interest No. 2. Taxpayer A elected under section 614(c)(2) to treat operating mineral interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for the taxable year 1960 and all subsequent taxable years. No. 2(a) contained the mine for which the first development expenditure was made in 1958, and No. 2(b) contained the mine for which the first development expenditure was made in 1960. If taxpayer A wishes to do so, he may elect to aggregate mineral interests Nos. 1 and 2(b) under section 614(c)(1) for the taxable year 1960 and all subsequent taxable years since the first development expenditure with respect to the mine on operating mineral interest No. 2(b) was made during the taxable year 1960. Taxpayer A may not elect to aggregate mineral interests Nos. 1 and 2(a) under such section since the time for making such an election has expired.

(c) **Operating mineral interest defined.** For the definition of the term "operating mineral interest" as used in this section, see paragraph (b) of § 1.614–2.

(d) **Operating unit defined.** For the definition of the term "operating unit" as used in this section, see paragraph (c) of § 1.614–2.

(e) **Mine defined.** For purposes of this section, the term "mine" means any excavation or other workings or series of related excavations or related workings, as the case may be, for the purpose of extracting any known mineral deposit except oil and gas deposits. For the purpose of the preceding sentence, the term "excavations" or "workings" includes quarries, pits, shafts, and wells (except oil and gas wells). The number of excavations or workings that constitute a mine is to be determined upon the basis of the facts and circumstances of the particular case such as the nature and position of the mineral deposit or deposits, the method of mining the mineral, the location of the excavations or other workings in relation to the mineral deposit or deposits, and the topography of the area. The determination of the taxpayer as to the composition of a mine is to be accepted unless there is a clear and convincing basis for a change in such determination.

(f) **Manner and scope of election—(1) Election to apply section 614(c)(1) and (2) for taxable years beginning after December 31, 1957.** Except as provided in subparagraphs (2) and (3) of this paragraph, the election under section 614(c)(1) and paragraph (a) of this section to treat an operating mineral interest as part of an aggregation shall be made under section 614(c)(3)(A) not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(i) The first taxable year beginning after December 31, 1957, or

(ii) The first taxable year in which any expenditure for development or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest.

Except as provided in subparagraphs (2) and (3) of this paragraph, the election under section 614(c)(2) and paragraph (b) of this section to treat a single operating mineral interest as more than one operating mineral interest shall be made under section 614(c)(3)(A) not later than the time prescribed by law for filing the taxpayer's income tax return

(including extensions thereof) for whichever of the following taxable years is the later:

(iii) The first taxable year beginning after December 31, 1957, or

(iv) The first taxable year in which expenditures for development or operation of more than one mine in respect of the separate operating mineral interest are made by the taxpayer after the acquisition of such interest.

However, if the latest time at which an election may be made under this subparagraph falls on or before May 1, 1961, such election may be made or modified at any time on or before May 1, 1961. See paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor.

(2) Election to apply section 614(c)(1) and (2) for taxable years beginning before January 1, 1958. In accordance with section 614(c)(3)(B), the election under section 614(c)(1) and paragraph (a) of this section to treat an operating mineral interest as part of an aggregation may, at the election of the taxpayer, be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(i) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, for which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from an election under section 614(c)(1), is not prevented on September 2, 1958, by the operation of any law or rule of law, or

(ii) The first taxable year in which any expenditure for development or operation in respect of the separate operating mineral interest is made by the taxpayer after the acquisition of such interest.

In accordance with section 614(c)(3)(B), the election under section 614(c)(2) and paragraph (b) of this section to treat an operating mineral interest as more than one operating mineral interest may, at the election of the taxpayer, be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for whichever of the following taxable years is the later:

(iii) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, for which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from an election under section 614(c)(2), is not prevented on September 2, 1958, by the operation of any law or rule of law, or

(iv) The first taxable year in which expenditures for development or operation of more than one mine in respect of the separate operating mineral interest are made by the taxpayer after the acquisition of such interest.

However, if the latest time at which an election may be made under this subparagraph falls on or before May 1, 1961, such election may be made or modified at any time on or before May 1, 1961. See paragraph (c) of § 1.614–6 as to the binding effect of an election where the basis of a separate operating mineral interest in the hands of the taxpayer is determined by reference to the basis in the hands of a transferor.

(3) Limitation. If the taxpayer makes an election under section 614(c)(1) or (2) in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph with respect to any operating mineral interest which constitutes part or all of an operating unit, such taxpayer may not make any election under section 614(c)(1) or (2) in accordance with section 614(c)(3)(A) and subparagraph (1) of this paragraph with respect to any operating mineral interest which constitutes part or all of such operating unit. The provisions of this subparagraph may be illustrated by the following example:

Example: In 1953, taxpayer A owned six separate operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Operating mineral interests Nos. 1 through 5 comprise a mine, and operating mineral interest No. 6 represents one mineral deposit in a single tract of land which is being extracted by means of two mines. In accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph, taxpayer A elects under section 614(c)(2) to treat operating mineral interest No. 6 as two separate operating mineral interests for the taxable year 1954 and all subsequent taxable years. Unless taxpayer A also makes an election under section 614(c)(1) to aggregate operating mineral interests Nos. 1 through 5 for the taxable year 1954 and all subsequent taxable years in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph, he shall be deemed to have made an election to treat each of such interests as a separate property. Taxpayer A may not elect, under section 614(c)(1) and (3)(A), to aggregate operating mineral interests Nos. 1 through 5 for the taxable year 1958 or any subsequent taxable year.

(4) Statute of limitations. If the taxpayer makes any election in accordance with section 614(c)(3)(B) and subparagraph (2) of this paragraph and if assessment of any deficiency for any taxable year resulting from such election is prevented on May 1, 1961, or at any time within one year after such first day, by the operation of any law or rule of law, such assessment may, nevertheless, be made within one year after May 1, 1961.

Any election by a taxpayer in accordance with section 614(c)(3)(B) shall constitute consent to the assessment of any deficiency resulting from any such election. If refund or credit of any overpayment of income tax resulting from any election made in accordance with section 614(c)(3)(B) is prevented on May 1, 1961, or at any time within one year after May 1, 1961, by the operation of any law or rule of law, refund or credit of such overpayment may, nevertheless, be made or allowed but only if claim therefor is filed within one year after May 1, 1961. This subparagraph shall not apply with respect to any taxable year of a taxpayer for which an assessment of a deficiency resulting from an election made in accordance with section 614(c)(3)(B) or a refund or credit of an overpayment resulting from any such election, as the case may be, is prevented by the operation of any law or rule of law on September 2, 1958.

(5) Elections—how made—(i) General rule. Except as provided in subdivision (ii) of this subparagraph, an election under section 614(c)(1) or (2) and paragraph (a) or (b) of this section must be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. The statement shall contain the following information:

(a) Whether the taxpayer is making an election or elections with respect to the operating unit in accordance with section 614(c)(3)(A) or (B);

(b) A description of the operating unit of the taxpayer in sufficient detail to identify the operating mineral interests which are included within such operating unit;

(c) A description of each aggregation to be formed within the operating unit in sufficient detail to show that each aggregation consists of all the separate operating mineral interests which comprise any one mine or any two or more mines;

(d) A description of each separate operating mineral interest within the operating unit which is to be treated as a separate property in sufficient detail to show that such interest is not a part of any mine for which an election to aggregate has been made;

(e) The taxable year in which the first expenditure for development or operation was made by the taxpayer with respect to each separate operating mineral interest within the operating unit, but if the first expenditure for development or operation has not been made with respect to a separate operating mineral interest before the close of the taxable year for which the election under this section is made, such information should also be included;

(f) A description of each separate operating mineral interest within the operating unit which the taxpayer elects to treat as more than one such interest under section 614(c)(2) in sufficient detail to show that the separate operating mineral interest was not a part of an aggregation formed by the taxpayer under section 614(c)(1) for any taxable year prior to the taxable year for which the election under section 614(c)(2) is made, and to show that the mineral deposit representing the separate operating mineral interest is being developed or extracted by means of two or more mines;

(g) The taxable year in which the first expenditure for development or operation was made by the taxpayer with respect to each mine on the separate operating mineral interest that the taxpayer is electing to treat as more than one such interest; and

(h) The allocation of the mineral deposit representing the separate operating mineral interest between (or among) the newly formed interests and the method by which such allocation was made.

For the purpose of applying subdivisions (e) and (g) of this subdivision, if the first expenditure for development or operation with respect to a separate operating mineral interest or a mine was made prior to the first taxable year for which the election with respect to such interest or mine is applicable, the taxpayer may state that such is the case in lieu of identifying the exact taxable year in which such first expenditure was made. In any case where part of the information required under this subdivision can be adequately supplied by means of appropriately marked maps, the statement may be accompanied by such maps and may omit the required descriptive material to the extent replaced by the maps. The taxpayer shall maintain adequate records and maps in support of the above information. In the event that the first expenditure for development or operation with respect to a separate operating mineral interest is made by the taxpayer in a taxable year subsequent to the taxable year for which an election under this section has been made with respect to the operating unit of which such interest is a part, the taxpayer shall furnish information describing such interest in sufficient detail to identify it as a part of such operating unit, to show whether it is a part of a mine with respect to which the interests have previously been aggregated or have previously been treated as separate properties, and to indicate whether it is to be included within an aggregation.

(ii) Special rule. If the last day prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for the first taxable year for which an election under section 614(c)(1) or (2) is made falls before May 1, 1961, the statement of election or modification thereof for such taxable year must be filed on or before May 1, 1961, with the district director for the district in which such return was filed. The statement must contain the information as required in subdivision (i) of this subparagraph, must indicate the first taxable year for which the election contained therein is made, and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for refund or credit.

(6) Elections; when effective. If the taxpayer has elected to form an aggregation under section 614(c)(1) and this section, the date on which the aggregation becomes effective is the first day of the first taxable year for which the election is made; except that if any separate operating mineral interest included in such aggregation was acquired after such first day, the date on which the inclusion of such interest in such aggregation becomes effective is the date of its acquisition. If the taxpayer elects to add another operating mineral interest to such aggregation for a subsequent taxable year, the date on which aggregation of the additional interest becomes effective is the first day of such subsequent taxable year or the date of acquisition of such interest, whichever is later. If an operating mineral interest is required to be included in the aggregation for a subsequent taxable year because such interest becomes a part of a mine which the taxpayer has previously elected to aggregate, the date on which the inclusion of such interest in the aggregation becomes effective is the first day of the subsequent taxable year or the date of acquisition of such interest, whichever is later. If the taxpayer has elected to treat a separate operating mineral interest as more than one such interest, the date on which the election becomes effective is the first day of the first taxable year for which the election is made or the earliest date on which the first expenditure for development or operation has been made by the taxpayer with respect to a mine on each newly formed separate operating mineral interest, whichever is later.

(7) Elections; binding effect. A valid election under section 614(c)(1) or (2) whether made in accordance with section 614(c)(3)(A) or (B) shall be binding upon the taxpayer for the taxable year for which made and for all subsequent taxable years unless consent to change the treatment of an operating mineral interest with respect to which an election has been made is obtained from the Commissioner. For rules relating to the binding effect of an election where the basis of a separate or an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6. A taxpayer can neither include within an aggregation a separate operating mineral interest which he has previously elected to treat as a separate property, nor exclude from an aggregation a separate operating mineral interest which he has properly elected to include within such aggregation unless consent to do so is obtained from the Commissioner. A change in tax consequences alone is not sufficient to obtain consent to change the treatment of an operating mineral interest. However, consent may be appropriate where, for example, there has been a substantial change in the taxpayer's operations so that a major part of an aggregation becomes a part of another operating unit. Applications for consent shall be made in writing to the Commissioner of Internal Revenue, Washington, D.C. 20224. The application must be accompanied by a statement indicating the reason or reasons for the change and furnishing the information required in subparagraph (5)(i) of this paragraph, unless such information has been previously filed and is current.

(8) Invalid aggregations—(i) General rule. In addition to aggregations which are invalid under this section because of the failure to make timely elections, aggregations may be invalid under this section in situations which may be divided into two general categories. The first category involves invalid basic aggregations. The second category involves invalid additions to basic aggregations.

(ii) Invalid basic aggregations. The term "invalid basic aggregations" refers to aggregations which are initially invalid. Generally, a basic aggregation is initially invalid because it does not include all the separate operating mineral interests which comprise a complete mine or mines or because it includes separate operating mineral interests which are not part of the same operating unit. If the taxpayer makes an invalid basic aggregation, each of the separate operating mineral interests included in such aggregation shall be treated as a separate property for the first taxable year for which the election is made and for all subsequent taxable years unless consent is obtained from the Commissioner to treat any such interest in a different manner. Consent will be granted in appropriate cases. For example, assume that the taxpayer elects to form an aggregation of the operating mineral interests which comprise one or more complete mines. If the taxpayer demon-

strates that he inadvertently failed to include a minor part of one of the aggregated mines or inadvertently included a minor part of another mine that is not a part of the aggregation, consent will ordinarily be granted to maintain the aggregation by including the part omitted or by excluding the part included. The provisions of this subdivision may be illustrated by the following examples:

Example (1). In 1958, taxpayer A owned ten operating mineral interests, designated No. 1 through No. 10, which he operated as a unit. Interests Nos. 1 through 5 comprised mine X, and interests Nos. 6 through 10 comprised mine Y. Taxpayer A had made his first development expenditure with respect to each of the ten interests before January 1, 1958. Taxpayer A elected under section 614(c)(1) and (3)(A) to aggregate interests Nos. 1 through 8 for 1958 and all subsequent taxable years. The aggregation formed by taxpayer A is an invalid basic aggregation because it does not include all the operating mineral interests which comprise a complete mine or mines. Therefore, interests Nos. 1 through 8 must be treated as separate properties for 1958 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

Example (2). In 1958, taxpayer B owned ten operating mineral interests designated No. 1 through No. 10. Interests Nos. 1 through 5 comprised mine X, and interests Nos. 6 through 10 comprised mine Y. Taxpayer B had made his first development expenditure with respect to each of the ten interests before January 1, 1958. Taxpayer B elected under section 614(c)(1) and (3)(A) to aggregate interests Nos. 1 through 10 for 1958 and all subsequent taxable years. Upon audit, it was determined that mines X and Y were in two separate operating units. Therefore, the aggregation formed by taxpayer B is invalid, and interests Nos. 1 through 10 must be treated as separate properties for 1958 and all subsequent taxable years unless consent is obtained from the Commissioner to treat any of such interests in a different manner.

(iii) Invalid additions. The term "invalid addition" refers to an operating mineral interest which is invalidly aggregated with an existing aggregation. Generally, an addition is invalid because it is a part of a mine and is aggregated with an aggregation which does not include other interests which are parts of the same mine, or because it is in one operating unit and is included as part of an aggregation which is in another operating unit. If an invalid addition is properly a part of a mine with respect to which other interests have been validly aggregated for a taxable year prior to the first taxable year for which the election to aggregate the invalid addition is made, then the invalid addition shall be included in the aggregation of which it is properly a part for such first taxable year and all subsequent taxable years. Any other invalid addition shall be treated as a separate property for the first taxable year for which the election to aggregate such addition is made and for all subsequent taxable years unless consent is obtained from the Commissioner to treat any such interest in a different manner. The provisions of this subdivision may be illustrated by the following examples:

Example (1). In 1958, taxpayer A owned six operating mineral interests, designated No. 1 through No. 6, which he operated as a unit. Interests Nos. 1 through 3 comprised mine X, and interests Nos. 4 through 6 comprised mine Y. Taxpayer A had made his first development expenditure with respect to each of the six interests before January 1, 1958. Taxpayer A elected under section 614(c)(1) and (3)(A) to aggregate interests Nos. 1 through 3 for 1958 and all subsequent taxable years. He elected to treat interests Nos. 4 through 6 as separate properties for 1958 and all subsequent taxable years. In 1959, taxpayer A acquired and made his first development expenditure with respect to interest No. 7. Interest No. 7 was a part of the mine composed of interests Nos. 4 through 6. Taxpayer A elected under section 614(c)(1) and (3)(A) to aggregate interest No. 7 with the aggregation of interests Nos. 1 through 3 for 1959 and all subsequent taxable years. Interest No. 7 is an invalid addition and must be treated as a separate property for 1959 and all subsequent taxable years. It cannot be aggregated with interests Nos. 4 through 6 since taxpayer A has previously elected to treat such interests as separate properties. However, the valid basic aggregation composed of interests Nos. 1 through 3 is not affected by the invalid addition of interest No. 7.

Example (2). Assume the same facts as in example (1) except that taxpayer A elected under section 614(c)(1) and (3)(A) to aggregate interests Nos. 1 through 3 as one aggregation and interests Nos. 4 through 6 as another aggregation for 1958 and all subsequent taxable years. The aggregation of interest No. 7 with the aggregation consisting of interests Nos. 1 through 3 constitutes an invalid addition. Interest No. 7 must be included in the aggregation consisting of interests Nos. 4 through 6 for 1959 and all subsequent taxable years.

Example (3). In 1958, taxpayer B owned three operating mineral interests, designated No. 1 through No. 3, which comprised mine X. Taxpayer B had made his first development expenditure with respect to each of the three interests before January 1, 1958. Taxpayer B elected under section 614(c)(1) and (3)(A) to aggregate interests Nos. 1 through 3 for 1958 and all subsequent taxable years. In 1959, taxpayer B acquired interests Nos. 4 through 7 which comprised mine Y. Taxpayer B made his first development expenditure with respect to each of the four interests during 1959. Taxpayer B elected under section 614(c)(1) and (3)(A) to aggregate interests Nos. 4 through 6 and to aggregate interest No. 7 with the aggregation consisting of interests Nos. 1 through 3 for 1959 and all subsequent taxable years. The aggregation consisting of interests Nos. 4 through 6 is an invalid basic aggregation, and the aggregation of interest No. 7 is an invalid addition. Interests Nos. 4 through 7 must be treated as separate properties for 1959 and all subsequent taxable years unless consent is obtained from the Commissioner to treat such interests in a different manner.

(g) Special rule as to deductions under section 615(a) prior to aggregation—(1) General rule. If an aggregation of operating mineral interests under section 614(c)(1) and paragraph (a) of this section includes any interest or interests in respect of which exploration expenditures, paid or incurred after the acquisition of such interest or interests, were deducted by the taxpayer under section 615(a) for any taxable year which precedes the date on which such aggregation becomes effective, then the tax imposed by chapter 1 of the Code for

the taxable year or years in which such exploration expenditures were so deducted shall be recomputed in accordance with the rules contained in this paragraph. If an operating mineral interest is added to such aggregation for a subsequent taxable year and exploration expenditures made with respect to such interest after its acquisition were deducted by the taxpayer under section 615(a) for any taxable year which precedes the date on which the aggregation of such additional interest becomes effective, then the tax imposed by chapter 1 of the Internal Revenue Code of 1954 for the taxable year or years in which such exploration expenditures were so deducted shall be recomputed. For purposes of this paragraph, such taxable year or years shall be referred to as the taxable year or years for which a recomputation is required to be made. See paragraph (f)(6) of this section for rules relating to the date on which an aggregation becomes effective or the date on which the aggregation of an additional interest to an aggregation becomes effective. See subparagraph (3) of this paragraph for rules relating to the method of recomputation of tax. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). In 1954, taxpayer A owned two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was in the production stage prior to 1954. The first exploration expenditures with respect to interest No. 2 were made by taxpayer A in 1954 and were deducted under section 615(a) on his return for that year. In 1955, taxpayer A made his first development expenditure with respect to interest No. 2, and thereafter it was operated with interest No. 1 as a unit. Taxpayer A elected under section 614(c)(1) and (3)(B) to form an aggregation of interests Nos. 1 and 2 for 1955 and all subsequent taxable years. Taxpayer A must recompute his tax for 1954 in accordance with this paragraph.

Example (2). Assume the same facts as in example (1) except that, in 1957, taxpayer A acquired another operating mineral interest, designated No. 3, made his first exploration expenditures with respect to such interest in that year, and deducted such expenditures under section 615(a) on his return for that year. In 1958, taxpayer A made his first development expenditure with respect to interest No. 3. Interest No. 3 was part of the same operating unit as interests Nos. 1 and 2. Taxpayer A elected under section 614(c)(1) and (3)(B) to add interest No. 3 to his aggregation of interests Nos. 1 and 2 for 1958 and all subsequent taxable years. Taxpayer A must recompute his tax for 1957 in accordance with this paragraph.

(2) Exceptions—(i) Taxable years beginning before January 1, 1958. In the case of exploration expenditures deducted by the taxpayer with respect to an operating mineral interest for any taxable year beginning before January 1, 1958, subparagraph (1) of this paragraph shall apply only if the taxpayer has made an election under section 614(c)(1) or (2) with respect to the operating unit of which such interest is a part and such election applies to the taxable year for which such exploration expenditures were deducted. Thus, if the taxpayer does not make an election with respect to the operating unit under section 614(c)(1) or (2) and (3)(B), subparagraph (1) of this paragraph does not apply in the case of exploration expenditures deducted with respect to any operating mineral interest which is a part of such operating unit for any taxable year beginning before January 1, 1958. The provisions of this subdivision may be illustrated by the following examples:

Example (1). In 1956, taxpayer A acquired two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was in the production stage at that time. Taxpayer A made his first exploration expenditures with respect to interest No. 2 in 1956, 1957, and 1958 and deducted such expenditures under section 615(a) on his returns for such years. In 1959, taxpayer A made his first development expenditure with respect to interest No. 2. Interests Nos. 1 and 2 were operated as a unit. Taxpayer A elected under section 614(c)(1) and (3)(A) to aggregate interests Nos. 1 and 2 for 1959 and all subsequent taxable years. Only the exploration expenditures deducted by the taxpayer for 1958 must be taken into account for purposes of applying subparagraph (1) of this paragraph.

Example (2). In 1954, taxpayer B owned two operating mineral interests, designated Nos. 1 and 2, which he operated as a unit. Interest No. 1 was in the production stage at that time, and interest No. 2 represented one mineral deposit in a single tract of land which was being extracted by means of two mines. Under section 614(c)(2) and (3)(B), taxpayer B elects to treat interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for 1954 and all subsequent taxable years. In 1955, taxpayer B acquired operating mineral interest No. 3. He made his first exploration expenditures with respect to interest No. 3 in 1955, 1956, and 1957 and deducted such expenditures under section 615(a) on his returns for such years. In 1958, taxpayer B made his first development expenditure with respect to interest No. 3, and thereafter it was operated with interests Nos. 1, 2(a), and 2(b) as a unit. Taxpayer B elects under section 614(c)(1) and (3)(B) to aggregate interests Nos. 1 and 3 for 1958 and all subsequent taxable years. The exploration expenditures deducted by the taxpayer for 1955, 1956, and 1957 must be taken into account for purposes of applying subparagraph (1) of this paragraph since the taxpayer has made an election under section 614(c)(2) with respect to the operating unit of which interest No. 3 is a part and such election applies to the taxable years 1955, 1956, and 1957.

(ii) Interests formed pursuant to an election under section 614(c)(2). In the case of exploration expenditures deducted with respect to an operating mineral interest which the taxpayer elects to treat as more than one such interest under section 614(c)(2) and paragraph (b) of this section, subparagraph (1) of this paragraph shall not apply. Thus, if the taxpayer deducts exploration expenditures with respect to an operating mineral interest, subsequently elects to treat such interest as more than one interest under section 614(c)(2), and includes one of the newly formed interests in an aggregation under section 614(c)(1), subparagraph (1) of this paragraph does not apply in the case of the exploration expenditures deducted with respect

to the interest which the taxpayer elected to treat as more than one interest. The provisions of this subdivision may be illustrated by the following examples:

Example (1). In 1958, taxpayer A acquired two operating mineral interests, designated Nos. 1 and 2, which he operated as a unit. Each interest was an interest in a single mineral deposit in a single tract or parcel of land. There was a mine in the production stage of each of two interests at that time. Taxpayer A elected under section 614(c)(1)(B) to treat interests Nos. 1 and 2 as separate properties. In 1959 and 1960, taxpayer A made exploration expenditures with respect to interest No. 2 for the purpose of extracting the mineral by means of a second mine, and he deducted such expenditures on his returns for such years. In 1961, taxpayer A made his first development expenditure with respect to a second mine on interest No. 2. Taxpayer A elected under section 614(c)(2) to treat interest No. 2 as two separate operating mineral interests, designated as Nos. 2(a) and 2(b), for 1961 and all subsequent taxable years. Interest No. 2(a) contained the producing mine and interest No. 2(b) contained the subsequently developed mine. In his return for 1961, taxpayer A also elected under section 614(c)(1)(A) to aggregate interests Nos. 1 and 2(b) for 1961 and all subsequent taxable years. The exploration expenditures deducted with respect to interest No. 2 prior to the effective date of the formation of interests Nos. 2(a) and 2(b) need not be taken into account for purposes of applying subparagraph (1) of this paragraph.

Example (2). In 1954, taxpayer B owned two operating mineral interests designated Nos. 1 and 2. Interest No. 1 was an interest in a single mineral deposit in a single tract of land which was being extracted by means of two mines. Taxpayer B elected under section 614(c)(2) and (3)(B) to treat interest No. 1 as two separate operating mineral interests, designated as Nos. 1(a) and 1(b), for 1954 and all subsequent taxable years. In 1955, 1956, and 1957, taxpayer B made exploration expenditures with respect to interest No. 2 and deducted such expenditures on his returns for such years. In 1958, taxpayer B made his first development expenditure with respect to interest No. 2, and, on his return for that year, taxpayer B elected to aggregate interests Nos. 1(a) and 2 under section 614(c)(1) for 1958 and all subsequent taxable years. The exploration expenditures deducted with respect to interest No. 2 for 1955, 1956, and 1957 shall be taken into account for purposes of applying subparagraph (1) of this paragraph since such exploration expenditures were deducted with respect to an interest to which this subdivision does not apply.

(3) Recomputation of tax—(i) General rule. In the case of an aggregation formed under section 614(c)(1) and paragraph (a) of this section in respect of which a recomputation of tax is required to be made under the provisions of subparagraphs (1) and (2) of this paragraph for any taxable year or years, the tax imposed by chapter 1 of the Internal Revenue Code of 1954 shall be recomputed for each such taxable year as if—

(a) The taxpayer had elected to form an aggregation for the taxable year for which the recomputation is required to be made, and

(b) Such aggregation had included all the interests included in the aggregation formed under section 614(c)(1) except those interests which the taxpayer did not own during the taxable year for which the recomputation is required to be made and those interests in respect of which the taxpayer had made no expenditures for exploration, development, or operation before or during the taxable year for which the recomputation is required to be made.

If a recomputation of tax is required to be made for any taxable year in the case of the aggregation of an additional interest to an existing aggregation under section 614(c)(1), such recomputation shall be made as if—

(c) The taxpayer had elected to form an aggregation for the taxable year for which the recomputation is required to be made, and

(d) Such aggregation had included all the interests included in the aggregation formed under section 614(c)(1) (including any interest which the taxpayer had disposed of prior to the date on which the aggregation of the additional interest becomes effective) except those interests which the taxpayer did not own during the taxable year for which the recomputation is required to be made and those interests in respect of which the taxpayer had made no expenditures for exploration, development, or operation before or during the taxable year for which the recomputation is required to be made.

For purposes of this paragraph, any aggregation which is treated as having been formed under subdivisions (a) and (b) or under subdivisions (c) and (d) shall be referred to as the "constructed aggregated property".

(ii) Recomputation of depletion allowance. The taxpayer shall compute the depletion allowance with respect to the constructed aggregated property for the taxable year for which the recomputation is required to be made. In making this computation, cost depletion for such taxable year shall be computed with reference to the depletion unit for the constructed aggregated property. See paragraph (a) of § 1.611–2. Percentage depletion for such taxable year shall not exceed 50 percent of the taxable income from the constructed aggregated property computed in accordance with § 1.613–5. If a recomputation is required to be made for the same taxable year with respect to any other aggregation or aggregations formed by the taxpayer under section 614(c)(1), the depletion allowance with respect to the other constructed aggregated property or properties shall be similarly computed. If, for a taxable year in respect of which a recomputation is required, the sum of the depletion allowance or allowances as computed under this subdivision is less than the sum of the

depletion allowance or allowances actually deducted for such taxable year with respect to all the properties required to be taken into account in making the computation under this subdivision, then the total depletion allowance deducted by the taxpayer for such taxable year shall be reduced by the difference. The taxable income or net operating loss of the taxpayer for such taxable year shall be adjusted to reflect such reduction for purposes of the recomputation of tax. However, if for a taxable year in respect of which a recomputation is required, the sum of the depletion allowance or allowances as computed under this subdivision exceeds the sum of the depletion allowance or allowances actually deducted for such taxable year with respect to all the properties required to be taken into account in making the computation under this subdivision, the recomputation of tax for such taxable year is disregarded for purposes of applying section 614(c)(4)(B), (C), and (D).

(iii) Effect of recomputation with respect to items based on amount of income. In making the recomputation of tax under this subparagraph for any taxable year, any deduction, credit, or other allowance which is based upon the adjusted gross income or taxable income of the taxpayer for such year shall be recomputed taking into account the adjustment required under subdivision (ii) of this subparagraph. For example, if a corporate taxpayer's taxable income is increased under the provisions of such subdivision, then the amount of charitable contributions which may be deducted under the limitation contained in section 170(b)(2) shall be correspondingly increased for purposes of the recomputation. Moreover, the effect that the recomputation of any deduction, credit, or other allowance for a taxable year has on the tax imposed for any other taxable year shall also be taken into account for purposes of the recomputation of tax under this subparagraph. Any change in items of tax preferences (as defined in section 57 and the regulations thereunder) must also be taken into account for purposes of the recomputation under this subparagraph.

(iv) Effect of recomputation with respect to a net operating loss and a net operating loss deduction. If the recomputation of tax under this subparagraph for the taxable year for which the recomputation is required to be made results in a reduction of a net operating loss for such year, then the taxpayer shall take into account the effect of such reduction on the tax imposed by chapter I of the Internal Revenue Code of 1954 (or by corresponding provisions of the Internal Revenue Code of 1939) for any taxable year affected by such reduction. If the recomputation of tax for the taxable year for which the recomputation is required to be made results in an increase in taxable income as defined in section 172(b)(2) for such year, then the taxpayer shall take into account the effect of such increase on the tax imposed by chapter I of the Internal Revenue Code of 1954 (or by corresponding provisions of the Internal Revenue Code of 1939) for any taxable year affected by such increase. Furthermore, in making the recomputation of tax for any taxable year for which the recomputation is required to be made, the taxpayer shall take into account any change in the net operating loss deduction for such year resulting from the recomputation of tax for any other taxable year for which a recomputation is required to be made. For provisions relating to the net operating loss deduction, see section 172 and the regulations thereunder. For rules relating to the effect of the net operating loss deduction on the minimum tax for tax preferences see section 56 and the regulations thereunder and § 1.58–7.

(v) Determination of increase in tax. If the taxpayer elects to form an aggregation or aggregations for a taxable year under section 614(c)(1) and if a recomputation of tax is required to be made under this paragraph for any prior taxable year or years, then the taxpayer shall compute the difference between the tax, including the tax imposed by section 56 (relating to the minimum tax for tax preferences), as recomputed under this subparagraph for such prior taxable year or years (and other taxable years affected by the recomputation) and the tax liability previously determined (computed without regard to section 614(c)(4)) with respect to such prior taxable year or years (and other taxable years affected by the recomputation). If the taxpayer is subsequently required to make a recomputation with respect to any taxable year or years for which he has previously made a recomputation, then the taxpayer shall compute the difference between the tax as subsequently recomputed for such taxable year or years (and other taxable years affected by the subsequent recomputation) and the tax as previously recomputed for such taxable year or years (and other taxable years affected by the subsequent recomputation). For treatment of the increase in tax resulting from the recomputation of tax under this subparagraph, see subparagraph (4) of this paragraph.

(4) Treatment of increase in tax—(i) General rule. If the taxpayer elects to form an aggregation or aggregations for a taxable year under section 614(c)(1) and if a recomputation of tax is required to be made for any prior taxable year or years, then the total increase in tax resulting from such

recomputation determined under subparagraph (3)(v) of this paragraph shall be taken into account in the first taxable year to which the election to form such aggregation or aggregations is applicable and in each succeeding taxable year until the full amount of such total increase in tax has been taken into account. The number of taxable years over which such total increase shall be taken into account shall be equal to the number of taxable years for which a recomputation of tax is required to be made under subparagraph (1) of this paragraph as limited by subparagraph (2) of this paragraph and for which such recomputation results in a reduction of the taxpayer's depletion allowance under subparagraph (3)(ii) of this paragraph. The amount of the increase in tax which is to be taken into account in a taxable year is determined by dividing the total increase in tax by the number of taxable years over which such total increase is to be taken into account. The tax imposed by chapter I of the Code for each of the taxable years over which the total increase in tax is to be taken into account shall be increased by the amount determined in accordance with the preceding sentence. However, such increase in tax for each of such taxable years shall have no effect upon the determination of the amount of any credit against the tax for any of such taxable years. For example, the amount of such increase shall not affect the computation of the limitation on the foreign tax credit under section 904. The amount of the increase in tax which is required to be taken into account by the taxpayer in a particular taxable year under section 614(c)(4)(C) shall be treated as a tax imposed with respect to such taxable years even though, without regard to section 614(c)(4) and this paragraph, such taxpayer would otherwise have no tax liability for such taxable year.

(ii) Increase in tax not determinable as of first taxable year of aggregation. If the recomputation of tax under subparagraph (3) of this paragraph, for any taxable year or years prior to the first taxable year to which the election to form an aggregation or aggregations under section 614(c)(1) applies, results in a reduction of any net operating loss carryover to a taxable year subsequent to such first taxable year, then the total increase in tax resulting from the recomputation is not determinable as of such first taxable year. In such case, the total increase in tax shall be taken into account in equal installments in the first taxable year for which such total increase is determinable and in each succeeding taxable year for which a portion of the increase in tax would have been taken into account under subdivision (i) of this subparagraph if the total increase had been determinable as of the first taxable year to which the election to form the aggregation or aggregations under section 614(c)(1) applies. The provisions of this subdivision may be illustrated by the following example:

Example. Assume that taxpayer A elects under section 614(c)(1) to form an aggregation for 1960 and all subsequent taxable years. Assume further that taxpayer A is required to recompute his tax for four prior taxable years under subparagraphs (1) and (2) of this paragraph and that the recomputation for each of such taxable years results in a reduction of taxpayer A's depletion allowance. Under subdivision (i) of this subparagraph, the total increase in tax resulting from the recomputation is to be taken into account in equal installments in 1960, 1961, 1962, and 1963. However, if the total increase in tax is not determinable until 1961 because the recomputation for the prior taxable years results in the reduction of a net operating loss carryover to 1961, then the total increase shall be taken into account in equal installments in 1961, 1962, and 1963. In like manner, if the total increase in tax is not determinable until 1962, it shall be taken into account in equal installments in 1962 and 1963.

(iii) Death or cessation of existence of taxpayer. If the taxpayer dies or ceases to exist, the portion of the increase in tax determined under subparagraph (3)(v) of this paragraph which has not been taken into account under subdivision (i) or (ii) of this subparagraph for taxable years prior to the taxable year of the occurrence of such death or such cessation of existence, as the case may be, shall be taken into account for the taxable year in which such death or such cessation of existence, as the case may be, occurs.

(5) Adjustments to basis of aggregated property. If the taxpayer elects to form an aggregated property or properties under section 614(c)(1) for a taxable year and if a recomputation of tax is required to be made for any taxable year which results in reduction of the depletion allowance previously deducted by the taxpayer for such year, then proper adjustments shall be made with respect to the adjusted basis of such aggregated property or properties. In such a case—

(i) If the sum of the depletion allowances actually deducted with respect to the interests included in a constructed aggregated property exceeds the depletion allowance computed under subparagraph (3)(ii) of this paragraph with respect to such constructed aggregated property, the adjusted basis of the aggregated property formed under section 614(c)(1) shall be increased by such excess, and

(ii) If the depletion allowance computed under subparagraph (3)(ii) of this paragraph with respect to a constructed aggregated property exceeds the sum of the depletion allowances actually deducted with respect to the interests included in such constructed aggregated property, the adjusted basis

of the aggregated property formed under section 614(c)(1) shall be reduced (but not below zero) by such excess.

However, the adjusted basis of an aggregated property formed under section 614(c)(1) may be increased only to the extent such excess would have resulted in an increase in such adjusted basis if taken into account under paragraph (a) of § 1.614–6. Thus, if depletion previously allowed with respect to the separate operating mineral interests included in the aggregation formed under section 614(c)(1) exceeds the total of the unadjusted bases of such interests by $5,000, and if the recomputation of tax required to be made under this paragraph results in a depletion allowance which is $7,000 less than the depletion actually deducted with respect to such interests, then the adjusted basis of such aggregation may be increased by only $2,000. If, with respect to the same aggregated property formed under section 614(c)(1), adjustments to adjusted basis are required under this subparagraph as a result of recomputation of tax for two or more taxable years, the total or net amount of such adjustments shall be taken into account. Any adjustment to the adjusted basis of an aggregation required by this subparagraph shall be taken into account as of the effective date of the election to form such aggregation under section 614(c)(1) and shall be effective for all purposes of subtitle A of the Code. For other rules relating to the determination of the adjusted basis of an aggregated property, see paragraph (a) of § 1.614–6.

[T.D. 6524, 26 FR 150, Jan. 10, 1961, as amended by T.D. 7170, 37 FR 5382, March 15, 1972; T.D. 7564, 43 FR 40494, Sept. 12, 1978]

§ 1.614–4 Treatment under the Internal Revenue Code of 1939 with respect to separate operating mineral interests for taxable years beginning before January 1, 1964, in the case of oil and gas wells.

(a) General rule. **(1)** All references in this section to section 614(b) or any paragraph or subparagraph thereof are references to section 614(b) or a paragraph or subparagraph thereof as it existed prior to its amendment by section 226(a) of the Revenue Act of 1964. All references in this section to section 614(d) are references to section 614(d) as it existed prior to its amendment by section 226(b)(3) of the Revenue Act of 1964.

(2) For taxable years beginning before January 1, 1964, in the case of oil and gas wells, a taxpayer may treat under section 614(d) and this section any property as if section 614(a) and (b) had not been enacted. For purposes of this section, the term "property" means each separate operating mineral interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. Separate tracts or parcels of land exist not only when areas of land are separated geographically, but also when areas of land are separated by means of the execution of conveyances or leases. If the taxpayer treats any property or properties under this section, the taxpayer must treat each such property as a separate property except that the taxpayer may treat any two or more properties that are included within the same tract or parcel of land as a single property provided such treatment is consistently followed. If the taxpayer treats two or more properties as a single property under this section, such properties shall be considered as a single property for all purposes of subtitle A of the Internal Revenue Code of 1954. The taxpayer may not make more than one combination of properties within the same tract or parcel of land. Thus, if the taxpayer treats two or more properties that are included within the same tract or parcel of land as a single property, each of the remaining properties included within such tract or parcel of land shall be treated as a separate property. If the taxpayer has treated two or more properties that are included within the same tract or parcel of land as a single property and subsequently discovers or acquires an additional mineral deposit within the same tract or parcel of land, he may include his interest in such deposit with the two or more properties which are being treated as a single property or he may treat his interest in such deposit as a separate property. If the taxpayer has treated each property included within a tract or parcel of land as a separate property and subsequently discovers or acquires an additional mineral deposit within the same tract or parcel of land, he may combine his interest in such deposit with any one of the separate properties included within the tract or parcel of land, but not with more than one of them since they cannot be validly combined with each other. The taxpayer may not combine properties which are included within different tracts or parcels of land under this section irrespective of whether such tracts or parcels of land are contiguous. The treatment of a property as a separate property or the treatment of two or more properties included within a single tract or parcel of land as a single property under this section shall be binding upon the taxpayer for the first taxable year for which such treatment is effective and for all subsequent taxable years beginning before January 1, 1964. For the continuation of such treatment under § 1.614–8 for taxable years beginning

after December 31, 1963, see paragraph (d) of § 1.614–8. For provisions relating to the first taxable year for which treatment under this section becomes effective, see paragraph (d) of this section.

(b) Treatment consistent with treatment for taxable years prior to 1954. If the taxpayer has treated properties in a manner consistent with the rules contained in paragraph (a) of this section for taxable years to which the Internal Revenue Code of 1939 applies and if the taxpayer desires to treat such properties under section 614(d), then such properties must continue to be treated in the same manner. The provisions of this paragraph may be illustrated by the following examples:

Example (1). In 1950, taxpayer A owned two separate tracts of land designated No. 1 and No. 2. Each tract contained three mineral deposits. In the case of tract No. 1, taxpayer A treated the three mineral deposits as a single property. In the case of tract No. 2, taxpayer A treated the first mineral deposit as a separate property and treated the second and third mineral deposits as a single property. This treatment was consistently followed for the taxable years 1950, 1951, 1952, and 1953. Taxpayer A desires, for 1954 and subsequent taxable years, to treat the properties in tracts Nos. 1 and 2 as if section 614(a) and (b) had not been enacted. For 1954 and subsequent taxable years, the three deposits in tract No. 1 must be treated as a single property; the first deposit in tract No. 2 must be treated as a separate property; and the second and third deposits in tract No. 2 must be treated as a single property.

Example (2). Assume the same facts as in example (1) except that, at the time the treatment under this section is adopted, assessment of any deficiency or credit or refund of any overpayment for the taxable years 1954 and 1955 resulting from the treatment of properties under this section is prevented by the operation of the statute of limitations. For 1956 and subsequent taxable years, the three deposits in tract No. 1 must be treated as a single property; the first deposit in tract No. 2 must be treated as a separate property; and the second and third deposits in tract No. 2 must be treated as a single property.

(c) Bases of separate properties previously included in an aggregation under section 614(b). If the taxpayer has made an election under section 614(b) to form an aggregation of operating mineral interests and if such taxpayer subsequently revokes such election for all taxable years for which it was made and treats the properties that are included within such aggregation under section 614(d) and this section by filing the statement required by paragraph (e) of this section, then the adjusted basis of each separate property (as defined in paragraph (a) of this section) that is a part of such aggregation shall be determined as if the taxpayer had made no election under section 614(b). However, if, at the time of the filing of the statement revoking the election under section 614(b), assessment of any deficiency or credit or refund of any overpayment, as the case may be, resulting from such revocation is prevented by the operation of any law or rule of law for any taxable year or years for which the election under section 614(b) was made, then the adjusted basis of each separate property that is a part of the aggregation shall be determined in accordance with the provisions contained in paragraph (a)(2) of § 1.614–6 as of the first day of the first taxable year for which the revocation is effective. After determining the adjusted basis of each separate property included within the aggregation, the taxpayer may treat such properties in any manner which is in accordance with paragraph (a) of this section. See, however, paragraph (b) of this section. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Taxpayer A owns two separate tracts of land, designated No. 1 and No. 2, each of which contains three mineral deposits. The interests in the two tracts of land constitute an operating unit as defined in paragraph (c) of § 1.614–2. Taxpayer A elects under section 614(b) to form an aggregation of all the interests in the operating unit for 1954 and all subsequent taxable years. Subsequently, taxpayer A revokes such election by filing a statement in accordance with paragraph (e) of this section. Such revocation is effective for 1956 and subsequent taxable years because, at the time of the filing of the statement of revocation, assessment of any deficiency or credit or refund of any overpayment for the taxable years 1954 and 1955 resulting from such revocation is prevented by the operation of the statute of limitations. The adjusted bases of the six properties that are included within the aggregation shall be determined in accordance with paragraph (a)(2) of § 1.614–6 as of the beginning of the taxable year 1956.

Example (2). Assume the same facts as in example (1) and, in addition, assume that for taxable years to which the Internal Revenue Code of 1939 is applicable, taxpayer A treated the three deposits in tract No. 1 as a single property and the three deposits in tract No. 2 as a single property. After determining the adjusted basis of each of the six properties as illustrated in example (1), the adjusted basis of the three properties in tract No. 1 must be combined and the adjusted bases of the three properties in tract No. 2 must be combined since the manner in which such properties were treated for taxable years to which the Internal Revenue Code of 1939 is applicable is consistent with the rules contained in paragraph (a) of this section.

(d) Treatment; when effective. If a taxpayer treats any property in accordance with this section, then such treatment shall be effective for whichever of the following taxable years is the later:

(1) The latest taxable year for which an election could have been made with respect to such property under section 614(b); or

(2) The first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in respect of which assessment of a deficiency or credit or refund of an overpayment, as the case may be, resulting from the treatment of such property under this section, is not prevented by

the operation of any law or rule of law on the date such treatment is adopted.

(e) Manner of adopting the treatment of properties under this section. If the taxpayer does not make an election under section 614(b) with respect to a property within the time prescribed for making such an election, then the taxpayer shall be deemed to have treated such property under this section. In such case, the manner in which such property is treated in filing the taxpayer's income tax return for the first taxable year for which the treatment of such property is effective under paragraph (d) of this section shall establish the treatment which must be consistently followed with respect to such property for subsequent taxable years. However, if the income tax return for such first taxable year is filed prior to May 1, 1961, then the taxpayer may adopt the treatment provided for under this section with respect to the property by filing a statement at any time on or before May 1, 1961, with the district director for the district in which the taxpayer's income tax return was filed for the first taxable year for which the treatment of such property is effective under paragraph (d) of this section. Such statement shall set forth the first taxable year for which the treatment of the property under this section is effective, shall revoke any previous elections made with respect to such property under section 614(b), shall state the manner in which such property was treated for taxable years subject to the Internal Revenue Code of 1939, shall state the manner in which such property is to be treated under this section, and shall be accompanied by an amended return or returns if necessary.

(f) Certain treatment under this section precludes election to aggregate under section 614(b) with respect to the same operating unit. If the taxpayer's treatment of any properties that are included within an operating unit (as defined in paragraph (c) of § 1.614–2) under section 614(d) and this section would constitute an aggregation under section 614(b) and if such taxpayer elects, or has elected, to form an aggregation within the same operating unit under section 614(b) for any taxable year for which the treatment under section 614(d) is effective, then the election made under section 614(b) shall not apply for any such taxable year.

[T.D. 6524, 26 FR 157, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13700, Oct. 28, 1965]

§ 1.614–5 Special rules as to aggregating nonoperating mineral interests.

(a) Aggregating nonoperating mineral interests for taxable years beginning before January 1, 1958. Upon proper showing to the Commissioner, a taxpayer who owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more contiguous tracts or parcels of land, shall be permitted to aggregate all such interests in each separate kind of mineral deposit and treat them as one property. Permission will be granted by the Commissioner only if the taxpayer establishes that he will sustain an undue hardship if such nonoperating mineral interests are not treated as one property. Such hardship may exist, for example, if it is impossible for the taxpayer to determine the boundaries, source, or costs of the separate interests, or if a taxpayer who owns a single royalty interest, production payment, or net profits interest cannot determine the separate deposits from which his payments will be derived. In no event shall undue hardship be deemed to exist solely by reason of tax disadvantage. The treatment of such interests as one property shall be applicable for all purposes of subtitle A of the Internal Revenue Code of 1954. In no event may nonoperating mineral interests in tracts or parcels of land which are not contiguous be treated as one property. The term "two or more contiguous tracts or parcels of land" means tracts or parcels of land which have common boundaries. Common boundaries include survey lines, public roads, or similar easements for the use of land without the existence of an intervening mineral right between the tracts or parcels of land. Tracts or parcels of land which touch only at a common corner are not contiguous. For the definition of "nonoperating mineral interests", see paragraph (g) of this section.

(b) Manner and scope of election—(1) Time for filing application for permission to aggregate separate nonoperating mineral interests under paragraph (a) of this section. The application for permission to aggregate separate nonoperating mineral interests under paragraph (a) of this section shall be filed at any time on or before May 1, 1961. Such application shall indicate the first taxable year for which the aggregation is to be formed. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with the requirements of subparagraph (2) of this paragraph.

(2) Contents of application and returns under permission. The application for permission to aggregate nonoperating mineral interests under paragraph (a) of this section shall include a com-

plete statement of the facts upon which the taxpayer relies to show the undue hardship which would result if such an aggregation was not permitted. Such application shall also include a description of the nonoperating mineral interests owned by the taxpayer within the tract or tracts of land involved. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and shows that the taxpayer is aggregating all the nonoperating mineral interests in a particular kind of mineral deposit within the tract or tracts of land involved will be sufficient. If the Commissioner grants permission, a copy of the letter granting such permission shall be filed with the district director for the district in which the taxpayer's income tax return was filed for the first taxable year for which such permission applies, and shall be accompanied by an amended return or returns if necessary.

(3) Election; binding effect. The election to aggregate separate nonoperating mineral interests under paragraph (a) of this section shall be binding upon the taxpayer for the first taxable year for which made and all subsequent taxable years beginning before January 1, 1958, unless consent to make a change is obtained from the Commissioner. The application for consent to make a change must set forth in detail the reason or reasons for such change. Consent to a different treatment shall not be granted where the principal purpose for such change is due to tax consequences. For rules relating to the binding effect of an election where the basis of an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(4) Aggregations under the Internal Revenue Code of 1939. An application for permission to aggregate nonoperating mineral interests under paragraph (a) of this section shall be submitted in accordance with the requirements of this paragraph notwithstanding the fact that the taxpayer may have aggregated such interests for taxable years to which the Internal Revenue Code of 1939 is applicable. If such interests were aggregated for taxable years to which the Internal Revenue Code of 1939 applies and the aggregation was approved by the Internal Revenue Service for such years after full consideration thereof on its merits, such approval will generally be accepted as evidence that undue hardship would result if the aggregation were not permitted.

(c) Termination of aggregation of nonoperating mineral interests—(1) General rule. Any aggregation of nonoperating mineral interests formed under paragraphs (a) and (b) of this section shall not apply with respect to any taxable year beginning after December 31, 1957. Thus, if a taxpayer makes a binding election to form such an aggregation for taxable years beginning before January 1, 1958, then in order to form an aggregation with respect to any taxable year beginning after December 31, 1957, he must obtain permission in accordance with the rules prescribed in paragraphs (d) and (e) of this section.

(2) Bases of separate nonoperating mineral interests. If a taxpayer forms an aggregation of nonoperating mineral interests under paragraphs (a) and (b) of this section which is terminated under subparagraph (1) of this paragraph, the adjusted bases of the separate nonoperating mineral interests included in such aggregation shall be determined in accordance with paragraph (a)(2) of § 1.614–6.

(d) Aggregating nonoperating mineral interests for taxable years beginning after December 31, 1957, or for earlier taxable years. Upon proper showing to the Commissioner, a taxpayer who owns two or more separate nonoperating mineral interests in a single tract or parcel of land, or in two or more adjacent tracts or parcels of land, shall be permitted, under section 614(e), to form an aggregation of all of such interests in each separate kind of mineral deposit and treat such aggregation as one property. Permission shall be granted by the Commissioner only if the taxpayer establishes that a principal purpose in forming the aggregation is not the avoidance of tax. The fact that the aggregation of nonoperating mineral interests will result in a substantial reduction in tax is evidence that avoidance of tax is a principal purpose of the taxpayer. An aggregation formed under the provisions of this paragraph shall be considered as one property for all purposes of the Code. In no event may nonoperating mineral interests in tracts or parcels of land which are not adjacent be aggregated and treated as one property. The term "two or more adjacent tracts or parcels of land" means tracts or parcels of land that are in reasonably close proximity to each other depending on the facts and circumstances of each case. Adjacent tracts or parcels of land do not necessarily have any common boundaries, and may be separated by intervening mineral rights. For the definition of "nonoperating mineral interests", see paragraph (g) of this section.

(e) Manner and scope of election—(1) Time for filing application for permission to aggregate separate nonoperating mineral interests under section

614(e). The application for permission to aggregate separate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall be made in writing to the Commissioner of Internal Revenue, Washington, D.C. 20224. Such application shall be filed within 90 days after the beginning of the first taxable year beginning after December 31, 1957, for which aggregation is desired or within 90 days after the acquisition of one of the nonoperating mineral interests which is to be included in the aggregation, whichever is later. However, if the last day on which the application may be filed under this paragraph falls before May 1, 1961, such application may be filed at any time on or before May 1, 1961. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with subparagraph (4) of this paragraph.

(2) Election to apply section 614(e) retroactively. The application for permission to aggregate separate nonoperating mineral interests under section 614(e) and paragraph (d) of this section may be filed, at the election of the taxpayer, for any taxable year beginning before January 1, 1958, to which the Internal Revenue Code of 1954 is applicable. In such case, the application may be filed at any time on or before May 1, 1961. Such application shall designate the first taxable year for which the aggregation is to be formed. If, prior to January 10, 1961, an application has been filed, the taxpayer need file only a supplemental application containing such additional information as is necessary to comply with the requirements of subparagraph (4) of this paragraph.

(3) Limitation. If the taxpayer forms any aggregation of nonoperating mineral interests under subparagraph (2) of this paragraph, then any aggregation of nonoperating mineral interests formed under paragraphs (a) and (b) of this section shall not apply for any taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1954, taxpayer A owns six separate nonoperating mineral interests designated No. 1 through No. 6. Interests Nos. 1 through 3 are royalty interests in contiguous tracts of land. Interests Nos. 4 through 6, which are located in an entirely different area from interests Nos. 1 through 3, are royalty interests in tracts of land which are not contiguous but which are adjacent to each other. In 1959 taxpayer A obtains permission and elects under section 614(e) and subparagraph (2) of this paragraph to form an aggregation of interests Nos. 4 through 6 for 1956 and all subsequent taxable years. Taxpayer A may not elect to form an aggregation of interests Nos. 1 through 3 under paragraphs (a) and (b) of this section for 1954 or any subsequent taxable year. If taxpayer A wishes to form an aggregation of interests Nos. 1 through 3, he must obtain permission under paragraph (d) of this section and this paragraph.

(4) Contents of application and returns under permission. The application for permission to aggregate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall include a complete statement of the facts upon which the taxpayer relies to show that avoidance of tax is not a principal purpose of forming the aggregation. Such application shall also include a description of the nonoperating mineral interests within the tract or tracts of land involved. A general description, accompanied by maps appropriately marked, which accurately circumscribes the scope of the aggregation and shows that the taxpayer is aggregating all the nonoperating mineral interests in a particular kind of mineral deposit within the tract or tracts of land involved will be sufficient. If the Commissioner grants permission, a copy of the letter granting such permission shall be attached to the taxpayer's income tax return for the first taxable year for which such permission applies. If the taxpayer has already filed such return, a copy of the letter of permission shall be filed with the district director for the district in which such return was filed and shall be accompanied by an amended return or returns if necessary or, if appropriate, a claim for credit or refund.

(5) Election; binding effect. The election to aggregate separate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall be binding upon the taxpayer for the first taxable year for which made and for all subsequent taxable years unless consent to make a change is obtained from the Commissioner. The application for consent to make a change must set forth in detail the reason or reasons for such change. Consent to a different treatment shall not be granted where the principal purpose for such change is due to tax consequences. For rules relating to the binding effect of an election where the basis of an aggregated property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(6) Aggregations under the Internal Revenue Code of 1939. An application for permission to aggregate nonoperating mineral interests under section 614(e) and paragraph (d) of this section shall be submitted in accordance with the requirements of this paragraph notwithstanding the fact that the taxpayer may have aggregated such interests for taxable years to which the Internal Revenue Code of 1939 is applicable. If such interests were aggregated for taxable years to which the

Internal Revenue Code of 1939 applies and the aggregation was approved by the Internal Revenue Service for such years after full consideration thereof on its merits, such approval will generally be accepted as evidence that avoidance of tax is not a principal purpose of forming the aggregation.

(f) **Elections; when effective.** If the taxpayer has elected to form an aggregation under either paragraph (a) or paragraph (d) of this section, the date on which the aggregation becomes effective is the first day of the first taxable year for which the election is made; except that if any separate nonoperating mineral interest included in such aggregation was acquired after such first day, the date on which the inclusion of such interest in such aggregation becomes effective is the date of its acquisition.

(g) **Definition of nonoperating mineral interests.** For purposes of this section, "nonoperating mineral interests" includes only those interests described in section 614(a) which are not operating mineral interests within the meaning of paragraph (b) of § 1.614–2. The taxpayer who holds the operating or working rights in a mineral deposit, but is not actually conducting operations with respect to such deposit, does not have a nonoperating mineral interest in such deposit notwithstanding the fact that he intends to transfer such operating rights at a later time.

[T.D. 6524, 26 FR 158, Jan. 10, 1961]

§ 1.614–6 Rules applicable to basis, holding period, and abandonment losses where mineral interests have been aggregated or combined.

(a) **Basis of property resulting from aggregation or combination—(1) General rule.** (i) When a taxpayer has aggregated as one property two or more interests under section 614(b) (prior to its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e), the unadjusted basis of such aggregated property shall be the sum of the unadjusted basis of the various mineral interests aggregated. The adjusted basis of the aggregated property on the effective date of the aggregation shall be the unadjusted basis of the aggregated property, adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the aggregated property for all purposes of subtitle A of the Code.

(ii) When a taxpayer has combined as one property two or more interests under section 614(b) (as amended by section 226(a) of the Revenue Act of 1964), the adjusted basis of such combined property shall be the sum of—

(a) The unadjusted bases of all such interests which have never been included in an aggregation; and

(b) The adjusted bases of all such interests which at some time have been included in an aggregation, as of the date on which they ceased to participate in an aggregation;

adjusted by the total of all adjustments to the bases of the several mineral interests combined, as required by section 1016,

(c) In the case of interests described in (a), for the entire period of the taxpayer's ownership of such interest; and

(d) In the case of interests described in (b), for the period, if any, between the time of deaggregation and the time of combination.

Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the combined property for all purposes of subtitle A of the Code.

(2) **Bases upon disposition of part of, or termination of, or change in, an aggregated or combined property—(i) In general.** (a) When a taxpayer has aggregated or combined two or more separate mineral interests as one property under section 614(b) (either before or after its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e) and thereafter sells, exchanges, or otherwise disposes of part of such property, the total adjusted basis of the property as of the date of sale, exchange, or other disposition shall be apportioned to determine the adjusted basis of the part disposed of and the part retained for purposes of computing gain or loss, depletion and for all other purposes of subtitle A of the Code. Such adjusted basis shall be determined by apportioning the total adjusted basis of the property between the part of the property disposed of and the part retained in the same proportion as the fair market value of each part (as of the date of sale, exchange, or other disposition) bears to the total fair market value of the property as of such date. For determining gain or loss on the sale or exchange of any part of the aggregated or combined property, the adjusted basis of the aggregated or combined property (from which the adjusted basis of the part is determined) shall not be reduced below zero.

(b) If, for any taxable year after the first taxable year for which an aggregation under section 614(b) (prior to its amendment by section 226(a) of the Revenue Act of 1964), (c), or (e) is effective—

(1) Any such aggregation is terminated for any reason other than the expiration of an aggregation by reason of section 614(b) as amended by section 226(a) of the Revenue Act of 1964 (see subdivision (ii) of this subparagraph), or

(2) The treatment of any mineral interests in any such aggregation is changed after obtaining the consent of the Commissioner,

then the adjusted basis of the aggregated property as of the first day of the first taxable year for which such termination or change is effective shall be apportioned to determine the adjusted bases of the resultant separate mineral interests, as of such first day, for purposes of computing gain or loss, depletion, and for all other purposes of subtitle A of the Code. The adjusted bases of such separate mineral interests shall be determined by apportioning the adjusted basis of the aggregated property (as of the first day of the first taxable year for which such termination or change is effective) between or among such interests in the same proportion as the fair market value of each such interest (as of such first day) bears to the total fair market value of the aggregated property as of such first day. For the purpose of determining the adjusted bases of the separate mineral interests, the adjusted basis of the aggregated property (from which the adjusted basis of each separate mineral interest is determined) shall not be reduced below zero.

(ii) Allocation of basis of aggregation of operating mineral interests in oil and gas wells as of the first day of the first taxable year beginning after December 31, 1963—(a) Fair market value method. Unless the taxpayer elects to use the allocation of adjustments method of determining basis provided in (b) of this subdivision (ii), the adjusted basis as of the first day of the first taxable year beginning after December 31, 1963, of each interest which was participating in an aggregation of operating mineral interests on the day preceding such first day shall be determined by multiplying the adjusted basis of the aggregation by a fraction the numerator of which is the fair market value of such interest and the denominator of which is the fair market value of such aggregation. For purposes of this subdivision (a), the adjusted basis and the fair market value of the aggregation, and the fair market value of such interest, shall be determined as of the day preceding the first day of the first taxable year which begins after December 31, 1963. Unless the taxpayer elects to use the allocation of adjustments method, he shall obtain accurate and reliable information, and keep records with respect thereto, establishing all facts necessary for making the computation prescribed in this subdivision (a). See example (5) of subparagraph (3) of this paragraph.

(b) Allocation of adjustments method. (i) The taxpayer may elect to determine basis by an allocation of adjustments in lieu of the fair market value method prescribed in (a) of this subdivision (ii). In such a case, the adjusted basis (as of the first day of the first taxable year beginning after December 31, 1963) of each interest which was participating in an aggregation of operating mineral interests on the day preceding such first day is the unadjusted basis of such interest immediately after its acquisition by the taxpayer, adjusted by the total of all adjustments to its basis as required by section 1016 to the effective date of aggregation, and by that portion of those section 1016 adjustments to the basis of the aggregation which is reasonably attributable to such interest. For this purpose, two or more interests which are being combined upon deaggregation shall be treated as one interest. An adjustment to the basis of the aggregation is reasonably attributable to such interest to the extent that the adjustment thereto resulted from inclusion of the interest in the aggregation, even though such interest would not have been entitled to the adjustment to the same extent if such interest had been treated separately because of the 50 percent of taxable income limitation or for any other reason. In a case in which the amount of a percentage depletion deduction which was allowed with respect to an aggregation was limited by the 50 percent of taxable income limitation of section 613(a), the portion of such amount which is attributable to each of the interests in the aggregation shall be determined by multiplying such amount by a fraction, the numerator of which is the gross income from such interest and the denominator of which is the gross income from the aggregation. The determination as to which property a particular adjustment is attributable may be based upon records of production or any other facts which establish the reasonableness of the determination. See example (6) of subparagraph (3) of this paragraph.

(ii) If, under the adjustment described in (i) of this subdivision (b), the total of the adjusted bases of the interests which were included in the aggregation exceeds the adjusted basis of the aggregation, the adjusted bases of the interests shall be further adjusted so that the total of the adjusted

bases of the interests equals the adjusted basis of the aggregation. This further adjustment shall be made by reducing the basis of each interest (other than an interest having a basis of zero) by an amount which is determined by multiplying such excess by a fraction, the numerator of which is the adjusted basis of such interest after making the adjustment described in (i) of this subdivision (b) and the denominator of which is the total of the adjusted bases of all such interests after making the adjustment described in (i) of this subdivision (b). See example (6) of subparagraph (3) of this paragraph.

(iii) The election provided for in this subdivision (b) shall be made not later than the time prescribed by law for filing the taxpayer's income tax return (including extensions thereof) for the first taxable year beginning after December 31, 1963, and shall be made in a statement attached to such return.

(3) The application of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). A taxpayer owning three operating mineral interests, designated Nos. 1, 2, and 3, within a single operating unit, properly elects to aggregate such properties under section 614(b) for the calendar year 1954 in his income tax return filed on April 15, 1955. The unadjusted bases and adjustments under section 1016 for depletion through December 31, 1953, in respect of such properties are as follows:

	Unadjusted basis	Adjustments under section 1016
No. 1	$25,000	$27,000
No. 2	18,000	10,000
No. 3	15,000	4,000
Total	58,000	41,000

The adjusted basis of the aggregated property as of January 1, 1954, is $17,000 ($58,000–$41,000).

Example (2). Assume the same facts as in example (1), except that a portion of the aggregated property is sold on June 1, 1956, for $15,000 which is also the fair market value of such portion on the date of sale. In order to determine the gain or loss from this sale as well as the adjusted basis of the retained property, an apportionment must be made. The aggregated property had a fair market value of $25,000 on the date of sale. From January 1, 1954, through May 31, 1956, $10,000 of depletion has been allowed with respect to the aggregated property. The adjusted basis of the portion sold is determined as follows:

$7,000 (adjusted basis of aggregated property)×$15,000÷$25,000=$4,200 (adjusted basis of portion sold)

Therefore, the gain on this sale of the portion sold is $10,800 ($15,000–$4,200). The adjusted basis of the property retained is $2,800 ($7,000–$4,200).

Example (3). Assume the same facts as in example (2), except that instead of selling, the taxpayer subleases one of the leases making up the aggregated property, retaining a one-eighth royalty interest therein. The fair market value of such lease is $15,000 on the date of the sublease. The adjusted basis of such royalty interest is $4,200 which is computed as follows:

$7,000 (adjusted basis of aggregated property)×$15,000 (FMV of portion transferred)÷$25,000 (FMV of aggregated property)

Example (4). In 1953, a taxpayer owned mineral interests Nos. 1, 2, and 3 which he operated as a unit. He owned no other operating interests during that year. The unadjusted bases of these properties were $10,000, $15,000, and $20,000, respectively, and depletion allowed through December 31, 1953, was $5,000 with respect to each property. The taxpayer operated these properties during the year 1954 and, in addition, operated as part of the unit mineral interest No. 4 which he acquired on July 1, 1954, on which date he made the first exploration expenditure with respect thereto. He paid $20,000 for No. 4. In his return for the calendar year 1954, the taxpayer elected under section 614(b) to aggregate all of these mineral interests. The taxpayer must compute cost depletion for the calendar year 1954 on the basis of an aggregated property with an adjusted basis of $30,000 ($45,000–$15,000) for the period from January 1 to June 30, and with an adjusted basis of $50,000 (less depletion for the first six months) for the period from July 1 to December 31. If applicable, the taxpayer must compute percentage depletion on the basis of gross income and taxable income from the aggregated property for the entire year, including the gross income and deductions with respect to operating mineral interest No. 4 for the period from July 1 to December 31. If a portion of the aggregated property is sold during the first six months, its adjusted basis must be determined at the time of sale with an adjustment for depletion to the date of sale. If percentage depletion is applicable, it must be allocated on an equitable basis to the periods prior and subsequent to the date of sale in order to determine the adjustment for depletion to the date of sale.

Example (5). A taxpayer owns two operating mineral interests in oil wells, designated Nos. 1 and 2, in tract A, and another such interest, designated No. 3, in tract B. All three interests are in the same operating unit (as defined in paragraph (c) of § 1.614–2). The taxpayer, who is on a calendar year basis, has properly elected under § 1.614–2 to aggregate such interests for the calendar years 1954 through 1963. The unadjusted bases and adjustments under section 1016 for depletion through December 31, 1953, in respect of such interests are as follows:

	Unadjusted basis	Adjustments under section 1016
No. 1	$42,000	$11,000
No. 2	37,000	4,000
No. 3	19,000	23,000
Total	98,000	38,000

The adjusted basis of the aggregated property as of January 1, 1954, is therefore $60,000 ($98,000 minus $38,000). The taxpayer properly elects under section 614(b) and § 1.614–8 to treat Nos. 1 and 2 as separate properties for the calendar year 1964 and thereafter and does not elect to use the allocation of adjustments method of determining basis provided in subparagraph (2)(ii)(b) of this paragraph. No. 3 will be treated as a separate property, also, because it is in a different tract than the taxpayer's other interests. From January 1, 1954, through December 31, 1963, $50,000 of depletion has been allowed with

respect to the aggregated property, leaving an adjusted basis of $10,000 ($60,000 minus $50,000) on January 1, 1964. On December 31, 1963, the aggregated property has a fair market value of $40,000. Nos. 1, 2, and 3 have fair market values of $16,000, $22,000, and $2,000, respectively. Accordingly, the adjusted bases of Nos. 1, 2, and 3 on January 1, 1964, are $4,000:

$10,000 (adjusted basis of aggregated property) × 16,000 ÷ 40,000; $5,500 ($10,000 × 22,000/40,000); and $500 ($10,000 × 2,000/40,000, respectively)

Example (6). A taxpayer owns four operating mineral interests in oil wells, designated Nos. 1, 2, 3, and 4. All four interests are in the same operating unit and the same tract or parcel of land. The taxpayer, who is on a calendar year basis, has properly elected under § 1.614–2 to aggregate such interests for the calendar years 1954 through 1963. The taxpayer properly elects under section 614(b) and paragraph (a) of § 1.614–8 to treat Nos. 1 and 2 as separate properties for the calendar year 1964 and thereafter. The taxpayer also properly elects to use the allocation of adjustments method of determining basis as provided in subparagraph (2)(ii)(b) of this paragraph. The unadjusted bases of Nos. 1, 2, and combined 3 and 4, the adjustments attributable to each, and the deaggregated basis of each (prior to further adjustment as provided in subparagraph (2)(ii)(b)(ii) of this paragraph) are as follows:

	Basis upon acquisition	Adjustments to time of aggregation	Attributable adjustments during aggregation	Basis upon deaggregation after first adjustment
No. 1	$35,000	$1,000	$16,000	$18,000
No. 2	30,000	11,000	23,000	0
No. 3	25,000	3,000	5,000	......
No. 4	10,000	12,000	9,000	6,000
Total	100,000	27,000	53,000	24,000

The total of the adjusted bases (prior to further adjustment) of the interests which were included in the aggregation is $24,000 while the adjusted basis of the aggregation is $20,000 ($100,000 minus the sum of $27,000 and $53,000). Therefore, the adjusted bases of the interests are further reduced by $4,000 ($24,000 minus $20,000). The adjusted basis of No. 1 of $18,000 is further reduced by $3,000 [$4,000 × (18,000 ÷ 24,000)] to $15,000. Similarly, the adjusted basis of combined Nos. 3 and 4 of $6,000 is further reduced by $1,000 [$4,000 × (6,000 ÷ 24,000)] to $5,000. Assume further that the taxpayer also owns interest No. 5 in the same tract or parcel of land, that such interest was not a part of any aggregation, that such interest had a basis of $15,000 upon acquisition and had subsequent adjustments in reduction of basis totalling $17,000, and that the taxpayer does not elect to treat such interest as a separate property. In such case, Nos. 3, 4, and 5 will be combined. The combination will have an adjusted basis of $3,000, determined by adding the unadjusted basis of No. 5 ($15,000) and the adjusted bases of combined Nos. 3 and 4 upon deaggregation ($5,000), and subtracting from the total thereof ($20,000) the adjustments to No. 5 ($17,000).

(4) Basis for gain and loss where mineral interests acquired before March 1, 1913, are included in an aggregation. Where mineral interests acquired before March 1, 1913, are included in an aggregation under section 614(b), (c), or (e), the aggregated property has two bases, one for the determination of gain and another for the determination of loss upon the disposition of the whole or a part of the aggregated property. For the purpose of determining gain, the adjusted basis of the aggregated property on the effective date of aggregation shall be the sum of—

(i) The unadjusted bases of those mineral interests acquired on or after March 1, 1913, plus

(ii) The cost of any interest acquired before March 1, 1913 (adjusted for the period before March 1, 1913), or the fair market value of such interest as of March 1, 1913, whichever is greater,

and such sum shall be adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. For the purpose of determining loss, the adjusted basis of the aggregated property on the effective date of aggregation shall be the sum of—

(iii) The unadjusted bases of those mineral interests acquired on or after March 1, 1913, plus

(iv) The cost of those interests acquired before March 1, 1913, adjusted for the period before March 1, 1913,

and such sum shall be adjusted by the total of all adjustments to the bases of the several mineral interests aggregated as required by section 1016 to the effective date of aggregation. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the aggregated property for all purposes of the Code. Upon disposition of a part of the aggregated property, or upon termination of the aggregation for any reason, or upon change in the treatment of any mineral interests in the aggregation with consent of the Commissioner, the adjusted basis for determining gain and the adjusted basis for determining loss with respect to each resultant part of the aggregated property shall be determined in accordance with subparagraph (2) of this paragraph.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). At the close of 1953 a taxpayer owned two operating mineral interests designated as Nos. 1 and 2 in the same operating unit. Operating mineral interest No. 1 was acquired by the taxpayer before March 1, 1913, and on such date its basis with reference to its fair market value was $50,000 and its adjusted basis with reference to its cost was $44,000. The unadjusted basis of operating mineral interest No. 2, acquired after March 1, 1913, was $30,000. Adjustments under section 1016 for depletion from March 1, 1913, through December 31, 1953, were $37,000 for operating mineral interest No. 1 and $20,000 for operating mineral interest No. 2. Assume that the taxpayer elected for the taxable year 1954 to aggregate operating mineral interests Nos. 1 and 2. The adjusted basis of the aggregated property as of January 1, 1954, for the purpose of determining gain would be $23,000 ($50,000 plus $30,000) minus ($37,000 plus $20,000). For the purpose of determining loss, the adjusted basis would be $17,000 ($44,000 plus $30,000) minus ($37,000 plus $20,000).

Example (2). Assume the same facts as in example (1) and further assume that for the taxable years 1954 and 1955, the taxpayer was allowed $5,000 of depletion on the aggregated property, that on January 1, 1956, he sold a portion of the aggregated property for $20,000, and that, as of January 1, 1956, the aggregated property had a fair market value of $24,000. At the time of sale, the adjusted basis of the aggregated property for the purpose of determining gain was $18,000 ($23,000–$5,000); and the adjusted basis for the purpose of determining loss was $12,000 ($17,000–$5,000). The adjusted basis of the portion sold would be computed as follows:

[$20,000 (FMV of portion sold) ÷ $24,000 (FMV of aggregated property)] × $18,000 (adjusted basis for gain) = $15,000 (adjusted basis of portion sold)

Taxpayer's gain would then be computed as follows: $20,000 (amount received for portion sold), less $15,000 (adjusted basis of portion sold) = $5,000 (gain on portion sold).

The adjusted basis of the portion retained as of January 1, 1956, for the purpose of determining gain is $3,000 ($18,000–$15,000). For the purpose of determining loss, the adjusted basis is $2,000 ($12,000–$10,000).

Example (3). Assume the same facts as in example (2), except that a portion of the aggregated property was sold for $5,000 and that the fair market value of the aggregated property at the time of sale was $10,000. The adjusted basis of the portion sold would be computed as follows:

[$5,000 (FMV of portion sold) ÷ $10,000 (FMV of aggregated property)] × $12,000 (adjusted basis for loss) = $6,000 (adjusted basis of portion sold)

Taxpayer's loss would then be computed as follows: $5,000 (amount received for portion sold), less: $6,000 (adjusted basis of portion sold) = ($1,000) loss on portion sold.

(5) **Basis for gain and loss where mineral interests acquired before March 1, 1913, are included in a combination and one or more of such interests have not previously been included in an aggregation.** Where mineral interests acquired before March 1, 1913, are included in a combination under section 614(b) and § 1.614–8 and one or more of such interests have not previously been included in an aggregation, the combined property has two bases, one for the determination of gain and another for the determination of loss upon the disposition of the whole or a part of the combined property. For the purpose of determining gain, the adjusted basis of the combined property on the effective date of combination shall be the sum of—

(i) The adjusted bases at the time of deaggregation, as determined under subparagraph (2) of this paragraph, of all interests which have previously been included in an aggregation,

(ii) The unadjusted bases of other mineral interests acquired on or after March 1, 1913, and

(iii) The cost of each other interest acquired before March 1, 1913 (adjusted for the period before March 1, 1913), or the fair market value of such interest as of March 1, 1913, whichever is greater,

and such sum shall be adjusted by the total of all adjustments to the bases of the mineral interests as required by section 1016 to the effective date of combination. For the purpose of determining loss, the adjusted basis of the combined property on the effective date of combination shall be the sum of—

(iv) The adjusted bases at the time of deaggregation, as determined under subparagraph (2) of this paragraph, of all interests which have previously been included in an aggregation,

(v) The unadjusted bases of other mineral interests acquired on or after March 1, 1913, and

(vi) The cost of other mineral interests acquired before March 1, 1913, adjusted for the period before March 1, 1913,

and such sum shall be adjusted by the total of all adjustments to the bases of the mineral interests as required by section 1016 to the effective date of combination. Thereafter, the adjustments to basis required by section 1016 shall apply to the total adjusted basis of the combined property for all purposes of the Code. Upon disposition of a part of the combined property, the adjusted basis for determining gain and the adjusted basis for determining loss with respect to each resultant part of the combined property shall be determined in accordance with subparagraph (2) of this paragraph.

(b) **Holding period of aggregated or combined properties.** Where a taxpayer sells or exchanges either a part or all of an aggregated or combined property which includes part or all of a mineral interest which the taxpayer has held for (1 year 6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less, the sales price and adjusted basis attributable

to the interest sold must be apportioned in proportion to the relative fair market values as of the date of sale to determine the amount of income represented by the sale of property held for (1 year 6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. The application of this rule may be illustrated by the following example:

Example. Taxpayer A owns operating mineral interests Nos. 1, 2, and 3. He acquired interests Nos. 1 and 2 in 1953 but purchased and made development expenditures on interest No. 3 on December 1, 1954. In his return for the taxable year 1954, taxpayer A elects to aggregate interests Nos. 1, 2, and 3 which are operated as a unit. On May 1, 1955, taxpayer A sells the north half of the aggregated property which includes portions of interests Nos. 1, 2, and 3. The sales price of the north half was $80,000; the adjusted basis of the aggregated property as of the date of sale was $20,000; and the fair market value of the aggregated property as of the date of sale was $100,000. The adjusted basis applicable to the north half is computed as follows:

[$80,000 (FMV of portion sold) ÷ $100,000 (FMV of aggregated property)] × $20,000 (adjusted basis of aggregated property) = $16,000 (adjusted basis of portion sold).

The total gain on the sale is $64,000 ($80,000–$16,000).

The gain attributable to the sale of the portion held for six months or less is computed as follows (assuming that the fair market value of the portion of No. 3 included in the sale as of the date of sale was $30,000):

[$30,000 (FMV of portion of No. 3 sold) ÷ $80,000 (FMV of north half)] × $16,000 (adjusted basis of north half) = $6,000 (adjusted basis of portion of No. 3 sold).

The gain on the portion of No. 3 sold is $24,000 ($30,000–$6,000).

(c) **Acquisition of property with transferor's basis.** If a separate property or an aggregated or combined property is acquired in a transaction in which the basis of such property in the hands of the taxpayer is determined by reference to the basis of such property in the hands of a transferor, then the election of such transferor as to the treatment of such separate, aggregated, or combined property shall be binding upon the taxpayer for all taxable years ending after the transfer unless, in the case of an aggregation, the aggregation terminates or consent to make a change is obtained under paragraph (d)(4) of § 1.614–2, paragraph (f)(7) of § 1.614–3, or paragraph (b)(3) or (e)(5) of § 1.614–5, whichever is applicable.

(d) **Abandonment and casualty losses.** In the case of mineral interests which are aggregated or combined as one property, no losses resulting from worthlessness or abandonment are allowable until all the mineral rights in the entire aggregated or combined property are proven to be worthless or until the entire aggregated or combined property is disposed of or abandoned. Casualty losses are allowable in accordance with the rules applicable to casualty losses in general. For rules applicable to losses in general, see section 165 and the regulations thereunder.

[T.D. 6524, 26 FR 159, Jan. 10, 1961, as amended by T.D. 6859, 30 FR 13701, Oct. 28, 1965; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§ 1.614–7 Extension of time for performing certain acts.

Sections 1.614–2 to 1.614–5, inclusive, require certain acts to be performed on or before May 1, 1961 (the first day of the first month which begins more than 90 days after the regulations under section 614 were published in the FEDERAL REGISTER as a Treasury decision). The district director may, upon good cause shown, extend for a period not exceeding 6 months the period within which such acts are to be performed, and shall, if the interests of the Government would otherwise be jeopardized thereby, grant such an extension only if the taxpayer and the district director agree in writing to a corresponding or greater extension of the period prescribed for the assessment of the tax, or in the case of taxable years described in section 614(c)(3)(E), the assessment of the tax resulting from the exercise or change in an election.

[T.D. 6561, 26 FR 3523, April 25, 1961]

§ 1.614–8 Elections with respect to separate operating mineral interests for taxable years beginning after December 31, 1963, in the case of oil and gas wells.

(a) **Election to treat separate operating mineral interests as separate properties—(1) General rule.** If a taxpayer has more than one operating mineral interest in oil and gas wells in one tract or parcel of land, he may elect to treat one or more of such interests as separate properties for taxable years beginning after December 31, 1963. Any such interests with respect to which the taxpayer does not so elect shall be combined and treated as one property. Nonoperating mineral interests may not be included in such combination. There may be only one such combination in one tract or parcel. Any such combination of interests shall be considered as one property for all purposes of subtitle A of the Code for the period to which the election applies. The preceding sentence does not preclude the use of more than one account under a single method of computing depreciation or the use of more than one method of computing depreciation under section 167, if otherwise proper. Any reasonable and consistently applied method or methods of computing depreciation of the improve-

ments made with respect to the separate interests which are combined may be continued in accordance with section 167 and the regulations thereunder. Except as provided in paragraph (b) of this section, such an interest in one tract or parcel may not be combined with such an interest in another tract or parcel. For rules with respect to the allocation of the basis of an aggregation of separate operating mineral interests under this section among such interests as of the first day of the first taxable year beginning after December 31, 1963, see paragraph (a)(2)(ii) of § 1.614–6. For the definition of "operating mineral interest" see paragraph (b) of § 1.614–2.

(2) **Election in respect of newly discovered or acquired interest or interest ceasing to participate in cooperative or unit plan of operation.** (i) If the taxpayer makes an election under this paragraph in respect of an operating mineral interest in a tract or parcel of land and, after the taxable year for which such election is made, an additional operating mineral interest in the same tract or parcel is discovered or acquired by the taxpayer or is the subject of an election under this paragraph because it ceases to participate in a cooperative or unit plan of operation to which paragraph (b) of this section applies, the additional operating mineral interest shall be treated—

(a) If there is no combination of interests in such tract or parcel, as a separate property unless the taxpayer elects to combine it with another interest, or

(b) If there is a combination of interests in such tract or parcel, as part of such combination unless the taxpayer elects to treat it as a separate property.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. Prior to 1964 a taxpayer acquired, and incurred development expenditures with respect to, three operating mineral interests in oil, designated Nos. 1, 2, and 3. All three interests are in the same tract or parcel of land. For the taxable year 1964, the taxpayer elects to treat such interests as three separate properties. During the taxable year 1965, the taxpayer discovers and incurs development costs with respect to a fourth operating mineral interest, No. 4, in the same tract of land. During the taxable year 1966, the taxpayer discovers and incurs development costs with respect to a fifth operating mineral interest, No. 5, in the same tract of land. If the taxpayer makes no election relative to No. 4 for 1965, such interest will thereafter be treated as a separate property. Alternatively, the taxpayer may make an election for 1965 to combine No. 4 with any one (and only one) of the three other interests and to treat such combination as one property. If, for example, he elects to combine No. 4 with No. 3, then in 1966, No. 5 will automatically become part of the combination of Nos. 3 and 4 if no election is made to treat it as a separate property. After the combination of Nos. 3 and 4 is formed, Nos. 1 and 2, which were acquired or discovered prior to the formation of the combination and which were not included in such combination within the time prescribed, may not be included in that or any other combination. However, see subparagraph (3)(iv) of this paragraph.

(3) **Manner and scope of election—(i) Election; when made.** Except as provided hereafter in this subdivision (i), any election under subparagraph (1) or (2) of this paragraph shall be made for each operating mineral interest not later than the time prescribed by law for filing the income tax return (including extensions thereof) for whichever of the following taxable years is later:

(a) The first taxable year beginning after December 31, 1963; or

(b) The first taxable year in which any expenditure for development or operation in respect of such operating mineral interest is made by the taxpayer after his acquisition of such interest.

Notwithstanding the provisions of (a) and (b), if it is determined that the operating mineral interest in respect of which the election is to be made was, during what would otherwise be the entire effective period of the election insofar as it would apply to the appropriate taxable year determined under (a) and (b), participating in a cooperative or unit plan of operation to which section 614(b)(3) applies, the election shall be made not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the taxable year in which the interest ceases to participate in the cooperative or unit plan. See subdivision (iii) of this subparagraph for provisions relating to the effective date of an election and paragraph (b) of this section for provisions relating to certain unitization or pooling arrangements. For purposes of this subparagraph, expenditures for development include any intangible drilling or development costs within the purview of section 263(c). Delay rentals are not considered as expenditures for development. For purposes of this subparagraph, the acquisition of an option to acquire an economic interest in minerals in place does not constitute the acquisition of a mineral interest.

(ii) **Election; how made.** Any election under this paragraph shall be made by a statement attached to the income tax return of the taxpayer for the first taxable year for which the election is made. This statement shall identify by name, code number, or other means the operating mineral interests within the same tract or parcel of land which the taxpayer is electing to treat as separate properties or in combination, as the case may be. The statement shall also identify by name, code number, or other means the tract or parcel and

shall set forth the facts upon which its treatment as a single and entire tract or parcel is based. See paragraph (a)(3) of § 1.614–1. However, if the taxpayer is electing to treat all of his operating mineral interests in a tract or parcel as separate properties, a blanket election with respect to all of such interests in that tract or parcel which are owned by the taxpayer at the time the election is made will suffice and only the tract or parcel itself need be so identified. The taxpayer shall maintain and have available records and maps sufficient to clearly define the tract or parcel and all of the taxpayer's operating mineral interests therein.

(iii) Election; when combination effective. (a) If, by reason of the exercise or nonexercise of an election under this paragraph, a combination is formed of two or more operating mineral interests, all of which are owned and operated by a taxpayer on the first day of the first taxable year beginning after December 31, 1963, and are not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies on such first day, the combination is effective on such first day.

(b) If, by reason of the exercise or nonexercise of an election under this paragraph, a combination of operating mineral interests not described in (a) of this subdivision (including a combination described in (a) to which another operating mineral interest is added) is formed, the date on which each operating mineral interest which is being combined by the taxpayer for the first time enters into the combination is the later of (1) the earliest date within the taxable year affected on which the taxpayer incurred any expenditure for development or operation of such interest at a time when such interest was not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies, or (2) the earliest date on which the taxpayer incurred any expenditure for development or operation of any other interest with which such interest is to be combined at a time when such other interest was not participating in a cooperative or unit plan of operation to which paragraph (b) of this section applies.

(c) The application of these provisions may be illustrated by the following examples:

Example (1). In 1963, a taxpayer owned and operated mineral interests Nos. 1 and 2, both of which are in the same tract or parcel of land. Neither No. 1 nor No. 2 participates in a cooperative or unit plan of operation. The taxpayer, who is on a calendar year basis, continued to own and operate these interests during the year 1964, and made no election with respect to such interests in his income tax return for that year. As a result, Nos. 1 and 2 are combined as of January 1, 1964.

Example (2). Assume that the taxpayer described in example (1) discovered operating mineral interests Nos. 3 and 4 in the same tract or parcel of land as Nos. 1 and 2, that he made his first expenditures for the development of No. 3 on June 1, 1964, and of No. 4 on September 1, 1964, and that, in a timely return for 1964, he elected to treat No. 3 as a separate property and made no election with respect to No. 4. As a result, No. 3 is treated as a separate property and No. 4 joins the combination of Nos. 1 and 2 as of September 1, 1964.

Example (3). On March 1, 1964, a taxpayer acquired a tract or parcel of land containing operating mineral interests Nos. 1 and 2. The taxpayer made his first operating expenditures on No. 1 on April 1, 1964. On October 1, 1964, the taxpayer made his first development expenditures with respect to operating mineral interest No. 2. The taxpayer made no election with respect to these interests. As a result, Nos. 1 and 2 enter into a combination as of October 1, 1964.

(iv) Election; binding effect. A valid election made under section 614(b) and this subparagraph shall be binding upon the taxpayer for the first taxable year for which made and for all subsequent taxable years. However, notwithstanding the preceding sentence, an election to treat one or more operating mineral interests as separate properties shall not prevent the making of a later election to combine a newly discovered or acquired operating mineral interest with one of such interests, if no other combination exists in the tract or parcel of land on the date when the later election would become effective under subdivision (iii) of this subparagraph. Nor will an election to treat an operating mineral interest as a separate property prevent its treatment with another interest as a single property under paragraph (b) of this section if such interest later participates in a cooperative or unit plan of operation to which paragraph (b) applies. For rules relating to the binding effect of an election in certain cases in which the basis of a separate or combined property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, see paragraph (c) of § 1.614–6.

(b) Certain unitization or pooling arrangements. (1) Except as provided in this paragraph, if one or more of the taxpayer's operating mineral interests, or a part or parts thereof, participate, under a voluntary or compulsory unitization or pooling agreement as defined in subparagraph (6) of this paragraph, in a single cooperative or unit plan of operation, then for the period of such participation in taxable years beginning after December 31, 1963, such interest or interests, and part or parts thereof, included in such unit, shall be treated for purposes of subtitle A of the Code as one property, separate from the interest or interests, or part or parts thereof, not included in such unit.

(2) Subparagraph (1) of this paragraph shall apply to a voluntary agreement only if all the operating mineral interests covered by the agree-

ment are in the same deposit or are in two or more deposits, the joint development or production of which is logical, without taking tax benefits into account, from the standpoint of geology, convenience, economy, or conservation, and which are in tracts or parcels of land which are contiguous or in close proximity. Operating mineral interests under a voluntary agreement to which subparagraph (1) does not apply are subject to the rules contained in paragraph (a) of this section. For purposes of this paragraph an agreement is voluntary unless required by the laws or rulings of any State or any agency of any State.

(3) Notwithstanding the provisions of subparagraph (1) of this paragraph, if the taxpayer, for the last taxable year beginning before January 1, 1964, treated as separate properties two or more operating mineral interests which participate, under a voluntary or compulsory unitization or pooling agreement entered into in any taxable year beginning before January 1, 1964, in a single cooperative or unit plan of operation, and if it is determined that such treatment was proper under the law applicable to such taxable year, the taxpayer may continue to treat all such interests in a consistent manner for the period of such participation. If it is determined that such treatment was not proper under the law applicable to such taxable year, or if the taxpayer does not continue to treat all such interests in a manner consistent with the treatment of them for the last taxable year beginning before January 1, 1964, the treatment of the interests shall be in accordance with the provisions of subparagraph (1).

(4) If only a part of an operating mineral interest, which interest is not being treated under paragraph (a) of this section as part of a combination of interests, participates in a unit or pool, such part shall, for the period of its participation in the unit or pool, be treated for purposes of this section as being separate from the nonparticipating portion of the operating mineral interest of which it is a part. A portion of the adjusted basis and of the units of mineral of such operating mineral interest remaining at the beginning of the period described in the preceding sentence shall be allocated to the participating part in accordance with the principles contained in paragraph (a)(2)(i)(a) of § 1.614–6 as if such participating part had been sold. If participation in the unit or pool ends, the separate status of the participating part shall immediately terminate. At such time the adjusted basis of such part and the units of mineral with respect to such part remaining at the time of termination shall be added to the adjusted basis and to the remaining units of mineral of the nonparticipating portion of the operating mineral interest. During the period of participation in the unit or pool such participating part shall not be treated separately from the nonparticipating portion of the operating mineral interest in applying section 165.

(5) Where an operating mineral interest which is being treated under paragraph (a) of this section as part of a combination of interests begins participation in a unit or pool, the combination shall remain in force but the treatment of such participating interest as a part of the combination shall be suspended for the period of its participation in the unit or pool. If, for example, a taxpayer owns operating mineral interests Nos. 1, 2, and 3 in a single tract or parcel of land, elects to treat No. 1 as a separate property (with mineral interests Nos. 2 and 3 thus being combined), is later required by an agency of a State to place No. 2 in a unit, and subsequently discovers operating mineral interest No. 4 in the same tract or parcel of land, then under paragraph (a)(2)(i)(b) of this section No. 4 will automatically be combined with No. 3 unless the taxpayer elects to treat it as a separate property. Under this subparagraph, an interest may be treated as part of a combination for a portion of a taxable year and as part of a unit or pool for a portion of a taxable year. At the commencement of participation in the unit or pool, a portion of the adjusted basis of the combination and a portion of the units of mineral with respect to the combination remaining at that time shall be allocated to such participating interest in accordance with the principles contained in paragraph (a)(2)(i)(a) of § 1.614–6 as if such interest had been sold. During the period of participation in the unit or pool such participating interest is nevertheless treated as a part of the combination for purposes of paragraph (d) of § 1.614–6. If participation in the unit or pool ends, the treatment of such interest as participating in the unit or pool shall immediately terminate. At such time, the adjusted basis of the participating interest and the units of mineral with respect to such interest remaining at the time of termination shall be added to the adjusted basis and to the remaining units of mineral of the nonparticipating portion of the combination. In determining the adjusted basis of the participating interest at the time of termination there shall be taken into account any section 1016 adjustments attributable to such interest for the period of its participation in the unit or pool. If two or more operating mineral interests of the taxpayer participate in a unit or pool and are treated as one property under subpara-

graph (1) of this paragraph, and if participation by such interests in the unit or pool terminates, the adjusted basis of each such interest at the time of termination shall be separately determined. If the total of the adjusted bases of such interests upon termination of their participation in the unit or pool exceeds the adjusted basis of such one property, then the adjusted bases of such interests shall be further adjusted by applying the principles contained in paragraph (a)(2)(ii)(b)(ii) of § 1.614–6 so that the total of the adjusted bases of such interests equals the adjusted basis of such one property. In addition, the units of oil and gas estimated to be attributable to a participating interest at the time of termination of participation shall be restored to the units of oil and gas of the combination of which it is a part. The rules stated in this subparagraph with respect to an operating mineral interest which is being treated under paragraph (a) of this section as part of a combination and which begins participation in a unit or pool shall also apply to a portion of an operating mineral interest which is being treated under paragraph (a) as part of a combination if such portion begins participation in a unit or pool.

(6) As used in this paragraph, the term "unitization or pooling agreement" means an agreement under which two or more persons owning operating mineral interests agree to have the interests operated on a unified basis and further agree to share in production on a stipulated percentage or fractional basis regardless of from which interest or interests the oil or gas is produced. In addition, in a situation in which one person owns operating mineral interests in several leases, an agreement of such person with his several royalty owners to determine the royalties payable to each on a stipulated percentage basis regardless of from which lease or leases oil or gas is obtained is also considered to be a unitizaiion or pooling agreement. No formal cross-conveyance of properties is necessary. An agreement between co-owners of a tract or parcel of land or a part thereof for the development of the property by one of such co-owners for the account of all is not a unitization or pooling agreement, provided that the agreement does not affect ownership of minerals or entitle any such co-owner to share in production from any operating mineral interests other than his own.

(c) **Operating mineral interest defined.** For the definition of the term "operating mineral interest" as used in this section, see paragraph (b) of § 1.614–2.

(d) **Alternative treatment under Internal Revenue Code of 1939.** If, on the day preceding the first day of the first taxable year beginning after December 31, 1963, the taxpayer has any operating mineral interests which he treats under section 614(d) (as in effect before the amendments made by the Revenue Act of 1964) and § 1.614–4, such treatment shall be continued and shall be deemed to have been adopted pursuant to the provisions of section 614(b) and paragraph (a) of this section. Accordingly, a taxpayer, who has four operating mineral interests in a single tract or parcel of land, and who has treated two of such interests as one property and two of such interests as separate properties under section 614(d) prior to the first day of the first taxable year beginning after December 31, 1963, is deemed to have adopted such treatment pursuant to the provisions of section 614(b) and paragraph (a) of this section. Hence, in the absence of an election to the contrary, a fifth operating mineral interest in the same tract or parcel acquired by the taxpayer in a taxable year beginning after December 31, 1963, will, after an expenditure for development or operation, be combined with the combination of two interests made under section 614(d). Furthermore, an election which was made for a taxable year beginning before January 1, 1964, under section 614(d) as then in effect will be binding for all taxable years beginning after December 31, 1963, even though the time for making an election under section 614(b) and paragraph (a) of this section has not elapsed.

[T.D. 6859, 30 FR 13703, Oct. 28, 1965]

§ 1.615–1 Pre-1970 exploration expenditures.

(a) **General rule.** Section 615 prescribes rules for the treatment of expenditures (paid or incurred before January 1, 1970) for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit. Such expenditures hereinafter in the regulations under section 615 will be referred to as exploration expenditures. The development stage of the mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. A taxpayer who elects under section (e) may treat exploration expenditures under either section 615(a) or section 615(b). See § 1.615–6 for the method of making the election to treat exploration expenditures under sec-

tion 615. Under section 615(a), a taxpayer may, at his option, deduct exploration expenditures paid or incurred in an amount not to exceed $100,000 for any taxable year. Under section 615(b) and § 1.615–2, he may elect to defer any part of such amount and deduct such part on a ratable basis as the units of produced minerals benefited by such expenditures are sold. If the taxpayer does not treat exploration expenditures under either section 615(a) or (b) in any year for which his election under section 615(e) is effective, the expenditures for such year will be charged to depletable capital account. The option to deduct under section 615(a) and the election to defer under section 615(b), however, are subject to the limitation provided in section 615(c) and § 1.615–4. In the case of certain corporations which are members of an affiliated group which has elected the 100 percent dividends received deduction under section 243(b), see section 243(b)(3) and § 1.243–5 for limitations on the option to deduct under section 615(a) and the election to defer under section 615(b).

(b) **Expenditures to which section 615 is not applicable.** (1) Section 615 is not applicable to expenditures which would be allowed as a deduction for the taxable year without regard to such section.

(2) Section 615 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the exploration of ores or minerals are considered exploration expenditures under section 615. If such improvements are used only in part for exploration during a taxable year, an allocable portion of the allowance for depreciation shall be treated as an exploration expenditure.

(3) Section 615 is applicable to exploration expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired by the taxpayer. The expenditures attributable to the remaining fractional share shall be considered as the cost of his acquired interest and shall be recovered through depletion allowances. For example, taxpayer A owns mineral leases on unexplored mineral lands and agrees to convey an undivided three-fourths (¾) interest in such leases to taxpayer B provided B will pay all of the exploration expenditures for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral which will be incurred before the beginning of the development stage. B shall treat three-fourths of such amount under section 615, and shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 615 do not apply to costs of exploration which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for exploration undertaken directly or through a contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred exploration expenditures in certain corporate acquisitions.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6685, 28 FR 11405, Oct. 24, 1963; T.D. 6992, 34 FR 826, Jan. 18, 1969; T.D. 7192, 37 FR 12938, June 30, 1972]

§ 1.615–2 Deduction of pre-1970 exploration expenditures in the year paid or incurred.

(a) *In general.* (1) If the election to treat exploration expenditures under section 615 has been made or is deemed made under § 1.615–6(b) subject to the total limitation of $100,000, a taxpayer who has made exploration expenditures prior to January 1, 1970, with respect to more than one mine or other natural deposit may deduct for a taxable year for which such election is effective any portion of such expenditures attributable to each mine or deposit. With respect to a particular mine or other natural deposit, a taxpayer who has made the election described in the preceding sentence may deduct under section 615(a) a portion of the exploration expenditures and may defer and deduct under section 615(b) the balance of such expenditures. For any taxable year for which the election to treat exploration expenditures under section 615 is effective, the taxpayer must charge any amount of exploration expenditures in excess of $100,000 to capital account and must charge to capital account whatever amount has not been deducted currently or deferred. For example, taxpayer A who has elected under section 615(e) has three mines, X, Y, and Z. In the taxable year 1967, A makes exploration expenditures of $75,000 with respect to each mine. The total allowable deduction for exploration expenditures is $100,000. A deducts $50,000 and defers $25,000 with respect to X. He deducts $25,000, and charges to capital account $50,000 with respect to Y, and charges to capital account the entire $75,000 paid with respect to Z. Thus, A has deducted or deferred $100,000 and capitalized the excess.

(2) Except as provided in section 615(e) and § 1.615–6, a taxpayer cannot change his treatment of exploration expenditures for a taxable year after the due date (including extensions of time) for filing the return for the taxable year except where it is subsequently determined that any part of such exploration expenditures deducted under section 615(a) or deferred under section 615(b) are not exploration expenditures for the taxable year. Where the taxpayer has made the election to treat exploration expenditures under section 615 and it is subsequently determined that part of the expenditures deducted under section 615(a) or deferred under section 615(b), for a taxable year, were not exploration expenditures for such taxable year, the exploration expenditures required to be charged to capital account for such taxable year by reason of the limitation may be deducted or deferred (to the extent of the subsequent determination) and proper adjustment made to capital account. A taxpayer claiming a deduction under section 615(a) shall indicate clearly on his income tax return the amount of the deduction claimed under such section with respect to each mine or other natural deposit. Such mine or deposit shall be identified by an adequate description.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7192, 37 FR 12938, June 30, 1972]

§ 1.615–3 Election to defer pre-1970 exploration expenditures.

(a) General rule. A taxpayer who makes the election provided in section 615(e) may defer any portion of the exploration expenditures made before January 1, 1970, with respect to each mine or other natural deposit, subject to the limitations described in section 615(c) and § 1.615–4. The amounts so deferred shall be deducted ratably as the units of produced ores or minerals discovered or explored by reason of such expenditures are sold.

(b) Effect and manner of making election. (1) The election to defer exploration expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(c) Expenditures made by the owner who retains a non-operating mineral interest. (1) A taxpayer who elects to defer exploration expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers exploration expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he shall deduct the exploration expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal or iron ore to which section 631(c) applies), the deferred exploration expenditures shall be allocated between the interest sold and the interest retained in proportion to the fair market values of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest.

(d) Losses from abandonment. Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) Computation of amount of deduction. The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred exploration expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the "number of units of ore or mineral benefited by

such expenditures remaining as of the taxable year" is the number of units of ore or mineral benefited by the deferred exploration expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in § 1.611-2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6685, 28 FR 11405, Oct. 24, 1963; T.D. 6841, 30 FR 9306, July 27, 1965; T.D. 7192, 37 FR 12939, June 30, 1972]

§ 1.615-4 Limitation of amount deductible.

(a) Taxable years beginning before July 7, 1960. For any taxable year beginning before July 7, 1960 (including taxable years of less than 12 months), a taxpayer may deduct or defer exploration expenditures paid or incurred in the taxable year in an amount not in excess of $100,000. However, for such taxable years, the taxpayer may not avail himself of the provisions of section 615 for more than four taxable years (including taxable years of less than 12 months and taxable years subject to the Internal Revenue Code of 1939). Such four taxable years need not be consecutive. In determining the number of years in which a taxpayer has availed himself of section 615, a year for which he makes an election to defer exploration expenditures shall count as one year. Any subsequent taxable year in which such deferred expenditures are deducted shall not be taken into account as one of the four years. For purposes of the 4-year limitation, a year in which both a deduction and an election to defer are availed of by the taxpayer shall be taken into account as only one year.

(b) Taxable years beginning after July 6, 1960. For any taxable year beginning after July 6, 1960 (including taxable years of less than 12 months), a taxpayer who is otherwise eligible may deduct or defer exploration expenditures paid or incurred before January 1, 1970, in the lesser of the following amounts:

(1) The amount paid or incurred in the taxable year,

(2) $100,000, or

(3) $400,000 minus all amounts deducted or deferred for taxable years ending after December 31, 1950.

For purposes of this paragraph, the number of taxable years for which the taxpayer availed himself of the provisions of section 615 or the corresponding provisions of prior law is immaterial.

(c) Special rules for previously deferred expenditures. In determining whether an election to defer was availed of in applying the limitations of paragraphs (a) and (b) of this section, there shall be taken into account any year with respect to which amounts were deferred but not fully deducted because of a sale or other disposition of the mineral property, even though the balance of the deferred amounts was treated as part of the basis of the mineral property in determining gain or loss from the sale.

(d) Example of application of provisions. The application of the provisions of subparagraphs (a) and (b) of this section may be illustrated by the following example:

Example. A taxpayer on the calendar year basis, who has never claimed the benefits of section 615, or section 23(ff) of the 1939 Code, expended $200,000 for exploration expenditures during the year 1956. For each of the years 1957, 1958, 1959, and 1960 the taxpayer had exploration costs of $80,000. The taxpayer deducted or deferred the maximum amounts allowed for each of the years 1956, 1957, 1958, and 1959. None of the $80,000 expenditures for 1960 could be deducted or deferred by the taxpayer because he had already deducted or deferred exploration expenditures for 4 prior years. In 1961 the taxpayer expended $200,000 for exploration expenditures. The maximum amount the taxpayer may deduct or defer for the taxable year 1961 is $60,000 computed as follows:

(1) Add all yearly amounts deducted or deferred for exploration expenditures by the taxpayer for prior years.

Year	Expenditures	Deducted or deferred
1956	$200,000	$100,000
1957	80,000	80,000
1958	80,000	80,000
1959	80,000	80,000
1960	80,000	0
Total		340,000

(2) Subtract the sum of the amounts obtained in (1), $340,000, from $400,000, the maximum amount allowable to the taxpayer for deductions or deferrals of exploration expenditures.

Maximum amount allowable to taxpayer	$400,000
Sum of amounts obtained in (1)	340,000
	60,000

(e) **Transferee of mineral property.** (1) Where an individual or corporation transfers any property to the taxpayer and the transfer is one to which any of the subdivisions of this subparagraph apply, the taxpayer shall take into account for purposes of the 4-year limitation described in paragraph (a) of this section, all years that the transferor deducted or deferred exploration expenditures, and for purposes of the $400,000 limitation described in paragraph (b) of this section, all amounts that the transferor deducted or deferred.

(i) The taxpayer acquired any mineral property in a transaction described in section 23(ff)(3) of the Internal Revenue Code of 1939, excluding the reference therein to section 113(a)(13).

(ii) The taxpayer would be entitled under section 381(c)(10) to deduct exploration expenditures if the transferor (or distributor) corporation had elected to defer such expenditures. For example, if the taxpayer acquired any mineral property in a transaction described in section 381(a) (relating to the acquisition of assets through certain corporate liquidations and reorganizations), there shall be taken into account in applying the limitations of paragraph (a) of this section the years in which the transferor exercised the election to defer or deduct exploration expenditures, and there shall be taken into account in applying the limitations of paragraph (b) of this section any amount so deducted or deferred. See also section 381(c)(10) and the regulations thereunder.

(iii) The taxpayer acquired any mineral property under circumstances which make applicable the following sections of the Internal Revenue Code:

(a) Section 334(b)(1), relating to the liquidation of a subsidiary where the basis of the property in the hands of the distributee is the same as it would be in the hands of the transferor.

(b) Section 362(a) and (b), relating to property acquired by a corporation as paid-in surplus or as a contribution to capital, or in connection with a transaction to which section 351 applies.

(c) Section 372(a), relating to reorganization in certain receiverships and bankruptcy proceedings.

(d) Section 373(b)(1), relating to property of a railroad corporation acquired in certain bankruptcy or receivership proceedings.

(e) Section 1051, relating to property acquired by a corporation that is a member of an affiliated group.

(f) Section 1082, relating to property acquired pursuant to a Securities Exchange Commission order.

(2) For purposes of subparagraph (1) of this paragraph, it is immaterial whether a deduction has been allowed or an election has been made by the transferor with respect to the specific mineral property transferred.

(3) Where a mineral property is acquired under any circumstance except those described in subparagraph (1) of this paragraph, the taxpayer is not required to take into account the election exercised by or deduction allowed to his transferor.

(4) For purposes of applying the limitations imposed by section 615(c): (i) the partner, and not the partnership, shall be considered as the taxpayer (see paragraph (a)(8)(iii) of § 1.702–1), and (ii) an electing small business corporation, as defined in section 1371(b), and not its shareholders, shall be considered as the taxpayer.

(5) For purposes of subparagraph (1)(iii)(b) of this paragraph: (i) if mineral property is acquired from a partnership, the transfer shall be considered as having been made by the individual partners, so that the number of years for which section 615 has been availed of by each partner and the amounts which each partner has deducted or deferred under section 615 shall be taken into account, or (ii) if on interest in a partnership having mineral property is transferred, the transfer shall be considered as a transfer of mineral property by the partner or partners relinquishing an interest, so that the number of years for which section 615 has been availed of by each such partner and the amounts which each such partner has deducted or deferred under section 615 shall be taken into account.

(f) **Examples.** The application of the provisions of this section may be illustrated by the following examples:

Example (1). A calendar year taxpayer who has never claimed the benefits of section 615 received in 1956 a mineral deposit from X Corporation upon a distribution in complete liquidation of the latter under conditions which would make the provisions of section 334(b)(1) applicable in determining the basis of the property in the hands of the taxpayer. During the year 1955 X Corporation expended $60,000 for exploration expenditures which it elected to treat as deferred expenses. Assume further that the taxpayer made similar expenditures of $150,000, $125,000, $100,000, $60,000, and $180,000 for the years 1956, 1957, 1958, 1959, and 1961, respectively, which the taxpayer elected to deduct for each of those years to the extent allowable. No such expenditures were made for 1960. On the basis of these facts, the taxpayer may deduct or defer $100,000 for each of the years 1956, 1957, and 1958. No deduction or deferral is allowable for 1959 since the 4-year limitation of paragraph (a) of this section applies. The taxpayer may deduct

or defer a maximum of $40,000 for 1961 since the $400,000 limitation of paragraph (b) of this section applies, but the 4-year limitation of paragraph (a) does not apply.

Example (2). Assume the same facts stated in example (1) except that, prior to acquisition by the taxpayer of the deposit from X Corporation in 1956, X Corporation had acquired the deposit in 1954 in a similar distribution from Y Corporation which, in the years 1952 and 1953, deducted exploration costs paid in respect of an entirely different deposit in the amounts of $30,000 and $50,000, respectively. Under these circumstances, the taxpayer may deduct or defer exploration expenditures paid or incurred in the amount of $100,000 for 1956. No deduction or deferral is allowable to the taxpayer for expenditures made in 1957, 1958, and 1959 since the 4-year limitation of paragraph (a) applies. The taxpayer may deduct or defer a maximum of $100,000 for 1961 since the 4-year limitation of paragraph (a) of this section no longer applies. If the taxpayer deducted or deferred $100,000 for each of the years 1956 and 1961 and also made exploration expenditures in 1962, the taxpayer may deduct or defer a maximum of $60,000 for that year under the $400,000 limitation of paragraph (b) of this section.

Example (3). In 1957, A and B transfer assets to a corporation under circumstances making section 351 applicable to such a transfer. Among the assets transferred by A is a mineral lease with respect to certain coal lands. A has deducted exploration expenditures under section 615 for the years 1954 and 1956 in the amounts of $50,000 and $100,000, respectively, made with respect to other deposits not included in the transfer to the corporation. The corporation shall be required to take into account the deductions previously made by A for purposes of applying the limitations of paragraphs (a) and (b) of this section.

Example (4). In 1956, A, B, and C form a partnership for the purpose of exploring for, developing, and producing uranium. A contributes a uranium lease to the partnership. A had individually made exploration expenses in the amount of $50,000 and $100,000 with respect to other mineral properties not contributed to the partnership and which he has deducted under section 615(a) for the years 1954 and 1955, respectively. B contributes a uranium lease to the partnership on which he made exploration expenditures in the amount of $100,000 in 1955 which he elected to defer under section 615(b). This is the only year in which B has used section 615. C contributes only cash to the partnership and has not previously used section 615. Subject to the limitations of section 615, for taxable years beginning before July 7, 1960, A may deduct or defer exploration expenses for two more taxable years (either as to expenditures incurred by him individually or with respect to his distributive share of partnership exploration expenses). B may deduct or defer exploration expenditures for three more years, and C may deduct or defer exploration expenditures for four years. For taxable years beginning after July 6, 1960, subject in each case to the $100,000 limitation per year, A may deduct or defer exploration expenditures in an amount not in excess of $250,000 ($400,000–$150,000), either as to expenditures incurred by him individually or with respect to his distributive share of partnership exploration expenditures. B may similarly deduct or defer exploration expenditures in an amount not in excess of $300,000 ($400,000–$100,000), and C may deduct or defer exploration expenditures in an amount not in excess of $400,000.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6685, 28 FR 11405, Oct. 24, 1963, as amended by T.D. 7192, 37 FR 12939, June 30, 1972]

§ 1.615-5 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time for exercising any option or making any election under section 615 shall expire on May 2, 1960.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.615-6 Election to deduct under section 615.

(a) **General rule.** The election to deduct or defer exploration expenditures under section 615 shall be made in a statement filed with the director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year ending after September 12, 1966, during which the taxpayer pays or incurs expenditures which are within the scope of section 615 and which are paid or incurred by him after September 12, 1966, this statement shall be attached to the taxpayer's income tax return for such taxable year. If the election is made after the time prescribed for filing such return but before the expiration of the period (described in paragraph (e) of this section) for making the election under section 615(e), the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him during such taxable year after such date. The statement shall clearly indicate that the taxpayer elects to have section 615 apply to all amounts deducted or deferred by him with respect to exploration expenditures paid or incurred after September 12, 1966, and before January 1, 1970. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year ending after September 12, 1966, in which he pays or incurs exploration expenditures. Except as provided in paragraph (b) of this section, if the taxpayer does not file such a statement within the period prescribed by section 615(e) and paragraph (e) of this section, any amounts deducted by him with respect to exploration expenditures paid or incurred after September 12, 1966, will be deemed to have been deducted pursuant to an election under section 617(a).

(b) Exception. The last sentence of paragraph (a) of this section shall not apply if all exploration expenditures paid or incurred by the taxpayer after September 12, 1966, and before January 1, 1970, and deducted by him on his income tax return for the first taxable year ending after September 12, 1966, during which he pays or incurs such expenditures are outside the scope of section 617(a) (as it existed before its amendment by section 504(b) of the Tax Reform Act of 1969). For example, assume that, in his return for his taxable year ending December 31, 1966, a calendar-year taxpayer deducts exploration expenditures paid or incurred after September 12, 1966, and does not attach to his return the statement described in paragraph (a) of this section. However, all of the exploration expenditures paid or incurred by the taxpayer after September 12, 1966, and before the end of the taxable year were paid or incurred with respect to minerals located neither in the United States nor on the Outer Continental Shelf. The taxpayer will be deemed to have made an election under section 615(e) by deducting all or part of those expenditures as expenses in his income tax return.

(c) Information to be furnished. A taxpayer who makes or has made an election under section 615(e) with respect to expenditures paid or incurred after September 12, 1966, and before January 1, 1970, shall indicate clearly on his income tax return for each taxable year for which he deducts any such expenditures the amount of the deduction claimed under section 615(a) or (b) with respect to each property or mine. The property or mine shall be identified by a description adequate to permit application of the rules of section 615(g) (relating to effect of transfer of mineral property).

(d) Effect of election—(1) In general. A taxpayer who has made or is deemed to have made an election under section 615(e) may not make an election under section 617(a) with respect to expenditures made before January 1, 1970, unless, within the period set forth in section 615(e), he revokes his election under section 615(e). Except as provided in paragraph (a)(2) of § 1.615–2, a taxpayer who makes an election under section 615(e) may not change his treatment of exploration expenditures deducted, deferred, or capitalized pursuant to such election unless he revokes the election made under section 615(e).

(2) Transfer of mineral property. The binding effect of a taxpayer's election under section 615(e) shall not be affected by his receiving property with respect to which deductions have been allowed under section 617(a). However, see section 615(g)(2) and § 1.615–7 for rules under which amounts deducted under section 615 by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 617(a). See § 1.617–3(d)(2)(ii) for rules under which amounts deducted under section 617(a) by a transferor may be subject to recapture in the hands of a transferee who has made an election under section 615(e).

(e) Time for making election under section 615(e). A taxpayer may not make an election under section 615(e) after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year ending after September 12, 1966, in which the taxpayer pays or incurs expenditures to which section 615(a) would apply if an election were made under section 615(e). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return for such year. An election under section 615(e) may not be made after the expiration of the 3-year period even though the taxpayer charged to capital account, or erroneously deducted as development expenditures under section 616, all exploration expenditures paid or incurred by him after September 12, 1966, and before the end of his first taxable year ending after September 12, 1966, in which he paid or incurred such expenditures.

(f) Revocation of section 615(e) election—(1) Manner of revoking election. A taxpayer may revoke an election made by him under section 615(e) by filing with the director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed, within the period set forth in subparagraph (2) of this paragraph, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the election previously made by him with respect to exploration expenditures paid or incurred after September 12, 1966, and states with whom and where the document making the election was filed. Such revocation shall be a revocation for all taxable years for which the taxpayer's election was in effect and the taxpayer revoking such an election shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the revocation of election. In applying the revocation of election to the years affected there shall be taken into account the effect that any adjustments resulting from the revocation of election shall have on other items affected thereby (such as the deduction

for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items in other taxable years.

(2) **Time for revoking election under section 615(e).** An election under section 615(e) may be revoked at any time before the expiration of the 3-year period described in paragraph (e) of this section. Such an election may not be revoked after the expiration of the 3-year period.

(3) **Additional information to be furnished by a transferor of mineral property.** If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures paid or incurred after September 12, 1966, and before January 1, 1970, to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined by reference to the basis in the hands of the transferor, the statement submitted pursuant to subparagraph (1) of this paragraph shall state that such property has been so transferred and shall identify the transferee, the property transferred, and the date of the transfer. The preceding sentence shall not apply in the case of any mineral property transferred after December 31, 1969.

(g) **Taxable years beginning before September 13, 1966, and ending after September 12, 1966—(1) In general.** An election made under section 615(e) applies only to expenditures paid or incurred after September 12, 1966. The income tax treatment of exploration expenditures paid or incurred before September 13, 1966, will be determined in accordance with the provisions of section 615 prior to its amendment by the Act of September 12, 1966 (Public Law 89–570, 80 Stat. 759). If a taxpayer makes an election under section 615(e) in his income tax return for a taxable year which begins before September 13, 1966, and which ends after September 12, 1966, amounts deducted and amounts deferred under section 615 with respect to expenditures paid or incurred during such taxable year but before September 13, 1966, will be taken into account in determining whether the $100,000 limitation set forth in section 615(a) is reached during the taxable year. Similarly, a taxpayer who makes an election under section 615(e) shall take into account expenditures deducted or deferred under section 615 for the period prior to September 13, 1966, in determining when the $400,000 overall limitation set forth in section 615(c) is reached. The fact that a taxpayer deducts or defers under section 615 exploration expenditures paid or incurred prior to September 13, 1966, shall not affect his right to make an election under section 617(a) to deduct under section 617 expenditures paid or incurred after September 12, 1966.

(2) **Allocation in case of inadequate records.** If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before September 13, 1966, and ending after September 12, 1966, but his records as to any mine or property are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after September 12, 1966, and the amount paid or incurred on or before such date, the exploration expenditures, as to which the records are inadequate, paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part year (that is, the part occurring before September 13, 1966, and the part occurring after September 12, 1966) in the same ratio which the number of days in each such part year bears to the number of days in the entire taxable year. For example, if the records of a calendar year taxpayer for 1966 are inadequate to permit a determination of the amount of exploration expenditures paid or incurred with respect to a certain mine or property after September 12, 1966, and the amount paid or incurred before September 13, 1966, 255/365 of the total exploration expenditures paid or incurred by the taxpayer with respect to the mine or property during 1966 shall be allocated to the period beginning January 1, 1966, and ending September 12, 1966, and 110/365 of the total exploration expenditures paid or incurred with respect to the mine or property during 1966 shall be allocated to the period beginning September 13, 1966, and ending December 31, 1966.

(3) **Partnership elections.** With respect to exploration expenditures paid or incurred by a partnership before September 13, 1966, the option to deduct under section 615(a) and the election to defer under section 615(b) shall be made by the partnership, rather than by the individual partners. With respect to exploration expenditures paid or incurred by a partnership after September 12, 1966, all elections under sections 615 and 617 as to the tax treatment of a partner's distributive share of exploration expenditures paid or incurred by a partnership of which he is a member shall be made by the individual partner, rather than by the partnership. See section 703(b) and the regulations thereunder.

[T.D. 7192, 37 FR 12939, June 30, 1972]

§ 1.615–7 Effect of transfer of mineral property.

(a) Transfer before election by transferor. **(1)** If mineral property is transferred in a transaction as a result of which the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor and the transferor had not made an election under either section 615(e) or 617(a) at the time of the transfer, no election made by the transferor after the transfer shall apply with respect to expenditures properly chargeable to the transferred property which were paid or incurred before the date of the transfer.

(2) For purposes of subparagraph (1) of this paragraph, a transferor of mineral property who made an election under section 617(a) or section 615(e) before the transfer but who revokes such election after such transfer and does not make an election under either section before the expiration of the 3-year period prescribed by section 6072 or other provision of law for filing his income tax return for the taxable year in which such transfer occurred shall be treated with respect to such property as not having made an election under either section.

(b) Transfer after election by transferor. If a transferee who at the time of the transfer of a mineral property has not made an election under section 617(a) receives property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to its basis in the hands of the transferor and with respect to such property the transferor has deducted expenditures under section 617(a), the adjusted exploration expenditures properly chargeable to the property immediately after the transfer shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. See section 617 and the regulations thereunder.

(c) Transfer after election by transferee. **(1)** If a transferee who makes an election under section 617(a) receives before January 1, 1970, mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to the basis of the property in the hands of the transferor and the transferor had in effect at the time of the transfer an election under section 615(e), an amount equal to the total of the amounts allowed as deductions to the transferor under section 615 with respect to the transferred mineral property shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. The preceding sentence shall not apply to expenditures which would not have been reflected in the basis of the property in the hands of the transferor had the transferor not made the section 615(e) election.

(2) Any expenditures with respect to the transferred property deferred by the transferor under section 615(b) which are not allowed as deductions to him prior to transfer of the property may not be deducted by the transferee and in his hands shall be charged to capital account.

[T.D. 7192, 37 FR 12940, June 30, 1972]

§ 1.615–8 Termination of section 615.

(a) In general. The provisions of section 615 shall not apply to exploration expenditures paid or incurred after December 31, 1969. Expenditures paid or incurred before January 1, 1970, which were deferred under section 615(b) will be deductible under such section after such date as the units of ore or mineral discovered or explored by reason of such expenditures are sold. An election under section 615(e) with respect to expenditures paid or incurred prior to January 1, 1970, shall remain in effect with respect to such expenditures unless it is revoked under section 615(e) and § 1.615–6. See § 1.615–9 for treatment of a section 615(e) election with respect to expenditures paid or incurred after December 31, 1969.

(b) Taxable years beginning before January 1, 1970, and ending after December 31, 1969—(1) In general. The termination of section 615 applies to expenditures paid or incurred after December 31, 1969. The income tax treatment of exploration expenditures paid or incurred before January 1, 1970, will be determined in accordance with the provisions of sections 615 and 617 prior to their amendment by the Tax Reform Act of 1969 (83 Stat. 487). The fact that on his income tax return for a taxable year beginning before January 1, 1970, and ending after December 31, 1969, a taxpayer deducts under section 615 expenditures paid or incurred before January 1, 1970, shall not affect his right to deduct under section 617(a) expenditures paid or incurred during such taxable year after December 31, 1969.

(2) Allocation in case of inadequate records. If a taxpayer pays or incurs exploration expenditures during a taxable year beginning before January 1, 1970, and ending after December 31, 1969, but his records are inadequate to permit a determination of the amount paid or incurred during the portion of the year ending after December 31, 1969, and the amount paid or incurred on or before such date, the exploration expenditures as to which the

records are inadequate paid or incurred with respect to the mine or property during the taxable year shall be allocated to each part of the year (that is, the part before January 1, 1970, and the part occurring after December 31, 1969) in the same ratio which the number of days in each such part year bears to the number of days in the entire taxable year.

[T.D. 7192, 37 FR 12941, June 30, 1972]

§ 1.615–9 Notification under Tax Reform Act of 1969.

(a) **In general.** An election under section 615(e) with respect to exploration expenditures paid or incurred prior to January 1, 1970, shall be treated as an election under section 617(a) with respect to exploration expenditures paid or incurred after December 31, 1969.

(b) **Exception.** Paragraph (a) of this section shall not apply to an election under section 615(e) if the taxpayer files the notice described in paragraph (c) of this section or the taxpayer revokes his election under section 615(e) before the date prescribed for the filing of notice under paragraph (c)(2) of this section.

(c) **Filing of notice—(1) In general.** The notice not to have a section 615(e) election treated as a section 617(a) election shall be made in a statement filed with the Director of the Internal Revenue service center with whom the taxpayer's income tax return is required to be filed. If the election is made within the time period prescribed for filing an income tax return (including extensions thereof) for the first taxable year during which the taxpayer pays or incurs, after December 31, 1969, expenditures which would be deductible by the taxpayer under section 617(a) if he made a valid election to deduct exploration expenditures under such section, the statement shall be attached to the taxpayer's income tax return for such year. If the statement is filed after the time prescribed for filing such return but before the expiration of the period (described in paragraph (e) of this section) for filing the notice, the statement must be signed by the taxpayer or his authorized representative. The statement shall be filed even though the taxpayer charges to capital account all such expenditures paid or incurred by him after December 31, 1969. If the taxpayer desires, he may file this statement by attaching it to his return for a taxable year prior to the first taxable year in which he pays or incurs after December 31, 1969, expenditures which would be deductible by him under section 617(a) if at such time he had in effect a valid election under such section.

(2) **Information to be furnished.** The notice shall clearly state that the taxpayer elects not to have his section 615(e) election treated as an election under section 617(a). The notice shall state the first taxable year for which the section 615(e) election was effective and with whom and where the election was filed.

(d) **Effect of notification.** A taxpayer who has filed notice pursuant to this section may make an election under section 617(a) with respect to exploration expenditures paid or incurred after December 31, 1969, without revoking either his section 615(e) election or his notice under this section.

(e) **Time for filing notice.** A taxpayer may not file the notice described in paragraph (c)(1) of this section after the expiration of the 3-year period beginning with the date prescribed by section 6072 or other provision of law for filing the taxpayer's income tax return for the first taxable year in which the taxpayer pays or incurs after December 31, 1969, expenditures which would be deductible by him if he made the election under section 617(a). This 3-year period shall be determined without regard to any extension of time for filing the taxpayer's income tax return.

[T.D. 7192, 37 FR 12941, June 30, 1972]

§ 1.616–1 Development expenditures.

(a) **General rule.** Section 616 prescribes rules for treating expenditures paid or incurred during the taxable year by the taxpayer for the development of a mine or other natural deposit (other than an oil or gas well). Development expenditures under section 616 are those which are made after such time when, in consideration of all the facts and circumstances (including actions of the taxpayer), deposits of ore or other mineral are shown to exist in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. Under section 616(a), a taxpayer is allowed a deduction for development expenditures whether or not such expenditures are made in the development or production state of the mine or other natural deposit. Under section 616(b), the taxpayer may elect to defer development expenditures made in the development or producing stage and to deduct such expenditures ratably as the minerals or ores benefited are sold. While the mine or other natural deposit is in the development stage, the election applies only to that portion of the development expenditures which is in excess of net receipts from the mine or other natural deposit. See § 1.616–2 for rules with respect to the election to defer. It is not necessary

that the taxpayer incur the development costs directly. He may engage a contractor to make the expenditures on his behalf.

(b) **Expenditures to which section 616 is not applicable.** (1) Section 616 is not applicable to development expenditures which are deductible for the taxable year under any other provision of the internal revenue laws.

(2) Section 616 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowance for depreciation of such improvements which are used in the development of ores or minerals are considered development expenditures under section 616. If such improvements are used only in part for development during a taxable year, an allocable portion of the allowance for depreciation shall be treated as a development expenditure.

(3) Section 616 is applicable to development expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired. The expenditure attributable to the remaining fractional share shall be considered as part of the cost of his acquired interest and shall be capitalized and recovered through depletion allowances. For example, taxpayer A owns mineral leases on undeveloped mineral lands. A agrees to convey an undivided three-fourths (¾) interest in such leases to B, provided B will pay all of the expenditures incurred during the development stage of the deposits on these leases. B may deduct three-fourths (¾) of such amount under section 616, but shall treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) The provisions of section 616 do not apply to costs of development paid or incurred by a prior owner which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Such provisions apply only to costs paid or incurred by the taxpayer for development undertaken directly or through contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred development expenditures in certain corporate acquisitions.

(c) **Mine or other natural deposit.** Section 616 has reference to expenditures made for the development of a mine or other natural deposit. Within an aggregated property, as that term is defined in section 614(b) and (c), or within a single tract or parcel of land, there may be more than one mine or other natural deposit. Where a property, as determined under section 614, contains more than one mine or other natural deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines or deposits, and may defer under section 616(b) the development expenditures made with respect to another of such mines or deposits. Where there is more than one mine with respect to a single underlying deposit, the taxpayer may deduct under section 616(a) the development expenditures made with respect to one of such mines, and may defer under section 616(b) the development expenditures made with respect to another of such mines. The taxpayer must treat consistently all development expenditures with respect to each such mine or other natural deposit in a taxable year. The taxpayer must make a separate determination of the units of minerals or ores benefited in a mine or other natural deposit (regardless of the computation of the depletion allowance) in order that deferred expenditures with respect to such mine or deposit may be deducted on a ratable basis. See paragraph (f) of § 1.616–2.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.616–2 Election to defer.

(a) **General rule.** In lieu of taking a deduction under section 616(a), in the taxable year when the development expenditures are paid or incurred, a taxpayer may elect under section 616(b) to treat such expenditures with respect to each mine or other natural deposit as deferred expenses to be deducted ratably as the units of the produced ore or minerals benefited by such expenditures are sold. Section 616(b) is applicable to development expenditures paid or incurred both in the development and producing stage of the mine or other natural deposit. However, in the case of such expenditures made in the development stage, this election is applicable only to the excess of the amount of such expenditures over the net receipts from the ore or minerals from such mine or deposit received or accrued during the development stage and in the same taxable year as the expenditures were paid or incurred. Such development expenditures not in excess of such net receipts shall be subject to the provisions of section 616(a).

(b) **Producing stage; definition of.** The mine or other natural deposit will be considered to be in a producing stage when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine or other natural deposit is the production of devel-

oped ores or minerals rather than the development of additional ores or minerals for mining.

(c) **Expenditures made by the owner who retains a nonoperating interest.** (1) A taxpayer who elects to defer development expenditures and thereafter transfers his interest in the mine or other natural deposit, retaining an economic interest therein, shall deduct an amount attributable to such interest on a pro rata basis as the interest pays out. For example, a taxpayer who defers development expenditures and then leases his deposit, retaining a royalty interest therein, shall deduct the deferred expenditures ratably as he receives the royalties. If the taxpayer receives a bonus or advanced royalties in connection with the transfer of his interest, he shall deduct the deferred expenditures allocable to such bonus or advanced royalties in an amount which is in the same proportion to the total of such costs as the bonus or advanced royalties bears to the bonus and total royalties expected to be received. Also, in the case of a transfer of a mine or other natural deposit by a taxpayer who retains a production payment therein, he may deduct the development expenditures ratably over the payments expected to be received.

(2) Where a taxpayer receives an amount, in addition to retaining an economic interest, which amount is treated as from the sale or exchange of a capital asset or property treated under section 1231 (except coal or iron ore to which section 631(c) applies), the deferred development expenditures shall be allocated between the interest sold and the interest retained in proportion to the fair market value of each interest as of the date of sale. The amount allocated to the interest sold may not be deducted, but shall be a part of the basis of such interest for the purpose of determining gain or loss upon the sale thereof.

(d) **Losses from abandonment.** Section 165 and the regulations thereunder contain general rules relating to the treatment of losses resulting from abandonment.

(e) **Effect of election.** (1) The election to defer development expenditures shall apply only to expenditures for the taxable year for which made. However, once made, the election shall be binding with respect to the expenditures for that taxable year. Thus, a taxpayer cannot revoke his election for any reason whatsoever.

(2) The election shall be made for each mine or other natural deposit by a clear indication on the return or by a statement filed with the district director with whom the return was filed, not later than the time prescribed by law for filing such return (including extensions thereof) for the taxable year to which such election is applicable.

(f) **Computation of amount of deduction.** The amount of the deduction allowable during the taxable year is an amount A, which bears the same ratio to B (the total deferred development expenditures for a particular mine or other natural deposit reduced by the amount of such expenditures deducted in prior taxable years) as C (the number of units of the ore or mineral benefited by such expenditures sold during the taxable year) bears to D (the number of units of ore or mineral benefited by such expenditures remaining as of the taxable year). For the purposes of this proportion, the "number of units of ore or mineral benefited by such expenditures remaining as of the taxable year" is the number of units of ore or mineral benefited by the deferred development expenditures remaining at the end of the year to be recovered from the mine or other natural deposit (including units benefited by such expenditures recovered but not sold) plus the number of units benefited by such expenditures sold within the taxable year. The principles outlined in § 1.611–2 are applicable in estimating the number of units remaining as of the taxable year and the number of units sold during the taxable year. The estimate is subject to revision in accordance with that section in the event it is ascertained, from any source, such as operations or development work, that the remaining units are materially greater or less than the number of units remaining from a prior estimate.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 6841, 30 FR 9307, July 27, 1965]

§ 1.616–3 Time for making election with respect to returns due on or before May 2, 1960.

In the case of any taxable year beginning after December 31, 1953, and ending after August 16, 1954, the income tax return for which is due not later than May 2, 1960, the time to deduct or defer development expenditures for such a year under section 616(a) or (b) shall expire on May 2, 1960.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

§ 1.617–1 Exploration expenditures.

(a) **General rule.** Section 617 prescribes rules for the treatment of expenditures paid or incurred after September 12, 1966, for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral for which a deduction for

depletion is allowable under section 613 (other than oil or gas) paid or incurred by the taxpayer before the beginning of the development stage of the mine or other natural deposit. Such expenditures hereinafter in the regulations under section 617 will be referred to as exploration expenditures. The development stage of the mine or other natural deposit will be deemed to begin at the time when, in consideration of all the facts and circumstances (including the actions of the taxpayer), deposits of ore or other mineral are disclosed in sufficient quantity and quality to reasonably justify commercial exploitation by the taxpayer. For example, core drilling expenditures paid or incurred by the taxpayer to ascertain the existence of commercially marketable ore are exploration expenditures within the meaning of this section. Also, expenditures for exploratory drilling from within a producing mine to ascertain the existence of what appears (on the basis of all of the facts and circumstances known at the time of the expenditures) to be a different ore deposit are exploration expenditures within the meaning of this section. Expenditures paid or incurred in connection with core drilling to further delineate the extent and location of an existing commercially marketable deposit to facilitate its development are development expenditures. Under section 617(a), a taxpayer may deduct exploration expenditures paid or incurred for the exploration of any deposit of ore or other mineral subject to the limitation of section 617(h). Under section 617(b), a taxpayer shall recapture the exploration expenditures previously deducted under section 617(a) either through including in income an amount equal to the amount of the adjusted exploration expenditures (as defined in section 617(f)) or through disallowance of the deduction for depletion under section 611. Certain rules are provided in section 617(c) for recapture of exploration expenditures made with respect to property for which the taxpayer later receives a bonus or royalty. Under section 617(d), gain from dispositions of mining property, with respect to which exploration expenditures have been previously deducted, is to be recognized notwithstanding certain other provisions of the Code.

(b) Expenditures to which section 617 is not applicable. **(1)** Section 617 is not applicable to expenditures which would be allowed as deductions for the taxable year without regard to section 617.

(2) Section 617 is not applicable to expenditures which are reflected in improvements subject to allowances for depreciation under sections 167 and 611. However, allowances for depreciation of such improvements which are used in the exploration of ores or minerals are considered exploration expenditures under section 617. If such improvements are used only in part for exploration during the taxable year, an allocable portion of the allowance for depreciation shall be treated as an exploration expenditure.

(3) Section 617 is applicable to exploration expenditures paid or incurred by a taxpayer in connection with the acquisition of a fractional share of the working or operating interest to the extent of the fractional interest so acquired by the taxpayer. The expenditures attributable to the remaining fractional share shall be considered as the cost of his acquired interest and shall be recovered through depletion allowances. For example, taxpayer A owns mineral leases on unexplored mineral lands and agrees to convey an undivided three-fourths (¾) interest in such leases to taxpayer B provided B will pay all of the expenses for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral which will be incurred before the beginning of the development stage. B may elect to treat three-fourths of such amount under section 617. B must treat one-fourth of such amount as part of the cost of his interest, recoverable through depletion.

(4) Section 617 is not applicable to costs of exploration which are reflected in the amount which the taxpayer paid or incurred to acquire the property. Section 617 applies only to costs paid or incurred by the taxpayer for exploration undertaken directly or through a contract by the taxpayer. See, however, sections 381(a) and 381(c)(10) for special rules with respect to deferred exploration expenditures in certain corporate acquisitions.

(5) Section 617 is not applicable to amounts paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of oil or gas or of any mineral with respect to which a deduction for percentage depletion is not allowable under section 613. The purpose of the expenditure shall be determined by reference to the facts and circumstances at the time the expenditure is paid or incurred.

(c) Elections—**(1) Election to deduct under section 617(a).** (i) The election to deduct exploration expenditures under section 617(a) may be made by deducting such expenditures in the taxpayer's income tax return for his first taxable year ending after September 12, 1966, for which the taxpayer desires to deduct exploration expenditures which are paid or incurred by him during such taxable year and after September 12, 1966. This election may be exercised by deducting such exploration

expenditures either in the taxpayer's return for such taxable year or in an amended return filed before the expiration of the period for filing a claim for credit or refund of income tax for such taxable year. Where the election is made in an amended return for a taxable year prior to the most recent year for which the taxpayer has filed a return, the taxpayer shall file amended income tax returns, reflecting any increase or decrease in tax attributable to the election, for all subsequent taxable years affected by the election for which he has filed income tax returns before making the election. See section 617(a)(2)(C) and subparagraph (4) of this paragraph for provisions relating to extension of the period of limitations for the assessment of any deficiency for any taxable year to the extent the deficiency is attributable to an election or revocation of an election under section 617(a). In applying the election to the years affected, there shall be taken into account the effect that any adjustments resulting from the election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items of other taxable years. Amended returns filed for taxable years subsequent to the taxable year for which the election under section 617(a) is made by amended return shall, where appropriate, apply the recapture rules of subsections (b), (c), and (d) of section 617. See §§ 1.617–3 and 1.617–4.

(ii) A taxpayer who makes or has made an election under section 617(a) shall state clearly on his income tax return for each taxable year for which he deducts exploration expenditures the amount of the deduction claimed under section 617(a) with respect to each property or mine. Such property or mine shall be identified by a description adequate to permit application of the recapture rules of section 617(b), (c), and (d).

(iii) A taxpayer who has made an election under section 617(a) may not make an election under section 615(e) unless, within the period set forth in section 615(e), he revokes his election under section 617(a). A taxpayer who has made and has not revoked an election under section 617(a) may not, in his return for the taxable year for which the election is made or for any subsequent taxable year, charge to capital account any exploration expenditures which are deductible by him under section 617(a); and he must deduct all such expenditures as expenses in computing adjusted gross income. Any exploration expenditures paid or incurred after December 31, 1969, which are not deductible by the taxpayer under section 617(a) solely because of the application of section 617(h) shall be charged to capital account.

(2) Time for making elections. The election under section 617(a) may be made at any time before the expiration of the period prescribed for filing a claim for credit or refund of the tax imposed by chapter 1 for the first taxable year for which the taxpayer desires to deduct exploration expenditures under section 617(a).

(3) Revocation of election to deduct. (i) A taxpayer may revoke an election made by him under section 617(a) by filing with the Internal Revenue service center with which the taxpayer's income tax return is required to be filed, within the period set forth in subdivision (ii) of this subparagraph, a statement, signed by the taxpayer or his authorized representative, which sets forth that the taxpayer is revoking the section 617(a) election previously made by him and states with whom and where the document making the election was filed. A taxpayer revoking a section 617(a) election shall file amended income tax returns which reflect any increase or decrease in tax attributable to the revocation of election for all taxable years affected by the revocation of election for which he has filed income tax returns before revoking the election. See section 617(a)(2)(C) and subparagraph (4) of this paragraph for provisions relating to extension of the period of limitations for the assessment of any deficiency attributable to an election or revocation of an election under section 617(a). In applying the revocation of election to the years affected, there shall be taken into account the effect that any adjustments resulting from the revocation of election shall have on other items affected thereby (such as the deduction for charitable contributions, the foreign tax credit, net operating loss, and other deductions or credits the amount of which is limited by the taxpayer's income) and the effect that adjustments of any such items have on items of other taxable years.

(ii) An election under section 617(a) may be revoked before the expiration of the last day of the third month following the month in which the final regulations under section 617(a) are published in the Federal Register. After the expiration of this period, a taxpayer who has made an election under section 617(a) may not revoke that election unless he obtains the prior consent of the Commissioner of Internal Revenue. Consent will not be granted where a principal purpose for the revocation of the election is to circumvent the recapture

provisions of section 517(b), (c), or (d). The request for consent shall be made in writing to the Commissioner of Internal Revenue, Attention T:I:E, Washington, D.C. 20224. The request shall include in detail:

(a) The reason or reasons for the revocation of election under section 617(a);

(b) An itemization of the taxpayer's deductions under section 617(a);

(c) A description of all properties and detailed information of the exploration activities with respect to which the taxpayer has taken deductions under section 617(a);

(d) A description of any development or production activities on all properties with respect to which exploration expenditures were deducted under section 617(a); and

(e) A recomputation of the tax for each prior taxable year affected by the revocation. A letter setting forth the Commissioner's determination will be mailed to the taxpayer. If consent is granted, a copy of the letter granting such consent shall be filed with the director of the Internal Revenue service center with which the taxpayer's income tax return is required to be filed and shall be accompanied by an amended return or returns, if necessary.

(iii) If, before revoking his election, the taxpayer has transferred any mineral property with respect to which he deducted exploration expenditures under section 617(a), to another person in a transaction as a result of which the basis of such property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor, the statement submitted pursuant to subdivision (i) of this paragraph shall state that such property has been so transferred, shall identify the transferee, the property transferred, the date of the transfer, and shall indicate the amount of the adjusted exploration expenditures with respect to such property on such date.

(4) Deficiency attributable to election or revocation of election. The statutory period for the assessment of any deficiency for any taxable year, to the extent such deficiency is attributable to an election or revocation of an election under section 617(a), shall not expire before the last day of the 2-year period which begins on the day after the date on which such election or revocation of election is made; and such deficiency may be assessed at any time before the expiration of such 2-year period, notwithstanding any law or rule which would otherwise prevent such assessment.

[T.D. 7192, 37 FR 12942, June 30, 1972]

§ 1.617–2 Limitation on amount deductible.

(a) Expenditures paid or incurred before January 1, 1970. In the case of expenditures paid or incurred before January 1, 1970, a taxpayer may deduct exploration expenditures paid or incurred during the taxable year with respect to any deposit of ore or other mineral for which a deduction for percentage depletion is allowable under section 613 (other than oil or gas) in the United States or on the Outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C. 1331).

(b) Expenditures paid or incurred after December 31, 1969. In the case of exploration expenditures paid or incurred after December 31, 1969, with respect to any deposit of ore or other mineral for which a deduction for percentage depletion is allowable under section 613 (other than oil or gas), a taxpayer may deduct—

(1) The amount of such expenditures paid or incurred during the taxable year with respect to any such deposit in the United States (as defined in section 638 and the regulations thereunder), and

(2) With respect to any such deposit located outside the United States (as defined in section 638 and the regulations thereunder) the lesser of:

(i) The amount of the exploration expenditures paid or incurred with respect to such deposits during the taxable year, or

(ii) $400,000 minus the sum of the amount to be deducted under subparagraph (1) of this paragraph for the taxable year and all amounts deducted or treated as deferred expenses during all preceding taxable years under section 617 and section 615 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939. See paragraph (d) of this section for application of the limitation in the case of a transferee of a mining property.

(c) Examples. The application of the provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). A, a calendar-year taxpayer who has claimed the benefits of section 615, expended $100,000 for exploration expenditures during the year 1966. For each of the years 1967, 1968, 1969, and 1970 A had exploration costs of $80,000 all with respect to coal deposits located within the United States.

A deducted or deferred the maximum amounts allowable for each of the years 1966 ($100,000), 1967 ($80,000), 1968 ($80,000), and 1969 ($80,000). The $80,000 of exploration expenditures for 1970 may be deducted under section 617 by A.

Example (2). B, a calendar-year taxpayer claimed deductions of $100,000 per year under section 615 for the years 1968 and 1969. In 1970, B deducted $150,000 under section 617 for exploration conducted with respect to coal deposits in the United States. In 1971, B paid $150,000 with respect to exploration of tin deposits outside the United States. The maximum amount B may deduct with respect to the foreign exploration in 1971 is $50,000 computed as follows:

(a) Add all amounts deducted or deferred for exploration expenditures by B for all years:

Year	Expenditures	Deducted or deferred
1968	$100,000	$100,000
1969	100,000	100,000
1970	150,000	150,000
Total		350,000

(b) Subtract from $400,000 (the maximum amount allowable to B for deduction of foreign exploration expenditures) the sum of the amounts obtained in (a) $350,000:

Maximum amount allowable to taxpayer	$400,000
Sum of amounts obtained in (a)	350,000
	50,000

Example (3). Assume the same facts as in example (2) except that in 1971 in addition to the $150,000 paid with respect to exploration outside the United States, B paid $100,000 with respect to exploration within the United States. As the following computation indicates, B may not deduct any amount with respect to the foreign exploration:

(a) Add all amounts deducted or deferred for exploration expenditures in prior years and the exploration expenditures with respect to exploration in the United States to be deducted in 1971:

Year	Expenditures	Deducted or deferred
1968	$100,000	$100,000
1969	100,000	100,000
1970	150,000	150,000
1971	250,000	[1] 100,000
Total		450,000

[1] Domestic.

(b) Because the sum of the amounts obtained in (a), $450,000, exceeds $400,000 no deduction would be allowable to B with respect to foreign exploration expenditures for 1971.

(d) Transferee of mineral property. (1) Where an individual or corporation transfers any mining property to the taxpayer, the taxpayer shall take into account for purposes of the $400,000 limitation described in paragraph (b)(ii) of this section all amounts deducted and amounts treated as deferred expenses by the transferor if—

(i) The taxpayer acquired any mineral property from the transferor in a transaction described in section 23(ff)(3) of the Internal Revenue Code of 1939, excluding the reference therein to section 113(a)(13),

(ii) The taxpayer acquired any mineral property by reason of the acquisition of assets of a corporation in a transaction described in section 381(a) as a result of which the taxpayer succeeds to and takes into account the items described in section 381(c),

(iii) The taxpayer acquired any mineral property under circumstances which make applicable any of the following sections of the Internal Revenue Code:

(a) Section 334(b)(1), relating to the liquidation of a subsidiary where the basis of the property in the hands of the distributee is the same as it would be in the hands of the transferor.

(b) Section 362(a) and (b), relating to property acquired by a corporation as paid-in surplus or as a contribution to capital, or in connection with a transaction to which section 351 applies.

(c) Section 372(a), relating to reorganization in certain receiverships and bankruptcy proceedings.

(d) Section 373(b)(1), relating to property of a railroad corporation acquired in certain bankruptcy or receivership proceedings.

(e) Section 1051, relating to property acquired by a corporation that is a member of an affiliated group.

(f) Section 1082, relating to property acquired pursuant to a Securities Exchange Commission order.

(2) For purposes of applying the limitations imposed by section 617(h):

(i) The partner, and not the partnership, shall be considered as the taxpayer (see paragraph (a)(8)(iii) of § 1.702–1), and

(ii) An electing small business corporation, as defined in section 1371(b), and not its shareholders, shall be considered as the taxpayer.

(3) For purposes of subparagraph (1)(iii)(b) of this paragraph, relating to a transaction to which section 362(a) and (b) applies or to which section 351 applies:

(i) If mineral property is acquired from a partnership, the transfer shall be considered as having been made by the individual partners, so that the amounts which each partner has deducted or de-

ferred under sections 615 and 617 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939 shall be taken into account, or

(ii) If an interest in a partnership having mineral property is transferred, the transfer shall be considered as a transfer of mineral property by the partner or partners relinquishing an interest, so that the amounts which each such partner has deducted or deferred under sections 615 and 617 of the Internal Revenue Code of 1954 and section 23(ff) of the Internal Revenue Code of 1939 shall be taken into account.

(e) Examples. The application of the provisions of this section may be illustrated by the following examples:

Example (1). A calendar year taxpayer (who has never claimed the benefits of section 617) received in 1970 a mineral deposit from X Corporation upon a distribution in complete liquidation of the latter under conditions which make the provisions of section 334(b)(1) applicable in determining the basis of the property in the hands of the taxpayer. During the year 1969, X Corporation expended $60,000 for exploration expenditures which it elected to treat under section 615(b) as deferred expenses. Subsequent to the transfer the taxpayer made similar expenditures for domestic exploration of $250,000 and $140,000, for the years 1970, and 1971, respectively, which the taxpayer elected to deduct. In 1972, the taxpayer made expenditures for domestic exploration of $100,000 and for foreign exploration of $50,000. The taxpayer may deduct the $100,000 domestic exploration expenditures but may not deduct any portion of the $50,000 of foreign exploration expenditures because the $400,000 limitation of section 617(h) applies.

Example (2). In 1971, A and B transfer assets to a corporation in a transfer to which section 351 applied. Among the assets transferred by A is a mineral lease with respect to certain coal lands. A has deducted exploration expenditures under section 615 for the years 1968 and 1969 in the amounts of $50,000 and $100,000, respectively, made with respect to other deposits not included in the transfer to the corporation. The corporation is required to take into account the deductions previously made by A for purpose of applying the $400,000 limitation on deduction of foreign exploration expenditures. Thus, if in 1970 the corporation incurred $400,000 of foreign exploration expenditures, the maximum which it could deduct under section 617(a) is $250,000.

[T.D. 7192, 37 FR 12944, June 30, 1972]

§ 1.617–3 Recapture of exploration expenditures.

(a) In general. (1)(i) Except as provided in subparagraphs (2) and (3) of this paragraph, if in any taxable year any mine (as defined in paragraph (c) of this section) with respect to which deductions have been allowed under section 617(a) reaches the producing stage (as defined in paragraph (c) of this section) the deduction for depletion under section 611 (whether determined under § 1.611–2 or under section 613) with respect to the property shall be disallowed for the taxable year and each subsequent taxable year until the aggregate amount of depletion which would be allowable but for section 617(b)(1)(B) and this subparagraph equals the amount of the adjusted exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) attributable to the mine. The preceding sentence shall apply notwithstanding the fact that such mine is not in the producing stage at the close of such taxable year. In the case of a taxpayer who owns more than one property in a mine with respect to which he has been allowed deductions under section 617(a), the depletion deduction described in the second preceding sentence shall be disallowed with respect to all of the properties until the aggregate amount of depletion disallowed under section 617(b)(1)(B) is equal to the adjusted exploration expenditures with respect to the mine. In the case of a taxpayer who elects under section 614(c)(1) to aggregate a mine, with respect to which he has been allowed deductions under section 617(a), with another mine, no deduction for depletion will be allowable under section 611 with respect to the aggregated property until the amount of depletion disallowed under section 617(b)(1)(B) equals the adjusted exploration expenditures attributable to all of the producing mines included in the aggregated property.

(ii) If a taxpayer who has made an election under section 617(a) receives or accrues a bonus or royalty with respect to a mining property with respect to which deductions have been allowed under section 617(a), the deduction for depletion under section 611 with respect to such bonus or royalty (whether determined under § 1.611–2 or under section 613) shall be disallowed for the taxable year of receipt or accrual and each subsequent taxable year until the aggregate amount of the depletion disallowed under section 617(c) and this section equals the amount of the adjusted exploration expenditures with respect to the property to which the bonus or royalty relates. The preceding sentence shall not apply if the bonus or royalty is paid with respect to a mineral for which a deduction is not allowable under section 617(a). In the case of the disposal of coal or domestic iron ore with a retained economic interest, see paragraph (a)(2) of § 1.617–4.

(2) If the taxpayer so elects with respect to all mines as to which deductions have been allowed under section 617(a) and which reach the producing stage during the taxable year, he shall include in gross income (but not "gross income from the property" for purposes of section 613) for such taxable year an amount equal to the adjusted

exploration expenditures (determined under section 617(f)(1) and paragraph (d) of this section) with respect to all of such mines. The amount so included in income shall be treated for purposes of subtitle A of the Internal Revenue Code as expenditures which are paid or incurred on the respective dates on which the mines reach the producing stage and which are properly chargeable to capital account. The fact that a taxpayer does not make the election described in this subparagraph for a taxable year during which mines with respect to which deductions have been allowed under section 617(a) reach the producing stage shall not preclude the taxpayer from making the election with respect to other mines which reach the producing stage during subsequent taxable years. However, the election described in this subparagraph may not be made for any taxable year with respect to any mines which reached the producing stage during a preceding taxable year.

(3) The provisions of section 617(b)(1) and subparagraphs (1) and (2) of this paragraph do not apply in the case of any deposit of oil or gas. For example, A in exploring for sulphur incurred $500,000 of exploration expenditures which he deducted under section 617(a). In the following year, A did not find sulphur but on the same mineral property located commercially marketable quantities of oil and gas. In computing the depletion allowance with respect to the oil and gas, no depletion would be disallowed because of section 617(b)(1).

(4) In the case of exploration expenditures which are paid or incurred with respect to a mining property which contains more than one mine, the provisions of subparagraphs (1) and (2) of this paragraph shall apply only to the amount of the adjusted exploration expenditures properly chargeable to the mine or mines which reach the producing stage during the taxable year. For example, A owns a mining property which contains mines X, Y, and Z. For 1970, A deducted under section 617(a), $250,000 with respect to X, $100,000 with respect to Y and $70,000 with respect to Z. In 1971, mine X reaches the producing stage. At that time, A will only have to recapture the $250,000 attributable to mine X.

(b) Manner and time for making election. **(1)** A taxpayer will be deemed not to have elected pursuant to section 617(b)(1)(A) and paragraph (a)(2) of this section unless he clearly indicates such election on his income tax return for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(2) The election described in paragraph (a)(2) of this section may be made (or changed) not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year in which the mine with respect to which deductions were allowed under section 617(a) reaches the producing stage.

(c) Definitions—(1) Mine. The term "mine" includes all quarries, pits, shafts, and wells, and any other excavations or workings for the purpose of extracting any known deposit of ore or other mineral.

(2) Producing stage. A mine will be considered to have reached the producing stage when (i) the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or (ii) the principal activity of the mine is the production of developed ores or minerals rather than the development of additional ores or minerals for mining.

(3) Mining property. The term "mining property" means any property (as the term is defined in section 614(a) after the application of subsections (c) and (e) thereof) with respect to which any expenditures allowed as deductions under section 617(a) are properly chargeable.

(d) Adjusted exploration expenditures—(1) In general. The term "adjusted exploration expenditures" means, with respect to any property or mine—

(i) The aggregate amount of the expenditures allowed as deductions under section 617(a) for the taxable year and all preceding taxable years to the taxpayer or any other person which are properly chargeable to such property or mine and which (but for the election under section 617(a)) would be reflected in the adjusted basis of such property or mine, reduced by

(ii) The excess, if any, of the amount which would have been allowable for all taxable years under section 613 but for the deduction of such expenditures over the amount allowable for depletion under section 611 (determined without regard to section 617(b)(1)(B)). The amount determined under the preceding sentence shall be reduced by the aggregate of the amounts included in gross income for the taxable year and all preceding taxable years under section 617(b) or (c) and the amount treated under section 617(d) as gain from the sale or exchange of the property which is neither a capital asset nor property described in section 1231.

(iii) If a taxpayer pays or incurs exploration expenditures on a property which contains a producing mine and if such taxpayer deducts any portion of such expenditures under section 617(a), an amount equal to the amount so deducted shall be taken into account in computing the taxpayer's "taxable income from the property" for the purposes of the limitation on the percentage depletion deduction under section 613(a) and the regulations thereunder. The amount of the adjusted exploration expenditures with respect to the producing mine shall be reduced by an amount equal to the amount by which the taxpayer's deduction under 617(a) (described in the preceding sentence) reduces the taxpayer's deduction for depletion for the taxable year. See example (1) in subparagraph (6) of this paragraph.

(iv) For purposes of § 1.617-4, the aggregate amount of adjusted exploration expenditures with respect to a mining property includes the aggregate amount of adjusted exploration expenditures properly allocable to all mines on such property.

(v)(a) For purposes of paragraph (a)(1) of this section, the aggregate amount of the adjusted exploration expenditures is determined as of the close of the taxpayer's taxable year.

(b) For purposes of § 1.617-4, the aggregate amount of the adjusted exploration expenditures is determined as of the date of the disposition of the mining property or portion thereof.

(2) Adjustments for certain expenditures of other taxpayers or in respect of other property. (i) For purposes of subparagraph (1) of this paragraph, the exploration expenditures which must be taken into account in determining the adjusted exploration expenditures with respect to any property or mine are not limited to those expenditures with respect to the property disposed of or which entered the production stage nor are such expenditures limited to those deducted by the taxpayer. For the manner of determining the amount of adjusted exploration expenditures immediately after certain dispositions, see subparagraph (4) of this paragraph.

(ii) If a transferee who at the time of the transfer has not made an election under section 617(a) (including a transferee who has made an election under section 615(e)) receives mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to its basis in the hands of the transferor and with respect to such property the transferor has deducted exploration expenditures under section 617(a), the adjusted exploration expenditures immediately after such transfer shall be treated as exploration expenditures allowed as deductions under section 617(a) to the transferee.

(iii) If a transferee who makes an election under section 617(a) receives mineral property in a transaction in which the basis of such property in his hands is determined in whole or in part by reference to the basis of such property in the hands of the transferor and the transferor had in effect at the time of the transfer an election under section 615(e), an amount equal to the total of the amounts allowed as deductions to the transferor under section 615 with respect to the transferred property shall be treated as expenditures allowed as deductions under section 617(a) to the transferee. The preceding sentence shall not apply to expenditures which could not have been reflected in the basis of the property in the hands of the transferee had the transferor not made the section 615(e) election.

(iv) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). On July 14, 1969, A purchased mineral property Z for $10,000. After deducting exploration expenditures of $20,000 under section 617(a), A transferred the property to his son as a gift on July 9, 1970. Since the exception for gifts in section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(1)) applies, A does not recognize gain under section 617(d). On September 30, 1972 after deducting exploration expenditures of $150,000 under section 617(a), the son transfers the mineral property to corporation X in a transaction under which no gain is recognized by the son under section 351. Since the exception of section 617(d)(3) (by incorporation by reference of the provisions of section 1245(b)(3)) applies, the son does not recognize gain under section 617(d). On November 14, 1972, corporation X sells the mineral property. No deductions for exploration expenditures were taken by corporation X. The amount of the adjusted exploration expenditures with respect to mineral property Z to be recaptured by corporation X upon such sale is $170,000 (the total amount deducted by A and the son).

Example (2). Assume the same facts as in example (1) except that A deducted the $20,000 of exploration expenditures under section 615(a). The amount of the adjusted exploration expenditures with respect to mineral property Z in corporation X's hands is $170,000 (the $20,000 deducted under section 615(a) by A plus the $150,000 deducted under section 617(a) by the son).

(3) Allocation of certain expenditures. A project area consists of that territory which the taxpayer has determined by analysis of certain variables (the size and topography of the area to be explored, existing information with respect to that area and nearby areas, and the quantity of equipment, men, and money available) can be explored advantageously as a single integrated operation. If exploration expenditures are paid or incurred with respect to a project area and one or more areas of interest are identified within such

project area, the entire amount of such expenditures shall be allocated equally to each such area of interest. If an area of interest contains one or more mines or deposits the expenditures allocable to such area of interest shall be allocated (i) if only one mine or deposit is located or identified, entirely to such mine or deposit, or (ii) if more than one mine or deposit is located or identified, equally among the various mines or deposits located. For purposes of this subparagraph, the term "area of interest" means each separable, noncontiguous portion of the project area which is identified as possessing sufficient mineral-producing potential to merit further exploration. The provisions of this subparagraph may be illustrated by the following example: A pays $100,000 for the exploration of a project area which results in the identification of two areas of interest. A pays an additional $60,000 for the exploration of one of the areas of interest in which he locates mineral deposit X and mineral deposit Y. With respect to the exploration of deposit X he incurs an additional $100,000 of expenses and with respect to deposit Y he incurs an additional $200,000 of expenses. The exploration expenditures properly attributable to deposit X would be $155,000 ($100,000 plus one-half of $50,000 plus one-half of $60,000) and the exploration expenditures properly attributable to deposit Y would be $255,000 ($200,000 plus one-half of $50,000 plus one-half of $60,000).

(4) Partnership distributions. The adjusted exploration expenditures with respect to any property or mine received by a taxpayer in a distribution with respect to all or part of his interest in a partnership (i) include the adjusted exploration expenditures (not otherwise included under section 617(f)(1)) with respect to such property or mine immediately prior to such distribution and (ii) shall be reduced by the amount of gain to which section 751(b) applies realized by the partnership (as constituted after the distribution) on the distribution of such property or mine. In the case of any property or mine held by a partnership after a distribution to a partner to which section 751(b) applies, the adjusted exploration expenditures with respect to such property or mine shall be reduced by the amount of gain (if any) to which section 751(b) applies realized by such partner with respect to such distribution on account of such property or mine.

(5) Amount of transferee's adjusted exploration expenditures immediately after certain acquisitions—(i) Transactions in which basis is determined by reference to the cost or fair market value of the property transferred. (a) If on the date a person acquires mining property his basis for the property is determined solely by reference to its cost (within the meaning of section 1012), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(b) If on the date a person acquires mining property his basis for the property is determined solely by reason of the application of section 301(d) (relating to basis of property received in corporate distribution) or section 334(a) (relating to basis of property received in a liquidation in which gain or loss is recognized), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(c) If on the date a person acquires mining property his basis for the property is determined solely under the provisions of section 334(b)(2) or (c) (relating to basis of property received in certain corporate liquidations), then on such date the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(d) If on the date a person acquires mining property from a decedent such person's basis is determined, by reason of the application of section 1014(a), solely by reference to the fair market value of the property on the date of the decedent's death or on the applicable date provided in section 2032 (relating to alternate valuation date), then on the date of acquisition the amount of the adjusted exploration expenditures for the mining property in such person's hands is zero.

(ii) Gifts and certain tax-free transactions. (a) If mining property is disposed of in a transaction described in (b) of this subdivision (ii), then the amount of the adjusted exploration expenditures for the mining property in the hands of a transferee immediately after the disposition shall be an amount equal to—

(1) The amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferor immediately before the disposition, minus

(2) The amount of any gain taken into account under section 617(d) by the transferor upon the disposition.

(b) The transactions referred to in (a) of this subdivision (ii) are—

(1) A disposition which is in part a sale or exchange and in part a gift, or

(2) A disposition which is described in section 617(d) through the incorporation by reference of the provisions of section 1245(b)(3) (relating to certain tax free transactions).

(iii) Property acquired from a decedent. If mining property is acquired in a transfer at death to which section 617(d) applies through incorporation by reference of the provisions of section 1245(b)(2), the amount of the adjusted exploration expenditures with respect to the mining property in the hands of the transferee immediately after the transfer shall include the amount, if any, of the exploration expenditures deducted by the transferee before the decedent's death, to the extent that the basis of the mining property (determined under section 1014(a)) is required to be reduced under the second sentence of section 1014(b)(9) (relating to adjustments to basis where the property is acquired from a decedent prior to his death).

(6) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A owns the working interest in a large tract of land located in the United States. A's interest in the entire tract of land constitutes one property for purposes of section 614. In the northwest corner of this tract is an operating mine, X, producing an ore of beryllium, which is entitled to a percentage depletion rate of 22 percent under section 613(b)(2)(B). During 1971, A conducts an exploration program in the southeast corner of this same tract of land, and he incurs $400,000 of expenditures to which section 617(a)(1) applies in connection with this exploration program. A elects to deduct this amount as expenses under section 617(a). During 1971, A's "gross income from the property" computed under section 613 was $1 million, with respect to the property encompassing mine X and the area in which exploration was conducted. A's "taxable income from the property" computed under section 613, before adjustment to reflect the deductions taken with respect to the property during the year under section 617, was $400,000. The cost depletion deduction allowable and deducted with respect to the property during 1971 was $50,000. The amount of adjusted exploration expenditures chargeable to the exploratory mine (hereinafter referred to as mine Y) at the close of 1971 is $250,000, computed as follows:

Expenditures allowed as deductions under sec. 617(a)		$400,000
Gross income from the property	$1,000,000	
22 percent thereof	220,000	
Taxable income from the property, before adjustment to reflect deductions allowed under sec. 617 during year	400,000	
50 percent thereof—tentative deduction	200,000	
Taxable income from the property after adjustment to reflect deductions allowed under sec. 617 during year ($400,000 minus $400,000)	0	
Cost depletion allowed for year	50,000	
Amount by which allowance for depletion under sec. 611 was reduced on account of deductions under sec. 617 ($200,000 minus $50,000)		150,000
Adjusted exploration expenditures at end of 1971		250,000

Example (2). Assume the same facts as in example 1. Assume further that mine Y, with respect to which exploration expenditures were deducted in 1971, enters the producing stage in 1972, and that no deductions were taken under section 617 with respect to that mine after 1971. A does not make an election under section 617(b)(1)(A) during 1972. Assume that the depletion deduction which would be allowable for 1972 with respect to the property (which includes both mines) but for the application of section 617(b)(1)(B) is $100,000. Pursuant to section 617(b)(1)(B), this depletion deduction is disallowed. Therefore, the amount of adjusted exploration expenditures with respect to mine Y at the end of 1972 is $150,000 ($250,000 less $100,000).

[T.D. 7192, 37 FR 12945, June 30, 1972]

§ 1.617–4 Treatment of gain from disposition of certain mining property.

(a) In general. (1) In general, section 617(d)(1) provides, that, upon a disposition of mining property, the lower of (i) the "adjusted exploration expenditures" (as defined in section 617(f)(1) and paragraph (d) of § 1.617–3) with respect to the property, or (ii) the amount, if any, by which the amount realized on the sale, exchange, or involuntary conversion (or the fair market value of the property on any other disposition, exceeds the adjusted basis of the property, shall be treated as gain from the sale of exchange of property which is neither a capital asset nor property described in section 1231 (that is, shall be recognized as ordinary income). However, any amount recognized under the preceding sentence shall not be included by the taxpayer in his "gross income from the property" for purposes of section 613. Generally, the ordinary income treatment applies even though in the absence of section 617(d) no gain would be recognized under any other provision of the Code. For example, if a corporation distributes mining property as a dividend, gain may be recognized as ordinary income to the corporation even though, in the absence of section 617, section 311(a) would preclude any recognition of gain to the corporation. For an exception to the recognition of gain with respect to dispositions which involve mineral production payments, see section 636 and the regulations thereunder. For the definition of the term "mining property", see section 617(f)(2) and paragraph (c)(3), of § 1.617–3. For exceptions and limitations to the application of section 617(d)(1), see section 617(d)(3) and paragraph (c) of this section.

(2) In the case of a sale, exchange, or involuntary conversion of mining property, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of the property. In the case of a disposition of mining property other than by a manner described in the preceding sentence, the gain to which section 617(d)(1) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the fair market value of the property on the date of disposition over the adjusted basis of the property. In the case of a disposal of coal or domestic iron ore subject to a retained economic interest to which section 631(c) applies, the excess of the amount realized over the adjusted basis of the mining property shall be treated as equal to the gain, if any, referred to in section 631(c). For determination of the amount realized upon a disposition of mining property and nonmining property, see paragraph (c)(3)(i) of this section.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). On July 14, 1970, A purchased undeveloped mining property for $100,000. During 1970, A incurred with respect to the property, $50,000 of exploration expenditures which he deducts under section 617(a). In 1971, A incurred $150,000 of exploration expenditures with respect to the property which he deducts on his income tax return. On January 2, 1972, A sells the mining property to B for $250,000. A's gain on the sale is $150,000 ($250,000 amount realized minus $100,000 basis). Since the excess of the amount realized over the adjusted basis of the mining property is less than the adjusted exploration expenditures with respect to the property ($200,000), the entire gain is treated as ordinary income under section 617(d)(1).

Example (2). Assume the same facts as in example (1) except that A sells the mining property to B for $400,000, thereby realizing gain of $300,000 ($400,000 minus $100,000 basis). Since the amount of adjusted exploration expenditures with respect to the mining property ($200,000) is less than the amount realized upon its disposition ($300,000), an amount equal to the amount of adjusted exploration expenditures is treated as ordinary income under section 617(d)(1). The remaining $100,000 is treated by A without regard to section 617(d)(1).

(4) Section 617(d) does not apply to losses. Thus, section 617(d) does not apply if a loss is realized upon a sale, exchange, or involuntary conversion of mining property, nor does section 617(d) apply to a disposition of mining property other than by way of sale, exchange, or involuntary conversion if at the time of the disposition the fair market value of such property is not greater than its adjusted basis.

(b) Disposition of portion of mining property. (1) For purposes of section 617(d)(1) and paragraph (a) of this section, except as provided in subparagraph (3) of this paragraph, in the case of the disposition of a portion of a mining property (other than an undivided interest), the entire amount of the adjusted exploration expenditures with respect to such property shall be treated as attributable to such portion to the extent of the amount of the gain to which section 617(d)(1) applies. If the amount of the gain to which section 617(d)(1) applies is less than the amount of the adjusted exploration expenditures with respect to the property, the balance of the adjusted exploration expenditures shall remain subject to recapture in the hands of the taxpayer under the provisions of sections 617(b), (c), and (d). The disposition of a portion of a mining property (other than an undivided interest) includes the disposition of a geographical portion of a mining property. For example, assume that A owns an 80-acre tract of land with respect to which he has deducted exploration expenditures under section 617(a). If A were to sell the north 40 acres, the entire amount of the adjusted exploration expenditures with respect to the 80-acre tract would be treated as attributable to the 40-acre portion sold (to the extent of the amount of the gain to which section 617(d)(1) applies).

(2) For purposes of section 617(d)(1), except as provided in subparagraph (3) of this paragraph, in the case of the disposition of an undivided interest in a mining property (or portion thereof) a proportionate part of the adjusted exploration expenditures with respect to such property shall be treated as attributable to such undivided interest to the extent of the amount of the gain to which section 617(d)(1) applies. For example, assume that A owns an 80-acre tract of land with respect to which he has deducted exploration expenditures under section 617(a). If A were to sell an undivided 40 percent interest in such tract, 40 percent of the adjusted exploration expenditures with respect to the 80-acre tract would be treated as attributable to the 40 percent of the 80-acre tract disposed of (to the extent of the amount of the gain to which section 617(d)(1) applies).

(3) Section 617(d)(2) and subparagraphs (1) and (2) of this paragraph shall not apply to any expenditure to the extent that such expenditure relates neither to the portion (or interest therein) disposed of nor to any mine, in the property held by the taxpayer before the disposition, which has reached the producing stage. In any case where a taxpayer disposes of a mining property (or interest therein) and treats adjusted exploration expenditures with respect to the mining property as if they

relate neither to the portion (or interest therein) disposed of nor to any mine, in the property held by the taxpayer before the disposition, which has reached the producing stage, the taxpayer shall attach to its return for the taxable year in which the disposition occurred, a statement which includes:

(i) A description of the portion (or interest therein) disposed of;

(ii) A description of the mineral property which included the portion (or interest therein) disposed of;

(iii) An itemization of all expenditures deducted under sections 617 and 615 with respect to such mineral property; and

(iv) A description of the location of all producing mines on such mineral property.

(c) Exceptions. (1)(i) Section 617(d)(3) provides, through incorporation by reference of the provisions of section 1245(b)(1), that no gain shall be recognized under section 617(d) upon a disposition by gift of mining property. For purposes of this subparagraph, the term "gift" means, except to the extent that subdivision (ii) of this subparagraph applies, a transfer of mining property which, in the hands of the transferee, has a basis determined under the provisions of section 1015(a) or (d) (relating to basis of property acquired by gift). For reduction in amount of the charitable contribution in case of a gift of section 617 property, see section 170(e) and paragraph (c)(3) of § 1.170–1.

(ii) Where a disposition of mining property is in part a sale or exchange and in part a gift, the gain to which section 617(d) applies is the lower of the adjusted exploration expenditures with respect to such property or the excess of the amount realized upon the disposition of the property over the adjusted basis of such property.

(2) Section 617(d)(3) provides, through incorporation by reference of the provisions of section 1245(b)(2), that, except as provided in section 691 (relating to income in respect to a decedent), no gain shall be recognized under section 617(d) upon a transfer at death. For purposes of this paragraph, the term "transfer at death" means a transfer of mining property which property, in the hands of the transferee, has a basis determined under the provisions of section 1014(a) (relating to basis of property acquired from a decedent) because of the death of the transferor.

(3)(i) Section 617(d) provides, through incorporation by reference of the provisions of section 1245(b)(3), that upon a transfer of property described in subdivision (ii) of this subparagraph, the amount of gain taken into account by the transferor under section 617(d) shall not exceed the amount of gain recognized to the transferor on the transfer (determined without regard to section 617). For purposes of this subdivision, in case of a transfer of mining property and nonmining property in one transaction, the amount realized from the disposition of the mining property shall be deemed to be equal to the amount which bears the same ratio to the total amount realized as the fair market value of the mining property bears to the aggregate fair market value of all of the property transferred. The preceding sentence shall be applied solely for purposes of computing the portion of the total gain (determined without regard to section 617) which shall be recognized as ordinary income under section 617(d). Section 617(d)(3) does not apply to a disposition of mining property to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code.

(ii) The transfers referred to in subdivision (i) of this subparagraph are transfers of mining property in which the basis of the mining property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of any of the following provisions:

(a) Section 332 (relating to distributions in complete liquidation of an 80-percent-or-more controlled subsidiary corporation). See subdivision (iii) of this subparagraph.

(b) Section 351 (relating to transfer to a corporation controlled by transferor).

(c) Section 361 (relating to exchanges pursuant to certain corporate reorganizations).

(d) Section 371(a) (relating to exchanges pursuant to certain receivership and bankruptcy proceedings).

(e) Section 374(a) (relating to exchanges pursuant to certain railroad reorganizations).

(f) Section 721 (relating to transfers to a partnership in exchange for a partnership interest).

(g) Section 731 (relating to distributions by a partnership to a partner).

(iii) In the case of a distribution in complete liquidation of an 80-percent-or-more controlled subsidiary to which section 332 applies, the limitation provided in section 617(d)(3), through incorporation by reference of the provisions of section

1245(b)(3), is confined to instances in which the basis of the mining property in the hands of the transferee is determined under section 334(b)(1), by reference to its basis in the hands of the transferor. Thus, for example, the limitation may apply in respect of a liquidating distribution of mining property by an 80-percent-or-more controlled corporation to the parent corporation, but does not apply in respect of a liquidating distribution of mining property to a minority shareholder. Section 617(d)(3) does not apply to a liquidating distribution of property by an 80-percent-or-more controlled subsidiary to its parent if the parent's basis for the property is determined, under section 334(b)(2), by reference to its basis in the stock of the subsidiary.

[T.D. 7192, 37 FR 12947, June 30, 1972]

Exclusions From Gross Income

§ 1.621–1 Payments to encourage exploration, development, and mining for defense purposes.

(a) **General rule.** (1) Under section 621, a taxpayer shall exclude from gross income amounts which are paid to him:

(i) By the United States or by an agency or instrumentality of the United States,

(ii) As a grant, gift, bounty, bonus, premium, incentive, subsidy, loan, or advance,

(iii) For the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal,

(iv) Pursuant to or in connection with an undertaking by the taxpayer to explore for, or develop or produce, such mineral or metal and to expend or use any amounts so received for the purpose and in accordance with the terms and conditions upon which such amounts are paid, which undertaking has been approved by the United States or by an agency or instrumentality of the United States, and

(v) For which the taxpayer has accounted, or is required to account, to an appropriate agency of the United States Government for the expenditure or use thereof for the purpose and in accordance with the terms and conditions upon which such amounts are paid.

In order for section 621 to apply, such amount must qualify under each of the foregoing subdivisions of this paragraph. Under section 621, there shall also be excluded from gross income any income attributable to the forgiveness or discharge of any indebtedness arising from amounts to which such section applies.

(2) Section 621 is applicable whether or not the payee is obligated to repay to the United States any portion or all of the amount so received. However, such section is not applicable to any loan or advance for the repayment of which the borrower's liability is unconditional and legally enforceable.

(3) Except as provided in paragraph (e) of this section any expenditure attributable to an amount received by a taxpayer to which section 621 applies shall not be deductible by the taxpayer as an expense under subtitle A of the Code, nor shall any such expenditure increase the basis of the taxpayer's property either for determining gain or loss on sale, exchange, or other disposition, or for computing depletion or depreciation (including amortization under section 168).

(b) **Allowance as part of purchase price.** (1) Section 621 is not applicable to any part of the purchase price of a critical and strategic mineral or metal which amount is received, whether before, on, or after delivery from the United States or any agency or instrumentality thereof, and irrespective of whether such purchase price is below, at, or above the currently prevailing market price.

(2) However, a payment of a separate and specific amount for the encouragement of exploration for, or development or mining of, a critical and strategic mineral or metal shall not be considered to be a part of the purchase price of such mineral or metal merely because such payment is added to, or included with, the payment of such purchase price.

(c) **Payments for expenditures previously deducted or capitalized.** (1) Where amounts described in section 621 and this section are paid to a taxpayer in reimbursement for expenditures previously allowed as a deduction, the taxpayer shall include in gross income that portion of such amounts which is equivalent to the deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to

tax on self-employment income), or prior income, war-profits, or excess-profits tax laws.

(2) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been deferred under sections 615 and 616 (relating to exploration and development expenditures) the taxpayer shall include in gross income that portion of such amounts which is equivalent to any deduction for such expenditures allowed to the taxpayer and which deduction resulted in a reduction for any taxable year of the taxpayer's taxes under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts, equivalent to expenditures which are reflected in the adjusted basis of the assets to which charged, shall be excluded from gross income, and such adjusted basis shall be decreased by the amount of such exclusion.

(3) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to capital account (either to a depletable or depreciable account), there shall be included in the taxpayer's gross income that portion of such amounts which is equivalent to such capital expenditures that have been recovered through cost depletion or depreciation deductions and which deductions have resulted in a reduction of the taxpayer's taxes for any taxable year under subtitle A of the Code (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws. The portion of such amounts which is equivalent to the expenditures which are reflected in the adjusted basis of the asset to which charged shall be excluded from gross income. The adjusted basis of such assets shall be reduced by the amount of such exclusion from gross income.

(4) Where amounts described in section 621 and this section are paid to the taxpayer in reimbursement for expenditures which have been charged to a depletable capital account, such amounts shall be excluded to the extent such expenditures are recovered through depletion deductions computed under section 613 (relating to percentage depletion).

(5) The amount of reimbursed expenditures charged to an account (depletable or depreciable) and recovered through depletion or depreciation deductions for any taxable year shall be that proportion of the total deductions allowed with respect to such account that such reimbursed expenditures bear to the total amount in the account. For example, in 1956 A incurs exploration expenditures of $12,000 which he charges to a depletable capital account. This brings the total amount in this account to $36,000 which is the adjusted basis of the property on January 1, 1957. In 1957, A is allowed a deduction for cost depletion of $9,000 which resulted in a reduction of A's income taxes. One-third of this deduction is attributable to the $12,000 of exploration expenditures since they were a third of the total in the capital account on January 1, 1957. Therefore, on January 1, 1958, these exploration expenditures make up $9,000 of the remaining $27,000 in the account. If on January 1, 1958, A receives $12,000, which qualifies under section 621, in reimbursement for these exploration expenditures, he must report $3,000 as income and reduce the capital account by $9,000.

(d) **Definition.** As used in section 621 and this section, the term "critical and strategic minerals or metals" means minerals and metals which are considered by those departments, agencies, and instrumentalities of the United States charged with the encouragement of exploration for, and development and mining of, critical and strategic minerals and metals, to constitute critical and strategic minerals and metals for defense purposes. See, for example, 30 CFR 301.3 (Regulations for Obtaining Federal Assistance in Financing Explorations for Mineral Reserves, Excluding Organic Fuels, in the United States, its Territories and Possessions).

(e) **Repayments of amounts excluded under section 621.** Upon the repayment by the taxpayer of any portion of any amount to which section 621 applies and which portion has been expended for the purpose and in accordance with the terms and conditions upon which it was paid to the taxpayer, any expenditures attributable to such amount made by the taxpayer shall be treated as if such expenditures had been made at the time of such repayment. Such expenditures shall to the extent of the repayment be expensed or capitalized, as the case may be, in the order in which they were actually made or in such other manner as may be adopted by the taxpayer with the approval of the Commissioner.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960]

Sales And Exchanges

§ 1.631-1 Election to consider cutting as sale or exchange.

(a) **Effect of election.** (1) Section 631(a) provides an election to certain taxpayers to treat the difference between the actual cost or other basis of certain timber cut during the taxable year and its fair market value as standing timber on the first day of such year as gain or loss from a sale or exchange under section 1231. Thereafter, any subsequent gain or loss shall be determined in accordance with paragraph (e) of this section.

(2) For the purposes of section 631(a) and this section, timber shall be considered cut at the time when in the ordinary course of business the quantity of timber felled is first definitely determined.

(3) The election may be made with respect to any taxable year even though such election was not made with respect to a previous taxable year. If an election has been made under the provisions of section 631(a), or corresponding provisions of prior internal revenue laws, such election shall be binding upon the taxpayer not only for the taxable year for which the election is made but also for all subsequent taxable years, unless the Commissioner on showing by the taxpayer of undue hardship permits the taxpayer to revoke his election for such subsequent taxable years. If the taxpayer has revoked a previous election, such revocation shall preclude any further elections unless the taxpayer obtains the consent of the Commissioner.

(4) Such election shall apply with respect to all timber which the taxpayer has owned, or has had a contract right to cut, for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when such timber is cut for sale or for use in the taxpayer's trade or business, irrespective of whether such timber or contract right was acquired before or after the election. (For purposes of the preceding sentence, the rules with respect to the holding period of property contained in section 1223 shall be applicable.) However, timber which is not cut for sale or for use in the taxpayer's trade or business (for example, firewood cut for the taxpayer's own household consumption) shall not be considered to have been sold or exchanged upon the cutting thereof.

(b) **Who may make election.** (1) A taxpayer who has owned, or has held a contract right to cut, timber for a period of more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) prior to when the timber is cut may elect under section 631(a) to consider the cutting of such timber during such year for sale or for use in the taxpayer's trade or business as a sale or exchange of the timber so cut. In order to have a "contract right to cut timber" within the meaning of section 631(a) and this section, a taxpayer must have a right to sell the timber cut under the contract on his own account or to use such cut timber in his trade or business.

(2) For purposes of section 631(a) and this section, the term "timber" includes evergreen trees which are more than six years old at the time severed from their roots and are sold for ornamental purposes, such as Christmas decorations. Section 631(a) is not applicable to evergreen trees which are sold in a live state, whether or not for ornamental purposes. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(a). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

(c) **Manner of making election.** The election under section 631(a) must be made by the taxpayer in his income tax return for the taxable year for which the election is applicable, and such election cannot be made in an amended return for such year. The election in the return shall take the form of a computation under the provisions of section 631(a) and section 1231.

(d) **Computation of gain or loss under the election.** (1) If the cutting of timber is considered as a sale or exchange pursuant to an election made under section 631(a), gain or loss shall be recognized to the taxpayer in an amount equal to the difference between the adjusted basis for depletion in the hands of the taxpayer of the timber which has been cut during the taxable year and the fair market value of such timber as of the first day of the taxable year in which such timber is cut. The adjusted basis for depletion of the cut timber shall be based upon the number of units of timber cut during the taxable year which are considered to be sold or exchanged and upon the depletion unit of the timber in the timber account or accounts pertaining to the timber cut, and shall be computed in the same manner as is provided in section 611 and the regulations thereunder with respect to the computation of the allowance for depletion.

(2) The fair market value of the timber as of the first day of the taxable year in which such timber is cut shall be determined, subject to approval or revision by the district director upon examination of the taxpayer's return, by the taxpayer in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, methods of exploitation, degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of that particular day. Due consideration will be given to the factors and the principles involved in the determination of the fair market value of timber as described in the regulations under section 611.

(3) The fair market value as of the beginning of the taxable year of the standing timber cut during the year shall be considered to be the cost of such timber, in lieu of the actual cost or other basis of such timber, for all purposes for which such cost is a necessary factor. See paragraph (e) of this section.

(4) For any taxable year for which the cutting of timber is considered to be a sale or exchange of such timber under section 631(a), the timber so cut shall be considered as property used in the trade or business for the purposes of section 1231, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether the gain or loss considered to have resulted from the cutting of the timber will be considered to be gain or loss resulting from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) depends upon the application of section 1231 to the taxpayer for the taxable year. See section 1231 and the regulations thereunder.

(e) Computation of subsequent gain or loss. **(1)** In case the products of the timber are sold after cutting, either in the form of logs or lumber or in the form of manufactured products, the income from such actual sales shall be considered ordinary income. When the election under section 631(a) is in effect, the cost of standing timber cut during the taxable year is determined as if the taxpayer had purchased such timber on the first day of the taxable year. Thus, in determining the cost of the products so sold, the cost of the timber shall be the fair market value on the first day of the taxable year in which the standing timber was cut, in lieu of the actual cost or other basis of such timber.

(2) This is also the rule in case the products of the timber cut during one taxable year, with respect to which an election has been made under section 631(a), are sold during a subsequent taxable year, whether or not the election provided in section 631(a) is applicable with respect to such subsequent year. If the products of the timber cut during a taxable year with respect to which an election under section 631(a) was made were not sold during such year and are included in inventory at the close of such year, the fair market value as of the beginning of the year of the timber cut during the year shall be used in lieu of the actual cost of such timber in computing the closing inventory for such year and the opening inventory for the succeeding year. With respect to the costs applicable in the determination of the amount of such inventories, there shall be included the fair market value of the timber cut, the costs of cutting, logging, and all other expenses incident to the cost of converting the standing timber into the products in inventory. See section 471 and the regulations thereunder. The fact that the fair market value as of the first day of the taxable year in which the timber is cut is deemed to be the cost of such timber shall not preclude the taxpayer from computing its inventories upon the basis of cost or market, whichever is lower, if such is the method used by the taxpayer. Nor shall it preclude the taxpayer from computing its inventories under the last-in, first-out inventory method provided by section 472 if such section is applicable to, and has been elected by, the taxpayer.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§ 1.631–2 Gain or loss upon the disposal of timber under cutting contract.

(a) In general. **(1)** If an owner disposes of timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal, under any form or type of contract whereby he retains an economic interest in such timber, the disposal shall be considered to be a sale of such timber. The difference between the amounts realized from disposal of such timber in any taxable year and the adjusted basis for depletion thereof shall be considered to be a gain or loss upon the

sale of such timber for such year. Such adjusted basis shall be computed in the same manner as provided in section 611 and the regulations thereunder with respect to the allowance for depletion. See paragraph (e)(2) of this section for definition of "owner". For the purpose of determining whether or not the timber disposed of was held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal the rules with respect to the holding period of property contained in section 1223 shall be applicable.

(2) In the case of such a disposal, the provisions of section 1231 apply and such timber shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether such timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the timber which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend upon the application of section 1231 to the taxpayer for the taxable year.

(b) Determination of date of disposal. (1) For purposes of section 631(b) and this section, the date of disposal of timber shall be deemed to be the date such timber is cut. However, if payment is made to the owner under the contract for timber before such timber is cut the owner may elect to treat the date of payment as the date of disposal of such timber. Such election shall be effective only for purposes of determining the holding period of such timber. Neither section 631(b) nor the election thereunder has any effect on the time of reporting gain or loss. See subchapter E, chapter 1 of the Code and the regulations thereunder. See paragraph (c)(2) of this section for the effect of exercising the election with respect to the payment for timber held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. See paragraph (d) of this section for the treatment of payments received in advance of cutting.

(2) For purposes of section 631(b) and this section, the "date such timber is cut" means the date when in the ordinary course of business the quantity of timber felled is first definitely determined.

(c) Manner and effect of election to treat date of payment as the date of disposal. (1) The election to treat the date of payment as the date of disposal of timber shall be evidenced by a statement attached to the taxpayer's income tax return filed on or before the due date (including extensions thereof) for the taxable year in which the payment is received. The statement shall specify the advance payments which are subject to the election and shall identify the contract under which the payments are made. However, in no case shall the time for making the election under section 631(b) expire before the close of March 21, 1958.

(2) Where the election to treat the date of payment as the date of disposal is made with respect to a payment made in advance of cutting, and such payment is made 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less from the date the timber disposed of was acquired, section 631(b) shall not apply to such payment irrespective of the date such timber is cut, since the timber was not held for more than six months prior to disposal.

(d) Payments received in advance of cutting. (1) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to cutting (such as advance royalty payments or minimum royalty payments) shall be treated under section 631(b) as realized from the sale of timber if the contract of disposal provides that such amounts are to be applied as payment for timber subsequently cut. Such amounts will be so treated irrespective of whether or not an election has been made under paragraph (c) of this section to treat the date of payment as the date of disposal. For example, if no election has been made under paragraph (c) of this section, amounts received or accrued prior to cutting will be treated as realized from the sale of timber, provided the timber paid for is cut more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the date of acquisition of such timber.

(2) However, if the right to cut timber under the contract expires, terminates, or is abandoned before the timber which has been paid for is cut, the taxpayer shall treat payments attributable to the uncut timber as ordinary income and not as received from the sale of timber under section 631(b). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received or accrued. The recomputation shall be made in the form of an amended return where necessary.

(3)(i) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(b) as amounts realized from the sale of timber to the extent attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(ii) The adjusted depletion basis attributable to the bonus shall be determined under the provisions of section 612 and the regulations thereunder. This subdivision may be illustrated as follows:

Example. Taxpayer A has held timber having a depletion basis of $90,000 for two months when he enters into a contract of disposal with B. B pays A a bonus of $5,000 upon the execution of the contract and agrees to pay X dollars per unit of timber to A as the timber is cut. A does not exercise the election to treat the date of payment as the date of disposal. It is estimated that there are 50,000 units of timber subject to the contract and that the total estimated royalties to be paid to A will be $95,000. A must report the bonus in the taxable year it is received or accrued by him. The portion of the basis of the timber attributable to the bonus is determined by the following formula:

(Bonus ÷ Bonus + amount of expected royalties) × Basis of timber = Basis attributable to bonus.

[($5,000 ÷ $100,000) × $90,000 = $4,500]

(iii) To the extent attributable to timber not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), such bonuses shall be treated as ordinary income subject to depletion. In order to determine the amount of the bonus allocable to timber not held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the bonus shall be apportioned ratably over the estimated number of units of timber covered by the contract of disposal. This subdivision may be illustrated as follows:

Example. Assume under the facts stated in the example in subdivision (ii) of this subparagraph that B cuts 10,000 units of timber that have been held by A for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less. The amount of the bonus (as well as the royalties) attributable to these units must be reported as ordinary income subject to depletion. The amount of the bonus attributable to these units is determined by the following formula:

(Number of units cut held for six months or less ÷ Total units covered by the contract) × Amount of bonus = Amount of bonus treated as ordinary income subject to depletion.

[($10,000 ÷ $50,000) × $5,000 = $1,000]

The amount of the depletion attributable to the portion of the bonus received for timber held for six months or less is determined by the following formula:

(Amount of bonus attributable to timber held for six months or less ÷ Total bonus) × Adjusted basis for depletion of bonus = Depletion allowance on timber held for six months or less.

[($1,000 ÷ $5,000) × $4,500 = $900]

The amount of the bonus attributable to timber held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and which is treated under section 631(b) as realized from the sale of timber would be $4,000. The gain on such amount is $400 ($4,000–$3,600).

(iv) If the right to cut timber under the contract of disposal expires, terminates, or is abandoned before any timber is cut, the taxpayer shall treat the bonus received under such contract as ordinary income, not subject to depletion. Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such bonus was received. The recomputation shall be made in the form of an amended return where necessary.

(e) **Other rules for application of section.** (1) Amounts paid by the lessee for timber or the acquisition of timber cutting rights, whether designated as such or as a rental, royalty, or bonus, shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor.

(2) The provisions of section 631(b) apply only to an owner of timber. An owner of timber means any person who owns an interest in timber, including a sublessor and a holder of a contract to cut timber. Such owner of timber must have a right to cut timber for sale on his own account or for use in his trade or business in order to own an interest in timber within the meaning of section 631(b).

(3) For purposes of section 631(b) and this section, the term "timber" includes evergreen trees which are more than 6 years old at the time severed from their roots and are sold for ornamental purposes such as Christmas decorations. Tops and other parts of standing timber are not considered as evergreen trees within the meaning of section 631(b). The term "evergreen trees" is used in its commonly accepted sense and includes pine, spruce, fir, hemlock, cedar, and other coniferous trees.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.631–3 Gain or loss upon the disposal of coal or domestic iron ore with a retained economic interest.

(a) **In general.** (1) The provisions of section 631(c) apply to an owner who disposes of coal

(including lignite), or iron ore mined in the United States, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) before such disposal under any form or type of contract whereby he retains an economic interest in such coal or iron ore. The difference between the amount realized from disposal of the coal or iron ore in any taxable year, and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272, shall be gain or loss upon the sale of the coal or iron ore. See paragraph (b)(4) of this section for the definition of "owner." See paragraph (e) of this section for special rules relating to iron ore.

(2) In the case of such a disposal, the provisions of section 1231 apply, and the coal or iron ore shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether the coal or iron ore is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the coal or iron ore which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) will depend on the application of section 1231 to the taxpayer for the taxable year; *i.e.*, if the gains do not exceed the losses, they shall not be considered as gains and losses from sales or exchanges of capital assets but shall be treated as ordinary gains and losses.

(b) Rules for application of section. **(1)** For purposes of section 631(c) and this section, the date of disposal of the coal or iron ore shall be deemed to be the date the coal or iron ore is mined. If the coal or iron ore has been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date it is mined, it is immaterial that it had not been held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) on the date of the contract. There shall be no allowance for percentage depletion provided in section 613 with respect to amounts which are considered to be realized from the sale of coal or iron ore under section 631(c).

(2) The term "adjusted depletion basis" as used in section 631(c) and this section means the basis for allowance of cost depletion provided in section 612 and the regulations thereunder. Such "adjusted depletion basis" shall include exploration or development expenditures treated as deferred expenses under section 615(b) or 616(b), or corresponding provisions of prior income tax laws, and be reduced by adjustments under section 1016(a)(9) and (10), or corresponding provisions of prior income tax laws, relating to deductions of deferred expenses for exploration or development expenditures in the taxable year or any prior taxable years. The depletion unit of the coal or iron ore disposed of shall be determined under the rules provided in the regulations under section 611, relating to cost depletion.

(3)(i) In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties (except rents and royalties paid by a lessee with respect to coal or iron ore disposed of by the lessee as an "owner" under section 631(c)) shall be determined without regard to the provisions of section 631(c). Thus, the amounts of rents and royalties paid or incurred by a lessee with respect to coal or iron ore shall be excluded from the lessee's gross income from the property for the purpose of determining his percentage depletion without regard to the treatment of such rents or royalties in the hands of the recipient under this section. See section 613 and the regulations thereunder.

(ii)(*a*) However, a lessee who is also a sublessor may dispose of coal or iron ore as an "owner" under section 631(c). Rents and royalties paid with respect to coal or iron ore disposed of by such a lessee under section 631(c) shall increase the adjusted depletion basis of the coal or iron ore and are not otherwise deductible.

(*b*) The provisions of this subdivision may be illustrated by the following example:

Example. B is a sublessor of a coal lease; A is the lessor; and C is the sublessee. B pays A a royalty of 50 cents per ton. C pays B a royalty of 60 cents per ton. The amount realized by B under section 631(c) is 60 cents per ton and will be reduced by the adjusted depletion basis of 50 cents per ton, leaving a gain of 10 cents per ton taxable under section 631(c).

(4)(i) The provisions of this section applies only to an owner who has disposed of coal or iron ore and retained an economic interest. For the purposes of section 631(c) and this section, the word "owner" means any person who owns an economic interest in coal or iron ore in place, including a sublessor thereof. A person who merely acquires an economic interest and has not disposed of coal or iron ore under a contract retaining an economic

interest does not qualify under section 631(c). A successor to the interest of a person who has disposed of coal or iron ore under a contract by virtue of which he retained an economic interest in such coal or iron ore is also entitled to the benefits of this section. Section 631(c) and this section shall not apply with respect to any income realized by any owner as co-adventurer, partner, or principal in the mining of such coal or iron ore.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A owns a tract of coal land in fee. A leases to B the right to mine all the coal in this tract in return for a royalty of 30 cents per ton. B subleases his right to mine coal in this tract to C, who agrees to pay A 30 cents per ton and to pay to B an additional royalty of 10 cents per ton. Section 631(c) applies to the royalties of both A and B, if the other requisites of the section have been met.

Example (2). Assume the same facts as in example (1), except that A dies leaving his royalty interest to D. D has an economic interest in the coal in place and qualifies for section 631(c) treatment with respect to his share of the royalties since he is a successor in title to A.

Example (3). Assume the same facts as in example (1), except that E agrees to pay a sum of money to C in return for 10 cents per ton on the coal mined by C. E has an economic interest, since he must look solely to the extraction of the coal for the return of his investment. However, E has not made a disposal of coal under a contract wherein he retains an economic interest, and, therefore does not qualify under section 631(c). E is entitled to depletion on his royalties.

(c) **Payments received in advance of mining.** (1)(i) Where the conditions of paragraph (a) of this section are met, amounts received or accrued prior to mining shall be treated under section 631(c) as received from the sale of coal or iron ore if the contract of disposal provides that such amounts are to be applied as payment for coal or iron ore subsequently mined. For example, advance royalty payments or minimum royalty payments received by an owner of coal or iron ore qualify under section 631(c) where the contract of disposal grants the lessee the right to apply such royalties in payment of coal or iron ore mined at a later time.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. A acquires coal rights on January 1. On January 30, A enters into a contract of disposal providing that mining shall begin July 2, and mining actually begins no earlier. Any advance payments which A receives qualify under section 631(c).

(2) However, if the right to mine coal or iron ore under the contract expires, terminates, or is abandoned before the coal or iron ore which had been paid for is mined, the taxpayer shall treat payments attributable to the unmined coal or iron ore as ordinary income and not as received from the sale of coal or iron ore under section 631(c). Accordingly, the taxpayer shall recompute his tax liability for the taxable year in which such payments were received. The recomputation shall be made in the form of an amended return where necessary.

(3) Bonuses received or accrued by an owner in connection with the grant of a contract of disposal shall be treated under section 631(c) as received from the sale of coal or iron ore to the extent attributable to coal or iron ore held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). The rules contained in paragraph (d) of § 1.631–2 relating to bonuses in the case of contracts for the disposal of timber shall be equally applicable in the case of bonuses received for the grant of a contract of disposal of coal or iron ore under this section.

(d) **Nonapplication of section.** Section 631(c) shall not affect the application of the provisions of subchapter G, chapter 1 of the Code, relating to corporations used to avoid income tax on shareholders. For example, for the purposes of applying section 543 (relating to personal holding companies), the amounts received from a disposal of coal or iron ore subject to section 631(c) shall be considered as mineral royalties. The determination of whether an amount received under a contract to which section 631(c) applies is "personal holding company income" shall be made in accordance with section 543 and the regulations thereunder, without regard to section 631(c) or this section. See also paragraph (e) of § 1.272–1.

(e) **Special rules with regard to iron ore.** (1) With regard to iron ore, section 631(c) and this section apply only to amounts received or accrued in taxable years beginning after December 31, 1963, attributable to iron ore mined in such taxable years.

(2) Section 631(c) and this section apply only to disposals of iron ore mined in the United States.

(3) For the purposes of section 631(c) and this section, iron ore is any ore which is used as a source of iron, including but not limited to taconite and jaspilite.

(4) Section 631(c) shall not apply to any disposal of iron ore to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b).

(5) Section 631(c)(2) results in the denial of section 631(c) treatment in the case of a contract

for disposal of iron ore entered into with a person owned or controlled, directly or indirectly, by the same interests which own or control the person disposing of the iron ore, even though section 631(c) treatment would not be denied under the provisions of section 631(c)(1). For example, section 631(c) treatment is denied in the case of a contract for disposal of iron ore entered into between two "brother and sister" corporations, or a parent corporation and its subsidiary. The presence or absence of control shall be determined by applying the same standards as are applied under section 482 (relating to the allocation of income and deductions between taxpayers).

[T.D. 6841, 30 FR 9307, July 27, 1965, as amended by T.D. 7730, 45 FR 72650, Nov. 3, 1980]

§ 1.632–1 Tax on sale of oil or gas properties.

(a) If the taxpayer, by prospecting and locating claims or by exploring or discovering undeveloped claims, has demonstrated the principal value of oil or gas property, which prior to his efforts had a relatively minor value, the portion of the tax (or, in the case of taxable years beginning before Jan. 1, 1971, the surtax) imposed by section 1 attributable to a sale of such property, or of any interest of the taxpayer therein, shall not exceed 33 percent (or, in the case of taxable year beginning before Jan. 1, 1971, 30 percent) of the selling price of such property or such interest. Shares of stock in a corporation owning oil or gas property do not constitute an interest in such property. To determine the application of section 632 to a particular case, the taxpayer should first compute the tax (or surtax) imposed by section 1 upon his entire taxable income, including the taxable income from any sale of such property or interest therein, without regard to section 632. The proportion of the tax (or surtax) so computed, indicated by the ratio which the taxpayer's taxable income from the sale of the property or interest therein, computed as prescribed in this section, bears to his total taxable income is the portion of the tax attributable to such sale and, if it exceeds 33 percent (or 30 percent) of the selling price of such property or interest, such portion of the tax (or surtax) shall be reduced to that amount.

(b) In determining the portion of the taxable income attributable to the sale of such oil or gas property or interest therein, the taxpayer shall allocate to the gross income derived from such sale, and to the gross income derived from all other sources, the expenses, losses, and other deductions properly appertaining thereto and shall apply any general expenses, losses, and deductions (which cannot properly be otherwise allocated) ratably to the gross income from all sources. The gross income derived from the sale of such oil or gas property or interest therein, less the deductions properly appertaining thereto and less its proportion of any general deductions, shall be the taxable income attributable to such sale. The taxpayer shall submit with his return a statement fully explaining the manner in which such expenses, losses, and deductions are allocated or apportioned.

[T.D. 6500, 25 FR 11737, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9421, May 25, 1971]

Mineral Production Payments

§ 1.636–1 Treatment of production payments as loans.

(a) In general. (1)(i) For purposes of subtitle A of the Internal Revenue Code of 1954, a production payment (as defined in paragraph (a) of § 1.636–3) to which this section applies shall be treated as a loan on the mineral property (or properties) burdened thereby and not as an economic interest in mineral in place, except to the extent that § 1.636–2 or paragraph (b) of this section applies. See paragraph (b) of § 1.611–1. A production payment carved out of mineral property which remains in the hands of the person carving out the production payment immediately after the transfer of such production payment shall be treated as a mortgage loan on the mineral property burdened thereby. A production payment created and retained upon the transfer of the mineral property burdened by such production payment shall be treated as a purchase money mortgage loan on the mineral property burdened thereby. Such production payments will be referred to hereinafter in the regulations under section 636 as carved-out production payments and retained production payments, respectively. Moreover, in the case of a transaction involving a production payment treated as a loan pursuant to this section, the production payment shall constitute an item of income (not subject to depletion), consideration for a sale or exchange, a contribution to capital, or a gift if in the transaction a debt obligation used in lieu of the production payment would constitute such an item of income, consideration, contribution to capital, or gift, as the case

may be. For the definition of the term "transfer" see paragraph (c) of § 1.636–3.

(ii) The payer of a production payment treated as a loan pursuant to this section shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income and "gross income from the property" (see section 613(a)) for the taxable year so applied. The payee shall include in his gross income (but not "gross income from the property") amounts received with respect to such production payment to the extent that such amounts would be includible in gross income if such production payment were a loan. The payer and payee shall determine their allowable deductions as if such production payment were a loan. See section 483, relating to interest on certain deferred payments in the case of a production payment created and retained upon the transfer of the mineral property burdened thereby, or in the case of a production payment transferred in exchange for property. See section 1232 in the case of a production payment which is originally transferred by a corporation at a discount and is a capital asset in the hands of the payee. In the case of a carved-out production payment treated as a mortgage loan pursuant to this section, the consideration received for such production payment by the taxpayer who created it is not included in either gross income or "gross income from the property" by such taxpayer.

(2) If a production payment is treated as a loan pursuant to this section, no transfer of such production payment or any property burdened thereby (other than a transfer between the payer and payee of the production payment which, if the production payment were a loan, would extinguish the loan) shall cause it to cease to be so treated. For example, A sells operating mineral interest X to B for $100,000, subject to a $500,000 retained production payment payable out of X. Subsequently, A sells the production payment to C, and B sells X to D. C and D must treat the production payment as a purchase money mortgage loan.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). On December 22, 1972, A, a cash-basis calendar-year taxpayer who owns operating mineral interest X, carves out of X a production payment in favor of B for $300,000 plus interest, payable out of 50 percent of the first oil produced and sold from X. In 1972, A treats the $300,000 received from B for the production payment as the proceeds of a mortgage loan on X. In 1973, A produces and sells 125,000 barrels of oil for $373,500. A pays B $186,750 with respect to the production payment, $168,750 being principal and $18,000 being interest. In computing his gross income and "gross income from the property" for the year 1973, A includes the $373,500 and takes as deductions the allowable expenses paid in production of such mineral. A also takes a deduction under section 163 for the $18,000 interest paid with respect to the production payment. For 1973, B would treat $18,000 as ordinary income not subject to the allowance for depletion under section 611.

Example (2). Assume the same facts as in example (1) except that the principal amount of the production payment is to be increased by the amount of the ad valorem tax on the mineral attributable to the production payment which is paid by B. Under State law, the ad valorem tax with respect to the mineral attributable to the production payment is a liability of the owner of the production payment. For 1973, B includes the amount received with respect to such taxes as income and takes a deduction under section 164 for the taxes paid by him. Since the ad valorem taxes paid by B are his liability under State law, A may not take a deduction under section 164 for such taxes.

Example (3). On December 31, 1974, C, a calendar-year taxpayer and owner of the operating mineral interest Y, sells Y to D for $10,000 cash and retains a $40,000 production payment payable out of Y. At the time D acquires the property, it is estimated that 500,000 tons of mineral are recoverable from the property. In 1975, D produces a total of 50,000 tons from the property. D's cost depletion for 1975 is $5,000 determined as follows:

Basis in property: $50,000

Total recoverable units: 500,000

Rate of depletion per ton: $0.10 ($50,000÷500,000)

Cost depletion for year: $5,000 ($0.10×50,000)

(b) Exception. (1) A production payment carved out of a mineral property (or properties) for exploration or development of such property (or properties) shall not be treated as a mortgage loan under section 636(a) and this section to the extent "gross income from the property" (for purposes of section 613) would not be realized by the taxpayer creating such production payment, under the law existing at the time of the creation of such production payment, in the absence of section 636(a). See section 83 and the regulations thereunder, relating to property transferred in connection with the performance of services. For purposes of section 636(a) and this paragraph, an expenditure is for exploration or development to the extent that it is necessary for ascertaining the existence, location, extent, or quality of any deposit of mineral or is incident to and necessary for the preparation of a deposit for the production of mineral. However, an expenditure which relates primarily to the production of mineral (as, for example, in the case of a pilot water flood program with respect to the secondary recovery of oil) is not for exploration or development as those terms are used in section 636(a) and this paragraph. Whether or not a production payment is carved out for exploration or development shall be determined in light of all relevant facts and circumstances, including any prior production of mineral

from the mineral deposit burdened by the production payment. However, a production payment shall not be treated as carved out for exploration or development to the extent that the consideration for the production payment—

(i) Is not pledged for use in the future exploration or development of the mineral property (or properties) which is burdened by the production payment;

(ii) May be used for the exploration or development of any other property, or for any other purpose than that described in subdivision (i) of this subparagraph;

(iii) Does not consist of a binding obligation of the payee of the production payment to pay expenses of the exploration or development described in subdivision (i) of this subparagraph; or

(iv) Does not consist of a binding obligation of the payee of the production payment to provide services, materials, supplies, or equipment for the exploration or development described in subdivision (i) of this subparagraph.

(2) In the case of a carved-out production payment only a portion of which is subject to the exception provided in this paragraph, the rules contained in paragraph (a) of this section with respect to the treatment of income and deductions where a production payment is treated as a loan shall apply to the portion of the taxpayer's income or expenses attributable to the production payment which bears the same ratio to the total amount of such income or expenses, as the case may be, as the amount of the consideration for the production payment which would have been realized as income in the absence of section 636(a), by the taxpayer creating such production payment, bears to the total consideration to the taxpayer for the production payment. For example, A, owner of a mineral property, carves out a production payment in favor of B for $600,000 plus interest in return for $600,000 cash. A pledges to use $400,000 for the development of the burdened mineral property. In each of the payout years loan treatment applies to one-third of the income and expenses of A and B attributable to the production payment.

(c) Treatment upon disposition or termination of mineral property burdened by production payment. (1)(i) In the case of a sale or other disposition of the mineral property burdened by a production payment treated as a loan pursuant to this section, there shall be included in determining the amount realized upon such disposition an amount equal to the outstanding principal balance of such production payment on the date of such disposition. However, if such a production payment is created in connection with the disposition, the amount to be so included shall be the fair market value of the production payment, rather than its principal amount, if the fair market value is established by clear and convincing evidence to be an amount which differs from the principal amount. See section 1001 and the regulations thereunder. In determining the cost of the transferred mineral property to the transferee for purposes of section 1012, the outstanding principal balance of the production payment shall be included in the cost.

(ii) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). A, the owner of mineral property X which is burdened by a carved-out production payment to which section 636(a) applies having an outstanding principal balance of $10,000, sells property X to B, an individual, for $100,000 cash. The amount realized by A on the sale of property X is $110,000. B's basis in property X for cost depletion and other purposes is also $110,000.

Example (2). Assume the same facts as in example (1) except that the production payment is retained by A in connection with the sale of property X to B, that section 636(b) applies to the production payment, that the production payment includes, in addition to the $10,000 principal amount, an additional amount equivalent to interest at a rate which precludes application of section 483, and that the fair market value of the production payment is $9,000. The amount realized by A on the sale of property X is $109,000. B's basis in property X for cost depletion and other purposes is $110,000. A's basis in the retained production payment is $9,000. If the production payment is paid in full, A realizes income of $1,000 plus the amount equivalent to interest, which income is includible in A's gross income at the time when such amounts would be so includible if such production payment were a loan.

Example (3). C, the owner of mineral property Y, sells the mineral property to D for $500,000 cash. Property Y is burdened by a carved-out production payment with an outstanding principal balance of $600,000, 40 percent of the consideration for which was pledged for the development of property Y. The amount realized by C on the sale is $860,000 ($500,000 plus $600,000×.60). D's basis in property Y for cost depletion and other purposes is $860,000.

(2) In the case of the expiration, termination, or abandonment of a mineral property burdened by a production payment treated as a loan pursuant to this section, for purposes of determining the amount of any loss under section 165 with respect to the burdened mineral property the adjusted basis of such property shall be reduced (but not below zero) by an amount equal to the outstanding principal balance of such production payment on the date of such expiration, termination, or abandonment. Thus, in example (2) in subparagraph (1)(ii) of this paragraph, if B abandons the mineral property at a time when $5,000 of the principal amount of the production payment remains unsatisfied, B's adjusted basis immediately before the

abandonment would be reduced by $5,000 for determining his loss on abandonment under section 165.

(3) In the case of a transfer of a portion of the mineral property burdened by a production payment treated as a loan pursuant to this section, such production payment shall be apportioned between the transferred portion and the retained portion by allocating to such transferred portion that part of the outstanding principal balance of the production payment which bears the same ratio to such balance as the value of such transferred portion (exclusive of any value not related to the burdened mineral) bears to the total value of the burdened mineral property (exclusive of any value not related to the burdened mineral).

(4) In general, the entire amount of gain or loss realized pursuant to this paragraph shall be recognized in the taxable year of such realization. See section 1211 for limitation on capital losses. This subparagraph shall not affect the applicability of rules providing exceptions to the recognition of gain or loss which has been realized (*e.g.*, a transfer to which section 351 or 1031 applies). However, see section 357(c) with respect to the assumption of liabilities in excess of basis in certain tax-free exchanges. Furthermore, in the case of a transaction which otherwise qualifies, gain realized on a transfer of a mineral property to which section 636(b) applies may be returned on the installment method under section 453.

[T.D. 7261, 38 FR 5463, March 1, 1973]

§ 1.636–2 Production payments retained in leasing transactions.

(a) Treatment by lessee. In the case of a production payment (as defined in paragraph (a) of § 1.636–3) which is retained by the lessor in a leasing transaction (including a sublease or the exercise of an option to acquire a lease or sublease), the lessee (or his successors in interest) shall treat the retained production payment for purposes of subtitle A of the Code as if it were a bonus granted by the lessee to the lessor payable in installments. Accordingly, the lessee shall include the proceeds from (or, if paid in kind, the value of) the mineral produced and applied to the satisfaction of the production payment in his gross income for the taxable year so applied. The lessee shall capitalize each payment (including any interest and any amounts added on to the production payment other than amounts for which the lessee would be liable in the absence of the production payment) paid or incurred with respect to such production payment. See paragraph (c)(5)(ii) of § 1.613–2 for rules relating to computation of percentage depletion with respect to a mineral property burdened by a production payment treated as a bonus under section 636(c) and this section.

(b) Treatment by lessor. The lessor who retains a production payment in a leasing transaction (or his successors in interest) shall treat the production payment without regard to the provisions of section 636 and § 1.636–1. Thus, the production payment will be treated as an economic interest in the mineral in place in the hands of the lessor (or his successors in interest) and the receipts in discharge of the production payment will constitute ordinary income subject to depletion.

(c) Example. The provisions of this section may be illustrated by the following example:

Example. In 1971, A leases a mineral property to B reserving a one-eighth royalty and a production payment (as defined in § 1.636–3(a)) with a principal amount of $300,000 plus an amount equivalent to interest. In 1972, B pays to A $60,000 with respect to the principal amount of the production payment plus $16,350 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1972 and subsequent years will include (subject to proper adjustment under section 1016) the $76,350 paid to A. In 1973, B pays to A $60,000 with respect to the principal amount of the production payment plus $12,750 equivalent to interest. The adjusted basis of the property in the hands of B for cost depletion and other purposes for 1973 and subsequent years will include (subject to proper adjustment under section 1016) the $72,750 paid to A. The $76,350 received by A in 1972, and the $72,750 received by A in 1973, will constitute ordinary income subject to depletion in the hands of A in the years of receipt of such amounts by A.

[T.D. 7261, 38 FR 5465, March 1, 1973]

§ 1.636–3 Definitions.

For purposes of section 636 and the regulations thereunder—

(a) Production payment. **(1)** The term "production payment" means, in general, a right to a specified share of the production from mineral in place (if, as, and when produced), or the proceeds from such production. Such right must be an economic interest in such mineral in place. It may burden more than one mineral property, and the burdened mineral property need not be an operating mineral interest. Such right must have an expected economic life (at the time of its creation) of shorter duration than the economic life of one or more of the mineral properties burdened thereby. A right to mineral in place which can be required to be satisfied by other than the production of mineral from the burdened mineral property is not an economic interest in mineral in place. A production payment may be limited

by a dollar amount, a quantum of mineral, or a period of time. A right to mineral in place has an economic life of shorter duration than the economic life of a mineral property burdened thereby only if such right may not reasonably be expected to extend in substantial amounts over the entire productive life of such mineral property. The term "production payment" includes payments which are commonly referred to as "in-oil payments", "gas payments", or "mineral payments".

(2) A right which is in substance economically equivalent to a production payment shall be treated as a production payment for purposes of section 636 and the regulations thereunder, regardless of the language used to describe such right, the method of creation of such right, or the form in which such right is cast (even though such form is that of an operating mineral interest). Whether or not a right is in substance economically equivalent to a production payment shall be determined from all the facts and circumstances. An example of an interest which is to be treated as a production payment under this subparagraph is that portion of a "royalty" which is attributable to so much of the rate of the royalty which exceeds the lowest possible rate of the royalty at any subsequent time (disregarding any reductions in the rate of the royalty which are based solely upon changes in volume of production within a specified period of no more than 1 year). For example, assume that A creates a royalty with respect to a mineral property owned by A equal to 5 percent for 5 years and thereafter equal to 4 percent for the balance of the life of the property. An amount equal to 1 percent for 5 years shall be treated as a production payment. On the other hand, if A leases a coal mine to B in return for a royalty of 30 cents per ton on the first 500,000 tons of coal produced from the mine in each year and 20 cents per ton on all coal in excess of 500,000 tons produced from the mine in each year, the fact that the royalty may decline to 20 cents per ton on some of the coal in each year does not result in a production payment of 10 cents per ton of coal on the first 500,000 tons in any year. Another example of an interest which is to be treated as a production payment under this subparagraph is the interest in a partnership engaged in operating oil properties of a partner who provides capital for the partnership if such interest is subject to a right of another person or persons to acquire or terminate it upon terms which merely provide for such partner's recovery of his capital investment and a reasonable return thereon.

(b) Property. The term "property" has the meaning assigned to it in section 614(a), without the application of section 614(b), (c), or (e).

(c) Transfer. The term "transfer" means any sale, exchange, gift, bequest, devise, or other disposition (including a distribution by an estate or a contribution to or distribution by a corporation, partnership, or trust).

[T.D. 7261, 38 FR 5465, March 1, 1973]

§ 1.636–4 Effective dates of section 636.

(a) In general. Except as provided hereinafter in this section, section 636 and §§ 1.636–1, 1.636–2, and 1.636–3 apply to production payments created on or after August 7, 1969, other than production payments created before January 1, 1971, pursuant to a binding contract entered into before August 7, 1969.

(b) Election. Under section 503(c)(2) of the Tax Reform Act of 1969, if the taxpayer so elects, section 636(a) of the Code and §§ 1.636–1 and 1.636–3 apply to all production payments carved out by him after the beginning of his last taxable year ending before August 7, 1969, including such production payments created after such date pursuant to a binding contract entered into before such date. No interest shall be allowed on any refund or credit of any overpayment of tax resulting from an election under section 503(c)(2) for any taxable year ending before August 7, 1969. The provisions of this paragraph may be illustrated by the following example:

Example. A, a fiscal-year taxpayer whose taxable year ends on October 31, carved out and sold (from a producing property) production payments on October 1, 1967, and on July 9, 1969. On August 1, 1969, A entered into a binding contract to create another carved-out production payment (from a different producing property) and the production payment was carved out on December 22, 1969. If A elects under section 503(c)(2), the production payments carved out on July 9, 1969, and December 22, 1969, are treated as mortgage loans under section 636(a). The production payment carved out on October 1, 1967, is not treated as a mortgage loan under section 636(a) because it was carved out before the beginning of A's last taxable year ending before August 7, 1969.

(c) Time and manner of making election. (1) Any election under section 503(c)(2) of the Tax Reform Act of 1969 must be made not later than May 30, 1973.

(2) An election under section 503(c)(2) shall be made by a statement attached to the taxpayer's income tax return (or amended return) for the first taxable year in which the taxpayer created a production payment (i) to which the election applies, and (ii) which, in the absence of section 636, would not have been treated as a loan. A state-

ment shall also be attached to an amended return for each subsequent taxable year for which he has filed his income tax return before making the election, but only if his tax liability for such year is affected by the election. Each such statement shall indicate the taxpayer's election under section 503(c)(2), and shall identify by date, amount, parties, and burdened mineral properties all production payments described in subdivisions (i) and (ii) of this subparagraph which have been created by the date on which the statement is filed. However, a taxpayer who, prior to the date on which permanent regulations under this section are published in the Federal Register, made a valid election under section 503(c)(2) pursuant to Part 13 of this chapter (Temporary Income Tax Regulations Under the Tax Reform Act of 1969) is not required to amend statements previously furnished which meet the requirements of paragraph (b)(1)(ii) of § 13.0 of Part 13 unless requested to do so by the district director. In applying the election to the taxable years affected, there shall be taken into account the effect that any adjustments resulting therefrom have on other items affected thereby and the effect that adjustments of any such items have on other taxable years. In the case of a member of a consolidated return group (as defined in paragraph (a) of § 1.1502–1), section 503(c)(2) and paragraphs (b), (c), and (d) of this section shall be applied as if such member filed a separate return.

(d) Revocation of election. A valid election under section 503(c)(2) shall be binding upon the taxpayer unless consent to revoke the election is obtained from the Commissioner. The application to revoke such election must be made in writing to the Commissioner of Internal Revenue, Washington, D.C. 20224, not later than May 30, 1973. Such application must set forth the reasons therefor and a recomputation of the tax reflecting such revocation for each prior taxable year affected by the revocation, whether or not the period of limitations for credit or refund or assessment and collection has expired with respect to such taxable year. Consent shall not be given in any case in which the revocation would result in an increase in the taxpayer's tax liability for a taxable year for which such period of limitations has expired unless the taxpayer waives his right to assert the statute of limitations.

(e) Special rule. **(1)** Except as provided in subparagraph (2) of this paragraph, in the case of a taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, section 636 of the Code applies to production payments carved out during the taxable year which includes August 7, 1969, as provided in paragraph (a) of this section, only to the extent that the aggregate amount of such production payments exceeds the lesser of—

(i) The excess of—

(a) The aggregate amount of production payments carved out and sold by the taxpayer during the 12-month period immediately preceding his taxable year which includes August 7, 1969, over

(b) The aggregate amount of production payments carved out and sold before August 7, 1969, by the taxpayer during his taxable year which includes such date, or

(ii) The amount necessary to increase the amount of the taxpayer's gross income within the meaning of chapter 1 of subtitle A of the Code, for his taxable year which includes August 7, 1969, to an amount equal to the amount of his deductions (other than any deduction under section 172) allowable for such year under such chapter.

In applying the preceding sentence, production payments carved out for exploration or development are to be taken into account only to the extent, if any, that "gross income from the property" (for purposes of section 613) would have been realized by the taxpayer creating such production payment under the law existing at the time of the creation of such production payment, in the absence of section 636(a).

(2) Subparagraph (1) of this paragraph shall not apply for any taxable year for purposes of determining the amount of any deduction for cost or percentage depletion allowable under section 611 or the limitation on any foreign tax credit under section 904.

(3) The application of this paragraph may be illustrated by the following examples:

Example (1). (a) A, a calendar-year taxpayer who does not make the election provided in section 503(c)(2) of the Tax Reform Act of 1969, carves out and sells on December 31, 1968, a $500,000 production payment. Further, A carves out and sells on March 4, 1969, a $300,000 production payment, and on November 14, 1969, a $150,000 production payment. None of the production payments are carved out for exploration or development. During 1969, A has gross income of $600,000 (determined initially for this purpose by treating the $150,000 production payment carved out on November 14, 1969, as a loan) and allowable deductions of $700,000.

(b) The provisions of section 636 do not apply to a portion of the November 14, 1969, production payment for purposes other than section 611 and section 904 of the Code, determined as follows:

(1) Amount of production payment carved out in 1969 on or after August 7, 1969........	$150,000

(2) Amount of production payment carved out during 1968	500,000
(3) Amount of production payment carved out during 1969 taxable year before August 7, 1969	300,000
(4) Item (2) minus item (3)	200,000
(5) Excess of allowable deductions over gross income for 1969	100,000
(6) Amount of production payment carved out in 1969 on or after August 7, 1969, to which section 636 does not apply (lesser of items (1), (4), and (5))	100,000

Thus, A will not treat $100,000 of the consideration received for the production payment carved out on November 14, 1969, as a loan and as a result his gross income for 1969 will be $700,000. However, in computing percentage depletion, A will not include the $100,000 in "gross income from property" and in computing cost depletion A will not include the mineral units attributable thereto. Nor, will A include the $100,000 in determining the limitation on foreign tax credit under section 904.

Example (2). Assume the same facts as in example (1) except that for taxable year 1969 A's gross income (determined initially for this purpose by treating the November 14, 1969, production payment as a loan) exceeds the amount of his allowable deductions under chapter 1 of subtitle A of the Code. The entire amount of the November 14, 1969, production payment is treated as a mortgage loan under section 636(a).

[T.D. 7261, 38 FR 5465, March 1, 1973]

Continental Shelf Areas

§ 1.638–1 Continental Shelf areas.

(a) **General rule.** For purposes of applying any provision of Chapter 1, 2, 3, or 24 (including section 861(a)(3), 862(a)(3), 1441, 3402, or other provisions dealing with the performance of personal services), with respect to mines, oil and gas wells, and other natural deposits—

(1) **United States and possession of the United States.** The terms "United States" and "possession of the United States" when used in a geographical sense include the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the United States or such possession and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources. The terms "Continental Shelf of the United States" and "Continental Shelf of a possession of the United States," as used in this section, refer to the seabed and subsoil included, respectively, in the terms "United States" and "possession of the United States," as provided in the preceding sentence.

(2) **Foreign country.** The term "foreign country" when used in a geographical sense includes the seabed and subsoil of those submarine areas which are adjacent to the territorial waters of the foreign country and over which such foreign country has exclusive rights, in accordance with international law, with respect to the exploration for, and exploitation of, natural resources, but this sentence applies only if such foreign country exercises, directly or indirectly, taxing jurisdiction with respect to such exploration or exploitation. The term "foreign continental shelf," as used in this section, refers to the seabed and subsoil described in the preceding sentence. A foreign country is not to be treated as a country contiguous to the United States by reason of the application of section 638 and this section.

(b) **Exercise of taxing jurisdiction.** For purposes of paragraph (a)(2) of this section, the exercise, directly or indirectly, of taxing jurisdiction with respect to the exploration for, or exploitation of, natural resources is deemed to include (but is not limited to) those cases in which a foreign country—

(1) Imposes a tax upon assets, equipment, or other property connected with or income derived from such exploration or exploitation, or

(2) Requires natural resources referred to in paragraph (a)(2) of this section to be transported to points within its landward boundaries and then levies a tax upon such natural resources or upon the income derived from the sale thereof.

A foreign country which, for purposes of paragraph (a)(2) of this section, exercises taxing jurisdiction by the imposition of tax upon any person, property, or activity engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section, or the income therefrom of any taxpayer, is deemed to exercise taxing jurisdiction over all such persons, property, and activities and over all income therefrom of all such taxpayers; thus, for example, a foreign country which imposes tax upon a person engaged in exploitation of oil and gas wells in its seabed and subsoil referred to in paragraph (a)(2) of this section is deemed to exercise taxing jurisdiction over property related to exploration for other natural deposits in such seabed and subsoil. A foreign country is deemed to be imposing tax upon a person, property, activity, or income described in the preceding sentence if such foreign country exempts such person, property, activity, or income

from tax for a period not in excess of 10 years from the commencement of such exploration or exploitation. Except in the case of a foreign country which is deemed under the preceding sentence to impose tax by virtue of an exemption for a period not in excess of 10 years, a foreign country which exempts all persons, property, and activities engaged in or related to the exploration for, or exploitation of, natural resources in the seabed or subsoil referred to in paragraph (a)(2) of this section and the income therefrom, from taxation is deemed not to be exercising, directly or indirectly, taxing jurisdiction for purposes of paragraph (a)(2) of this section. For purposes of paragraph (a)(2) of this section, the exercise of taxing jurisdiction with respect to any type of tax constitutes the exercise of taxing jurisdiction with respect to all types of taxes. However, a royalty or other charge (whether payable in a lump sum or over a period of time or in amounts dependent upon the volume of production of natural resources) for the right to explore for or exploit natural resources does not constitute a tax.

(c) Scope. (1) For purposes of applying this section, persons, property, or activities which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits need not be physically upon, connected, or attached to the seabed or subsoil referred to in subparagraph (1) or (2) of paragraph (a) of this section to be deemed to be within the United States, a possession of the United States, or a foreign country, as the case may be, to the extent provided in subparagraph (2) or (3) and subparagraph (4) of this paragraph.

(2) Persons, property, or activities which are not in a foreign country (determined without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil referred to in paragraph (a)(1) of this section, are generally within the United States or a possession of the United States, as the case may be, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) a foreign country, other than transportation on a regular basis from (or to) a base of operations.

(3) Persons, property, or activities which are not in the United States or in a third country (determined in each case without regard to section 638 or this section), and which are engaged in or related to the exploration for, or exploitation of, mines, oil and gas wells, or other natural deposits of the seabed or subsoil of a foreign country referred to in paragraph (a)(2) of this section, are generally within such foreign country, unless such persons, property, or activities are solely involved in or constitute transportation to (or from) the site of exploration or exploitation from (or to) the United States or a possession of the United States or a third country, as the case may be, other than transportation on a regular basis from (or to) a base of operations.

(4) Persons, property, or activities are within the United States, a possession of the United States, or a foreign country, as the case may be, pursuant to this paragraph, only to the extent such persons, property, or activities are engaged in or related to the exploration for or exploitation of, mines, oil and gas wells, or other natural deposits.

(d) Natural deposits and natural resources. For purposes of this section, the terms "natural deposits" and "natural resources" mean nonliving resources to which section 611(a) applies. Such terms do not include sedentary species (organisms which, at the harvestable stage, either are immovable on or under the seabed or are unable to move except in constant physical contact with the seabed or subsoil), fish or other animal or plant life.

(e) Rights under international law. Nothing in this section shall prejudice or affect the freedoms of the high seas and other rights under international law, or the exercise of such freedoms and rights by the United States or foreign countries.

(f) Examples. The application of the provisions of section 638 and this section may be illustrated by the following examples:

Example (1). A, a citizen of the United States employed as an engineer, is engaged in the exploitation of oil and is physically present on an offshore oil drilling platform operated by employees of L Corporation. Such platform is affixed to the foreign continental shelf of foreign country X. Assuming that foreign country X exercises taxing jurisdiction as provided in paragraph (b) of this section, A is to be treated as being employed in foreign country X with respect to compensation for his employment for purposes of chapters 1 and 24.

Example (2). The facts are the same as in example (1) except that B, a citizen of the United States engaged in the private practice of law, is physically present on such platform for the sole purpose of interviewing his client, A, whom he represents in a domestic relations matter. Since B is not engaged in activities related to the exploration for, or exploitation of, natural deposits, he is not to be treated as being in foreign country X for purposes of chapters 1 and 2.

Example (3). The facts are the same as in example (1) except that C, a citizen of the United States engaged in the private practice of medicine, is physically present on such platform for the purpose of making routine physical examinations of L Corporation's employees who are engaged in the exploitation of oil on the platform. C is paid by L Corporation to give such examinations on the platform at regular intervals

in order to determine whether the state of any employee's health is such that he should not continue work on the platform. The balance of C's medical practice is conducted at his office on the U.S. mainland. Since C is engaged in activities related to the exploitation of oil, he is treated as being in foreign country X under section 638 and this section while making physical examinations on L Corporation's platform, provided that foreign country X exercise taxing jurisdiction as provided in paragraph (b) of this section. For purposes of chapters 1 and 2, amounts paid by L Corporation to C are treated as derived from sources within foreign country X.

Example (4). C, a nonresident alien individual employed as an engineer in a foreign country, designs equipment for use on oil drilling platforms affixed to the continental shelf of the United States and engaged in the exploitation of oil. Although C's activities in this respect are related to the exploitation of oil, C is not treated as being in the United States under section 638 and this section by reason of such activities.

Example (5). M Corporation, a domestic corporation, chartered a ship from N Corporation, also a domestic corporation, under a time charter under which N Corporation's personnel continued to navigate and manage the shop. M Corporation equipped the ship with special oil exploration equipment and furnished its personnel to operate the equipment. The ship then commenced to explore for oil in the foreign Continental Shelf of foreign country Y. Foreign country Y exercises taxing jurisdiction as provided in paragraph (b) of this section. The ship is treated as being within foreign country Y under section 638 and this section for the period it was engaged in the exploration for oil in such foreign Continental Shelf. Thus, the entire income derived during such period by N Corporation from the charter is income derived from sources within foreign country Y, since N Corporation had property and employees engaged in the exploration for oil in such foreign Continental Shelf.

Example (6). The facts are the same as in example (5) except that C, a citizen of the United States, was employed by N Corporation as a cook and was physically present on the ship. C's sole duties consisted of cooking meals for personnel aboard such ship. In such case, as C's activities are related to the exploration for oil, C is to be treated as being in foreign country Y under section 638 and this section for the period he was aboard such ship while it was engaged in activities relating to the exploration for oil in the foreign Continental Shelf referred to in example (5). For purposes of chapters 1 and 24, C's compensation as a cook for such period is treated as derived from sources without the United States.

Example (7). Z Corporation, a foreign corporation, entered into a contract with Y Corporation, a United States corporation, to engage in exploratory oil drilling activities on a leasehold held by Y Corporation. Such leasehold was located in the Continental Shelf of the United States. Since Z Corporation is engaged in and has property and activities which are engaged in the exploration for oil, such property and activities are to be treated as being in the United States under section 638 and this section for the period such property and activities were engaged in or related to the exploration for oil in the Continental Shelf of the United States and were not in a foreign country. For purposes of chapters 1 and 3, amounts paid to Z Corporation pursuant to the contract are treated as derived from sources within the United States.

Example (8). M Corporation is a controlled foreign corporation (within the meaning of section 957(b)) for its entire taxable year beginning in 1972. During such taxable year, M Corporation issues a policy of insurance relating to fire damage to an offshore oil drilling platform, owned by N Corporation (a foreign corporation), which is attached to the Continental Shelf of the United States. The income attributable to the issuing of such policy would be taxed under subchapter L, chapter 1, subtitle A of the Code (as modified, for this purpose, by section 953(b)(1), (2), and (3)) if such income were the income of a domestic insurance corporation. Since N Corporation's oil drilling platform is located within the United States under section 638 and this section, M Corporation's income attributable to the issuing of the insurance in connection with such platform is income derived from the insurance of United States risks, within the meaning of section 953(a)(1)(A).

[T.D. 7277, 38 FR 12740, May 15, 1973]

§ 1.638–2 Effective date.

The specific requirements and limitations of § 1.638–1 apply on and after December 30, 1969.

[T.D. 7277, 38 FR 12742, May 15, 1973]

ESTATES, TRUSTS, BENEFICIARIES, AND DECEDENTS

Estates, Trusts, and Beneficiaries

General Rules For Taxation Of Estates And Trusts

§ 1.641 [Reserved]

§ 1.641(a)–0 Scope of Subchapter J.

(a) In general. Subchapter J (sections 641 and following), Chapter 1 of the Code, deals with the taxation of income of estates and trusts and their beneficiaries, and of income in respect of decedents. Part I of Subchapter J contains general rules for taxation of estates and trusts (Subpart A), specific rules relating to trusts which distribute current income only (Subpart B), estates and trusts which may accumulate income or which distribute corpus (Subpart C), treatment of excess distributions by trusts (Subpart D), grantors and other persons treated as substantial owners (Subpart E), and miscellaneous provisions relating to limitations on charitable deductions, income of an estate or trust in case of divorce, and taxable years to which the provisions of Subchapter J are applicable (Subpart F). Part I has no application to any organization which is not to be classified for tax purposes as a trust under the classification rules of §§ 301.7701–2, 301.7701–3, and 301.7701–4 of this chapter (Regulations on Procedure and Administration). Part II of Subchapter J relates to

the treatment of income in respect of decedents. However, the provisions of Subchapter J do not apply to employee trusts subject to Subchapters D and F, Chapter 1 of the Code, and common trust funds subject to Subchapter H, Chapter 1 of the Code.

(b) Scope of Subparts A, B, C, and D. Subparts A, B, C, and D (section 641 and following), Part I, Subchapter J, Chapter 1 of the Code, relate to the taxation of estates and trusts and their beneficiaries. These subparts have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Code, as that of the grantor or others treated as its substantial owners. See Subpart E (section 671 and following), Part I, Subchapter J, Chapter 1 of the Code, and the regulations thereunder for rules for the treatment of any portion of a trust where the grantor (or another person) is treated as the substantial owner. So-called alimony trusts are treated under Subparts A, B, C, and D, except to the extent otherwise provided in section 71 or section 682. These subparts have no application to beneficiaries of nonexempt employees' trusts. See section 402(b) and the regulations thereunder.

(c) Multiple trusts. Multiple trusts that have—

(1) No substantially independent purposes (such as independent dispositive purposes),

(2) The same grantor and substantially the same beneficiary, and

(3) The avoidance or mitigation of (i) the progressive rates of tax (including mitigation as a result of deferral of tax) or (ii) the minimum tax for tax preferences imposed by section 56 as their principal purpose,

shall be consolidated and treated as one trust for the purposes of Subchapter J.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 731, Jan. 17, 1969; T.D. 7204, 37 FR 17158, Aug. 25, 1972]

§ 1.641(a)–1 Imposition of tax; application of tax.

For taxable years beginning after December 31, 1970, section 641 prescribes that the taxes imposed by section 1(d), as amended by the Tax Reform Act of 1969, shall apply to the income of estates or of any kind of property held in trust. For taxable years ending before January 1, 1971, section 641 prescribes that the taxes imposed upon individuals by chapter 1 of the Code apply to the income of estates or of any kind of property held in trust. The rates of tax, the statutory provisions respecting gross income, and, with certain exceptions, the deductions and credits allowed to individuals apply also to estates and trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7117, 36 FR 9421, May 25, 1971]

§ 1.641(a)–2 Gross income of estates and trusts.

The gross income of an estate or trust is determined in the same manner as that of an individual. Thus, the gross income of an estate or trust consists of all items of gross income received during the taxable year, including:

(a) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(b) Income accumulated or held for future distribution under the terms of the will or trust;

(c) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

(d) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(e) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated. The several classes of income enumerated in this section do not exclude others which also may come within the general purposes of section 641.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.641(b)–1 Computation and payment of tax; deductions and credits of estates and trusts.

Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts. However, there are special rules for the computation of certain deductions and for the allocation between the estate or trust and the beneficiaries of certain credits and deductions. See section 642 and the regulations thereunder. In addition, an estate or trust is allowed to deduct, in computing its taxable income, the deductions provided by sections 651 and 661 and regulations thereunder, relating to distributions to beneficiaries.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.641(b)–2 Filing of returns and payment of the tax.

(a) The fiduciary is required to make and file the return and pay the tax on the taxable income

of an estate or of a trust. Liability for the payment of the tax on the taxable income of an estate attaches to the person of the executor or administrator up to and after his discharge if, prior to distribution and discharge, he had notice of his tax obligations or failed to exercise due diligence in ascertaining whether or not such obligations existed. For the extent of such liability, see section 3467 of the Revised Statutes, as amended by section 518 of the Revenue Act of 1934 (31 U.S.C. 192). Liability for the tax also follows the assets of the estate distributed to heirs, devisees, legatees, and distributees, who may be required to discharge the amount of the tax due and unpaid to the extent of the distributive shares received by them. See section 6901. The same considerations apply to trusts.

(b) The estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or a corporation in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or of a trust. See section 6012(b)(2) and (3) for provisions relating to the obligation of the fiduciary with respect to returns of such persons.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6580, 26 FR 11486, Dec. 5, 1961]

§ 1.641(b)–3 Termination of estates and trusts.

(a) The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(b) Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).

(c)(1) Except as provided in subparagraph (2) of this paragraph, during the period between the occurrence of an event which causes a trust to terminate and the time when the trust is considered as terminated under this section, whether or not the income and the excess of capital gains over capital losses of the trust are to be considered as amounts required to be distributed currently to the ultimate distributee for the year in which they are received depends upon the principles stated in § 1.651(a)–2. See § 1.663–1 et seq. for application of the separate share rule.

(2)(i) Except in cases to which the last sentence of this subdivision applies, for taxable years of a trust ending before September 1, 1957, subparagraph (1) of this paragraph shall not apply and the rule of subdivision (ii) of this subparagraph shall

apply unless the trustee elects to have subparagraph (1) of this paragraph apply. Such election shall be made by the trustee in a statement filed on or before April 15, 1959, with the district director with whom such trust's return for any such taxable year was filed. The election provided by this subdivision shall not be available if the treatment given the income and the excess of capital gains over capital losses for taxable years for which returns have been filed was consistent with the provisions of subparagraph (1) of this paragraph.

(ii) The rule referred to in subdivision (i) of this subparagraph is as follows: During the period between the occurrence of an event which causes a trust to terminate and the time when a trust is considered as terminated under this section, the income and the excess of capital gains over capital losses of the trust are in general considered as amounts required to be distributed for the year in which they are received. For example, a trust instrument provides for the payment of income to A during her life, and upon her death for the payment of the corpus to B. The trust reports on the basis of the calendar year. A dies on November 1, 1955, but no distribution is made to B until January 15, 1956. The income of the trust and the excess of capital gains over capital losses for the entire year 1955, to the extent not paid, credited, or required to be distributed to A or A's estate, are treated under sections 661 and 662 as amounts required to be distributed to B for the year 1955.

(d) If a trust or the administration or settlement of an estate is considered terminated under this section for Federal income tax purposes (as for instance, because administration has been unduly prolonged), the gross income, deductions, and credits of the estate or trust are, subsequent to the termination, considered the gross income, deductions, and credits of the person or persons succeeding to the property of the estate or trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(a)(1)–1 Partially tax-exempt interest.

An estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit does not relate to interest properly allocable to a beneficiary under section 652 or 662 and the regulations thereunder. A beneficiary of an estate or trust is allowed the credit against tax for partially tax-exempt interest provided by section 35 only to the extent that the credit relates to interest properly allocable to him under section 652 or 662 and the regulations thereunder. If an estate or trust holds partially tax-exempt bonds and elects under section 171 to treat the premium on the bonds as amortizable, the credit allowable under section 35, with respect to the bond interest (whether allowable to the estate or trust or to the beneficiary), is reduced under section 171(a)(3) by reducing the shares of the interest allocable, respectively, to the estate or trust and its beneficiary by the portion of the amortization deduction attributable to the shares.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(a)(2)–1 Foreign taxes.

An estate or trust is allowed the credit against tax for taxes imposed by foreign countries and possessions of the United States to the extent allowed by section 901 only for so much of those taxes as are not properly allocable under that section to the beneficiaries. See section 901(b)(4). For purposes of section 901(b)(4), the term "beneficiaries" includes charitable beneficiaries.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(a)(3)–1 Dividends received by an estate or trust.

An estate or trust is allowed a credit against the tax for dividends received on or before December 31, 1964 (see section 34), only for so much of the dividends as are not properly allocable to any beneficiary under section 652 or 662. Section 642(a)(3), and this section do not apply to amounts received as dividends after December 31, 1964. For treatment of the credit in the hands of the beneficiary see § 1.652(b)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17808, Dec. 16, 1964]

§ 1.642(a)(3)–2 Time of receipt of dividends by beneficiary.

In general, dividends are deemed received by a beneficiary in the taxable year in which they are includible in his gross income under section 652 or 662. For example, a simple trust, reporting on the basis of a fiscal year ending October 30, receives quarterly dividends on November 3, 1954, and February 3, May 3, and August 3, 1955. These dividends are all allocable to beneficiary A, reporting on a calendar year basis, under section 652 and are deemed received by A in 1955. See section 652(c). Accordingly, A may take all these dividends into account in determining his credit for dividends received under section 34 and his dividends exclusion under section 116. However, solely for purposes of determining whether divi-

dends deemed received by individuals from trusts or estates qualify under the time limitations of section 34(a) or section 116(a), section 642(a)(3) provides that the time of receipt of the dividends by the trust or estate is also considered the time of receipt by the beneficiary. For example, a simple trust reporting on the basis of a fiscal year ending October 30 receives quarterly dividends on December 3, 1953, and March 3, June 3, and September 3, 1954. These dividends are all allocable to beneficiary A, reporting on the calendar year basis, under section 652 and are includible in his income for 1954. However, for purposes of section 34(a) or section 116(a), these dividends are deemed received by A on the same dates that the trust received them. Accordingly, A may take into account in determining the credit under section 34 only those dividends received by the trust on September 3, 1954, since the dividend received credit is not allowed under section 34 for dividends received before August 1, 1954 (or after December 31, 1964). Section 642(a)(3) and this section do not apply to amounts received by an estate or trust as dividends after December 31, 1964. However, the rules in this section relating to time of receipt of dividends by a beneficiary are applicable to dividends received by an estate or trust prior to January 1, 1965, and accordingly, such dividends are deemed to be received by the beneficiary (even though received after December 31, 1964) on the same dates that the estate or trust received them for purposes of determining the credit under section 34 or the exclusion under section 116.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17808, Dec. 16, 1964]

§ 1.642(a)(3)–3 Cross reference.

See § 1.683–2(c) for examples relating to the treatment of dividends received by an estate or trust during a fiscal year beginning in 1953 and ending in 1954.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(b)–1 Deduction for personal exemption.

In lieu of the deduction for personal exemptions provided by section 151:

(a) An estate is allowed a deduction of $600,

(b) A trust which, under its governing instrument, is required to distribute currently all of its income for the taxable year is allowed a deduction of $300, and

(c) All other trusts are allowed a deduction of $100.

A trust which, under its governing instrument, is required to distribute all of its income currently is allowed a deduction of $300, even though it also distributes amounts other than income in the taxable year and even though it may be required to make distributions which would qualify for the charitable contributions deduction under section 642(c) (and therefore does not qualify as a "simple trust" under sections 651–652). A trust for the payment of an annuity is allowed a deduction of $300 in a taxable year in which the amount of the annuity required to be paid equals or exceeds all the income of the trust for the taxable year. For the meaning of the term "income required to be distributed currently", see § 1.651(a)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(c)–0 Effective dates.

The provisions of section 642(c) (other than section 642(c)(5)) and of §§ 1.642(c)–1 through 1.642(c)–4 apply to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning after December 31, 1969. The provisions of section 642(c)(5) and of §§ 1.642(c)–5 through 1.642(c)–7 apply to transfers in trust made after July 31, 1969. For provisions relating to amounts paid, permanently set aside, or to be used for a charitable purpose in taxable years beginning before January 1, 1970, see 26 CFR 1.642(c)–1 through 1.642(c)–4 (Rev. as of Jan. 1, 1971).

[T.D. 7357, 40 FR 23739, June 2, 1975]

§ 1.642(c)–1 Unlimited deduction for amounts paid for a charitable purpose.

(a) *In general.* (1) Any part of the gross income of an estate, or trust which, pursuant to the terms of the governing instrument is paid (or treated under paragraph (b) of this section as paid) during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to such estate or trust in lieu of the limited charitable contributions deduction authorized by section 170(a). In applying this paragraph without reference to paragraph (b) of this section, a deduction shall be allowed for an amount paid during the taxable year in respect of gross income received in a previous taxable year, but only if no deduction was allowed for any previous taxable year for the amount so paid.

(2) In determining whether an amount is paid for a purpose specified in section 170(c)(2) the provisions of section 170(c)(2)(A) shall not be

taken into account. Thus, an amount paid to a corporation, trust, or community chest, fund, or foundation otherwise described in section 170(c)(2) shall be considered paid for a purpose specified in section 170(c) even though the corporation, trust, or community chest, fund, or foundation is not created or organized in the United States, any State, the District of Columbia, or any possession of the United States.

(3) See section 642(c)(6) and § 1.642(c)–4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were a private foundation (as defined in section 509(a) and the regulations thereunder) and not exempt from taxation under section 501(a).

(b) Election to treat contributions as paid in preceding taxable year—(1) In general. For purposes of determining the deduction allowed under paragraph (a) of this section, the fiduciary (as defined in section 7701(a)(6)) of an estate or trust may elect under section 642(c)(1) to treat as paid during the taxable year (whether or not such year begins before January 1, 1970) any amount of gross income received during such taxable year or any preceding taxable year which is otherwise deductible under such paragraph and which is paid after the close of such taxable year but on or before the last day of the next succeeding taxable year of the estate or trust. The preceding sentence applies only in the case of payments actually made in a taxable year which is a taxable year beginning after December 31, 1969. No election shall be made, however, in respect of any amount which was deducted for any previous taxable year or which is deducted for the taxable year in which such amount is paid.

(2) Time for making election. The election under subparagraph (1) of this paragraph shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year. Such election shall, except as provided in subparagraph (4) of this paragraph, become irrevocable after the last day prescribed for making it. Having made the election for any taxable year, the fiduciary may, within the time prescribed for making it, revoke the election without the consent of the Commissioner.

(3) Manner of making the election. The election shall be made by filing with the income tax return (or an amended return) for the taxable year in which the contribution is treated as paid a statement which—

(i) States the name and address of the fiduciary,

(ii) Identifies the estate or trust for which the fiduciary is acting,

(iii) Indicates that the fiduciary is making an election under section 642(c)(1) in respect of contributions treated as paid during such taxable year,

(iv) Gives the name and address of each organization to which any such contribution is paid, and

(v) States the amount of each contribution and date of actual payment or, if applicable, the total amount of contributions paid to each organization during the succeeding taxable year, to be treated as paid in the preceding taxable year.

(4) Revocation of certain elections with consent. An application to revoke with the consent of the Commissioner any election made on or before June 8, 1970, must be in writing and must be filed not later than September 2, 1975.

No consent will be granted to revoke an election for any taxable year for which the assessment of a deficiency is prevented by the operation of any law or rule of law. If consent to revoke the election is granted, the fiduciary must attach a copy of the consent to the return (or amended return) for each taxable year affected by the revocation. The application must be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224, and must indicate—

(i) The name and address of the fiduciary and the estate or trust for which he was acting,

(ii) The taxable year for which the election was made,

(iii) The office of the district director, or the service center, where the return (or amended return) for the year of election was filed, and

(iv) The reason for revoking the election.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23739, June 2, 1975; 40 FR 24361, June 6, 1975]

§ 1.642(c)–2 Unlimited deduction for amounts permanently set aside for a charitable purpose.

(a) Estates. Any part of the gross income of an estate which pursuant to the terms of the will—

(1) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(2) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit,

shall be allowed as a deduction to the estate in lieu of the limited charitable contributions deduction authorized by section 170(a).

(b) **Certain trusts—(1) In general.** Any part of the gross income of a trust to which either subparagraph (3) or (4) of this paragraph applies, that by the terms of the governing instrument—

(i) Is permanently set aside during the taxable year for a purpose specified in section 170(c), or

(ii) Is to be used (within or without the United States or any of its possessions) exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit,

shall be allowed, subject to the limitation provided in subparagraph (2) of this paragraph, as a deduction to the trust in lieu of the limited charitable contributions deduction authorized by section 170(a). The preceding sentence applied only to a trust which is required by the terms of its governing instrument to set amounts aside. See section 642(c)(6) and § 1.642(c)-4 for disallowance of a deduction under this section to a trust which is, or is treated under section 4947(a)(1) as though it were, a private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a).

(2) **Limitation of deduction.** Subparagraph (1) of this paragraph applies only to the gross income earned by a trust with respect to amounts transferred to the trust under a will executed on or before October 9, 1969, and satisfying the requirements of subparagraph (4) of this paragraph or transferred to the trust on or before October 9, 1969. For such purposes, any income, gains, or losses, which are derived at any time from the amounts so transferred to the trust shall also be taken into account in applying subparagraph (1) of this paragraph. If any such amount so transferred to the trust is invested or reinvested at any time, any asset received by the trust upon such investment or reinvestment shall also be treated as an amount which was so transferred to the trust. In the case of a trust to which this paragraph applies which contains (i) amounts transferred pursuant to transfers described in the first sentence of this subparagraph and (ii) amounts transferred pursuant to transfers not so described, subparagraph (1) of this paragraph shall apply only if the amounts described in subdivision (i) of this subparagraph, together with all income, gains, and losses derived therefrom, are separately accounted for from the amounts described in subdivision (ii) of this subparagraph, together with all income, gains, and losses derived therefrom. Such separate accounting shall be carried out consistently with the principles of paragraph (c)(4) of § 53.4947-1 of this chapter (Foundation Excise Tax Regulations), relating to accounting for segregated amounts of split-interest trusts.

(3) **Trusts created on or before October 9, 1969.** A trust to which this subparagraph applies is a trust, testamentary or otherwise, which was created on or before October 9, 1969, and which qualifies under either subdivision (i) or (ii) of this subparagraph.

(i) **Transfer of irrevocable remainder interest to charity.** To qualify under this subdivision the trust must have been created under the terms of an instrument granting an irrevocable remainder interest in such trust to or for the use of an organization described in section 170(c). If the instrument granted a revocable remainder interest but the power to revoke such interest terminated on or before October 9, 1969, without the remainder interest having been revoked, the remainder interest will be treated as irrevocable for purposes of the preceding sentence.

(ii) **Grantor under a mental disability to change terms of trust.** (A) To qualify under this subdivision (ii) the trust must have been created by a grantor who was at all times after October 9, 1969, under a mental disability to change the terms of the trust. The term "mental disability" for this purpose means mental incompetence to change the terms of the trust, whether or not there has been an adjudication of mental incompetence and whether or not there has been an appointment of a committee, guardian, fiduciary, or other person charged with the care of the person or property of the grantor.

(B) If the grantor has not been adjudged mentally incompetent, the trustee must obtain from a qualified physician a certificate stating that the grantor of the trust has been mentally incompetent at all times after October 9, 1969, and that there is no reasonable probability that the grantor's mental capacity will ever improve to the extent that he will be mentally competent to change the terms of

the trust. A copy of this certification must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such medical opinion must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. The original certificate must be retained by the trustee of the trust.

(C) If the grantor has been adjudged mentally incompetent, a copy of the judgment or decree, and any modification thereof, must be filed with the first return on which a deduction is claimed by reason of this subdivision (ii) and subparagraph (1) of this paragraph. Thereafter, a statement referring to such judgment or decree must be attached to any return for a taxable year for which such a deduction is claimed and during which the grantor's mental incompetence continues. A copy of such judgment or decree must also be retained by the trustee of the trust.

(D) This subdivision (ii) applies even though a person charged with the care of the person or property of the grantor has the power to change the terms of the trust.

(4) Testamentary trust established by will executed on or before October 9, 1969. A trust to which this subparagraph applies is a trust which was established by will executed on or before October 9, 1969, and which qualifies under either subdivision (i), (ii), or (iii) of this subparagraph. This subparagraph does not apply, however, to that portion of any trust, not established by a will executed on or before October 9, 1969, which was transferred to such trust by a will executed on or before October 9, 1969. Nor does it apply to that portion of any trust, not established by a will executed on or before October 9, 1969, which was subject to a testamentary power of appointment that fails by reason of the testator's nonexercise of the power in a will executed on or before October 9, 1969.

(i) Testator dying within 3 years without republishing his will. To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, but before October 9, 1972, without having amended any dispositive provision of the will after October 9, 1969, by codicil or otherwise.

(ii) Testator having no right to change his will. To qualify under this subdivision the trust must have been established by the will of a testator who died after October 9, 1969, and who at no time after that date had the right to change any portion of such will pertaining to such trust. This subdivision could apply, for example, where a contract has been entered into for the execution of wills containing reciprocal provisions as well as provisions for the benefit of an organization described in section 170(c) and under applicable local law the surviving testator is prohibited from revoking his will because he has accepted the benefit of the provisions of the will of the other contracting party.

(iii) Testator under a mental disability to republish his will. To qualify under this subdivision the trust must have been established by the will of a testator who died after October 8, 1972, without having amended any dispositive provision of such will after October 9, 1969, and before October 9, 1972, by codicil or otherwise, and who is under a mental disability at all times after October 8, 1972, to amend such will, by codicil or otherwise. The provisions of subparagraph (3)(ii) of this paragraph with respect to mental incompetence apply for purposes of this subdivision.

(iv) Amendment of dispositive provisions. The provisions of paragraph (e)(4) and (5) of § 20.2055–2 of this chapter (Estate Tax Regulations) are to be applied under subdivisions (i) and (iii) of this subparagraph in determining whether there has been an amendment of a dispositive provision of a will.

(c) Pooled income funds. Any part of the gross income of a pooled income fund to which § 1.642(c)–5 applies for the taxable year that is attributable to net long-term capital gain (as defined in section 1222(7)) which, pursuant to the terms of the governing instrument, is permanently set aside during the taxable year for a purpose specified in section 170(c) shall be allowed as a deduction to the fund in lieu of the limited charitable contributions deduction authorized by section 170(a). No deduction shall be allowed under this paragraph for any portion of the gross income of such fund which is (1) attributable to income other than net long-term capital gain (2) earned with respect to amounts transferred to such fund before August 1, 1969. However, see paragraph (b) of this section for a deduction (subject to the limitations of such paragraph) for amounts permanently set aside by a pooled income fund which meets the requirements of that paragraph. The principles of paragraph (b) or (2) of this section with respect to investment, reinvestment, and separate accounting shall apply under this paragraph in the case of

amounts transferred to the fund after July 31, 1969.

(d) Disallowance of deduction for certain amounts not deemed to be permanently set aside for charitable purposes. No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible. Thus, for example, where there is possibility of the invasion of the corpus of a charitable remainder trust, as defined in § 1.664–1(a)(1)(ii), in order to make payment of the annuity amount or unitrust amount, no deduction will be allowed under paragraph (a) of this section in respect of any amount set aside by an estate for distribution to such a charitable remainder trust.

For treatment of distributions by an estate to a charitable remainder trust, see paragraph (a)(5)(iii) of § 1.664–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23740, June 2, 1975; 40 FR 24361, June 6, 1975]

§ 1.642(c)–3 Adjustments and other special rules for determining unlimited charitable contributions deduction.

(a) Income in respect of a decedent. For purposes of §§ 1.642(c)–1 and 1.642(c)–2, an amount received by an estate or trust which is includible in its gross income under section 691(a)(1) as income in respect of a decedent shall be included in the gross income of the estate or trust.

(b) Reduction of charitable contributions deduction by amounts not included in gross income. (1) If an estate, pooled income fund, or other trust pays, permanently sets aside, or uses any amount of its income for a purpose specified in section 642(c)(1), (2) or (3) and that amount includes any items of estate or trust income not entering into the gross income of the estate or trust, the deduction allowable under § 1.642(c)–1 or § 1.642(c)–2 is limited to the gross income so paid, permanently set aside, or used. In the case of a pooled income fund for which a deduction is allowable under paragraph (c) of § 1.642(c)–2 for amounts permanently set aside, only the gross income of the fund which is attributable to net long-term capital gain (as defined in section 1222(7)) shall be taken into account.

(2) In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust not included in gross income, the specific provision controls if the governing instrument specifically provides as to the source out of which amounts are to be paid, permanently set aside, or used for such a purpose.

In the absence of specific provisions in the governing instrument, an amount to which section 642(c)(1), (2) or (3) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See paragraph (b) of § 1.643(a)–5 for the method of determining the allocable portion of exempt income and foreign income.

(3) For examples showing the determination of the character of an amount deductible under § 1.642(c)–1 or § 1.642(c)–2, see examples (1) and (2) in § 1.662(b)–2 and paragraph (e) of the example in § 1.662(c)–4.

(4) For the purpose of this paragraph, the provisions of section 116 are not to be taken into account.

(c) Capital gains included in charitable contribution. Where any amount of the income paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3), is attributable to net long-term capital gain (as defined in section 1222(7)), the amount of the deduction otherwise allowable under § 1.642(c)–1 or § 1.642(c)–2, must be adjusted for any deduction provided in section 1202 of 50 percent of the excess, if any, of the net long-term capital gain over the net short-term capital loss. For determination of the extent to which the contribution to which § 1.642(c)–1 or § 1.642(c)–2 applies is deemed to consist of net long-term capital gains, see paragraph (b) of this section. The application of this paragraph may be illustrated by the following examples:

Example (1). Under the terms of the trust instrument, the income of a trust described in § 1.642(c)–2(b)(3)(i) is currently distributable to A during his life and capital gains are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of A. Upon A's death the corpus of the trust is to be distributed to M University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During the taxable year ending December 31, 1970, the trust has long-term capital gains of $100,000 from property transferred to it on or before October 9, 1969, which are permanently set aside for charitable purposes. The trust includes $100,000 in gross income but is allowed a deduction of $50,000 under section 1202 for the long-term capital gains and a charitable contributions deduction of $50,000 under section 642(c)(2) ($100,000 permanently

set aside for charitable purposes less $50,000 allowed as a deduction under section 1202 with respect to such $100,000).

Example (2). Under the terms of the will, $200,000 of the income (including $100,000 capital gains) for the taxable year 1972 of an estate is distributed, one-quarter to each of two individual beneficiaries and one-half to N University, an organization described in section 501(c)(3) which is exempt from taxation under section 501(a). During 1972 the estate has ordinary income of $200,000, long-term capital gains of $100,000, and no capital losses. It is assumed that for 1972 the estate has no other items of income or any deductions other than those discussed herein. The entire capital gains of $100,000 are included in the gross income of the estate for 1972, and N University receives $100,000 from the estate in such year. However, the amount allowable to the estate under section 642(c)(1) is subject to appropriate adjustment for the deduction allowable under section 1202. In view of the distributions of $25,000 of capital gains to each of the individual beneficiaries, the deduction allowable to the estate under section 1202 is limited by such section to $25,000 [($100,000 capital gains less $50,000 capital gains includible in income of individual beneficiaries under section 662) × 50%]. Since the whole of this $25,000 deduction under section 1202 is attributable to the distribution of $50,000 of capital gains to N University, the deduction allowable to the estate in 1972 under section 642(c)(1) is $75,000 [$100,000 (distributed to N) less $25,000 (proper adjustment for section 1202 deduction)].

Example (3). Under the terms of the trust instrument, 30 percent of the gross income (exclusive of capital gains) of a trust described in § 1.642(c)–2(b)(3)(i) is currently distributed to B, the sole income beneficiary. Net capital gains (capital gain net income for taxable years beginning after December 31, 1976) and undistributed ordinary income are allocable to corpus. No provision is made in the trust instrument for the invasion of corpus for the benefit of B. Upon B's death the remainder of the trust is to be distributed to M Church. During the taxable year 1972, the trust has ordinary income of $100,000, long-term capital gains of $15,000, short-term capital gains of $1,000, long-term capital losses of $5,000, and short-term capital losses of $2,500. It is assumed that the trust has no other items of income or any deductions other than those discussed herein. All the ordinary income and capital gains and losses are attributable to amounts transferred to the trust before October 9, 1969. The trust includes in gross income for 1972 the total amount of $116,000 [$100,000 (ordinary income) + $16,000 (total capital gains determined without regard to capital losses)]. Pursuant to the terms of the governing instrument the trust distributes to B in 1972 the amount of $30,000 ($100,000 × 30%). The balance of $78,500 [($116,000 less $7,500 capital losses)–030,000 distribution] is available for the set-aside for charitable purposes. In determining taxable income for 1972 the capital losses of $7,500 ($5,000 + $2,500) are allowable in full under section 1211(b)(1). The net capital gain (capital gain net income for taxable years beginning after December 31, 1976) of $8,500 ($16,000 less $7,500) is the excess of the net long-term capital gain of $10,000 ($15,000 less $5,000) over the net short-term capital loss of $1,500 ($2,500 less $1,000). The deduction under section 1202 is $4,250 ($8,500 × 50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, for 1972 the deduction allowable to the trust under section 642(c)(2) is $74,250 [$78,500 (set-aside for M) less $4,250 (proper adjustment for section 1202 deduction)].

Example (4). During the taxable year a pooled income fund, as defined in § 1.642(c)–5, has in addition to ordinary income long-term capital gains of $150,000, short-term capital gains of $15,000, long-term capital losses of $100,000, and short-term capital losses of $10,000. Under the Declaration of Trust and pursuant to State law net long-term capital gain is allocable to corpus and net short-term capital gain is to be distributed to the income beneficiaries of the fund. All the capital gains and losses are attributable to amounts transferred to the fund after July 31, 1969. In view of the distribution of the net short-term capital gain of $5,000 ($15,000 less $10,000) to the income beneficiaries, the deduction allowed to the fund under section 1202 is limited by such section to $25,000 [($150,000 (long-term capital gains) less $100,000 (long-term capital losses)) × 50%]. Since the whole of this deduction under section 1202 is attributable to the set-aside for charitable purposes, the deduction of $50,000 ($150,000 less $100,000) otherwise allowable under section 642(c)(3) is subject to appropriate adjustment under section 642(c)(4) for the deduction allowable under section 1202. Accordingly, the amount of the set-aside deduction is $25,000 [$50,000 (set-aside for public charity) less $25,000 (proper adjustment for section 1202 deduction)].

Example (5). The facts are the same as in example (4) except that under the Declaration of Trust and pursuant to State law all the net capital gain (capital gain net income for taxable years beginning after December 31, 1976) for the taxable year is allocable to corpus of the fund. The fund would thus include in gross income total capital gains of $165,000 ($150,000 + $15,000). In determining taxable income for the taxable year the capital losses of $110,000 ($100,000 + $10,000) are allowable in full under section 1211(b)(1). The net capital gain of $55,000 ($165,000 less $110,000) is available for the set-aside for charitable purposes under section 642(c)(3) only in the amount of the net long-term capital gain of $50,000 ($150,000 long-term gains less $100,000 long-term losses). The deduction under section 1202 is $25,000 ($50,000 × 50%), all of which is attributable to the set-aside for charitable purposes. Accordingly, the deduction allowable to the fund under section 642(c)(3) is $25,000 [$50,000 (set-aside for public charity) less $25,000 (proper adjustment for section 1202 deduction)]. The $5,000 balance of net capital gain (capital gain net income for taxable years beginning after December 31, 1976) is taken into account in determining taxable income of the pooled income fund for the taxable year.

(d) Disallowance of deduction for amounts allocable to unrelated business income. In the case of a trust, the deduction otherwise allowable under § 1.642(c)–1 or § 1.642(c)–2 is disallowed to the extent of amounts allocable to the trust's unrelated business income. See section 681(a) and the regulations thereunder.

(e) Disallowance of deduction in certain cases. For disallowance of certain deductions otherwise allowable under section 642(c)(1), (2), or (3), see sections 508(d) and 4948(c)(4).

(f) Information returns. For rules applicable to the annual information return that must be filed by trusts claiming a deduction under section 642(c) for the taxable year, see section 6034 and the regulations thereunder.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23741, June 2, 1975; 40 FR 24361, June 6, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.642(c)–4 Nonexempt private foundations.

In the case of a trust which is, or is treated under section 4947(a)(1) as though it were, a

private foundation (as defined in section 509(a) and the regulations thereunder) that is not exempt from taxation under section 501(a) for the taxable year, a deduction for amounts paid or permanently set aside, or used for a purpose specified in section 642(c)(1), or (2) shall not be allowed under § 1.642(c)–1 or § 1.642(c)–2, but such trust shall, subject to the provisions applicable to individuals, be allowed a deduction under section 170 for charitable contributions paid during the taxable year. Section 642(c)(6) and this section do not apply to a trust described in section 4947(a)(1) unless such trust fails to meet the requirements of section 508(e). However, if on October 9, 1969, or at any time thereafter, a trust is recognized as being exempt from taxation under section 501(a) as an organization described in section 501(c)(3), if at such time such trust is a private foundation, and if at any time thereafter such trust is determined not to be exempt from taxation under section 501(a) as an organization described in section 501(c)(3), section 642(c)(6) and this section will apply to such trust. See § 1.509(b)–1(b).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23742, June 2, 1975; 40 FR 24362, June 6, 1975]

§ 1.642(c)–5 Definition of pooled income fund.

(a) In general—(1) Application of provisions. Section 642(c)(5) prescribes certain rules for the valuation of contributions involving transfers to certain funds described in that section as pooled income funds. This section sets forth the requirements for qualifying as a pooled income fund and provides for the manner of allocating the income of the fund to the beneficiaries. Section 1.642(c)–6 provides for the valuation of a remainder interest in property transferred to a pooled income fund. § 1.642(c)–7 provides transitional rules under which certain funds may be amended so as to qualify as pooled income funds in respect to transfers of property occurring after July 31, 1969.

(2) Tax status of fund and its beneficiaries. Notwithstanding any other provision of this chapter, a fund which meets the requirements of a pooled income fund, as defined in section 642(c)(5) and paragraph (b) of this section, shall not be treated as an association within the meaning of section 7701(a)(3). Such a fund, which need not be a trust under local law, and its beneficiaries shall be taxable under Part I, Subchapter J, Chapter 1 of the Code, but the provisions of Subpart E (relating to grantors and others treated as substantial owners) of such part shall not apply to such fund.

(3) Recognition of gain or loss on transfer to fund. No gain or loss shall be recognized to the donor on the transfer of property to a pooled income fund. In such case, the fund's basis and holding period with respect to property transferred to the fund by a donor shall be determined as provided in sections 1015(b) and 1223(2). If, however, a donor transfers property to a pooled income fund and, in addition to creating or retaining a life income interest therein, receives property from the fund, or transfers property to the fund which is subject to an indebtedness, this subparagraph shall not apply to the gain realized by reason of (i) the receipt of such property or (ii) the amount of such indebtedness, whether or not assumed by the pooled income fund, which is required to be treated as an amount realized on the transfer. For applicability of the bargain sale rules, see section 1011(b) and the regulations thereunder.

(4) Charitable contributions deduction. A charitable contributions deduction for the value of the remainder interest, as determined under § 1.642(c)–6, may be allowed under section 170, 2055, 2106, or 2522, where there is a transfer of property to a pooled income fund. For a special rule relating to the reduction of the amount of a charitable contribution of certain ordinary income property or capital gain property, see section 170(e)(1)(A) or (B)(i) and the regulations thereunder.

(5) Definitions. For purposes of this section, §§ 1.642(c)–6, and § 1.642(c)–7—

(i) The term "income" has the same meaning as it does under section 643(b) and the regulations thereunder.

(ii) The term "donor" includes a decedent who makes a testamentary transfer of property to a pooled income fund.

(iii) The term "governing instrument" means either the governing plan under which the pooled income fund is established and administered or the instrument of transfer, as the context requires.

(iv) The term "public charity" means an organization described in clause (i) to (vi) of section 170(b)(1)(A). If an organization is described in clause (i) to (vi) of section 170(b)(1)(A) and is also described in clause (viii) of such section, it shall be treated as a public charity.

(v) The term "fair market value", when used with respect to property, means its value in excess of the indebtedness or charges against such property.

(vi) The term "determination date" means each day within the taxable year of a pooled income fund on which a valuation is made of the property in the fund. The property in the fund shall be valued on the first day of the taxable year of the fund and on at least 3 other days within the taxable year. The period between any two consecutive determination dates within the taxable year shall not be greater than 3 calendar months. In the case of a taxable year of less than 12 months, the property in the fund shall be valued on the first day of such taxable year and on such other days within such year as occur at successive intervals of no greater than 3 calendar months. Where a valuation date falls on a Saturday, Sunday, or legal holiday (as defined in section 7503 and the regulations thereunder), the valuation may be made on either the next preceding day which is not a Saturday, Sunday, or legal holiday or the next succeeding day which is not a Saturday, Sunday, or legal holiday, so long as the next such preceding day or next such succeeding day is consistently used where the valuation date falls on a Saturday, Sunday, or legal holiday.

(6) Cross references. (i) See section 4947(a)(2) and section 4947(b)(3)(B) for the application to pooled income funds of the provisions relating to private foundations and section 508(e) for rules relating to provisions required in the governing instrument prohibiting certain activities specified in section 4947(a)(2).

(ii) For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

(b) Requirements for qualification as a pooled income fund. A pooled income fund to which this section applies must satisfy all of the following requirements:

(1) Contribution of remainder interest to charity. Each donor must transfer property to the fund and contribute an irrevocable remainder interest in such property to or for the use of a public charity, retaining for himself, or creating for another beneficiary or beneficiaries, a life income interest in the transferred property. A contingent remainder interest shall not be treated as an irrevocable remainder interest for purposes of this subparagraph.

(2) Creation of life income interest. Each donor must retain for himself for life an income interest in the property transferred to such fund, or create an income interest in such property for the life of one or more beneficiaries, each of whom must be living at the time of the transfer of the property to the fund by the donor. The term "one or more beneficiaries" includes those members of a named class who are alive and can be ascertained at the time of the transfer of the property to the fund. In the event more than one beneficiary of the income interest is designated, such beneficiaries may enjoy their shares of income concurrently, consecutively, or both concurrently and consecutively. The donor may retain the power exercisable only by will to revoke or terminate the income interest of any designated beneficiary other than the public charity. The governing instrument must specify at the time of the transfer the particular beneficiary or beneficiaries to whom the income is payable and the share of income distributable to each person so specified. The public charity to or for the use of which the remainder interest is contributed may also be designated as one of the beneficiaries of an income interest. The donor need not retain or create a life interest in all the income from the property transferred to the fund provided any income not payable under the terms of the governing instrument to an income beneficiary is contributed to, and within the taxable year in which it is received is paid to, the same public charity to or for the use of which the remainder interest is contributed. No charitable contributions deduction shall be allowed to the donor for the value of such income interest of the public charity or for the amount of any such income paid to such organization.

(3) Commingling of property required. The property transferred to the fund by each donor must be commingled with, and invested or reinvested with, other property transferred to the fund by other donors satisfying the requirements of subparagraphs (1) and (2) of this paragraph. The governing instrument of the pooled income fund must contain a provision requiring compliance with the preceding sentence. The public charity to or for the use of which the remainder interest is contributed may maintain more than one pooled income fund, provided that each such fund is maintained by the organization and is not a device to permit a group of donors to create a fund which may be subject to their manipulation. The fund must not include property transferred under arrangements other than those specified in section 642(c)(5) and this paragraph. However, a fund shall not be disqualified as a pooled income fund

under this paragraph because any portion of its properties is invested or reinvested jointly with other properties, not a part of the pooled income fund, which are held by, or for the use of, the public charity which maintains the fund, as for example, with securities in the general endowment fund of the public charity to or for the use of which the remainder interest is contributed. Where such joint investment or reinvestment of properties occurs, records must be maintained which sufficiently identify the portion of the total fund which is owned by the pooled income fund and the income earned by, and attributable to, such portion. Such a joint investment or reinvestment of properties shall not be treated as an association or partnership for purposes of the Code. A bank which serves as trustee of more than one pooled income fund may maintain a common trust fund to which section 584 applies for the collective investment and reinvestment of moneys of such funds.

(4) **Prohibition against exempt securities.** The property transferred to the fund by any donor must not include any securities, the income from which is exempt from tax under subtitle A of the Code, and the fund must not invest in such securities. The governing instrument of the fund must contain specific prohibitions against accepting or investing in such securities.

(5) **Maintenance by charitable organization required.** The fund must be maintained by the same public charity to or for the use of which the irrevocable remainder interest is contributed. The requirement of maintenance will be satisfied where the public charity exercises control directly or indirectly over the fund. For example, this requirement of control shall ordinarily be met when the public charity has the power to remove the trustee or trustees of the fund and designate a new trustee or trustees. A national organization which carries out its purposes through local organizations, chapters, or auxiliary bodies with which it has an identity of aims and purposes may maintain a pooled income fund (otherwise satisfying the requirements of this paragraph) in which one or more local organizations, chapters, or auxiliary bodies which are public charities have been named as recipients of the remainder interests. For example, a national church body may maintain a pooled income fund where donors have transferred property to such fund and contributed an irrevocable remainder interest therein to or for the use of various local churches or educational institutions of such body. The fact that such local organizations or chapters have been separately incorporated from the national organization is immaterial.

(6) **Prohibition against donor or beneficiary serving as trustee.** The fund must not have, and the governing instrument must prohibit the fund from having, as a trustee a donor to the fund or a beneficiary (other than the public charity to or for the use of which the remainder interest is contributed) of an income interest in any property transferred to such fund. Thus, if a donor or beneficiary (other than such public charity) directly or indirectly has general responsibilities with respect to the fund which are ordinarily exercised by a trustee, such fund does not meet the requirements of section 642(c)(5) and this paragraph. The fact that a donor of property to the fund, or a beneficiary of the fund, is a trustee, officer, director, or other official of the public charity to or for the use of which the remainder interest is contributed ordinarily will not prevent the fund from meeting the requirements of section 642(c)(5) and this paragraph.

(7) **Income of beneficiary to be based on rate of return of fund.** Each beneficiary entitled to income of any taxable year of the fund must receive such income in an amount determined by the rate of return earned by the fund for such taxable year with respect to his income interest, computed as provided in paragraph (c) of this section. The governing instrument of the fund shall direct the trustee to distribute income currently or within the first 65 days following the close of the taxable year in which the income is earned. Any such payment made after the close of the taxable year shall be treated as paid on the last day of the taxable year. A statement shall be attached to the return of the pooled income fund indicating the date and amount of such payments after the close of the taxable year. Subject to the provisions of Part I, Subchapter J, Chapter 1 of the Code, the beneficiary shall include in his gross income all amounts properly paid, credited, or required to be distributed to the beneficiary during the taxable year or years of the fund ending within or with his taxable year. The governing instrument shall provide that the income interest of any designated beneficiary shall either terminate with the last regular payment which was made before the death of the beneficiary or be prorated to the date of his death.

(8) **Termination of life income interest.** Upon the termination of the income interest retained or created by any donor, the trustee shall sever from the fund an amount equal to the value of the remainder interest in the property upon which the income interest is based. The value of the remain-

der interest for such purpose may be either (i) its value as of the determination date next succeeding the termination of the income interest or (ii) its value as of the date on which the last regular payment was made before the death of the beneficiary if the income interest is terminated on such payment date. The amount so severed from the fund must either be paid to, or retained for the use of, the designated public charity, as provided in the governing instrument. However, see subparagraph (3) of this paragraph for rules relating to commingling of property.

(c) Allocation of income to beneficiary—(1) In general. Every income interest retained or created in property transferred to a pooled income fund shall be assigned a proportionate share of the annual income earned by the fund, such share, or unit of participation, being based on the fair market value of such property on the date of transfer, as provided in this paragraph.

(2) Units of participation—(i) Unit plan. (a) On each transfer of property by a donor to a pooled income fund, one or more units of participation in the fund shall be assigned to the beneficiary or beneficiaries of the income interest retained or created in such property, the number of units of participation being equal to the number obtained by dividing the fair market value of the property by the fair market value of a unit in the fund at the time of the transfer.

(b) The fair market value of a unit in the fund at the time of the transfer shall be determined by dividing the fair market value of all property in the fund at such time by the number of units then in the fund. The initial fair market value of a unit in a pooled income fund shall be the fair market value of the property transferred to the fund divided by the number of units assigned to the income interest in that property. The value of each unit of participation will fluctuate with each new transfer of property to the fund in relation to the appreciation or depreciation in the fair market value of the property in the fund, but all units in the fund will always have equal value.

(c) The share of income allocated to each unit of participation shall be determined by dividing the income of the fund for the taxable year by the outstanding number of units in the fund at the end of such year, except that, consistently with paragraph (b)(7) of this section, income shall be allocated to units outstanding during only part of such year by taking into consideration the period of time such units are outstanding. For this purpose the actual income of such part of the taxable year, or a prorated portion of the annual income, may be used, after making such adjustments as are reasonably necessary to reflect fluctuations during the year in the fair market value of the property in the fund.

(ii) Other plans. The governing instrument of the fund may provide any other reasonable method not described in subdivision (i) of this subparagraph for assigning units of participation in the fund and allocating income to such units which reaches a result reasonably consistent with the provisions of such subdivision.

(iii) Transfers between determination dates. For purposes of subdivisions (i) and (ii) of this subparagraph, if a transfer of property to the fund by a donor occurs on other than a determination date, the number of units of participation assigned to the income interest in such property may be determined by using the fair market value of the property in the fund on the determination date immediately preceding the date of transfer (determined without regard to the property so transferred), subject, however, to appropriate adjustments on the next succeeding determination date. Such adjustments may be made by any reasonable method, including the use of a method whereby the fair market value of the property in the fund at the time of the transfer is deemed to be the average of the fair market values of the property in the fund on the determination dates immediately preceding and succeeding the date of transfer. For purposes of determining such average any property transferred to the fund between such preceding and succeeding dates, or on such succeeding date, shall be excluded. The application of this subdivision may be illustrated by the following example:

Example. The determination dates of a pooled income fund are the first day of each calendar month. On April 1, 1971, the fair market value of the property in the fund is $100,000, at which time 1,000 units of participation are outstanding with a value of $100 each. On April 15, 1971, B transfers property with a fair market value of $50,000 to the fund, retaining for himself for life an income interest in such property. No other property is transferred to the fund after April 1, 1971. On May 1, 1971, the fair market value of the property in the fund, including the property transferred by B, is $160,000. The average of the fair market values of the property in the fund (excluding the property transferred by B) on April 1 and May 1, 1971, is $105,000 ($100,000+ [$160,000–$50,000]÷2). Accordingly, the fair market value of a unit of participation in the fund on April 15, 1971, at the time of B's transfer may be deemed to be $105 ($105,000/1,000 units), and B is assigned 476.19 units of participation in the fund ($50,000/$105).

(3) Special rule for partial allocation of income to charity. Notwithstanding subparagraph (2) of this paragraph, the governing instrument may provide that a unit of participation is entitled to share in the income of the fund in a lesser amount than

would otherwise be determined under such subparagraph, provided that the income otherwise allocable to the unit under such subparagraph is paid within the taxable year in which it is received to the public charity to or for the use of which the remainder interest is contributed under the governing instrument.

(4) **Illustrations.** The application of this paragraph may be illustrated by the following examples:

Example (1). On July 1, 1970, A and B transfer separate properties with a fair market value of $20,000 and $10,000, respectively, to a newly created pooled income fund which is maintained by Y University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves for life an income interest in such property, the remainder interest being contributed to Y University. The pooled income fund assigns an initial value of $100 to each unit of participation in the fund, and under the governing instruments A receives 200 units, and B receives 100 units, in the fund. On October 1, 1970, which is a determination date, C transfers property to the fund with a fair market value of $12,000, retaining in himself for life an income interest in such property and contributing the remainder interest to Y University. The fair market value of the property in the fund at the time of C's transfer is $36,000. The fair market value of A's and B's units at the time of such transfer is $120 each ($36,000/300). By reason of his transfer of property C is assigned 100 units of participation in the fund ($12,000/$120).

Example (2). Assume that the pooled income fund in example (1) earns $2,600 for its taxable year ending June 30, 1971, and there are no further contributions of property to the fund in such year. Further assume $300 is earned in the first quarter ending September 30, 1970. Therefore, the fund earns $1 per unit for the first quarter ($300 divided by 300 units outstanding) and $5.75 per unit for the remainder of the taxable year ([$2,600–$300] divided by 400 units outstanding). If the fund distributes its income for the year based on its actual earnings per quarter, the income must be distributed as follows:

Beneficiary	*Share of income*
A	$1,350 ([200 × $1] + [200 × $5.75]).
B	$675 ([100 × $1] + [100 × $5.75]).
C	$575 (100 × $5.75).

Example (3). (a) On July 1, 1970, A and B transfer separate properties with a fair market value of $10,000 and $20,000, respectively, to a newly created pooled income fund which is maintained by X University and uses as its taxable year the fiscal year ending June 30. A and B each retain in themselves an income interest for life in such property, the remainder interest being contributed to X University. The governing instrument provides that each unit of participation in the fund shall have a value of not more than its initial fair market value; the instrument also provides that the income allocable to appreciation in the fair market value of such unit (to the extent in excess of its initial fair market value) at the end of each quarter of the fiscal year is to be distributed currently to X University. On October 1, 1970, which is a determination date, C contributes to the fund property with a fair market value of $60,000 and retains in himself an income interest for life in such property, the remainder interest being contributed to X University. The initial fair market value of the units assigned to A, B, and C is $100. A, B, and C's units of participation are as follows:

Beneficiary	*Units of participation*
A	100 ($10,000 divided by $100).
B	200 ($20,000 divided by $100).
C	100 ($10,000 divided by $100).

(b) The fair market value of the property in the fund at the time of C's contribution is $40,000. Assuming the fair market value of the property in the fund is $100,000 on December 31, 1970, and that the income of the fund for the second quarter ending December 31, 1970, is $2,000, the income is shared by the income beneficiaries and X University as follows:

Beneficiary	*Allocation of income*
A, B, and C	90% ($90,000 divided by $100,000).
X University	10% ($10,000 divided by $100,000).

(c) For the quarter ending December 31, 1970, each unit of participation is allocated $2 (90 percent × $2,000 divided by 900) of the income earned for that quarter. A, B, C, and X University share in the income as follows:

Beneficiary	*Share of income*
A	$200 (100 × $2).
B	$400 (200 × $2).
C	$1,200 (600 × $2).
X University	$200 (10% × $2,000).

[T.D. 7105, 36 FR 6477, April 6, 1971; 36 FR 7004, April 13, 1971, as amended by T.D. 7125, 36 FR 11032, June 8, 1971; T.D. 7357, 40 FR 23742, June 2, 1975; T.D. 7633, 44 FR 57925, Oct. 9, 1979]

§ 1.642(c)–6 Valuation of a remainder interest in property transferred to a pooled income fund.

(a) **In general.** (1) For purposes of sections 170, 2055, 2106, and 2522 the fair market value of a remainder interest in property transferred after July 31, 1969, to a pooled income fund to which § 1.642(c)–5 applies is its present value determined under this section. The present value of the remainder interest at the time of the transfer of property to the fund shall be determined by computing the present value at such time of the life income interest in the transferred property (as determined under paragraph (b) of this section) and subtracting such value from the fair market value of the transferred property on the appropriate valuation date. The fact that the income beneficiary of the income interest in such property may not receive the last income payment, as provided in paragraph (b)(7) of § 1.642(c)–5, shall not be taken into account for purposes of determining the present value of the life income interest. For purposes of this section, the term "appropriate valuation date" means the date on which property is transferred to the fund by the donor except that, for purposes of section 2055 or 2106, it means the alternate valuation date if it is elected

in accordance with section 2032 and the regulations thereunder.

(2) The method for determining the present value of a remainder interest in property transferred to a pooled income fund where such value is dependent on the termination of one life is set forth in paragraph (d) of this section. If the computation of the value of the remainder interest requires the use of a factor which is not provided in paragraph (d) of this section, the Commissioner may, if conditions permit, supply the factor upon request. The request must be accompanied by a statement of the pooled income fund's yearly rate of return and of the date of birth and sex of each individual the duration of whose life may affect the value of the remainder interest and by copies of the relevant instruments. If the Commissioner furnishes the factor, a copy of the letter supplying the factor shall be attached to the tax return in which the deduction is claimed. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in this section. A copy of the publication containing many such special factors, may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, D.C. 20402. Any claim for deduction in any return for the value of a remainder interest in property transferred to a pooled income fund must be supported by a statement attached to the return showing the computation of the present value of such interest.

(b) Present value of life income interest. The present value of the life income interest in property transferred to a pooled income fund shall be computed on the basis of—

(1) Life contingencies determined, from the values of l_x that are set forth in Table LN of paragraph (f) of § 20.2031–7 or § 20.2031–10, whichever is appropriate, of this chapter (Estate Tax Regulations), and

(2) Discount at a rate of interest, compounded annually, equal to the highest yearly rate of return of the pooled income fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. For purposes of this subparagraph, the first taxable year of a pooled income fund shall be considered a taxable year even though such taxable year consists of less than 12 months. However, appropriate adjustments shall be made to annualize the rate of return earned by the fund for such period. Where it appears from the facts and circumstances that the highest yearly rate of return for the 3 taxable years immediately preceding the taxable year in which the transfer of property is made has been purposely arranged to be substantially incommensurate with the reasonably anticipated earnings of the fund with the objective of obtaining an excessive charitable contributions deduction, such rate of return shall not be used. In such a case the highest yearly rate of return of the fund shall be determined by treating the fund as a pooled income fund which has been in existence for less than 3 preceding taxable years. If a pooled income fund has been in existence less than 3 taxable years immediately preceding the taxable year in which the transfer of property to the fund is made, the highest yearly rate of return shall be deemed to be 9 percent (6 percent for transfers of property to pooled income funds made before December 1, 1983). For purposes of this subparagraph the yearly rate of return of a pooled income fund shall be determined as provided in paragraph (c) of this section unless the highest yearly rate of return is deemed to be 9 percent (6 percent for transfers of property to pooled income funds made before December 1, 1983).

(c) Computation of pooled income fund's yearly rate of return. **(1)** For purposes of paragraph (b) of this section, the yearly rate of return earned by a pooled income fund for a taxable year shall be that percentage obtained by dividing the amount of income earned by the pooled income fund for such taxable year by an amount equal to (i) the average fair market value for such taxable year of the property in such fund less (ii) the corrective term adjustment.

(2) The average fair market value of the property in a pooled income fund for a taxable year shall be the sum of the amounts of the fair market value of all property held by the pooled income fund on each determination date, as defined in paragraph (a)(5)(vi) of § 1.642(c)–5, of such taxable year divided by the number of determination dates in such taxable year. For such purposes the fair market value of property held by the fund shall be determined without including any income earned by the fund.

(3)(i) The corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within its taxable year by the percentage set forth in column (2) of the following table opposite the period within such year, set forth in column (1), which includes the date on which that payment is made:

TABLE

(1) *Payment period*	(2) *Percentage of payment*
Last week of 4th quarter	0
Balance of 4th quarter	.25
Last week of 3d quarter	.25
Balance of 3d quarter	.50
Last week of 2d quarter	.50
Balance of 2d quarter	.75
Last week of 1st quarter	.75
Balance of 1st quarter	100

(ii) If the taxable year of the fund consists of less than 12 months, the corrective term adjustment shall be the sum of the products obtained by multiplying each income payment made by the pooled income fund within such taxable year by the percentage obtained by subtracting from 1 a fraction the numerator of which is the number of days from the first day of such taxable year to the date of such income payment and the denominator of which is 365.

(4) A pooled income fund's method of calculating its yearly rate of return must be supported by a full statement attached to the income tax return of the pooled income fund for each taxable year.

(5) The application of this paragraph may be illustrated by the following examples:

Example (1). (a) The pooled income fund maintained by W University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned $5,000 of income during 1971. The fair market value of its property (determined without including any income earned by the fund), and the income paid out, on the first day of each calendar quarter in 1971 are as follows:

Date	Fair market value of property	Income payment
Jan. 1	$100,000	$1,200
Apr. 1	105,000	1,200
July 1	95,000	1,200
Oct. 1	100,000	1,400
	400,000	5,000

(b) The average fair market value of the property in the fund for 1971 is $100,000 ($400,000, divided by 4).

(c) The corrective term adjustment for 1971 is $3,050, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

Multiplication:	Product
100% × $1,200	$1,200
75% × $1,200	900
50% × $1,200	600
25% × $1,400	350
Sum of products	3,050

(d) The pooled income fund's yearly rate of return for 1971 is 5.157 percent, determined as follows:

$5,000 ÷ $100,000 − $3,050 = 0.05157

Example (2). (a) The pooled income fund maintained by X University has established determination dates on the first day of each calendar quarter. The pooled income fund is on a calendar-year basis. The pooled income fund earned $5,000 of income during 1971 and paid out $3,000 on December 15, 1971, and $2,000 on January 15, 1972, the last amount being treated under paragraph (b)(7) of § 1.642(c)–5 as paid on December 31, 1971. The fair market value of its property (determined without including any income earned by the fund) on the determination dates in 1971 and the income paid out during 1971 are as follows:

Date	Fair market value of property	Income payment
Jan. 1	$125,000	
Apr. 1	125,000	
July 1	75,000	
Oct. 1	75,000	
Dec. 15		$3,000
Dec. 31		2,000
	400,000	5,000

(b) The average fair market value of the property in the fund for 1971 is $100,000 ($400,000 divided by 4).

(c) The corrective term adjustment for 1971 is $750, determined by applying the percentages obtained in column (2) of the table in subparagraph (3) of this paragraph:

Multiplication:	Product
0% × $2,000	
25% × $3,000	$750
Sum of products	750

(d) The pooled income fund's yearly rate of return for 1971 is 5.038 percent, determined as follows:

$5,000÷$100,000–$750=0.05038

(d) Present value of remainder interest dependent on the termination of one life; for transfers to pooled income funds made after November 30, 1983—(1) In general. For transfers to pooled income funds made after November 30, 1983, the present value under this section of a remainder interest which is dependent on the termination of the life of one individual shall be determined under paragraphs (d)(1) through (3) of this section. The present value of such a remainder interest shall be computed by the use of Table G in paragraph (d)(3) of this section. For purposes of the computations under this section, the age of an individual is to be taken as the age of the individual at the individual's nearest birthday. For transfers to pooled income funds made before December 1, 1983, see paragraphs (e)(1) through (3) of this section.

(2) Computation of value of remainder interest. The factor which is used in determining the present value of the remainder interest is the factor

under the appropriate yearly rate of return in column (2) of Table G opposite the number in column (1) which corresponds to the age of the individual upon whose life the value of the remainder interest is based. If the yearly rate of return is a percentage which is between yearly rates of return for which factors are provided in Table G, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying, by the factor determined under this paragraph (d)(2), the fair market value on the appropriate valuation date. If the yearly rate of return is below 2.2 percent or above 14 percent, see paragraph (a)(2) of this section. This paragraph (d)(2) may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers $100,000 to a pooled income fund on January 1, 1985, and retains a life income interest in such property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 9.9 percent. In Table G the figure in column (2) opposite 50 years under 9.8 percent is .15653 and under 10 percent is .15257. The present value of the remainder interest is $15,455, computed as follows:

Factor at 9.8 percent for person aged 50	.15653
Factor at 10 percent for person aged 50	.15257
Difference	.00396
Interpolation adjustment:	

$$9.9\%-9.8\% \div .2\% = x \div .00396$$

$$x = .00198$$

Factor at 9.8 percent for person aged 50	0.15653
Less:	
Interpolation adjustment	.00198
Interpolated factor	.15455
Present value of remainder interest ($100,000 × .15455)	$15,455

(3) Actuarial tables. The following tables shall be used in the application of the provisions of this section.

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN SHOWN

(1) Age	(2) Yearly rate of return 2.2%	2.4%	2.6%	2.8%	3.0%
0	.23930	.21334	.19077	.17113	.15401
1	.22891	.20224	.17903	.15880	.14114
2	.23297	.20610	.18265	.16218	.14429
3	.23744	.21035	.18669	.16600	.14787
4	.24212	.21485	.19098	.17006	.15171
5	.24701	.21955	.19547	.17434	.15577
6	.25207	.22442	.20015	.17880	.16001
7	.25726	.22944	.20497	.18342	.16441
8	.26259	.23461	.20995	.18820	.16898
9	.26809	.23995	.21511	.19315	.17373
10	.27373	.24544	.22043	.19828	.17865
11	.27953	.25110	.22592	.20358	.18375
12	.28546	.25690	.23156	.20904	.18902
13	.29149	.26280	.23731	.21462	.19440
14	.29757	.26877	.24312	.22026	.19986
15	.30368	.27476	.24896	.22593	.20535
16	.30978	.28075	.25481	.23161	.21085
17	.31589	.28676	.26068	.23732	.21637
18	.32204	.29280	.26659	.24306	.22193
19	.32825	.29892	.27257	.24889	.22759
20	.33457	.30514	.27867	.25484	.23336
21	.34099	.31148	.28489	.26092	.23927
22	.34751	.31794	.29124	.26712	.24532
23	.35416	.32452	.29773	.27348	.25152
24	.36096	.33127	.30439	.28002	.25791
25	.36793	.33821	.31124	.28676	.26452
26	.37509	.34535	.31832	.29374	.27136
27	.38244	.35269	.32560	.30093	.27844
28	.38998	.36023	.33311	.30836	.28577
29	.39767	.36795	.34080	.31599	.29330
30	.40553	.37584	.34868	.32382	.30104
31	.41352	.38388	.35672	.33182	.30897
32	.42165	.39208	.36494	.34001	.31710
33	.42993	.40044	.37333	.34839	.32543
34	.43834	.40894	.38188	.35694	.33395
35	.44689	.41760	.39060	.36567	.34266
36	.45556	.42640	.39947	.37458	.35156
37	.46435	.43534	.40850	.38365	.36063
38	.47325	.44440	.41767	.39288	.36987
39	.48226	.45358	.42696	.40225	.37927
40	.49136	.46288	.43640	.41177	.38884
41	.50056	.47228	.44596	.42143	.39856
42	.50988	.48182	.45566	.43125	.40846
43	.51927	.49145	.46547	.44120	.41850
44	.52874	.50118	.47540	.45128	.42869
45	.53828	.51099	.48543	.46146	.43899
46	.54788	.52088	.49554	.47176	.44943
47	.55754	.53083	.50574	.48216	.45998
48	.56726	.54087	.51604	.49267	.47065
49	.57703	.55097	.52642	.50327	.48144
50	.58685	.56114	.53688	.51398	.49234
51	.59670	.57136	.54740	.52476	.50333
52	.60658	.58161	.55798	.53560	.51441
53	.61647	.59189	.56859	.54651	.52556
54	.62635	.60217	.57923	.55744	.53675
55	.63622	.61246	.58987	.56840	.54798
56	.64606	.62273	.60052	.57937	.55923
57	.65589	.63299	.61117	.59037	.57052
58	.66569	.64324	.62181	.60136	.58183
59	.67546	.65347	.63246	.61237	.59316
60	.68521	.66368	.64309	.62338	.60450
61	.69492	.67388	.65372	.63440	.61587
62	.70461	.68406	.66434	.64542	.62726
63	.71425	.69420	.67494	.65643	.63865
64	.72384	.70430	.68550	.66742	.65002
65	.73336	.71434	.69602	.67837	.66137
66	.74281	.72431	.70647	.68926	.67267
67	.75216	.73419	.71684	.70009	.68391
68	.76143	.74399	.72714	.71085	.69509
69	.77060	.75370	.73735	.72153	.70622
70	.77969	.76334	.74750	.73215	.71728
71	.78870	.77290	.75758	.74272	.72830
72	.79764	.78240	.76760	.75323	.73928
73	.80646	.79178	.77751	.76364	.75016
74	.81511	.80099	.78725	.77387	.76086
75	.82353	.80995	.79674	.78386	.77132
76	.83169	.81866	.80596	.79357	.78149
77	.83960	.82710	.81491	.80301	.79139
78	.84727	.83530	.82360	.81218	.80101
79	.85473	.84328	.83207	.82112	.81041
80	.86201	.85106	.84034	.82986	.81960
81	.86905	.85861	.84837	.83835	.82853

(1) Age	(2) Yearly rate of return				
	2.2%	2.4%	2.6%	2.8%	3.0%
82	.87585	.86589	.85612	.84655	.83717
83	.88239	.87291	.86360	.85447	.84552
84	.88873	.87971	.87085	.86216	.85362
85	.89487	.88630	.87789	.86963	.86150
86	.90070	.89258	.88459	.87674	.86901
87	.90609	.89838	.89079	.88332	.87597
88	.91106	.90372	.89650	.88939	.88239
89	.91570	.90872	.90184	.89507	.88839
90	.92014	.91350	.90696	.90051	.89416
91	.92435	.91804	.91182	.90569	.89964
92	.92822	.92222	.91630	.91045	.90469
93	.93170	.92597	.92032	.91474	.90923
94	.93477	.92929	.92387	.91853	.91325
95	.93743	.93216	.92695	.92181	.91673
96	.93967	.93458	.92955	.92458	.91966
97	.94167	.93674	.93186	.92704	.92228
98	.94342	.93863	.93389	.92921	.92457
99	.94508	.94041	.93580	.93124	.92673
100	.94672	.94218	.93770	.93326	.92887
101	.94819	.94377	.93940	.93508	.93080
102	.94979	.94550	.94125	.93704	.93288
103	.95180	.94766	.94357	.93952	.93550
104	.95377	.94979	.94585	.94194	.93806
105	.95663	.95288	.94916	.94547	.94181
106	.96101	.95762	.95425	.95091	.94760
107	.96688	.96398	.96110	.95824	.95539
108	.97569	.97354	.97141	.96928	.96717
109	.98924	.98828	.98733	.98638	.98544

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN SHOWN—Continued

(1) Age	(2) Yearly rate of return				
	3.2%	3.4%	3.6%	3.8%	4.0%
0	.13908	.12603	.11461	.10461	.09583
1	.12570	.11220	.10036	.08998	.08086
2	.12862	.11489	.10284	.09225	.08293
3	.13198	.11802	.10576	.09496	.08544
4	.13559	.12141	.10893	.09793	.08821
5	.13943	.12503	.11234	.10112	.09121
6	.14345	.12884	.11593	.10451	.09439
7	.14763	.13280	.11968	.10805	.09773
8	.15198	.13694	.12360	.11176	.10125
9	.15652	.14126	.12771	.11567	.10495
10	.16123	.14576	.13200	.11975	.10883
11	.16613	.15045	.13648	.12402	.11290
12	.17119	.15531	.14113	.12847	.11715
13	.17638	.16029	.14591	.13304	.12152
14	.18164	.16535	.15076	.13769	.12597
15	.18693	.17044	.15565	.14238	.13045
16	.19224	.17554	.16055	.14707	.13494
17	.19756	.18066	.16547	.15178	.13945
18	.20294	.18584	.17044	.15655	.14401
19	.20840	.19110	.17550	.16140	.14866
20	.21399	.19650	.18069	.16639	.15344
21	.21972	.20203	.18602	.17152	.15836
22	.22559	.20771	.19151	.17680	.16344
23	.23162	.21356	.19716	.18225	.16869
24	.23784	.21960	.20301	.18791	.17414
25	.24429	.22588	.20910	.19380	.17984
26	.25098	.23240	.21545	.19996	.18581
27	.25792	.23918	.22206	.20639	.19205
28	.26512	.24623	.22894	.21310	.19858
29	.27253	.25350	.23605	.22004	.20534
30	.28016	.26100	.24341	.22724	.21236
31	.28799	.26871	.25097	.23464	.21961
32	.29603	.27664	.25877	.24230	.22710
33	.30428	.28478	.26679	.25018	.23484
34	.31273	.29314	.27504	.25830	.24280
35	.32139	.30172	.28351	.26665	.25102
36	.33024	.31050	.29220	.27523	.25948
37	.33929	.31949	.30111	.28404	.26816
38	.34851	.32867	.31022	.29305	.27707
39	.35791	.33804	.31953	.30228	.28620
40	.36749	.34759	.32904	.31172	.29555
41	.37724	.35733	.33874	.32137	.30512
42	.38717	.36727	.34866	.33124	.31493
43	.39727	.37739	.35877	.34132	.32495
44	.40752	.38768	.36906	.35159	.33518
45	.41791	.39811	.37952	.36204	.34560
46	.42844	.40871	.39014	.37267	.35621
47	.43910	.41944	.40092	.38347	.36701
48	.44990	.43034	.41188	.39446	.37801
49	.46083	.44137	.42299	.40562	.38919
50	.47189	.45256	.43427	.41695	.40056
51	.48306	.46386	.44567	.42844	.41209
52	.49432	.47528	.45721	.44006	.42378
53	.50567	.48679	.46886	.45182	.43562
54	.51708	.49838	.48060	.46367	.44756
55	.52854	.51004	.49242	.47563	.45962
56	.54004	.52175	.50430	.48766	.47177
57	.55159	.53352	.51626	.49978	.48402
58	.56316	.54533	.52827	.51196	.49636
59	.57478	.55719	.54036	.52424	.50879
60	.58643	.56910	.55250	.53658	.52131
61	.59811	.58107	.56471	.54901	.53393
62	.60982	.59307	.57697	.56150	.54662
63	.62155	.60510	.58928	.57405	.55940
64	.63327	.61714	.60161	.58664	.57222
65	.64498	.62918	.61395	.59926	.58508
66	.65666	.64120	.62628	.61188	.59796
67	.66829	.65319	.63859	.62448	.61083
68	.67986	.66512	.65086	.63706	.62370
69	.69139	.67702	.66311	.64963	.63656
70	.70286	.68888	.67533	.66218	.64942
71	.71431	.70073	.68754	.67474	.66231
72	.72572	.71255	.69974	.68730	.67520
73	.73704	.72429	.71188	.69980	.68805
74	.74819	.73586	.72384	.71214	.70075
75	.75909	.74718	.73557	.72424	.71320
76	.76971	.75822	.74700	.73606	.72538
77	.78004	.76897	.75815	.74758	.73726
78	.79010	.77944	.76902	.75883	.74886
79	.79993	.78968	.77965	.76984	.76023
80	.80955	.79971	.79008	.78064	.77140
81	.81891	.80948	.80024	.79118	.78230
82	.82796	.81894	.81009	.80140	.79288
83	.83672	.82810	.81962	.81131	.80314
84	.84525	.83700	.82891	.82096	.81314
85	.85352	.84567	.83795	.83037	.82291
86	.86141	.85394	.84659	.83936	.83224
87	.86874	.86162	.85461	.84771	.84092
88	.87549	.86870	.86201	.85542	.84893
89	.88182	.87534	.86895	.86266	.85645
90	.88789	.88171	.87562	.86961	.86369
91	.89367	.88779	.88198	.87625	.87059
92	.89900	.89338	.88784	.88237	.87697
93	.90379	.89842	.89312	.88788	.88271
94	.90803	.90288	.89780	.89277	.88781
95	.91171	.90675	.90185	.89701	.89223
96	.91481	.91001	.90527	.90058	.89594
97	.91757	.91291	.90831	.90376	.89926
98	.91999	.91546	.91098	.90655	.90217

(1) Age	(2) Yearly rate of return				
	3.2%	3.4%	3.6%	3.8%	4.0%
99	.92227	.91786	.91349	.90917	.90490
100	.92453	.92023	.91598	.91177	.90761
101	.92656	.92236	.91821	.91410	.91003
102	.92875	.92467	.92063	.91662	.91266
103	.93152	.92758	.92367	.91980	.91597
104	.93423	.93042	.92665	.92291	.91920
105	.93818	.93458	.93101	.92747	.92395
106	.94430	.94104	.93779	.93457	.93127
107	.95256	.94975	.94696	.94418	.94143
108	.96507	.96298	.96090	.95883	.95676
109	.98450	.98356	.98263	.98170	.98077

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN SHOWN—Continued

(1) Age	(2) Yearly rate of return				
	4.2%	4.4%	4.6%	4.8%	5.0%
0	.08811	.08132	.07534	.07006	.06539
1	.07283	.06576	.05952	.05400	.04912
2	.07471	.06746	.06106	.05539	.05037
3	.07704	.06962	.06304	.05722	.05205
4	.07962	.07202	.06528	.05930	.05398
5	.08243	.07464	.06773	.06159	.05612
6	.08542	.07745	.07037	.06406	.05844
7	.08857	.08042	.07316	.06669	.06091
8	.09189	.08355	.07612	.06948	.06354
9	.09540	.08687	.07926	.07245	.06635
10	.09908	.09037	.08258	.07560	.06934
11	.10296	.09406	.08609	.07894	.07251
12	.10701	.09793	.08977	.08245	.07586
13	.11119	.10191	.09358	.08608	.07932
14	.11544	.10597	.09745	.08978	.08285
15	.11972	.11007	.10136	.09350	.08640
16	.12402	.11416	.10527	.09723	.08995
17	.12832	.11827	.10919	.10096	.09351
18	.13268	.12243	.11315	.10474	.09711
19	.13712	.12667	.11720	.10860	.10078
20	.14170	.13105	.12138	.11259	.10459
21	.14642	.13557	.12570	.11671	.10853
22	.15129	.14024	.13017	.12099	.11261
23	.15634	.14508	.13481	.12544	.11687
24	.16159	.15013	.13967	.13009	.12133
25	.16709	.15543	.14477	.13500	.12604
26	.17286	.16101	.15014	.14018	.13103
27	.17891	.16688	.15580	.14564	.13630
28	.18525	.17301	.16175	.15140	.14137
29	.19183	.17940	.16796	.15742	.14770
30	.19867	.18606	.17443	.16370	.15380
31	.20574	.19295	.18114	.17023	.16013
32	.21307	.20010	.18811	.17702	.16674
33	.22064	.20751	.19535	.18407	.17362
34	.22846	.21516	.20283	.19138	.18075
35	.23653	.22307	.21058	.19896	.18816
36	.24484	.23124	.21859	.20681	.19584
37	.25340	.23966	.22685	.21492	.20379
38	.26219	.24831	.23536	.22328	.21199
39	.27120	.25720	.24411	.23188	.22044
40	.28045	.26633	.25311	.24075	.22916
41	.28992	.27569	.26236	.24986	.23814
42	.29965	.28532	.27188	.25926	.24741
43	.30960	.29518	.28163	.26890	.25693
44	.31977	.30527	.29164	.27880	.26671
45	.33013	.31557	.30185	.28892	.27673
46	.34071	.32609	.31230	.29929	.28700
47	.35148	.33681	.32296	.30988	.29750
48	.36246	.34777	.33387	.32072	.30826
49	.37364	.35893	.34499	.33179	.31927
50	.38503	.37030	.35634	.34310	.33053
51	.39659	.38187	.36790	.35462	.34201
52	.40832	.39362	.37965	.36636	.35371
53	.42021	.40554	.39158	.37829	.36562
54	.43222	.41760	.40367	.39039	.37771
55	.44436	.42980	.41591	.40264	.38997
56	.45860	.44212	.42828	.41504	.40239
57	.46897	.45456	.44079	.42760	.41498
58	.48142	.46712	.45342	.44030	.42771
59	.49399	.47980	.46620	.45314	.44062
60	.50666	.49260	.47910	.46613	.45367
61	.51944	.50552	.49214	.47927	.46690
62	.53232	.51856	.50531	.49256	.48028
63	.54529	.53169	.51860	.50598	.49381
64	.55832	.54491	.53198	.51950	.50746
65	.57140	.55819	.54544	.53312	.52121
66	.58451	.57152	.55895	.54681	.53506
67	.59763	.58486	.57251	.56054	.54896
68	.61076	.59823	.58609	.57432	.56292
69	.62390	.61162	.59971	.58816	.57695
70	.63705	.62503	.61337	.60204	.59104
71	.65023	.63849	.62709	.61600	.60522
72	.66344	.65199	.64086	.63003	.61949
73	.67861	.66547	.65463	.64407	.63378
74	.68964	.67882	.66827	.65798	.64796
75	.70243	.69193	.68168	.67168	.66192
76	.71495	.70477	.69482	.68511	.67563
77	.72717	.71731	.70768	.69826	.68905
78	.73912	.72959	.72026	.71114	.70221
79	.75083	.74163	.73262	.72379	.71515
80	.76235	.75348	.74479	.73627	.72792
81	.77360	.76506	.75669	.74848	.74043
82	.78452	.77632	.76827	.76036	.75260
83	.79513	.78725	.77952	.77192	.76446
84	.80547	.79792	.79051	.78322	.77606
85	.81557	.80836	.80126	.79429	.78742
86	.82524	.81835	.81157	.80489	.79832
87	.83423	.82764	.82115	.81477	.80847
88	.84253	.83623	.83002	.82390	.81787
89	.85033	.84430	.83836	.83250	.82672
90	.85784	.85208	.84639	.84079	.83525
91	.86502	.85951	.85408	.84871	.84342
92	.87164	.86638	.86118	.85605	.85098
93	.87761	.87257	.86759	.86267	.85781
94	.88290	.87806	.87327	.86854	.86386
95	.88750	.88282	.87820	.87364	.86913
96	.89136	.88683	.88236	.87793	.87355
97	.89481	.89041	.88606	.88176	.87750
98	.89783	.89354	.88930	.88511	.88096
99	.90067	.89649	89235	.88826	.88420
100	.90349	.89941	.89538	.89138	.88743
101	.90600	.90202	.89807	.89416	.89029
102	.90873	.90484	.90099	.89717	.89339
103	.91217	.90841	.90468	.90099	.89733
104	.91553	.91188	.90827	.90469	.90114
105	.92047	.91701	.91358	.91018	.90680
106	.92819	.92504	.92191	.91880	.91571
107	.93868	.93596	.93325	.93056	.92788
108	.95471	.95267	.95064	.94862	.94661
109	.97985	.97893	.97801	.97710	.97619

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWINO THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUNO HAVINO THE YEARLY RATE OF RETURN SHOWN—Continued

(1) Age	(2) Yearly rate of return				
	5.2%	5.4%	5.6%	5.8%	6.0%
0	.06126	.05759	.05433	.05143	.04884
1	.04480	.04096	.03754	.03450	.03179
2	.04591	.04194	.03841	.03527	.03246
3	.04745	.04336	.03972	.03646	.03355
4	.04924	.04502	.04125	.03789	.03487
5	.05124	.04689	.04300	.03952	.03639
6	.05342	.04893	.04492	.04131	.03808
7	.05574	.05112	.04697	.04324	.03990
8	.05822	.05346	.04918	.04533	.04186
9	.06089	.05598	.05156	.04759	.04400
10	.06372	.05868	.05411	.05000	.04630
11	.06673	.06153	.05684	.05260	.04877
12	.06992	.06457	.05973	.05536	.05141
13	.07322	.06772	.06274	.05824	.05415
14	.07659	.07093	.06581	.06117	.05695
15	.07998	.07417	.06890	.06411	.05976
16	.08377	.07739	.07197	.06704	.06255
17	.08675	.08062	.07504	.06996	.06533
18	.09018	.08387	.07813	.07290	.06813
19	.09367	.08720	.08130	.07591	.07099
20	.09730	.09065	.08458	.07904	.07397
21	.10106	.09423	.08800	.08229	.07707
22	.10496	.09796	.09155	.08568	.08030
23	.10903	.10185	.09526	.08923	.08368
24	.11330	.10594	.09918	.09297	.08726
25	.11782	.11028	.10334	.09696	.09108
26	.12262	.11489	.10778	.10122	.09518
27	.12771	.11979	.11249	.10576	.09955
28	.13309	.12499	.11751	.11060	.10421
29	.13873	.13044	.12278	.11570	.10914
30	.14464	.13617	.12833	.12107	.11433
31	.15079	.14214	.13412	.12668	.11977
32	.15722	.14838	.14018	.13256	.12548
33	.16391	.15490	.14652	.13873	.13147
34	.17087	.16168	.15312	.14515	.13772
35	.17811	.16874	.16001	.15186	.14426
36	.18562	.17608	.16717	.15886	.15108
37	.19340	.18369	.17462	.16613	.15819
38	.20144	.19157	.18233	.17368	.16557
39	.20974	.19971	.19031	.18149	.17322
40	.21830	.20812	.19856	.18959	.18115
41	.22714	.21681	.20710.	19797	.18938
42	.23627	.22579	.21594	.20665	.19791
43	.24566	.23505	.22505	.21562	.20673
44	.25532	.24458	.23445	.22488	.21585
45	.26522	.25436	.24410	.23440	.22523
46	.27538	.26441	.25402	.24420	.23490
47	.28579	.27471	.26421	.25427	.24484
48	.29647	.28529	.27469	.26463	.25508
49	.30739	.29613	.28543	.27527	.26562
50	.31859	.30724	.29646	.28620	.27645
51	.33001	.31860	.30774	.29740	.28755
52	.34167	.33020	.31928	.30886	.29893
53	.35355	.34204	.33105	.32057	.31056
54	.36562	.35407	.34304	.33250	.32243
55	.37787	.36630	.35523	.34465	.33452
56	.39029	.37870	.36761	.35699	.34682
57	.40289	.39130	.38020.	36956	.35935
58	.41565	.40408	.39297	.38231	.37208
59	.42859	.41704	.40595	.39529	.38504
60	.44170	.43019	.41912	.40847	.39822
61	.45499	.44353	.43250	.42187	.41164
62	.46845	.45706	.44607	.43548	.42527
63	.48208	.47076	.45984	.44930	.43913
64	.49583	.48461	.47377	.46329	.45317
65	.50971	.49859	.48784	.47744	.46738
66	.52369	.51269	.50204	.49173	.48175
67	.53774	.52688	.51635	.50614	.49625
68	.55187	.54115	.53075	.52066	.51088
69	.56607	.55551	.54526	.53530	.52563
70	.58035	.56997	.55987	.55006	.54053
71	.59474	.58455	.57463	.56498	.55559
72	.60923	.59924	.58952	.58004	.57082
73	.62375	.61398	.60446	.59518	.58613
74	.63818	.62864	.61933	.61026	.60140
75	.65240	.64310	.63402	.62515	.61649
76	.66636	.65731	.64846	.63981	.63135
77	.68005	.67124	.66263	.65420	.64596
78	.69347	.68492	.67655	.66836	.66033
79	.70669	.69840	.69028	.68232	.67452
80	.71973	.71171	.70384	.69613	.68856
81	.73252	.72477	.71717	.70970	.70237
82	.74499	.73751	.73016	.72295	.71587
83	.75713	.74992	.74284	.73589	.72905
84	.76901	.76208	.75527	.74857	.74198
85	.78067	.77402	.76748	.76104	.75471
86	.79185	.78548	.77921	.77304	.76695
87	.80228	.79617	.79015	.78423	.77838
88	.81193	.80607	.80029	.79460	.78899
89	.82102	.81540	.80985	.80438	.79899
90	.82979	.82441	.81909	.81384	.80867
91	.83820	.83304	.82795	.82292	.81796
92	.84598	.84104	.83616	.83134	.82657
93	.85300	.84826	.84357	.83894	.83437
94	.85924	.85468	.85017	.84570	.84130
95	.86466	.86025	.85589	.85158	.84732
96	.86922	.86494	.86071	.85652	.85238
97	.87329	.86913	.86501	.86093	.85690
98	.87685	.87279	.86877	.86479	.86085
99	.88019	.87622	.87230	.86841	.86456
100	.88351	.87964	.87580	.87200	.86824
101	.88646	.88267	.87891	.87519	.87150
102	.88965	.88594	.88227	.87863	.87503
103	.89370	.89011	.88654	.88301	.87952
104	.89763	.89414	.89068	.88725	.88385
105	.90345	.90013	.89683	.89356	.89032
106	.91265	.90961	.90658	.90358	.90060
107	.92522	.92258	.91995	.91734	.91474
108	.94461	.94262	.94063	.93866	.93670
109	.97529	.97438	.97348	.97259	.97170

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUNO HAVING THE YEARLY RATE OF RETURN SHOWN—Continued

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
0	.04653	.04447	.04262	.04095	.03946
1	.02937	.02720	.02525	.02351	.02194
2	.02994	.02769	.02567	.02385	.02221
3	.03094	.02860	.02650	.02460	.02290
4	.03216	.02973	.02755	.02558	.92380
5	.03359	.03106	.02879	.02674	.02488
6	.03517	.03255	.03019	.02805	.02612
7	.03688	.03416	.03171	.02949	.02747
8	.03874	.03592	.03337	.03106	.02896
9	.04077	.03784	.03519	.03279	.03061
10	.04295	.03992	.03717	.03467	.03240
11	.04531	.04217	.03931	.03672	.03436
12	.04782	.04457	.04161	.03892	.02647
13	.05045	.04708	.04402	.04122	.03868

(1) Age	(2) Yearly rate of return				
	6.2%	6.4%	6.6%	6.8%	7.0%
14	.05312	.04964	.04646	.04357	.04093
15	.05581	.05220	.04891	.04591	.04317
16	.05847	.05474	.05134	.04822	.04538
17	.06111	.05726	.05374	.05051	.04756
18	.06378	.05979	.05615	.05280	.04974
19	.06650	.06238	.05861	.05514	.05196
20	.06933	.06507	.06117	.05758	.05429
21	.07228	.06788	.06384	.06013	.05671
22	.07535	.07081	.06664	.06279	.05925
23	.07858	.07389	.06958	.06559	.06192
24	.08201	.07717	.07270	.06858	.06477
25	.08567	.08067	.07606	.07179	.06785
26	.08960	.08444	.07968	.07527	.07118
27	.09380	.08849	.08357	.07901	.07478
28	.09830	.09283	.08775	.08304	.07867
29	.10306	.09742	.09218	.08732	.08280
30	.10808	.10228	.09688	.09187	.08720
31	.11335	.10738	.10182	.09665	.09182
32	.11889	.11275	.10704	.10170	.09672
33	.12471	.11840	.11252	.10703	.10189
34	.13079	.12432	.11827	.11261	.10732
35	.13716	.13052	.12431	.11849	.11305
36	.14381	.13701	.13063	.12465	.11905
37	.15075	.14378	.13724	.13110	.12534
38	.15796	.15083	.14412	.13782	.13190
39	.16545	.15815	.15129	.14483	.13875
40	.17322	.16576	.15874	.15212	.14589
41	.18129	.17367	.16649	.15971	.15332
42	.18967	.18190	.17456	.16763	.16108
43	.19834	.19041	.18293	.17585	.16915
44	.20731	.19924	.19160	.18437	.17753
45	.21655	.20834	.20055	.19318	.18619
46	.22608	.21773	.20981	.20229	.19516
47	.23590	.22741	.21935	.21170	.20443
48	.24602	.23741	.22922	.22144	.21403
49	.25644	.24770	.23939	.23148	.22394
50	.26716	.25831	.24989	.24185	.23419
51	.27816	.26921	.26068	.25253	.24475
52	.28945	.28040	.27176	.26351	.25562
53	.30100	.29187	.28313	.27478	.26679
54	.31279	.30357	.29475	.28631	.27822
55	.32482	.31553	.30663	.29810	.28992
56	.33707	.32771	.31875	.31014	.30188
57	.34955	.34015	.33112	.32244	.31411
58	.36225	.35280	.34372	.33499	.32659
59	.37519	.36571	.35659	.34781	.33936
60	.38836	.37886	.36971	.36089	.35239
61	.40177	.39226	.38309	.37425	.36572
62	.41542	.40591	.39674	.38788	.37932
63	.42930	.41981	.41064	.40178	.39321
64	.44338	.43392	.42477	.41591	.40734
65	.45765	.44823	.43910	.43027	.42171
66	.47208	.46271	.45364	.44483	.43630
67	.48666	.47736	.46834	.45958	.45108
68	.50138	.49215	.48320	.47450	.46605
69	.51624	.50711	.49824	.48961	.48122
70	.53125	.52223	.51345	.50491	.49660
71	.54645	.53755	.52889	.52045	.51223
72	.56183	.55307	.54453	.53621	.52809
73	.57731	.56870	.56030	.55211	.54412
74	.59275	.58431	.57606	.56801	.56015
75	.60803	.59976	.59168	.58379	.57607
76	.62308	.61500	.60709	.59936	.59179
77	.63789	.63000	.62227	.61470	.60730
78	.65247	.64477	.63723	.62984	.62261
79	.66687	.65938	.65203	.64483	.63777
80	.68114	.67386	.66672	.65971	.65284
81	.69518	.68812	.68119	.67438	.66770
82	.70891	.70207	.69535	.68875	.68227
83	.72232	.71572	.70922	.70283	.69655
84	.73550	.72913	.72285	.71668	.71061
85	.74847	.74234	.73630	.73035	.72449
86	.76096	.75506	.74925	.74353	.73789
87	.77263	.76696	.76137	.75585	.75042
88	.78345	.77799	.77261	.76730	.76207
89	.79367	.78842	.78323	.77812	.77308
90	.80356	.79851	.79353	.78862	.78376
91	.81306	.80821	.80344	.79871	.79405
92	.82187	.81722	.81263	.80810	.80361
93	.82984	.82538	.82096	.81659	.81228
94	.83694	.83263	.82837	.82416	.81999
95	.84310	.83893	.83481	.83073	.82670
96	.84829	.84424	.84023	.83626	.83234
97	.85291	.84897	.84506	.84120	.83738
98	.85696	.85310	.84929	.84551	.84177
99	.86075	.85698	.85325	.84956	.84590
100	.86452	.86084	.85719	.85357	.85000
101	.86785	.86424	.86066	.85711	.85360
102	.87146	.86792	.86442	.86094	.85750
103	.87605	.87261	.86921	.86583	.86248
104	.88047	.87713	.87382	.87053	.86727
105	.88710	.88390	.88073	.87758	.87446
106	.89764	.89471	.89179	.88889	.88601
107	.91216	.90960	.90705	.90451	.90199
108	.93474	.93280	.93086	.92894	.92702
109	.97081	.96992	.96904	.96816	.96729

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN SHOWN—Continued

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03811	.03689	.03579	.03479	.03388
1	.02052	.01924	.01809	.01704	.01609
2	.02074	.01940	.01819	.01710	.01611
3	.02136	.01996	.01870	.01756	.01652
4	.02219	.02074	.01942	.01822	.01713
5	.02321	.02169	.02031	.01905	.01791
6	.02437	.02278	.02134	.02003	.01883
7	.02565	.02399	.02248	.02111	.01986
8	.02706	.02533	.02376	.02232	.02101
9	.02863	.02682	.02518	.02367	.02230
10	.03034	.02846	.02674	.02517	.02373
11	.03221	.03025	.02846	.02682	.02532
12	.03424	.03219	.03032	.02861	.02704
13	.03635	.03422	.03228	.03049	.02885
14	.03851	.03630	.03427	.03240	.03069
15	.04066	.03836	.03624	.03430	.03252
16	.04277	.04037	.03817	.03615	.03429
17	.04485	.04236	.04007	.03796	.03602
18	.04693	.04434	.04196	.03976	.03773
19	.04904	.04635	.04387	.04159	.03947
20	.05125	.04845	.04588	.04349	.04129
21	.05356	.05065	.04797	.04549	.04319
22	.05597	.05295	.05016	.04758	.04519
23	.05853	.05539	.05248	.04979	.04730
24	.06124	.05799	.05497	.05217	.04957
25	.06420	.06081	.05767	.05475	.05205
26	.06739	.06388	.06062	.05758	.05476
27	.07086	.06721	.06382	.06067	.05773
28	.07460	.07082	.06730	.06402	.06097
29	.07859	.07467	.07102	.06762	.06444
30	.08284	.07879	.07500	.07146	.06815
31	.08733	.08312	.07920	.07553	.07209
32	.09207	.08773	.08366	.07986	.07629
33	.09709	.09260	.08839	.08445	.08075
34	.10237	.09773	.09338	.08929	.08546

(1) Age	(2) Yearly rate of return				
	7.2%	7.4%	7.6%	7.8%	8.0%
35	.10794	.10315	.09865	.09442	.09045
36	.11379	.10884	.10420	.09983	.09572
37	.11992	.11483	.11003	.10552	.10126
38	.12633	.12108	.11614	.11148	.10708
39	.13302	.12762	.12253	.11772	.11318
40	.14000	.13445	.12921	.12425	.11957
41	.14728	.14158	.13619	.13109	.12626
42	.15490	.14904	.14350	.13825	.13328
43	.16260	.15680	.15111	.145072	.14060
44	.17104	.16488	.15905	.15351	.14825
45	.17955	.17326	.16727	.16159	.15619
46	.18838	.18194	.17582	.16999	.16445
47	.19751	.19093	.18467	.17870	.17302
48	.20698	.20026	.19386	.18776	.18194
49	.21676	.20991	.20338	.19715	.19119
50	.22689	.21991	.21325	.20689	.20080
51	.23732	.23023	.22344	.21695	.21074
52	.24808	.24086	.23396	.22735	.22102
53	.25914	.25181	.24479	.23807	.24252
54	.27047	.26304	.25591	.24908	.25372
55	.28208	.27455	.26733	.26039	.25372
56	.29395	.28633	.37901	.27197	.26521
57	.30610	.29840	.29099	.28386	.27700
58	.31851	.31074	.30325	.29604	.28909
59	.33122	.32337	.31581	.30853	.30150
60	.34420	.33630	.32867	.32132	.31422
61	.35748	.34953	.34185	.33444	.32727
62	.37106	.36307	.35535	.34788	.34066
63	.38492	.37691	.36915	.36165	.35438
64	.39905	.39102	.38324	.37571	.36841
65	.41342	.40539	.39760	.39005	.38272
66	.42803	.42000	.41221	.40465	.39731
67	.44283	.43483	.42705	.41949	.41215
68	.45784	.44987	.44211	.43457	.42724
69	.47307	.46513	.45741	.44990	.44254
70	.48851	.48063	.47296	.46549	.45821
71	.50422	.49641	.48880	.48139	.47416
72	.52018	.51246	.50493	.49758	.49042
73	.53631	.52870	.52126	.51400	.50691
74	.55247	.54497	.53764	.53048	.52347
75	.56852	.56115	.55393	.54687	.53997
76	.58439	.57714	.57005	.56311	.55632
77	.60005	.59294	.58599	.57917	.57249
78	.61551	.60856	.60174	.59506	.58851
79	.63084	.62405	.61739	.61085	.60443
80	.64609	.63946	.63296	.62657	.62030
81	.66114	.65469	.64835	.64213	.63602
82	.67589	.66963	.66347	.65742	.65146
83	.60937	.68429	.67831	.67243	.66664
84	.70463	.69875	.69296	.68726	.68165
85	.71872	.71304	.70745	.70194	.69651
86	.73233	.72685	.72146	.71614	.71089
87	.74507	.73978	.73458	.72944	.72438
88	.75691	.75181	.74679	.74183	.73694
89	.76810	.76319	.75834	.75355	.74883
90	.77897	.77424	.76957	.76496	.76040
91	.78945	.78490	.78040	.77596	.77158
92	.79919	.79481	.79048	.78621	.78198
93	.80801	.80380	.79963	.79550	.79143
94	.81587	.81180	.80777	.80379	.79985
95	.82271	.81877	.81487	.81100	.80719
96	.82846	.82462	.82083	.81707	.81335
97	.83360	.82985	.82615	.82248	.81885
98	.83808	.83441	.83079	.82720	.82365
99	.84228	.83869	.83514	.83163	.82815
100	.84645	.84294	.83947	.83603	.83262
101	.85012	.84668	.84327	.83988	.83653
102	.85409	.85072	.84737	.84405	.84077
103	.85917	.85588	.85262	.84939	.84619
104	.86403	.86083	.85765	.85449	.85136
105	.87136	.86829	.86524	.86221	.85921
106	.88315	.88032	.87750	.87470	.87192
107	.89949	.89700	.89452	.89206	.88961
108	.92511	.92321	.92132	.91944	.91757
109	.96642	.96555	.96468	.96382	.96296

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEAR RATE OF RETURN SHOWN—Continued

(1) Age	(2) Yearly rate of return				
	8.2%	8.4%	8.6%	8.8%	9.0%
0	.03305	.03230	.03161	.03098	.03040
1	.01523	.01444	.01372	.01307	.01247
2	.01520	.01438	.01362	.01294	.01230
3	.01557	.01470	.01391	.01319	.01253
4	.01613	.01522	.01439	.01363	.01294
5	.01687	.01591	.01504	.01424	.01351
6	.01774	.01674	.01582	.01498	.01421
7	.01871	.01766	.01670	.01581	.01500
8	.01980	.01870	.01769	.01676	.01591
9	.02104	.01989	.01883	.01785	.01695
10	.02241	.02120	.02009	.01906	.01812
11	.02394	.02267	.02150	.02042	.01943
12	.02560	.02427	.02305	.02192	.02088
13	.02734	.02595	.02467	.02349	.02240
14	.02912	.02766	.02632	.02509	.02394
15	.03087	.02935	.02795	.02666	.02546
16	.03257	.03099	.02952	.02817	.02691
17	.03423	.03257	.03104	.02962	.02831
18	.03586	.03414	.03253	.03105	.02967
19	.03752	.03572	.03404	.03249	.03105
20	.03925	.03737	.03562	.03399	.03248
21	.04107	.03910	.03727	.03557	.03398
22	.04297	.04091	.03899	.03722	.03556
23	.04498	.04283	.04083	.03897	.03723
24	.04715	.04491	.04282	.04087	.03905
25	.04953	.04718	.04499	.04295	.04105
26	.05213	.04968	.04740	.04527	.04327
27	.05499	.05243	.05005	.04782	.04573
28	.05811	.05545	.05295	.05062	.04844
29	.06146	.05868	.05608	.05365	.05136
30	.06506	.06217	.05945	.05691	.05452
31	.06888	.06586	.06303	.06038	.05789
32	.07295	.06981	.06687	.06410	.06149
33	.07728	.07401	.07095	.06806	.06535
34	.08185	.07846	.07527	.07227	.06944
35	.08671	.08319	.07988	.07675	.07380
36	.09184	.08819	.08475	.08150	.07843
37	.09725	.09347	.08989	.08652	.08332
38	.10293	.09901	.09531	.09180	.08848
39	.10889	.10483	.10099	.09736	.09391
40	.11514	.11094	.10697	.10320	.09963
41	.12168	.11735	.11324	.10934	.10564
42	.12856	.12409	.11984	.11581	.11197
43	.13574	.13113	.12675	.12258	.11862
44	.14325	.13850	.13398	.12967	.12558
45	.15105	.14616	.14150	.13706	.13283
46	.15917	.15414	.14935	.14478	.14041
47	.16760	.16244	.15751	.15280	.14831
48	.17639	.17109	.16602	.16119	.15656
49	.18551	.18007	.17488	.16991	.16516
50	.19499	.18942	.18410	.17900	.17412
51	.20480	.19911	.19366	.18844	.18343

	8.2%	8.4%	8.6%	8.8%	9.0%
52	.21495	.20914	.20357	.19822	.19309
53	.22544	.21951	.21381	.20835	.20309
54	.23622	.23018	.22437	.21878	.21341
55	.24732	.24116	.23524	.22954	.22406
56	.25870	.25244	.24641	.24060	.23501
57	.27040	.26404	.25791	.25200	.24630
58	.28239	.27594	.26971	.26370	.25791
59	.29472	.28817	.28186	.27576	.26987
60	.30736	.30074	.29434	.28816	.28218
61	.32035	.31365	.30718	.30092	.29486
62	.33368	.32692	.32038	.31405	.30791
63	.34735	.34054	.33394	.32754	.32134
64	.36133	.35448	.34783	.34138	.33512
65	.37562	.36873	.36204	.35554	.34924
66	.39019	.38327	.37655	.37002	.36367
67	.40502	.39809	.39134	.38479	.37841
68	.42011	.41317	.40642	.39985	.39345
69	.43547	.42854	.42179	.41522	.40882
70	.45112	.44421	.43748	.43091	.42451
71	.46711	.46023	.45352	.44698	.44059
72	.48342	.47659	.46992	.46341	.45705
73	.49998	.49321	.48660	.48014	.47382
74	.51663	.50994	.50339	.49699	.49073
75	.53322	.52661	.52014	.51381	.50762
76	.54967	.54315	.53678	.53053	.52440
77	.56595	.55954	.55326	.54710	.54106
78	.58209	.57579	.56961	.56355	.55761
79	.59814	.59196	.58590	.57995	.57410
80	.61415	.60810	.60217	.59633	.59060
81	.63001	.62410	.61830	.61260	.60699
82	.64561	.63985	.63419	.62862	.62314
83	.66095	.65535	.64983	.64441	.63907
84	.67612	.67068	.66533	.66005	.65486
85	.69116	.68589	.68070	.67559	.67055
86	.70573	.70063	.69561	.69066	.68578
87	.71939	.71446	.70961	.70481	.70009
88	.73211	.72735	.72265	.71801	.71343
89	.74417	.73956	.73501	.73053	.72609
90	.75590	.75146	.74707	.74273	.73845
91	.76724	.76296	.75873	.75454	.75041
92	.77781	.77368	.76960	.76556	.76158
93	.78740	.78342	.77948	.77558	.77173
94	.79596	.79210	.78829	.78452	.78079
95	.80341	.79967	.79597	.79231	.78869
96	.80967	.80603	.80242	.79885	.79532
97	.81526	.81170	.80818	.80470	.80125
98	.82013	.81665	.81320	.80979	.80641
99	.82470	.82129	.81791	.81456	.81125
100	.82924	.82590	.82258	.81930	.81605
101	.83322	.82993	.82667	.82344	.82024
102	.83751	.83428	.83108	.82791	.82477
103	.84301	.83986	.83674	.83365	.83058
104	84826	.84518	.84213	.83910	.83610
105	.85623	.85327	.85033	.84741	84452
106	.86915	.86641	.86369	.86098	.85829
107	.88718	.88476	.88236	.87997	.87759
108	.91571	.91385	.91201	.91017	.90834
109	.96211	.96125	.96041	.95956	.95872

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN SHOWN—Continued

(1) Age	(2) Yearly rate of return				
	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02987	.02938	.02893	.02851	.02812
1	.01192	.01141	.01094	.01051	.01012
2	.01173	.01119	.01070	.01025	.00983
3	.01192	.01136	.01084	.01036	.00992
4	.01229	.01170	.01116	.01066	.01019
5	.01283	.01221	.01164	.01111	.01062
6	.01350	.01284	.01224	.01168	.01116
7	.01425	.01356	.01292	.01233	.01178
8	.01512	.01439	.01372	.01309	.01252
9	.01612	.01535	.01464	.01398	.01337
10	.01724	.01644	.01569	.01499	.01435
11	.01851	.01766	.01688	.01615	.01547
12	.01991	.01902	.01819	.01742	.01671
13	.02139	.02045	.01958	.01877	.01802
14	.02288	.02190	.02098	.02013	.01934
15	.02435	.02331	.02235	.02146	.02063
16	.02575	.02466	.02366	.02272	.02185
17	.02709	.02595	.02490	.02391	.02300
18	.02839	.02721	.02610	.02507	.02410
19	.02971	.02846	.02730	.02621	.02520
20	.03108	.02977	.02855	.02741	.02635
21	.03251	.03114	.02986	.02866	.02755
22	.03402	.03258	.03123	.02998	.02880
23	.03562	.03410	.03269	.03137	.03014
24	.03735	.03577	.03428	.03290	.03159
25	.03927	.03761	.03605	.03459	.03322
26	.04141	.03966	.03803	.03649	.03505
27	.04377	.04194	.04023	.03861	.03710
28	.04639	.04447	.04267	.04098	.03938
29	.04922	.04721	.04532	.04354	.04187
30	.05228	.05017	.04819	.04633	.04457
31	.05554	.05334	.05126	.04930	.04746
32	.05904	.05674	.05456	.05251	.05058
33	.06279	.06038	.05810	.05595	.05392
34	.06677	.06435	.06187	.05962	.05750
35	.07102	.06839	.06590	.06355	.06132
36	.07553	.07278	.07019	.06773	.06540
37	.08030	.07745	.07474	.07217	.06974
38	.08534	.08237	.07955	.07687	.07433
39	.09065	.08755	.08462	.08182	.07917
40	.09624	.09302	.08996	.08706	.08429
41	.10212	.09878	.09560	.09258	.08970
42	.10833	.10486	.10156	.09842	.09543
43	.11484	.11125	.10783	.10456	.10145
44	.12167	.11795	.11441	.11102	.10779
45	.12880	.12495	.12128	.11777	.11442
46	.13625	.13227	.12847	.12484	.12137
47	.14402	.13991	.13599	.13223	.12863
48	.15214	.14791	.14385	.13997	.13626
49	.16060	.15625	.15207	.14806	.14422
50	.16944	.16496	.16065	.15653	.15257
51	.17862	.17401	.16959	.16534	.16126
52	.18816	.18343	.17888	.17451	.17031
53	.19805	.19320	.18853	.18404	.17972
54	.20825	.20328	.19850	.19390	.18946
55	.21878	.21370	.20881	.20409	.19954
56	.22963	.22443	.21943	.21460	.20994
57	.24081	.23551	.23040	.22546	.22069
58	.25231	.24691	.24170	.23665	.23178
59	.26418	.25868	.25336	.24822	.24325
60	.27640	.27081	.26540	.26016	.25509
61	.28899	.28332	.27782	.27249	.26733
62	.30197	.29622	.29064	.28523	.27998
63	.31533	.30950	.30385	.29836	.29304
64	.32905	.32316	.31743	.31188	.30648
65	.34311	.33716	.33138	.32576	.32030
66	.35751	.35151	.34568	.34001	.33449
67	.37221	.36618	.36030	.35459	.34902
68	.38723	.38116	.37526	.36950	.36390
69	.40257	.39649	.39056	.38478	.37914
70	.41826	.41217	.40623	.40043	.39478

(1) Age	(2) Yearly rate of return				
	9.2%	9.4%	9.6%	9.8%	10.0%
71	.43435	.42827	.42233	.41652	.41086
72	.45084	.44478	.43885	.43305	.42739
73	.46765	.46161	.45571	.44994	.44429
74	.48460	.47861	.47274	.46700	.46138
75	.50155	.49561	.48979	.48409	.47851
76	.51841	.51253	.50677	.50112	.49559
77	.53514	.52934	.52364	.51806	.51258
78	.55177	.54605	.54043	.53492	.52951
79	.56837	.56273	.55720	.55177	.54643
80	.58497	.57944	.57401	.56866	.56341
81	.60148	.59606	.59073	.58548	.58033
82	.61775	.61245	.60723	.60210	.59705
83	.63381	.62863	.62354	.61852	.61358
84	.64974	.64470	.63973	.63484	.63002
85	.66558	.66068	.65586	.65110	.64641
86	.68096	.67622	.67154	.66692	.66236
87	.69542	.69082	.68628	.68180	.67738
88	.70891	.70445	.70005	.69570	.69141
89	.72172	.71739	.71312	.70891	.70474
90	.73422	.73004	.72591	.72182	.71779
91	.74632	.74229	.73829	.73435	.73045
92	.75763	.75373	.74988	.74606	.74229
93	.76791	.76414	.76042	.75673	.75308
94	.77710	.77345	.76983	.76626	.76272
95	.78510	.78155	.77804	.77457	.77113
96	.79183	.78837	.78494	.78155	.77819
97	.79783	.79445	.79110	.78779	.78450
98	.80306	.79975	.79647	.79322	.79000
99	.80797	.80471	.80149	.79830	.79514
100	.81283	.80964	.80648	.80335	.80025
101	.81708	.81394	.81082	.80774	.80468
102	.82165	.81856	.81550	.81247	.80946
103	.82754	.82452	.82153	.81857	.81563
104	.83312	.83017	.82723	.82433	.82144
105	.84165	.83880	.83597	.83316	.83038
106	.85562	.85297	.85034	.84772	.84512
107	.87523	.87288	.87054	.86822	.86591
108	.90652	.90471	.90291	.90111	.89932
109	.95788	.95704	.95620	.95537	.95455

TABLE G.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN—Continued

(1) Age	(2) Yearly rate of return				
	10.2%	10.4%	10.6%	10.8%	11.0%
0	.02776	.02743	.02712	.02682	.02655
1	.00975	.00941	.00909	.00880	.00852
2	.00945	.00909	.00875	.00844	.00816
3	.00952	.00914	.00879	.00846	.00815
4	.00976	.00936	.00899	.00865	.00832
5	.01016	.00974	.00935	.00898	.00864
6	.01068	.01023	.00981	.00943	.00907
7	.01128	.01080	.01036	.00995	.00957
8	.01198	.01148	.01101	.01058	.01017
9	.01281	.01228	.01179	.01133	.01090
10	.01375	.01319	.01267	.01219	.01173
11	.01483	.01425	.01370	.01318	.01270
12	.01604	.01542	.01484	.01430	.01379
13	.01732	.01666	.01605	.01548	.01494
14	.01860	.01792	.01727	.01667	.01610
15	.01986	.01913	.01845	.01782	.01723
16	.02103	.02027	.01956	.01889	.01827
17	.02214	.02134	.02059	.01989	.01923
18	.02320	.02236	.02157	.02084	.02014
19	.02426	.02337	.02254	.02177	.02104
20	.02536	.02442	.02355	.02273	.02197
21	.02650	.02552	.02460	.02374	.02293
22	.02770	.02667	.02570	.02479	.02394
23	.02898	.02789	.02687	.02591	.02501
24	.03037	.02923	.02815	.02714	.02619
25	.03194	.03073	.02960	.02853	.02752
26	.03370	.03243	.03123	.03010	.02904
27	.03568	.03434	.03307	.03188	.03076
28	.03789	.03647	.03514	.03389	.03271
29	.04029	.03880	.03740	.03608	.03483
30	.04291	.04135	.03987	.03848	.03716
31	.04572	.04407	.04252	.04105	.03966
32	.04875	.04702	.04538	.04384	.04237
33	.05200	.05019	.04847	.04684	.04530
34	.05548	.05358	.05177	.05006	.04843
35	.05921	.05722	.05532	.05352	.05181
36	.06319	.06110	.05911	.05722	.05543
37	.06743	.06524	.06315	.06117	.05929
38	.07191	.06962	.06744	.06536	.06338
39	.07665	.074425	.07197	.06980	.06773
40	.08166	.07916	.07677	.07450	.07233
41	.08696	.08434	.08185	.07947	.07721
42	.09257	.08985	.08725	.08477	.08239
43	.09848	.09564	.09293	.09034	.08787
44	.10470	.10175	.09893	.09623	.09365
45	.11121	.10815	.10522	.10241	.09972
46	.11805	.11486	.11182	.10890	.10610
47	.12519	.12189	.11873	.11569	.11279
48	.13269	.12927	.12600	.12285	.11983
49	.14054	.13600	.13361	.13035	.12721
50	.14876	.14511	.14160	.13822	.13497
51	.15734	.15356	.14994	.14645	.14309
52	.16627	.16238	.15864	.15504	.15156
53	.17557	.17156	.16770	.16399	.16040
54	.18519	.18107	.17710	.17327	.16957
55	.19515	.19092	.18684	.18290	.17909
56	.20544	.20110	.19691	.19286	.18894
57	.21609	.21164	.20734	.20318	.19916
58	.22707	.22252	.21811	.21385	.20972
59	.23844	.23378	.22928	.22491	.22068
60	.25018	.24543	.24082	.23636	.23203
61	.26233	.25749	.25279	.24823	.24381
62	.27490	.26996	.26517	.26052	.25601
63	.28787	.28286	.27798	.27325	.26865
64	.30124	.29615	.29120	.28639	.28171
65	.31500	.30983	.30481	.29993	.29517
66	.32912	.32390	.31881	.31386	.30904
67	.34360	.33832	.33318	.32817	.32328
68	.35843	.35311	.34791	.34285	.33791
69	.37365	.36828	.36305	.35794	.35296
70	.38925	.38386	.37860	.37346	.36844
71	.40532	.39991	.39463	.38946	.38442
72	.42185	.41644	.41115	.40597	.40091
73	.43876	.43336	.42807	.42289	.41782
74	.45588	.45050	.44522	.44005	.43499
75	.47304	.46769	.46244	.45729	.45225
76	.49016	.48485	.47963	.47451	.46949
77	.50721	.50193	.49676	.49168	.48670
78	.52419	.51898	.51385	.50882	.50388
79	.54119	.53604	.53097	.52600	.52111
80	.55825	.55318	.54819	.54328	.53846
81	.57526	.57027	.56536	.56053	.55578
82	.59208	.58718	.58236	.57762	.57295
83	.60871	.60392	.59920	.59455	.58997
84	.62527	.62059	.61597	.61143	.60695
85	.64179	.63723	.63273	.62830	.62393
86	.65787	.65344	.64907	.64475	.64050
87	.67302	.66871	.66446	.66026	.65612

(1) Age	(2) Yearly rate of return				
	10.2%	10.4%	10.6%	10.8%	11.0%
88	.68717	.68298	.67885	.67477	.67074
89	.70063	.69656	.69255	.68858	.68466
90	.71380	.70986	.70597	.70212	.69831
91	.72659	.72278	.71901	.71528	.71160
92	.73856	.73488	.73123	.72762	.72405
93	.74947	.74590	.74236	.73887	.73541
94	.75922	.75575	.75233	.74893	.74557
95	.76773	.76436	.76102	.75772	.75445
96	.77487	.77158	.76832	.76510	.76190
97	.78125	.77803	.77485	.77169	.76856
98	.78681	.78365	.78052	.77742	.77435
99	.79201	.78891	.78583	.78279	.77977
100	.79717	.79412	.79111	.78811	.78515
101	.80165	.79865	.79568	.79273	.78981
102	.80648	.80353	.80060	.79769	.79481
103	.81271	.80982	.80695	.80411	.80129
104	.81858	.81574	.81292	.81013	.80736
105	.83761	.82487	.82214	.81943	.81675
106	.84254	.83998	.83743	.83490	.83238
107	.86362	.86133	.85906	.85681	.85456
108	.89755	.89577	.89401	.89226	.89051
109	.95372	.95290	.95208	.95126	.95045

Table G.—Table, Single Life, Unisex, Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Continued

(1) Age	(2) Yearly rate of return				
	11.2%	11.4%	11.6%	11.8%	12.0%
0	.02630	.02606	.02583	.02562	.02542
1	.00827	.00803	.00780	.00759	.00739
2	.00789	.00763	.00740	.00718	.00697
3	.00787	.00760	.00736	.00712	.00690
4	.00802	.00774	.00748	.00723	.00700
5	.00832	.00802	.00774	.00748	.00724
6	.00873	.00841	.00812	.00784	.00758
7	.00921	.00888	.00856	.00827	.00799
8	.00979	.00944	.00910	.00879	.00850
9	.01049	.01012	.00976	.00943	.00912
10	.01131	.01091	.01053	.01018	.00985
11	.01225	.01183	.01143	.01106	.01070
12	.01331	.01286	.01244	.01205	.01168
13	.01444	.01397	.01352	.01311	.01271
14	.01558	.01508	.01461	.01417	.01375
15	.01667	.01614	.01565	.01519	.01475
16	.01768	.01713	.01661	.01612	.01566
17	.01862	.01803	.01749	.01697	.01649
18	.01949	.01888	.01831	.01776	.01725
19	.02035	.01971	.01910	.01853	.01799
20	.02124	.02056	.01992	.01932	.01875
21	.02217	.02145	.02078	.02014	.01954
22	.02313	.02238	.02166	.02099	.02035
23	.02416	.02336	.02261	.02190	.02122
24	.02529	.02445	.02365	.02290	.02218
25	.02657	.02568	.02484	.02404	.02328
26	.02804	.02710	.02620	.02536	.02456
27	.02970	.02870	.02776	.02686	.02601
28	.03159	.03053	.02953	.02858	.02768
29	.03365	.03253	.03147	.03047	.02951
30	.03591	.03473	.03361	.03255	.03154
31	.03834	.03709	.03591	.03478	.03372
32	.04098	.03966	.03841	.03722	.03610
33	.04383	.04244	.04112	.03987	.03867
34	.04689	.04543	.04403	.04271	.04145
35	.05019	.04865	.04718	.04578	.04445
36	.05372	.05210	.05055	.04907	.04767
37	.05749	.05578	.05416	.05260	.05112
38	.06150	.05970	.05799	.05636	.05480
39	.06575	.06387	.06207	.06035	.05871
40	.07026	.06828	.06639	.06459	.06286
41	.07504	.07297	.07099	.06909	.06728
42	.08013	.07796	.07589	.07390	.07200
43	.08550	.08323	.08106	.07898	.07699
44	.09118	.08881	.08654	.08437	.08228
45	.09714	.09467	.09230	.09003	.08784
46	.10341	.10084	.09837	.09599	.09371
47	.10999	.10731	.10473	.10226	.09988
48	.11693	.11414	.11145	.10888	.10639
49	.12420	.12130	.11852	.11583	.11325
50	.13185	.12884	.12595	.12316	.12047
51	.13985	.13674	.13373	.13084	.12805
52	.14822	.14499	.14188	.13888	.13598
53	.15695	.15361	.15039	.14729	.14428
54	.16601	.16256	.15924	.15602	.15292
55	.17542	.17186	.16843	.16511	.16190
56	.18516	.18150	.17796	.17454	.17122
57	.19527	.19150	.18786	.18433	.18091
58	.20573	.20186	.19811	.19448	.19096
59	.21659	.21262	.20877	.20504	.20142
60	.22784	.22377	.21982	.21599	.21227
61	.23952	.23535	.23131	.22738	.22357
62	.25163	.24737	.24324	.23922	.23531
63	.26418	.25984	.25561	.25151	.24751
64	.27716	.27273	.26842	.26423	.26015
65	.29054	.28604	.28165	.27738	.27322
66	.30434	.29976	.29530	.29096	.28672
67	.31852	.31388	.30935	.30494	.30063
68	.33310	.32840	.32381	.31933	.31496
69	.34809	.34334	.33870	.33417	.32975
70	.36353	.35874	.35405	.34948	.34500
71	.37948	.37466	.36994	.36532	.36081
72	.39595	.39111	.38636	.38172	.37718
73	.41286	.40801	.40325	.39859	.39403
74	.43004	.42518	.42042	.41575	.41118
75	.44730	.44245	.43770	.43304	.42846
76	.46457	.45974	.45500	.45035	.44579
77	.48181	.47700	.47229	.46766	.46311
78	.49903	.49426	.48958	.48497	.48045
79	.51631	.51159	.50694	.50238	.49789
80	.53371	.52905	.52446	.51994	.51550
81	.55110	.54650	.54197	.53752	.53313
82	.56835	.56382	.55937	.55497	.55065
83	.58546	.58101	.57663	.57231	.56806
84	.60253	.59817	.59388	.58965	.58547
85	.61961	.61536	.61116	.60703	.60294
86	.63630	.63215	.62806	.62402	.62004
87	.65203	.64800	.64401	.64007	.63619
88	.66676	.66282	.65894	.65510	.65131
89	.68079	.67696	.67318	.66944	.66574
90	.69455	.69084	.68716	.68353	.67993
91	.70795	.70435	.70078	.69726	.69377
92	.72052	.71703	.71357	.71015	.70677
93	.73198	.72860	.72524	.72192	.71864
94	.74225	.73896	.73570	.73248	.72928
95	.75121	.74801	.74483	.74169	.73858
96	.75874	.75561	.75250	.74943	.74639
97	.76546	.76240	.75936	.75635	.75336
98	.77131	.76830	.76531	.76235	.75942
99	.77678	.77382	.77088	.76798	.76509
100	.78221	.77930	.77642	.77356	.77072
101	.78691	.78404	.78119	.77837	.77557
102	.79196	.78912	.78632	.78353	.78077
103	.79849	.79572	.79297	.79024	.78753
104	.80460	.80188	.79917	.79648	.79381

(1) Age	(2) Yearly rate of return				
	11.2%	11.4%	11.6%	11.8%	12.0%
105	.81408	.81143	.80881	.80620	.80361
106	.82989	.82740	.82494	.82249	.82006
107	.85233	.85012	.84791	.84572	.84353
108	.88877	.88704	.88532	.88361	.88190
109	.94964	.94883	.94803	.94723	.94643

Table G.—Table, Single Life, Unisex, Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Continued

(1) Age	(2) Yearly rate of return				
	12.2%	12.4%	12.6%	12.8%	13.0%
0	.02523	.02505	.02488	.02472	.02456
1	.00721	.00703	.00687	.00671	.00657
2	.00678	.00659	.00642	.00626	.00610
3	.00670	.00650	.00632	.00615	.00599
4	.00678	.00658	.00638	.00620	.00603
5	.00701	.00679	.00658	.00639	.00620
6	.00733	.00710	.00688	.00668	.00648
7	.00733	.00748	.00725	.00703	.00682
8	.00822	.00796	.00771	.00748	.00726
9	.00882	.00854	.00828	.00803	.00780
10	.00953	.00924	.00896	.00869	.00844
11	.01037	.01006	.00976	.00948	.00922
12	.01132	.01099	.01068	.01038	.01010
13	.01234	.01199	.01166	.01134	.01104
14	.01336	.01299	.01264	.01231	.01199
15	.01434	.01395	.01358	.01323	.01289
16	.01522	.01481	.01442	.01405	.01371
17	.01603	.01559	.01518	.01480	.01443
18	.01677	.01631	.01588	.01547	.01508
19	.01748	.01700	.01654	.01611	.01570
20	.01821	.01770	.01722	.01677	.01633
21	.01897	.01843	.01792	.01744	.01698
22	.01975	.01918	.01864	.01813	.01765
23	.02059	.01998	.01941	.01887	.01836
24	.02151	.02087	.02027	.01970	.01915
25	.02257	.02189	.02125	.02064	.02006
26	.02380	.02308	.02240	.02175	.02114
27	.02521	.02445	.02373	.02304	.02239
28	.02683	.02602	.02525	.02452	.02383
29	.02861	.02775	.02694	.02616	.02543
30	.03058	.02967	.02881	.02798	.02720
31	.03270	.03174	.03082	.02995	.02911
32	.03502	.03400	.03303	.03210	.03122
33	.03754	.03646	.03543	.03444	.03350
34	.04025	.03910	.03801	.03697	.03597
35	.04318	.04197	.04081	.03971	.03865
36	.04633	.04505	.04383	.04266	.04154
37	.04971	.04836	.04707	.04583	.04465
38	.05331	.05188	.05052	.04922	.04797
39	.05714	.05564	.05420	.05282	.05150
40	.06121	.05963	.05812	.05667	.05528
41	.06554	.06388	.06229	.06076	.05929
42	.07018	.06843	.06675	.06514	.06360
43	.07508	.07324	.07148	.06979	.06817
44	.08028	.07325	.07651	.07473	.07303
45	.08575	.08373	.08180	.07993	.07814
46	.09152	.08941	.08738	.08543	.08355
47	.09759	.09539	.09326	.09122	.08926
48	.10401	.10171	.09949	.09735	.09530
49	.11076	.10836	.10605	.10382	.10167
50	.11788	.11538	.11297	.11065	.10840
51	.12535	.12276	.12025	.11782	.11548
52	.13319	.13049	.12788	.12536	.12292
53	.14139	.13858	.13588	.13326	.13072
54	.14992	.14701	.14420	.14149	.13885
55	.15880	.15579	.15288	.15006	.14733
56	.16801	.16491	.16190	.15898	.15615
57	.17760	.17439	.17128	.16827	.16534
58	.18755	.18424	.18103	.17792	.17489
59	.19790	.19450	.19119	.18798	.18486
60	.20866	.20516	.20175	.19844	.19523
61	.21986	.21626	.21276	.20936	.20605
62	.23151	.22782	.22423	.22073	.21733
63	.24362	.23984	.23616	.23257	.22908
64	.25617	.25231	.24854	.24487	.24129
65	.26917	.26522	.26137	.25761	.25395
66	.28259	.27857	.27464	.27081	.26707
67	.29643	.29233	.28833	.28443	.38061
68	.31070	.30653	.30246	.29849	.29461
69	.32542	.32120	.31707	.31303	.30908
70	.34063	.33635	.33217	.32807	.32407
71	.35639	.35207	.34784	.34370	.33965
72	.37273	.36837	.36410	.35993	.35583
73	.38955	.38517	.38088	.37667	.37255
74	.40670	.40230	.39799	.39377	.38962
75	.42398	.41958	.41526	.41102	.40686
76	.44131	.43691	.43259	.42825	.42419
77	.45864	.45425	.44994	.44571	.44155
78	.47601	.47164	.46734	.46312	.45897
79	.49348	.48914	.48487	.48067	.47654
80	.51112	.50682	.50259	.49842	.49432
81	.52881	.52455	.52036	.51624	.51218
82	.54639	.54219	.53805	.53398	.52996
83	.56386	.55973	.55566	.55164	.54768
84	.58136	.57730	.57329	.56934	.56545
85	.59891	.59494	.59102	.58715	.58333
86	.61610	.61222	.60839	.60460	.60086
87	.62335	.62856	.62481	.62111	.61746
88	.64757	.64386	.64021	.63659	.63302
89	.66209	.65848	.65491	.65139	.64790
90	.67638	.67287	.66939	.66596	.66256
91	.69032	.68691	.68353	.68019	.67689
92	.70342	.70011	.69683	.69359	.69038
93	.71539	.71217	.70899	.70584	.70271
94	.72612	.72299	.71989	.71683	.71379
95	.73550	.43245	.72943	.72643	.72347
96	.74337	.74039	.73743	.73450	.73160
97	.75041	.74748	.74458	.74171	.73886
98	.74652	.75364	.75079	.74797	.74517
99	.76224	.75941	.75660	.75382	.75106
100	.76791	.76513	.76237	.75963	.75692
101	.77280	.77005	.76732	.67462	.76194
102	.77804	.77532	.77263	.76996	.76732
103	.78485	.78218	.77954	.77692	.77432
104	.79117	.78854	.78594	.78335	.78078
105	.80103	.79848	.78595	.79343	.79093
106	.81764	.81524	.81285	.81048	.80813
107	.84137	.93921	.83706	.83493	.83281
108	.88020	.87851	.87682	.87515	.87348
109	.94563	.94484	.94405	.94326	.94248

Table G.—Table, Single Life, Unisex, Showing the Present Worth of the Remainder Interest in Property Transferred to a Pooled Income Fund Having the Yearly Rate of Return Shown—Continued

(1) Age	(2) Yearly rate of return				
	13.2%	13.4%	13.6%	13.8%	14.0%
0	.02442	.02428	.02414	.02402	.02389
1	.00643	.00629	.00617	.00605	.00594
2	.00596	.00582	.00569	.00556	.00544

(1) Age	(2) Yearly rate of return				
	13.2%	13.4%	13.6%	13.8%	14.0%
3	.00583	.00569	.00555	.00542	.00529
4	.00586	.00571	.00556	.00542	.00529
5	.00603	.00587	.00571	.00556	.00542
6	.00630	.00612	.00595	.00580	.00565
7	.00663	.00644	.00626	.00610	.00594
8	.00705	.00685	.00666	.00648	.00631
9	.00757	.00736	.00716	.00697	.00679
10	.00821	.00798	.00777	.00756	.00737
11	.00896	.00872	.00850	.00828	.00807
12	.00983	.00958	.00934	.00911	.00889
13	.01076	.01049	.01024	.00999	.00976
14	.01170	.01141	.01114	.01088	.01064
15	.01258	.01228	.01200	.01172	.01147
16	.01337	.01306	.01276	.01247	.01220
17	.01408	.01375	.01343	.01313	.01284
18	.01471	.01436	.01403	.01371	.01341
19	.01531	.01494	.01459	.01426	.01394
20	.01592	.01553	.01516	.01481	.01447
21	.01655	.01614	.01574	.01537	.01502
22	.01719	.01675	.01634	.01594	.01557
23	.01787	.01741	.01697	.01655	.01615
24	.01863	.01814	.01768	.01723	.01681
25	.01952	.01899	.01850	.01802	.01757
26	.02056	.02000	.01947	.01897	.01849
27	.02177	.02118	.02061	.02008	.01956
28	.02317	.02254	.02194	.02137	.02082
29	.02472	.02405	.02342	.02281	.02223
30	.02645	.02574	.02506	.02441	.02379
31	.02832	.02756	.02684	.02615	.02549
32	.03037	.02957	.02880	.02806	.02736
33	.03261	.03175	.03093	.03015	.02940
34	.03502	.03411	.03324	.03241	.03162
35	.03764	.03668	.03576	.03488	.03403
36	.04048	.03945	.03847	.03754	.03664
37	.04352	.04244	.04140	.04040	.03945
38	.04677	.04563	.04453	.04347	.04246
39	.05024	.04903	.04787	.04675	.04568
40	.05394	.05266	.05143	.05025	.04912
41	.05789	.05653	.05524	.05399	.05279
42	.06212	.06069	.05932	.05800	.05674
43	.06661	.06511	.06366	.06227	.06093
44	.07138	.06980	.06828	.06682	.06541
45	.07642	.07476	.07316	.07162	.07013
46	.08174	.08000	.07832	.07670	.07514
47	.08736	.08553	.08377	.08207	.08042
48	.09331	.09140	.08955	.08776	.08604
49	.09959	.09759	.09565	.09378	.09198
50	.10624	.10414	.10212	.10016	.09827
51	.11322	.11104	.10892	.10688	.10490
52	.12057	.11829	.11608	.11395	.11188
53	.12827	.12590	.12360	.12138	.11922
54	.13631	.13384	.13145	.12913	.12689
55	.14469	.14213	.13964	.13724	.13490
56	.15341	.15075	.14817	.14567	.14324
57	.16250	.15975	.15708	.15448	.15196
58	.17196	.16911	.16634	.16365	.16104
59	.18183	.17888	.17602	.17324	.17053
60	.19210	.18906	.18611	.18323	.18043
61	.20283	.19970	.19665	.19368	.19079
62	.21402	.21079	.20766	.20460	.20162
63	.22568	.22237	.21914	.21600	.21293
64	.23780	.23440	.23109	.22786	.22471
65	.25038	.24690	.24350	.24019	.23695
66	.26342	.25986	.25638	.25298	.24967
67	.27689	.27325	.26970	.26623	.26284
68	.29081	.28711	.28248	.27994	.27647
69	.30523	.30145	.29776	.29415	.29062
70	.32015	.31632	.31257	.30890	.30530
71	.33568	.33179	.32799	.32426	.32061
72	.35182	.34789	.34404	.34027	.33657
73	.36851	.36455	.36066	.35685	.35311
74	.38555	.38156	.37765	.37381	.37004
75	.40278	.39877	.39484	.39098	.38710
76	.42010	.41608	.41213	.40826	.40445
77	.43746	.43344	.42949	.42561	.42179
78	.45489	.45088	.44693	.44305	.43923
79	.47248	.46848	.46454	.46067	.45686
80	.49028	.48631	.48240	.47854	.47475
82	.50818	.50423	.50035	.49653	.59276
82	.52600	.52210	.51826	.51447	.51074
83	.54377	.53992	.53613	.53238	.52869
84	.56160	.55781	.55407	.55038	.54674
85	.57956	.57584	.57216	.56854	.56496
86	.59717	.59353	.58993	.58638	.58287
87	.61385	.61028	.60676	.60328	.59984
88	.62950	.62601	.62256	.61915	.61578
89	.64445	.64104	.63767	.63434	.63105
90	.65920	.65588	.65259	.64934	.64612
91	.67362	.67039	.66719	.66402	.66089
92	.68720	.68405	.68094	.67786	.67481
93	.69962	.69657	.69354	.69054	.68757
94	.71078	.70780	.70485	.70193	.69903
95	.72053	.71763	.71475	.71189	.70906
96	.72872	.72587	.72305	.72026	.71748
97	.73604	.73325	.73048	.72773	.72501
98	.74239	.73964	.73692	.73422	.73154
99	.74833	.74562	.74294	.74028	.73764
100	.75423	.75156	.74892	.74630	.74370
101	.75928	.75664	.75403	.75144	.74887
102	.76469	.76209	.75950	.75694	.75440
103	.77174	.76918	.76664	.76413	.76163
104	.77824	.77571	.77320	.77071	.76824
105	.78845	.78599	.78354	.78111	.77870
106	.80579	.80346	.80115	.79885	.79657
107	.83070	.82860	.82652	.82444	.82238
108	.87182	.87016	.86852	.86688	.86525
109	.94170	.94092	.94014	.93937	.93860

(e) Present value of remainder interest dependent on the termination of one life; for transfers to pooled income funds made before December 1, 1983—(1) In general. For transfers to pooled income funds made before December 1, 1983, the present value under this section of a remainder interest which is dependent on the termination of the life of one individual shall be determined under paragraphs (e)(1) through (3) of this section. The present value of such a remainder interest shall be computed by the use of Table G(1) or Table G(2) in subparagraph (3) of this paragraph. Table G(1) is to be used when the individual upon whose life the present value of the remainder interest is based is a male, and Table G(2) is to be used when the individual upon whose life the present value of the remainder interest is based is a female whose age is less than 95 years. In the case of a female whose age is more than 94 years, Table G(1) is to be used. The factors in these tables have been obtained by subtracting from 1 the factor for deter-

mining the present value of the life income interest. For purposes of the computations under this section, the age of an individual is to be taken as the age of that individual at his nearest birthday. For transfers to pooled income funds made after November 30, 1983, see paragraphs (d)(1) through (3) of this section.

(2) Computation of value of remainder interest. The factor which is used in determining the present value of the remainder interest is the factor under the appropriate yearly rate of return in column (2) of Table G(1) or Table G(2) opposite the number in column (1) which corresponds to the age of the individual upon whose life the value of the remainder interest is based. If the yearly rate of return is a percentage which is between yearly rates of return for which factors are provided in Table G(1) or Table G(2), a linear interpolation must be made. The present value of the remainder interest is determined by multiplying, by the factor determined under this subparagraph, the fair market value on the appropriate valuation date. If the yearly rate of return is below 2.2 percent or above 8 percent, see paragraph (a)(2) of this section. The application of this subparagraph may be illustrated by the following example:

Example. M, a male who will be 50 years old on April 15, 1970, transfers $100,000 to a pooled income fund on January 1, 1970, and retains in himself a life income interest in such property. The highest yearly rate of return earned by the fund for its 3 preceding taxable years is 4.717 percent. In Table G(1) the figure in column (2) opposite 50 years under 4.6 percent is 0.40087 and under 4.8 percent is 0.38764. The present value of the remainder interest is $39,313, computed as follows:

Factor at 4.6 percent for male aged 50	0.40087
Factor at 4.8 percent for male aged 50	.38764
Difference	.01323
Interpolation adjustment:	
4.717% − 4.6% ÷ 0.2% = x ÷ 0.01323	
x = 0.00774	
Factor at 4.6 percent for male aged 50	0.40087
Less: Interpolation adjustment	.00774
Interpolated factor	.39313
Present value of remainder interest ($100,000 × 0.39313)	$39,313

(3) Actuarial tables. The following tables, which show the factor obtained by subtracting from 1 the factor for determining the present value of the life income interest dependent on the termination of the life of one individual, shall be used in the application of the provisions of this section:

TABLE G(1)

TABLE, SINGLE LIFE, MALE, SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN SHOWN

(1)	(2)				
	Yearly rate of return				
Age	2.2%	2.4%	2.6%	2.8%	3%
0........	.26256	.2362	.21314	.19296	.17526
1........	.24606	.21876	.19485	.17389	.15548
2........	.25009	.22258	.19844	.17724	.15859
3........	.25473	.22702	.20267	.18125	.16238
4........	.25966	.23178	.20723	.18559	.16649
5........	.26483	.23677	.21203	.19018	.17087
6........	.27017	.24195	.21702	.19497	.17545
7........	.27568	.2473	.22219	.19994	.18021
8........	.28134	.25282	.22753	.20509	.18516
9........	.28716	.2585	.23305	.21043	.19029
10.......	.29314	.26436	.23875	.21595	.19562
11.......	.29928	.27038	.24462	.22165	.20114
12.......	.30555	.27654	.25065	.22751	.20681
13.......	.31193	.28282	.25678	.23349	.21261
14.......	.31836	.28915	.26299	.23954	.21849
15.......	.32483	.29553	.26925	.24565	.22443
16.......	.33131	.30194	.27554	.25179	.23041
17.......	.33784	.30839	.28187	.25798	.23643
18.......	.3444	.31487	.28825	.26422	.24251
19.......	.35102	.32143	.29471	.27055	.24868
20.......	.35772	.32808	.30126	.27697	.25495
21.......	.3645	.33481	.3079	.28349	.26133
22.......	.37136	.34163	.31465	.29012	.26782
23.......	.37836	.3486	.32154	.29691	.27446
24.......	.38551	.35573	.32862	.30389	.28134
25.......	.39287	.3631	.33593	.31113	.28846
26.......	.40045	.37069	.3435	.31863	.29586
27.......	.40824	.37852	.35131	.32638	.30353
28.......	.41622	.38655	.35935	.33438	.31146
29.......	.42439	.39479	.36761	.34262	.31964
30.......	.43272	.40321	.37605	.35106	.32803
31.......	.44121	.4118	.38469	.3597	.33664
32.......	.44985	.42056	.39352	.36855	.34547
33.......	.45865	.4295	.40254	.3776	.35452
34.......	.4676	.4386	.41174	.38686	.36379
35.......	.47669	.44787	.42113	.39631	.37327
36.......	.48592	.45728	.43068	.40595	.38295
37.......	.49528	.46684	.44039	.41577	.39283
38.......	.50475	.47654	.45026	.42575	.40289
39.......	.51433	.48637	.46027	.4359	.41313
40.......	.52399	.49629	.4704	.44618	.42352
41.......	.53374	.50632	.48064	.4566	.43406
42.......	.54356	.51642	.49099	.46713	.44473
43.......	.55343	.52661	.50143	.47777	.45553
44.......	.56337	.53687	.51195	.48851	.46644
45.......	.57335	.54719	.52256	.49935	.47748
46.......	.58337	.55757	.53324	.51029	.48861
47.......	.59343	.568	.54399	.5213	.49985
48.......	.60349	.57845	.55477	.53235	.51114
49.......	.61352	.58887	.56553	.54341	.52244
50.......	.62348	.59924	.57625	.55444	.53373
51.......	.63337	.60954	.58691	.56541	.54498
52.......	.64318	.61978	.59752	.57634	.55618
53.......	.65293	.62996	.60808	.58724	.56737
54.......	.66266	.64012	.61864	.59814	.57858
55.......	.67236	.65028	.6292	.60906	.58982
56.......	.68206	.66044	.63977	.62001	.6011

(1)	(2)				
	Yearly rate of return				
Age	2.2%	2.4%	2.6%	2.8%	3%
57	.69173	.67059	.65035	.63097	.61241
58	.70135	.68069	.66089	.64191	.6237
59	.71086	.69069	.67134	.65276	.63492
60	.72024	.70056	.68166	.66349	.64602
61	.72947	.71029	.69184	.67408	.65699
62	.73856	.71987	.70188	.68454	.66783
63	.74751	.72932	.71178	.69487	.67855
64	.75633	.73865	.72157	.70508	.68916
65	.76504	.74786	.73125	.71519	.69966
66	.77362	.75694	.7408	.72518	.71005
67	.78209	.76591	.75024	.73505	.72034
68	.79043	.77476	.75956	.74482	.73052
69	.79867	.78351	.76879	.7545	.74062
70	.80683	.79218	.77794	.7641	.75064
71	.8149	.80076	.78701	.77363	.7606
72	.82288	.80926	.796	.78308	.7705
73	.83078	.81768	.80491	.79246	.78032
74	.83856	.82599	.81372	.80174	.79005
75	.84624	.83418	.82241	.8109	.79966
76	.85379	.84226	.83098	.81996	.80917
77	.86124	.85023	.83945	.8289	.81858
78	.86854	.85804	.84776	.8377	.82783
79	.87564	.86566	.85587	.84627	.83686
80	.88249	.873	.8637	.85457	.8456
81	.88897	.87996	.87112	.86243	.8539
82	.89501	.88645	.87804	.86977	.86164
83	.90065	.89251	.88451	.87664	.86889
84	.90606	.89833	.89072	.88323	.87586
85	.91143	.90411	.8969	.8898	.8828
86	.91659	.90967	.90285	.89612	.88949
87	.92155	.91502	.90857	.90221	.89594
88	.92629	.92012	.91404	.90803	.90211
89	.93072	.9249	.91916	.91349	.90789
90	.93475	.92926	.92383	.91846	.91317
91	.93838	.93318	.92803	.92295	.91792
92	.94165	.93671	.93182	.92699	.92221
93	.94457	.93986	.9352	.9306	.92604
94	.94717	.94267	.93822	.93382	.92946
95	.94954	.94523	.94097	.93675	.93257
96	.95184	.94772	.94365	.93961	.93561
97	.95403	.95009	.94619	.94232	.93849
98	.95611	.95234	.9486	.9449	.94124
99	.95808	.95447	.9509	.94736	.94385
100	.95996	.95651	.95309	.94969	.94633
101	.96175	.95845	.95517	.95192	.9487
102	.96348	.96032	.95718	.95407	.95099
103	.96517	.96214	.95915	.95617	.95324
104	.96687	.96399	.96114	.9583	.95542
105	.96871	.96598	.96328	.96059	.95798
106	.97092	.96838	.96585	.96334	.96082
107	.97401	.97173	.96947	.96721	.96495
108	.97919	.97735	.97552	.9737	.97187
109	.98924	.98828	.98733	.98638	.98549

(1)	(2)				
	Yearly rate of return				
Age	3.2%	3.4%	3.6%	3.8%	4%
0	.15973	.14608	.13407	.12348	.11414
1	.1393	.12506	.11252	.10145	.09167
2	.14218	.1277	.11493	.10364	.09365
3	.14573	.13103	.11804	.10654	.09634
4	.14962	.1347	.12149	.10977	.09938
5	.15378	.13864	.12521	.11328	.10268
6	.15814	.14278	.12913	.117	.10619
7	.16269	.14711	.13325	.1209	.10989
8	.16743	.15164	.13757	.12501	.11379
9	.17236	.15636	.14207	.12931	.11788
10	.17748	.16127	.14678	.13381	.12218
11	.1828	.16639	.15169	.13851	.12668
12	.18828	.17167	.15676	.14338	.13135
13	.19389	.17708	.16198	.1484	.13616
14	.19959	.18259	.16728	.1535	.14106
15	.20534	.18815	.17265	.15866	.14602
16	.21114	.19375	.17805	.16386	.15102
17	.21698	.19941	.18351	.16912	.15608
18	.22289	.20512	.18903	.17444	.1612
19	.22888	.21093	.19465	.17986	.16642
20	.23498	.21685	.20037	.18539	.17174
21	.2412	.22289	.20622	.19103	.17719
22	.24753	.22904	.21219	.19681	.18276
23	.25403	.23537	.21834	.20277	.18853
24	.26075	.24193	.22471	.20896	.19452
25	.26773	.24876	.23137	.21544	.20082
26	.275	.25589	.23834	.22224	.20744
27	.28256	.26331	.24562	.22934	.21437
28	.29039	.27101	.25318	.23675	.2216
29	.29848	.27899	.26102	.24445	.22914
30	.30679	.2872	.26911	.2524	.23694
31	.31534	.29566	.27746	.26062	.24502
32	.32412	.30436	.28606	.2691	.25336
33	.33314	.31331	.29492	.27785	.26199
34	.34238	.32251	.30404	.28687	.2709
35	.35186	.33194	.31341	.29616	.28008
36	.36154	.34161	.32303	.3057	.28953
37	.37144	.3515	.33288	.31549	.29924
38	.38155	.3616	.34296	.32553	.30922
39	.39184	.37192	.35327	.33581	.31943
40	.4023	.38241	.36378	.34629	.32988
41	.41292	.39309	.37447	.35698	.34053
42	.42369	.40393	.38534	.36785	.3514
43	.43461	.41492	.39639	.37892	.36246
44	.44566	.42607	.4076	.39017	.37372
45	.45684	.43736	.41897	.4016	.38518
46	.46814	.44879	.43049	.41319	.39681
47	.47956	.46035	.44217	.42494	.40862
48	.49104	.47199	.45394	.43681	.42055
49	.50255	.48368	.46576	.44875	.43257
50	.51406	.49537	.4776	.46071	.44463
51	.52554	.50704	.48944	.47267	.4567
52	.53699	.5187	.50127	.48465	.4688
53	.54843	.53036	.51311	.49665	.48093
54	.5599	.54206	.52502	.50872	.49314
55	.57142	.55382	.537	.52089	.50547
56	.58299	.56566	.54906	.53315	.5179
57	.59461	.57756	.5612	.5455	.53045
58	.60623	.58946	.57336	.5579	.54304
59	.61778	.60131	.58547	.57025	.5556
60	.62922	.61305	.59749	.58252	.56809
61	.64053	.62468	.6094	.59468	.58049
62	.65172	.63619	.6212	.60675	.5928
63	.6628	.64759	.6329	.61872	.60502
64	.67377	.6589	.64452	.63061	.61717
65	.68464	.67011	.65605	.64243	.62925
66	.69541	.68123	.66748	.65417	.64126
67	.70607	.69225	.67883	.66582	.6532
68	.71664	.70317	.69009	.6774	.66506

(1)	(2)				
	Yearly rate of return				
Age	3.2%	3.4%	3.6%	3.8%	4%
69	.72713	.71403	.7013	.68892	.67689
70	.73756	.72483	.71245	.70041	.68869
71	.74793	.73559	.72357	.71186	.70046
72	.75824	.74629	.73464	.72328	.71221
73	.76848	.75693	.74566	.73466	.72392
74	.77863	.76748	.7566	.74597	.73558
75	.78868	.77794	.76745	.75719	.74716
76	.79862	.78831	.77821	.76833	.75866
77	.80846	.79857	.78887	.77938	.77008
78	.81816	.80869	.7994	.7903	.78138
79	.82764	.81859	.80971	.801	.79245
80	.83681	.82817	.8197	.81138	.8032
81	.84552	.83729	.8292	.82125	.81344
82	.85365	.8458	.83808	.83049	.82302
83	.86128	.85378	.84641	.83915	.83201
84	.8686	.86146	.85442	.84749	.84068
85	.87591	.86912	.86243	.85584	.84935
86	.88296	.87652	.87016	.8639	.85773
87	.88975	.88365	.87763	.87169	.86583
88	.89626	.89049	.88479	.87916	.87361
89	.90236	.8969	.89151	.88618	.88092
90	.90793	.90276	.89765	.8926	.88761
91	.91295	.90804	.90319	.89839	.89365
92	.91748	.91281	.90819	.90362	.8991
93	.92153	.91707	.91266	.9083	.90398
94	.92515	.92088	.91666	.91247	.90834
95	.92844	.92435	.92029	.91628	.91231
96	.93165	.92773	.92384	.92	.91619
97	.9347	.93094	.92722	.92353	.91988
98	.9376	.934	.93044	.9269	.9234
99	.94036	.93691	.93349	.9301	.92674
100	.94299	.93969	.93641	.93316	.92993
101	.94551	.94234	.9392	.93608	.93298
102	.94793	.94489	.94188	.93889	.93592
103	.95029	.94739	.94451	.94164	.9388
104	.95269	.94991	.94716	.94443	.94171
105	.95527	.95264	.95002	.94743	.94485
106	.95837	.95591	.95346	.95103	.94862
107	.96274	.96052	.95832	.95613	.95395
108	.97009	.9683	.96651	.96474	.96297
109	.9845	.98356	.98263	.9817	.98077

(1)	(2)				
	Yearly rate of return				
Age	4.2%	4.4%	4.6%	4.8%	5%
0	.10589	.09859	.09212	.08638	.08128
1	.08301	.07535	.06856	.06252	.05715
2	.0848	.07695	.06998	.06378	.05826
3	.0873	.07926	.07211	.06574	.06006
4	.09014	.08191	.07459	.06805	.06221
5	.09324	.08483	.07732	.07061	.06462
6	.09655	.08795	.08027	.07338	.06722
7	.10006	.09126	.08339	.07634	.07001
8	.10375	.09477	.08672	.07948	.07299
9	.10765	.09847	.09023	.08282	.07616
10	.11175	.10237	.09395	.08636	.07952
11	.11605	.10648	.09787	.0901	.08309
12	.12052	.11076	.10196	.094	.08682
13	.12513	.11518	.10619	.09806	.0907
14	.12983	.11968	.1105	.10219	.09465
15	.13459	.12425	.11488	.10638	.09866
16	.13939	.12885	.11929	.1106	.1027

(1)	(2)				
	Yearly rate of return				
Age	4.2%	4.4%	4.6%	4.8%	5%
17	.14425	.13352	.12376	.11488	.1068
18	.14917	.13823	.12827	.1192	.11094
19	.15418	.14304	.13289	.12363	.11517
20	.15931	.14797	.13762	.12816	.11951
21	.16455	.15301	.14246	.13281	.12397
22	.16993	.15819	.14744	.13758	.12855
23	.17549	.16355	.1526	.14255	.13332
24	.18129	.16915	.158	.14775	.13832
25	.18739	.17505	.16371	.15326	.14364
26	.19382	.18129	.16975	.15911	.14929
27	.20057	.18785	.17612	.16529	.15528
28	.20763	.19473	.18281	.17179	.1616
29	.215	.20193	.18983	.17862	.16824
30	.22264	.20939	.19712	.18573	.17517
31	.23056	.21715	.2047	.19314	.1824
32	.23876	.2252	.21259	.20086	.18994
33	.24725	.23354	.22077	.20888	.1978
34	.25603	.24217	.22926	.21721	.20596
35	.26509	.25111	.23805	.22585	.21445
36	.27443	.26032	.24714	.2348	.22325
37	.28405	.26983	.25652	.24405	.23236
38	.29393	.27962	.26619	.2536	.24177
39	.30408	.28967	.27614	.26344	.25149
40	.31446	.29997	.28635	.27354	.26148
41	.32507	.31052	.29681	.2839	.27174
42	.3359	.32129	.30752	.29452	.28226
43	.34694	.33229	.31846	.3054	.29305
44	.35819	.34352	.32964	.31651	.30409
45	.36965	.35495	.34104	.32787	.31538
46	.3813	.3666	.325267	.33946	.32692
47	.39314	.37846	.36451	.35128	.33871
48	.40512	.39046	.37653	.36328	.35068
49	.4172	.40258	.38866	.37542	.3628
50	.42933	.41476	.40087	.38764	.37502
51	.44148	.42697	.41313	.39991	.3873
52	.45367	.43923	.42544	.41226	.39966
53	.46591	.45155	.43782	.42469	.41212
54	.47824	.46398	.45032	.43725	.42472
55	.4907	.47655	.46298	.44998	.43751
56	.50328	.48926	.4758	.46288	.45048
57	.51599	.5021	.48877	.47595	.46363
58	.52876	.51503	.50182	.48912	.4769
59	.54151	.52795	.51489	.50231	.4902
60	.5542	.54082	.52791	.51547	.50348
61	.56681	.55361	.54087	.52857	.51671
62	.57933	.56632	.55376	.54162	.52989
63	.59178	.57897	.5666	.55462	.54304
64	.60416	.59157	.57939	.56759	.55617
65	.61649	.60412	.59214	.58053	.56928
66	.62875	.61662	.60485	.59344	.58236
67	.64095	.62906	.61751	.6063	.59542
68	.65308	.64145	.63014	.61914	.60845
69	.66519	.65381	.64275	.63197	.6215
70	.67728	.66617	.65535	.64482	.63456
71	.68935	.67853	.66798	.65769	.64767
72	.70141	.69088	.6806	.67058	.6608
73	.71345	.70322	.69323	.68348	.67395
74	.72543	.71552	.70583	.69636	.6871
75	.73735	.72775	.71837	.70919	.70021
76	.7492	.73993	.73086	.72198	.71329
77	.76097	.75205	.74331	.73473	.72634

(1)	(2)				
	Yearly rate of return				
Age	4.2%	4.4%	4.6%	4.8%	5%
78	.77263	.76405	.75564	.74739	.7393
79	.78407	.77584	.76776	.75983	.75205
80	.79518	.7873	.77955	.77195	.76448
81	.80577	.79822	.79081	.78352	.77635
82	.81568	.80846	.80135	.79437	.78749
83	.82499	.81807	.81126	.80456	.79796
84	.83396	.82734	.82083	.8144	.80808
85	.84295	.83664	.83042	.8243	.81826
86	.85164	.84563	.83971	.83387	.82811
87	.86005	.85434	.84871	.84316	.83768
88	.86813	.86272	.85737	.85209	.84689
89	.87573	.87059	.86552	.86051	.85557
90	.88268	.8778	.87298	.86823	.86352
91	.88896	.88432	.87974	.8752	.87072
92	.89463	.89021	.88583	.88151	.87723
93	.89971	.89548	.8913	.88716	.88306
94	.90424	.90019	.89618	.89221	.88827
95	.90838	.90448	.90063	.89681	.89303
96	.91241	.90868	.90498	.90131	.89768
97	.91626	.91268	.90912	.9056	.90211
98	.91992	.91648	.91307	.90969	.90634
99	.92341	.92011	.91683	.91359	.91037
100	.92674	.92357	.92042	.91731	.91422
101	.92992	.92688	.92386	.92086	.9179
102	.93298	.93006	.92717	.92429	.92144
103	.93598	.93319	.93041	.92765	.92492
104	.93902	.93634	.93369	.93105	.92843
105	.94228	.93974	.93721	.93471	.93222
106	.94622	.94383	.94147	.93911	.93678
107	.95178	.94963	.94749	.94536	.94324
108	.96121	.95946	.95772	.95598	.95426
109	.97985	.97893	.97801	.9771	.97619

(1)	(2)				
	Yearly rate of return				
Age	5.2%	5.4%	5.6%	5.8%	6%
0	.07674	.07269	.06908	.06585	.06295
1	.05237	.0481	.04429	.04088	.03783
2	.05332	.04893	.04499	.04146	.0383
3	.05499	.05045	.04638	.04274	.03947
4	.05699	.05231	.04811	.04434	.04095
5	.05924	.05442	.05009	.04619	.04268
6	.06169	.05672	.05226	.04823	.0446
7	.06432	.05921	.0546	.05044	.04669
8	.06714	.06187	.05712	.05283	.04895
9	.07015	.06473	.05983	.0554	.05139
10	.07335	.06777	.06273	.05816	.05402
11	.07675	.07102	.06582	.06111	.05684
12	.08032	.07442	.06908	.06423	.05981
13	.08403	.07797	.07247	.06747	.06292
14	.08781	.08159	.07594	.07079	.06609
15	.09165	.08526	.07945	.07415	.06931
16	.09551	.08896	.08298	.07753	.07254
17	.09943	.0927	.08656	.08095	.07581
18	.10338	.09649	.09018	.08441	.07911
19	.10744	.10036	.09388	.08794	.08249
20	.11159	.10433	.09768	.09158	.08597
21	.11586	.10842	.10159	.09531	.08954
22	.12025	.11262	.10561	.09916	.09322
23	.12482	.11701	.10982	.10319	.09708
24	.12963	.12164	.11426	.10745	.10116
25	.13476	.12657	.11901	.11202	.10555
26	.14022	.13184	.1241	.11693	.11028
27	.14602	.13746	.12952	.12217	.11535
28	.15215	.1434	.13528	.12774	.12075
29	.15861	.14967	.14137	.13365	.12647
30	.16535	.15623	.14775	.13985	.1325
31	.1724	.16311	.15444	.14637	.13883
32	.17977	.1703	.16145	.1532	.14549
33	.18745	.1778	.16879	.16036	.15248
34	.19546	.18563	.17645	.16785	.1598
35	.20378	.1938	.18444	.17568	.16745
36	.21242	.20228	.19277	.18384	.17545
37	.22139	.21109	.20142	.19233	.18378
38	.23066	.22022	.2104	.20116	.19245
39	.24024	.22966	.2197	.21031	.20146
40	.25011	.2394	.2293	.21977	.21077
41	.26026	.24942	.2392	.22953	.2204
42	.27067	.25973	.24938	.23959	.23033
43	.28137	.27031	.25985	.24994	.24056
44	.29232	.28118	.27061	.26059	.25109
45	.30354	.29231	.28165	.27153	.26192
46	.31502	.30372	.29298	.28277	.27305
47	.32676	.31539	.30458	.29429	.28448
48	.33869	.32727	.3164	.30603	.29615
49	.35078	.33932	.3284	.31797	.30802
50	.36298	.35149	.34052	.33004	.32003
51	.37526	.36375	.35274	.34222	.33215
52	.38762	.37609	.36507	.35451	.3444
53	.40009	.38856	.37752	.36694	.3568
54	.41271	.4012	.39016	.37957	.3694
55	.42554	.41405	.40302	.39242	.38224
56	.43856	.42711	.4161	.40552	.39534
57	.45178	.44038	.42941	.41885	.40869
58	.46513	.45379	.44287	.43235	.42222
59	.47852	.46726	.4564	.44593	.43583
60	.4919	.48073	.46995	.45954	.44948
61	.50524	.49417	.48347	.47313	.46313
62	.51855	.50758	.49698	.48672	.47679
63	.53183	.52098	.51048	.50031	.49046
64	.5451	.53438	.52399	.51392	.50415
65	.55836	.54778	.53751	.52755	.51788
66	.57161	.56117	.55104	.5412	.53164
67	.58484	.57456	.56457	.55486	.54542
68	.59806	.58795	.57811	.56854	.55923
69	.61129	.60136	.59169	.58228	.57311
70	.62457	.61483	.60533	.59608	.58706
71	.63789	.62835	.61905	.60997	.60111
72	.65125	.64193	.63282	.62394	.61526
73	.66464	.65554	.64666	.63798	.62949
74	.67804	.66919	.66052	.65205	.64376
75	.69141	.6828	.67438	.66613	.65806
76	.70476	.69642	.68825	.68023	.67239
77	.7181	.71003	.70211	.69435	.68673
78	.73135	.72356	.71592	.70841	.70105
79	.7444	.7369	.72953	.7223	.71519
80	.75713	.74992	.74283	.73587	.72902
81	.76931	.76238	.75556	.74886	.74227
82	.78073	.77407	.76752	.76107	.75473
83	.79146	.78507	.77877	.77256	.76646
84	.80185	.79571	.78966	.7837	.77783
85	.8123	.80643	.80063	.79492	.7893
86	.82243	.81682	.81129	.80583	.80045
87	.83226	.82692	.82165	.81644	.8113
88	.84174	.83666	.83164	.82668	.82178

(1)	(2)				
	Yearly rate of return				
Age	5.2%	5.4%	5.6%	5.8%	6%
89.......	.85067	.84584	.84107	.83635	.83169
90.......	.85887	.85427	.84972	.84523	.84078
91.......	.86628	.8619	.85756	.85327	.84903
92.......	.873	.8688	.86466	.86056	.8565
93.......	.87901	.87499	.87102	.86709	.86319
94.......	.88438	.88053	.87671	.87293	.86919
95.......	.88928	.88557	.8819	.87826	.87465
96.......	.89408	.89052	.88698	.88348	.88002
97.......	.89866	.89523	.89183	.88847	.88513
98.......	.90301	.89972	.89646	.89322	.89001
99.......	.90717	.90401	.90087	.89776	.89468
100......	.91115	.9081	.90509	.9021	.89913
101......	.91495	.91202	.90912	.90625	.90339
102......	.91861	.9158	.91302	.91025	.9075
103......	.9222	.9195	.91683	.91417	.91154
104......	.92583	.92324	.92068	.91813	.91561
105......	.92974	.92728	.92484	.92241	.92
106......	.93445	.93214	.92984	.92756	.92529
107......	.94114	.93904	.93696	.93488	.93282
108......	.95253	.95083	.94912	.94743	.94574
109......	.97528	.97438	.97348	.97259	.9717

(1)	(2)				
	Yearly rate of return				
Age	6.2%	6.4%	6.6%	6.8%	7%
0........	.06036	.05802	.05592	.05403	.05232
1........	.03509	.03263	.03041	.02841	.02661
2........	.03546	.0329	.0306	.02852	.02664
3........	.03652	.03386	.03147	.02931	.02735
4........	.0379	.03515	.03266	.03041	.02837
5........	.03952	.03667	.03408	.03174	.02962
6........	.04133	.03836	.03568	.03325	.03104
7........	.0433	.04022	.03744	.03491	.03261
8........	.04544	.04225	.03936	.03673	.03434
9........	.04775	.04445	.04146	.03872	.03624
10.......	.05026	.04684	.04373	.0409	.03831
11.......	.05295	.04941	.04619	.04325	.04056
12.......	.0558	.05213	.04879	.04575	.04295
13.......	.05877	.05499	.05153	.04837	.04547
14.......	.06181	.0579	.05432	.05104	.04804
15.......	.06489	.06084	.05714	.05375	.05063
16.......	.06799	.0638	.05998	.05646	.05323
17.......	.07111	.06679	.06283	.05919	.05584
18.......	.07426	.0698	.0657	.06194	.05847
19.......	.07749	.07289	.06865	.06476	.06116
20.......	.0808	.07605	.07168	.06764	.06392
21.......	.08422	.07932	.07479	.07062	.06675
22.......	.08774	.08268	.07801	.07368	.06969
23.......	.09143	.08621	.08139	.07691	.07277
24.......	.09535	.08996	.08498	.08036	.07607
25.......	.09956	.09402	.08887	.0841	.07967
26.......	.10412	.09841	.0931	.08817	.08358
27.......	.10902	.10313	.09766	.09257	.08783
28.......	.11424	.10819	.10255	.09729	.0924
29.......	.11979	.11357	.10777	.10235	.09729
30.......	.12564	.11924	.11327	.10769	.10247
31.......	.1318	.12523	.11909	.11335	.10797
32.......	.13829	.13155	.12524	.11933	.11379
33.......	.14509	.13818	.1317	.12563	.11993
34.......	.15224	.14516	.13852	.13228	.12641
35.......	.15974	.15249	.14568	.13928	.13325
36.......	.16757	.16015	.15318	.14661	.14043
37.......	.17574	.16817	.16103	.15431	.14797
38.......	.18425	.17652	.16923	.16235	.15585
39.......	.19311	.18522	.17778	.17074	.16408
40.......	.20228	.19424	.18664	.17946	.17265
41.......	.21176	.20358	.19584	.1885	.18155
42.......	.22155	.21324	.20535	.19787	.19078
43.......	.23165	.22321	.21519	.20758	.20033
44.......	.24206	.23349	.22534	.2176	.21023
45.......	.25278	.24409	.23583	.22795	.22046
46.......	.26381	.25501	.24662	.23864	.23102
47.......	.27514	.26624	.25775	.24965	.24192
48.......	.28673	.27773	.26914	.26094	.2531
49.......	.29851	.28943	.28076	.27246	.26452
50.......	.31045	.3013	.29254	.28415	.27612
51.......	.32252	.31329	.30446	.29599	.28788
52.......	.33472	.32543	.31652	.30798	.29979
53.......	.34707	.33773	.32877	.32016	.31189
54.......	.35963	.35025	.34124	.33258	.32425
55.......	.37245	.36305	.354	.34529	.3369
56.......	.38554	.37612	.36704	.35829	.34987
57.......	.3989	.38946	.38037	.3716	.36314
58.......	.41244	.40301	.39391	.38513	.37666
59.......	.42608	.41667	.40758	.39879	.39031
60.......	.43977	.43038	.42131	.41253	.40404
61.......	.45346	.44411	.43506	.4263	.41782
62.......	.46718	.45787	.44885	.44012	.43166
63.......	.48091	.47165	.46269	.45399	.44555
64.......	.49468	.48549	.47658	.46793	.45953
65.......	.5085	.49939	.49053	.48194	.47359
66.......	.52235	.51332	.50454	.49602	.48772
67.......	.53624	.52731	.51862	.51016	.50193
68.......	.55017	.54134	.53275	.52437	.51622
69.......	.56417	.55546	.54698	.5387	.53064
70.......	.57826	.56969	.56132	.55316	.54519
71.......	.59247	.58403	.5758	.56776	.5599
72.......	.60678	.5985	.59041	.5825	.57477
73.......	.62119	.61307	.60514	.59737	.58978
74.......	.63565	.62772	.61995	.61235	.60491
75.......	.65015	.64241	.63482	.62739	.62011
76.......	.66469	.65715	.64976	.64251	.63541
77.......	.67927	.67195	.66476	.65771	.65079
78.......	.69382	.68673	.67975	.67291	.6662
79.......	.7082	.70134	.6946	.68798	.68147
80.......	.72228	.71567	.70916	.70276	.69647
81.......	.73578	.7294	.72312	.71695	.71087
82.......	.74848	.74233	.73627	.73031	.72444
83.......	.76044	.75451	.74867	.74291	.73724
84.......	.77203	.76632	.7607	.75515	.74968
85.......	.78374	.77827	.77287	.76754	.76228
86.......	.79513	.78989	.78471	.77961	.77457
87.......	.80622	.80121	.79626	.79138	.78655
88.......	.81695	.81217	.80744	.80277	.79817
89.......	.82708	.82252	.81802	.81357	.80917
90.......	.83639	.83204	.82775	.82349	.8193
91.......	.84483	.84068	.83657	.83251	.82849
92.......	.85248	.84851	.84457	.84068	.83682
93.......	.85934	.85553	.85175	.84801	.84431
94.......	.86548	.86181	.85818	.85458	.85102
95.......	.87108	.86755	.86405	.86057	.85714
96.......	.87658	.87318	.8698	.86646	.86315
97.......	.88183	.87855	.8753	.87209	.86889
98.......	.88684	.88368	.88055	.87746	.87438
99.......	.89162	.88858	.88557	.88258	.87963

(1)	(2)				
	Yearly rate of return				
Age	6.2%	6.4%	6.6%	6.8%	7%
100......	.89618	.89326	.89037	.88749	.88464
101......	.90056	.89775	.89496	.89219	.88945
102......	.90478	.90208	.8994	.89673	.89409
103......	.90892	.90632	.90374	.90118	.89863
104......	.91309	.9106	.90813	.90567	.90323
105......	.9176	.91523	.91286	.91051	.90818
106......	.92303	.92079	.91857	.91636	.91416
107......	.93078	.92874	.92671	.9247	.92269
108......	.94406	.94239	.94073	.93908	.93743
109......	.97081	.96993	.96905	.96816	.96729

(1)	(2)				
	Yearly rate of return				
Age	7.2%	7.4%	7.6%	7.8%	8%
0........	.05077	.04937	.04809	.04693	.04588
1........	.02498	.0235	.02215	.02094	.01983
2........	.02494	.0234	.022	.02073	.01957
3........	.02558	.02397	.02251	.02118	.01996
4........	.02652	.02484	.02332	.02193	.02066
5........	.02769	.02594	.02434	.02289	.02156
6........	.02903	.0272	.02554	.02401	.02262
7........	.03052	.02861	.02687	.02527	.02382
8........	.03216	.03017	.02836	.02669	.02517
9........	.03397	.0319	.03	.02826	.02666
10.......	.03595	.03379	.03181	.02999	.02833
11.......	.0381	.03585	.03379	.0319	.03015
12.......	.0404	.03806	.03591	.03393	.03211
13.......	.04282	.04038	.03814	.03608	.03418
14.......	.04528	.04274	.04042	.03827	.0363
15.......	.04777	.04513	.04271	.04048	.03842
16.......	.05026	.04752	.045	.04267	.04052
17.......	.05276	.04991	.04729	.04487	.04263
18.......	.05527	.05232	.04959	.04707	.04474
19.......	.05784	.05477	.05194	.04931	.04688
20.......	.06047	.05729	.05434	.05161	.04908
21.......	.06319	.05988	.05682	.05398	.05134
22.......	.06599	.06255	.05937	.05641	.05366
23.......	.06894	.06537	.06207	.05899	.05613
24.......	.07209	.0684	.06496	.06176	.05878
25.......	.07554	.07171	.06813	.06481	.0617
26.......	.07931	.07534	.07163	.06817	.06494
27.......	.08341	.07929	.07544	.07185	.06849
28.......	.08782	.08356	.07957	.07584	.07235
29.......	.09257	.08815	.08402	.08015	.07652
30.......	.0976	.09303	.08874	.08473	.08097
31.......	.10293	.09821	.09378	.08962	.08572
32.......	.10859	.10371	.09913	.09483	.09078
33.......	.11457	.10954	.10481	.10036	.09616
34.......	.1209	.11571	.11083	.10623	.10189
35.......	.12758	.12223	.11719	.11244	.10795
36.......	.1346	.1291	.12391	.11901	.11437
37.......	.14198	.13632	.13097	.12592	.12114
38.......	.1497	.14389	.1384	.13319	.12826
39.......	.15779	.15183	.14618	.14082	.13575
40.......	.1662	.16009	.15429	.14879	.14358
41.......	.17495	.1687	.16275	.15711	.15174
42.......	.18404	.17764	.17155	.16577	.16026
43.......	.19346	.18692	.18069	.17477	.16912
44.......	.20322	.19654	.19018	.18411	.17834
45.......	.21331	.20651	.20002	.19382	.1879
46.......	.22375	.21682	.2102	.20388	.19783
47.......	.23454	.22748	.22075	.2143	.20814
48.......	.24561	.23844	.23159	.22503	.21874
49.......	.25692	.24965	.24269	.23601	.22962
50.......	.26843	.26106	.25398	.24721	.2407
51.......	.28009	.27262	.26546	.25858	.25197
52.......	.29192	.28437	.2771	.27013	.26342
53.......	.30395	.29631	.28897	.2819	.2751
54.......	.31624	.30853	.3011	.29396	.28708
55.......	.32883	.32106	.31357	.30635	.29938
56.......	.34175	.33392	.32637	.31908	.31206
57.......	.35499	.34711	.33951	.33217	.32509
58.......	.36847	.36057	.35292	.34554	.3384
59.......	.3821	.37417	.3665	.35908	.3519
60.......	.39583	.38789	.3802	.37275	.36554
61.......	.40961	.40167	.39395	.38649	.37925
62.......	.42346	.41551	.4078	.40032	.39306
63.......	.43737	.42943	.42172	.41424	.40698
64.......	.45137	.44345	.43576	.42829	.42102
65.......	.46547	.45758	.44991	.44246	.4352
66.......	.47966	.4718	.46416	.45673	.4495
67.......	.49392	.48612	.47853	.47113	.46392
68.......	.50828	.50054	.493	.48564	.47847
69.......	.52277	.5151	.50762	.50032	.4932
70.......	.53741	.52983	.52242	.51518	.50812
71.......	.55223	.54474	.53741	.53026	.52326
72.......	.56722	.55983	.5526	.54553	.53862
73.......	.58235	.57508	.56797	.56101	.55419
74.......	.59761	.59048	.58349	.57665	.56994
75.......	.61298	.60598	.59913	.59241	.58582
76.......	.62844	.6216	.6149	.60832	.60187
77.......	.644	.63734	.6308	.62438	.61807
78.......	.6596	.65312	.64675	.6405	.63435
79.......	.67508	.66879	.66261	.65653	.65056
80.......	.69028	.68419	.6782	.67231	.66651
81.......	.70489	.69901	.69321	.6875	.68189
82.......	.71866	.71297	.70736	.70184	.69639
83.......	.73166	.72615	.72072	.71538	.7101
84.......	.74429	.73897	.73373	.72856	.72346
85.......	.75709	.75198	.74694	.74195	.73704
86.......	.76959	.76467	.75982	.75503	.7503
87.......	.78178	.77708	.77243	.76783	.7633
88.......	.79361	.78911	.78466	.78027	.77592
89.......	.80482	.80052	.79627	.79206	.7879
90.......	.81513	.81103	.80696	.80293	.79896
91.......	.82451	.82057	.81668	.81282	.80901
92.......	.83301	.82924	.8255	.8218	.81814
93.......	.84065	.83702	.83342	.82987	.82634
94.......	.84748	.84399	.84053	.8371	.8337
95.......	.85373	.85036	.84701	.8437	.84042
96.......	.85987	.85661	.85339	.85019	.84702
97.......	.86573	.86259	.85948	.8564	.85334
98.......	.87134	.86831	.86531	.86235	.85939
99.......	.87669	.87378	.87089	.86802	.86518
100......	.88181	.879	.87622	.87346	.87072
101......	.88672	.88402	.88133	.87867	.87603
102......	.89147	.88886	.88627	.88371	.88116
103......	.89611	.8936	.89111	.88864	.88618
104......	.90081	.8984	.896	.89363	.89127
105......	.90586	.90356	.90128	.89901	.89674
106......	.91197	.9098	.90764	.9055	.90336
107......	.9207	.91872	.91675	.91479	.91284
108......	.93579	.93415	.93253	.93092	.9293
109......	.96642	.96555	.96468	.96382	.96296

TABLE G(2)

TABLE, SINGLE LIFE, FEMALE, SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A POOLED INCOME FUND HAVING THE YEARLY RATE OF RETURN, SHOWN

(1)	(2)				
	Yearly rate of return				
Age	2.2%	2.4%	2.6%	2.8%	3%
0	.22662	.20119	.17921	.1602	.14372
1	.21362	.18742	.16474	.14508	.12802
2	.21706	.19061	.16768	.14777	.13046
3	.2211	.19443	.17126	.1511	.13358
4	.2254	.19852	.17511	.15472	.13694
5	.2299	.2028	.17917	.15855	.14053
6	.23455	.20724	.18339	.16254	.14429
7	.23937	.21186	.1878	.16672	.14823
8	.24433	.21663	.19235	.17105	.15233
9	.24944	.22155	.19707	.17554	.1566
10	.25468	.22662	.20193	.18019	.16103
11	.26006	.23183	.20694	.18499	.16561
12	.26557	.23717	.21209	.18993	.1703
13	.27118	.24262	.21736	.195	.1751
14	.2769	.24818	.22274	.20018	.18015
15	.28271	.25385	.22823	.20548	.18524
16	.28861	.25961	.23382	.21088	.19043
17	.29461	.26547	.23952	.21638	.19574
18	.3007	.27144	.24533	.22201	.20117
19	.3069	.27752	.25126	.22776	.20673
20	.31323	.28374	.25733	.23367	.21244
21	.31967	.29008	.26354	.23971	.2183
22	.32625	.29656	.26989	.24591	.22432
23	.33295	.30318	.27639	.25226	.2305
24	.33979	.30995	.28305	.25877	.23685
25	.34676	.31686	.28986	.26545	.24337
26	.35387	.32393	.29683	.2723	.25007
27	.36112	.33114	.30396	.27931	.25694
28	.36851	.3385	.31126	.28651	.264
29	.37603	.34601	.31871	.29387	.27123
30	.38369	.35367	.32632	.30139	.27865
31	.39147	.36147	.33409	.30909	.28623
32	.39938	.36941	.34201	.31695	.294
33	.40743	.3775	.3501	.32498	.30195
34	.41562	.38574	.35834	.33319	.31009
35	.42394	.39414	.36675	.34158	.31842
36	.43239	.40268	.37533	.35014	.32693
37	.44098	.41136	.38406	.35888	.33563
38	.44969	.42019	.39295	.36778	.34452
39	.45852	.42915	.40199	.37685	.35358
40	.46746	.43825	.41118	.38609	.36281
41	.47652	.44747	.42051	.39548	.37222
42	.48568	.45681	.42998	.40502	.3818
43	.49495	.46628	.43959	.41472	.39154
44	.50433	.47587	.44933	.42457	.40146
45	.51382	.48559	.45922	.43458	.41155
46	.52341	.49543	.46925	.44476	.42182
47	.5331	.50539	.47942	.45508	.43224
48	.54289	.51545	.48971	.46554	.44284
49	.55275	.52562	.50012	.47614	.45358
50	.5627	.53588	.51064	.48686	.46446
51	.57271	.54622	.52125	.4977	.47548
52	.58278	.55665	.53197	.50866	.48663
53	.59293	.56716	.5428	.51974	.49792
54	.60317	.57779	.55375	.53098	.50939
55	.61353	.58856	.56487	.54239	.52105
56	.62399	.59945	.57613	.55397	.5329
57	.63456	.61046	.58753	.56571	.54494
58	.64518	.62155	.59904	.57758	.55711
59	.65583	.63269	.6106	.58951	.56938
60	.66648	.64383	.62218	.60149	.5817
61	.67711	.65496	.63377	.61349	.59406
62	.68771	.66609	.64537	.62551	.60647
63	.6983	.67722	.65699	.63757	.61891
64	.7089	.68837	.66864	.64967	.63143
65	.71951	.69954	.68033	.66183	.64402
66	.73013	.71075	.69207	.67406	.6567
67	.74075	.72196	.70384	.68634	.66945
68	.75134	.73316	.7156	.69862	.68221
69	.76185	.74429	.7273	.71086	.69495
70	.77226	.75533	.73892	.72303	.70762
71	.78256	.76626	.75044	.7351	.72021
72	.79275	.77709	.76187	.74709	.73273
73	.80281	.78778	.77318	.75897	.74515
74	.81271	.79833	.78433	.7707	.75742
75	.82243	.80869	.7953	.78225	.76952
76	.83199	.81889	.80612	.79365	.78147
77	.8414	.82894	.81678	.8049	.79329
78	.8506	.83879	.82724	.81594	.80489
79	.85951	.84833	.83739	.82667	.81618
80	.86807	.8575	.84715	.837	.82705
81	.87619	.86621	.85642	.84682	.8374
82	.88384	.87442	.86517	.85609	.84718
83	.89111	.88223	.8735	.86493	.8565
84	.8982	.88985	.88164	.87357	.86562
85	.9053	.89749	.88981	.88225	.8748
86	.91192	.90462	.89743	.89035	.88337
87	.91802	.9112	.90447	.89784	.8913
88	.92364	.91726	.91096	.90475	.89862
89	.92876	.92279	.91689	.91106	.90531
90	.93339	.92778	.92224	.91677	.91137
91	.93752	.93224	.92703	.92187	.91678
92	.94115	.93617	.93124	.92637	.92155
93	.94432	.93959	.93491	.93029	.92571
94	.94708	.94257	.93811	.9337	.92934

(1)	(2)				
	Yearly rate of return				
Age	3.2%	3.4%	3.6%	3.8%	4%
0	.12943	.11702	.10624	.09684	.08866
1	.11321	.10032	.08911	.07932	.07079
2	.1154	.10228	.09084	.08085	.07212
3	.11826	.10491	.09325	.08305	.07412
4	.12141	.10783	.09595	.08555	.07642
5	.12476	.11096	.09886	.08824	.07891
6	.12829	.11426	.10194	.09111	.08158
7	.13201	.11775	.10521	.09416	.08443
8	.13588	.12139	.10863	.09737	.08743
9	.13992	.12521	.11223	.10075	.0906
10	.14412	.12918	.11598	.10429	.09393
11	.14847	.13331	.11988	.10798	.09741
12	.15297	.13759	.12394	.11182	.10104
13	.1576	.142	.12813	.11579	.1048
14	.16236	.14653	.13244	.11989	.10868
15	.16723	.15118	.13687	.1241	.11269
16	.17221	.15594	.14141	.12842	.1168
17	.1773	.16082	.14607	.13286	.12102
18	.18252	.16582	.15086	.13743	.12537

(1)	(2)				
	Yearly rate of return				
Age	3.2%	3.4%	3.6%	3.8%	4%
19	.18787	.17096	.15578	.14213	.12986
20	.19338	.17626	.16087	.14701	.13452
21	.19905	.18172	.16611	.15204	.13934
22	.20487	.18734	.17152	.15724	.14432
23	.21086	.19313	.1771	.16261	.14948
24	.21703	.1991	.18288	.16817	.15483
25	.22338	.20526	.18883	.17392	.16038
26	.2299	.2116	.19498		.16612
27	.23661	.21814	.20132	.18601	.17206
28	.24352	.22487	.20787	.19237	.17822
29	.2506	.23179	.21461	.19892	.18457
30	.25788	.23891	.22156	.20568	.19114
31	.26534	.24621	.22869	.21264	.19792
32	.27298	.25371	.23604	.21981	.2049
33	.28082	.26142	.24359	.2272	.21211
34	.28886	.26933	.25136	.23481	.21955
35	.29709	.27745	.25934	.24264	.22722
36	.30553	.28578	.26754	.2507	.23513
37	.31416	.29432	.27597	.25899	.24327
38	.32299	.30306	.28461	.2675	.25164
39	.33201	.31201	.29346	.27624	.26024
40	.34121	.32116	.30252	.28519	.26908
41	.3506	.3305	.31179	.29437	.27814
42	.36018	.34004	.32126	.30376	.28742
43	.36993	.34977	.33095	.31337	.29694
44	.37987	.3597	.34084	.3232	.30668
45	.39	.36983	.35095	.33326	.31668
46	.40032	.38018	.36128	.34355	.32691
47	.41082	.39071	.37182	.35407	.33738
48	.4215	.40144	.38257	.36481	.34809
49	.43234	.41235	.39351	.37576	.35902
50	.44335	.42343	.40464	.38691	.37016
51	.4545	.43468	.41595	.39825	.38152
52	.46579	.44609	.42745	.40979	.39308
53	.47725	.45768	.43913	.42155	.40487
54	.48891	.46948	.45105	.43355	.41692
55	.50078	.48152	.46322	.44582	.42927
56	.51286	.49379	.47565	.45837	.44191
57	.52515	.50629	.48832	.47118	.45484
58	.53759	.51896	.50119	.48421	.468
59	.55015	.53177	.51421	.49741	.48135
60	.56278	.54467	.52733	.51073	.49484
61	.57546	.55763	.54054	.52416	.50844
62	.5882	.57067	.55384	.53769	.52218
63	.601	.58378	.56724	.55133	.53604
64	.61388	.597	.58076	.56512	.55007
65	.62687	.61034	.59442	.57907	.56427
66	.63996	.62381	.60822	.59318	.57866
67	.65313	.63737	.62215	.60743	.59322
68	.66634	.65099	.63615	.62178	.60788
69	.67954	.66462	.65017	.63617	.6226
70	.69268	.6782	.66416	.65054	.63732
71	.70576	.69174	.67812	.66489	.65204
72	.71878	.70522	.69203	.67921	.66675
73	.7317	.71861	.70588	.69348	.68141
74	.74449	.73189	.71961	.70765	.69599
75	.75711	.745	.73319	.72167	.71043
76	.76959	.75798	.74665	.73558	.72478
77	.78194	.77084	.76	.7494	.73903
78	.79408	.7835	.77315	.76302	.7531
79	.8059	.79583	.78597	.77631	.76685
80	.8173	.80774	.79837	.78917	.78016
81	.82815	.81908	.81018	.80144	.79286
82	.83842	.82982	.82137	.81307	.80491
83	.84821	.84007	.83206	.82419	.81644
84	.8578	.85011	.84254	.8351	.82777
85	.86746	.86024	.85313	.84613	.83923
86	.8765	.86972	.86304	.85646	.84997
87	.88486	.8785	.87223	.86605	.85994
88	.89258	.88661	.88072	.87491	.86917
89	.89964	.89403	.8885	.88303	.87764
90	.90603	.90075	.89554	.89039	.88531
91	.91174	.90677	.90185	.89699	.89218
92	.91678	.91207	.90742	.90281	.89825
93	.92118	.9167	.91227	.90789	.90355
94	.92502	.92075	.91652	.91233	.90818

(1)	(2)				
	Yearly rate of return				
Age	4.2%	4.4%	4.6%	4.8%	5%
0	.08151	.07526	.06979	.065	.06079
1	.06333	.0568	.05108	.04606	.04165
2	.06447	.05777	.05188	.04672	.04217
3	.06629	.05941	.05337	.04805	.04336
4	.0684	.06135	.05514	.04967	.04484
5	.0707	.06347	.0571	.05147	.0465
6	.07318	.06577	.05922	.05344	.04831
7	.07583	.06824	.06152	.05557	.0503
8	.07864	.07086	.06396	.05785	.05242
9	.08162	.07365	.06657	.06029	.0547
10	.08474	.07659	.06933	.06288	.05713
11	.08802	.07967	.07224	.06561	.0597
12	.09145	.08291	.07529	.06848	.0624
13	.09501	.08627	.07846	.07148	.06523
14	.09868	.08975	.08175	.07458	.06816
15	.10248	.09334	.08515	.0778	.07121
16	.10638	.09704	.08865	.08112	.07435
17	.1104	.10085	.09227	.08455	.07759
18	.11454	.10479	.09601	.0881	.08096
19	.11881	.10886	.09988	.09178	.08445
20	.12326	.1131	.10392	.09562	.0881
21	.12787	.1175	.10811	.09961	.09191
22	.13264	.12206	.11247	.10378	.09588
23	.13759	.1268	.11701	.10811	.10003
24	.14273	.13173	.12174	.11264	.10436
25	.14806	.13686	.12666	.11736	.10888
26	.1536	.14219	.13178	.12229	.11361
27	.15933	.14772	.13711	.12741	.11854
28	.16529	.15347	.14266	.13276	.12369
29	.17145	.15942	.14841	.13831	.12904
30	.17782	.1656	.15439	.14409	.13462
31	.1844	.17199	.16057	.15007	.14041
32	.1912	.17859	.16699	.15629	.14644
33	.19822	.18543	.17363	.16274	.15269
34	.20549	.1925	.18051	.16944	.1592
35	.21298	.19982	.18765	.17638	.16595
36	.22072	.20738	.19503	.18358	.17296
37	.2287	.2152	.20267	.19104	.18023
38	.23692	.22325	.21056	.19875	.18777
39	.24538	.23155	.21869	.20671	.19556
40	.25407	.2401	.22708	.21494	.20361
41	.26301	.24889	.23572	.22342	.21192
42	.27217	.25792	.24461	.23215	.2205

(1) Age	(2) Yearly rate of return 4.2%	4.4%	4.6%	4.8%	5%
43	.28157	.2672	.25375	.24115	.22934
44	.29122	.27674	.26315	.25041	.23846
45	.30112	.28653	.27283	.25996	.24787
46	.31128	.29659	.28278	.2698	.25757
47	.32168	.30691	.293	.2799	.26756
48	.33234	.31749	.3035	.2903	.27784
49	.34323	.32832	.31425	.30095	.28839
50	.35434	.33939	.32525	.31187	.29922
51	.36568	.35069	.3365	.32305	.31031
52	.37724	.36223	.34799	.33449	.32168
53	.38904	.37403	.35976	.34622	.33334
54	.40113	.38612	.37184	.35826	.34534
55	.41352	.39854	.38426	.37067	.35772
56	.42623	.41129	.39704	.38344	.37048
57	.43924	.42436	.41015	.39657	.38361
58	.45251	.43771	.42355	.41001	.39706
59	.46598	.45127	.43719	.42371	.41079
60	.47961	.46501	.45102	.43761	.42474
61	.49337	.47891	.46502	.45169	.43889
62	.50727	.49296	.4792	.46597	.45325
63	.52133	.50718	.49356	.48045	.46783
64	.53557	.5216	.50814	.49516	.48266
65	.55	.53624	.52296	.51014	.49777
66	.56464	.5511	.53802	.52539	.51317
67	.57947	.56617	.55331	.54088	.52884
68	.59443	.5814	.56878	.55656	.54472
69	.60945	.59671	.58435	.57237	.56075
70	.6245	.61206	.51997	.58825	.57686
71	.63956	.62743	.63565	.60419	.59305
72	.65463	.64283	.63136	.62019	.60932
73	.66966	.65822	.64707	.63621	.62563
74	.68462	.67354	.66273	.65219	.64192
75	.69946	.68876	.6783	.6681	.65814
76	.71422	.70389	.69381	.68395	.67432
77	.72889	.71897	.70927	.69978	.69049
78	.74339	.73388	.72458	.71546	.70654
79	.75757	.74848	.73957	.73084	.72228
80	.77131	.76264	.75413	.74578	.73758
81	.78444	.77617	.76805	.76007	.75224
82	.7969	.78902	.78128	.77368	.7662
83	.80882	.80133	.79397	.78672	.77959
84	.82055	.81345	.80646	.79958	.7928
85	.83243	.82574	.81914	.81265	.80624
86	.84358	.83727	.83106	.82493	.81889
87	.85393	.84799	.84214	.83636	.83066
88	.86351	.85792	.8524	.84696	.84158
89	.8723	.86704	.86184	.8567	.85163
90	.88028	.87531	.8704	.86555	.86076
91	.88743	.88273	.87809	.8735	.86895
92	.89374	.88929	.88488	.88051	.8762
93	.89926	.89502	.89081	.88666	.88254
94	.90408	.90002	.896	.89202	.88809

(1) Age	(2) Yearly rate of return 5.2%	5.4%	5.6%	5.8%	6%
0	.05709	.05383	.05096	.04842	.04617
1	.03776	.03435	.03132	.02866	.0263
2	.03816	.03463	.0315	.02873	.02628
3	.03922	.03557	.03233	.02947	.02692
4	.04057	.03679	.03344	.03047	.02783
5	.04209	.03818	.03472	.03164	.0289
6	.04377	.03973	.03614	.03295	.03011
7	.04561	.04144	.03774	.03443	.03147
8	.04759	.04329	.03945	.03603	.03297
9	.04972	.04528	.04131	.03777	.03459
10	.05199	.04741	.04331	.03964	.03635
11	.05441	.04968	.04545	.04165	.03824
12	.05696	.05208	.04771	.04378	.04025
13	.05962	.0546	.05008	.04602	.04236
14	.06239	.05721	.05255	.04835	.04457
15	.06527	.05994	.05512	.05078	.04686
16	.06824	.06274	.05778	.0533	.04924
17	.07132	.06565	.06054	.05591	.05171
18	.07451	.06868	.0634	.05862	.05428
19	.07782	.07182	.06638	.06145	.05697
20	.0813	.07512	.06952	.06443	.05979
21	.08492	.07857	.0728	.06755	.06276
22	.08871	.08218	.07624	.07082	.06588
23	.09266	.08595	.07984	.07426	.06915
24	.09681	.08992	.08362	.07787	.07261
25	.10114	.09406	.08759	.08167	.07625
26	.10567	.09841	.09176	.08566	.08007
27	.1104	.10296	.09613	.08985	.08409
28	.11537	.10773	.10071	.09426	.08832
29	.12052	.11269	.1055	.09887	.09275
30	.12591	.11789	.11051	.10369	.09741
31	.13151	.1233	.11573	.10873	.10227
32	.13734	.12894	.12118	.114	.10735
33	.1434	.13481	.12686	.1195	.11267
34	.14971	.14093	.1328	.12524	.11824
35	.15627	.14731	.13898	.13125	.12407
36	.1631	.15394	.14543	.13752	.13015
37	.17019	.16085	.15215	.14405	.13651
38	.17754	.16802	.15914	.15086	.14313
39	.18515	.17545	.16639	.15793	.15002
40	.19303	.18315	.17392	.16528	.15719
41	.20118	.19112	.18171	.1729	.16464
42	.20958	.19936	.18978	.1808	.17236
43	.21827	.20788	.19814	.18898	.18038
44	.22723	.21669	.20678	.19746	.18869
45	.23649	.2258	.21573	.20625	.19731
46	.24606	.23521	.22499	.21535	.20626
47	.25591	.24493	.23456	.22477	.21552
48	.26607	.25495	.24445	.23452	.22512
49	.2765	.26527	.25463	.24456	.23502
50	.28723	.27588	.26512	.25491	.24524
51	.29823	.28677	.2759	.26558	.25577
52	.30951	.29795	.28697	.27654	.26661
53	.3211	.30946	.29838	.28784	.2778
54	.33304	.32132	.31016	.29952	.28938
55	.34537	.33359	.32236	.31164	.30141
56	.3581	.34627	.33498	.3242	.31388
57	.37121	.35935	.34802	.33718	.3268
58	.38467	.3728	.36144	.35055	.34012
59	.39841	.38654	.37517	.36426	.35378
60	.41239	.40054	.38916	.37824	.36774
61	.42659	.41477	.4034	.39248	.38197
62	.44101	.42923	.4179	.40698	.39648
63	.45566	.44395	.43266	.42178	.41129
64	.47059	.45896	.44773	.4369	.42645
65	.48582	.47429	.46314	.45238	.44197
66	.50136	.48994	.4789	.46822	.45789
67	.51719	.50591	.49499	.48441	.47417

(1)	(2)				
	Yearly rate of return				
Age	5.2%	5.4%	5.6%	5.8%	6%
68.......	.53324	.52213	.51134	.50089	.49076
69.......	.54947	.53853	.5279	.5176	.50759
70.......	.56579	.55505	.54461	.53446	.5246
71.......	.58222	.57169	.56144	.55147	.54177
72.......	.59874	.58844	.5784	.56864	.55912
73.......	.61531	.60526	.59546	.58591	.57659
74.......	.63188	.6221	.61255	.60323	.59413
75.......	.6484	.6389	.62961	.62054	.61167
76.......	.6649	.6557	.64669	.63788	.62927
77.......	.6814	.67251	.6638	.65528	.64693
78.......	.69779	.68922	.68083	.6726	.66454
79.......	.71388	.70565	.69758	.68966	.68189
80.......	.72954	.72165	.7139	.70629	.69883
81.......	.74455	.73699	.72957	.72227	.71511
82.......	.75884	.75162	.74451	.73752	.73065
83.......	.77257	.76567	.75888	.75219	.74561
84.......	.78613	.77956	.77309	.76671	.76044
85.......	.79994	.79371	.78759	.78155	.77559
86.......	.81293	.80705	.80126	.79554	.7899
87.......	.82503	.81948	.814	.80859	.80326
88.......	.83627	.83103	.82585	.82074	.81569
89.......	.84661	.84166	.83677	.83193	.82715
90.......	.85601	.85133	.84669	.84212	.83759
91.......	.86446	.86002	.85563	.85128	.84699
92.......	.87193	.86771	.86353	.8594	.8553
93.......	.87847	.87444	.87045	.8665	.86259
94.......	.88419	.88033	.8765	.87272	.86897

(1)	(2)				
	Yearly rate of return				
Age	6.2%	6.4%	6.6%	6.8%	7%
0........	.04418	.04241	.04083	.03943	.03817
1........	.0242	.02234	.02069	.01922	.0179
2........	.0241	.02217	.02045	.01891	.01754
3........	.02466	.02264	.02085	.01925	.01782
4........	.02548	.02338	.02151	.01984	.01834
5........	.02646	.02428	.02233	.02059	.01902
6........	.02757	.02531	.02327	.02145	.01983
7........	.02884	.02648	.02437	.02247	.02076
8........	.03023	.02777	.02557	.02359	.02181
9........	.03175	.0292	.0269	.02484	.02298
10.......	.0334	.03075	.02836	.02621	.02427
11.......	.03517	.03242	.02993	.02769	.02566
12.......	.03707	.03421	.03162	.02929	.02718
13.......	.03906	.03609	.0334	.03097	.02876
14.......	.04115	.03806	.03526	.03273	.03044
15.......	.04332	.04012	.03721	.03458	.03218
16.......	.04557	.04225	.03922	.03649	.03399
17.......	.04791	.04446	.04132	.03847	.03588
18.......	.05035	.04676	.04351	.04055	.03784
19.......	.05289	.04918	.04581	.04272	.03991
20.......	.05557	.05173	.04823	.04502	.04209
21.......	.0584	.05442	.05078	.04745	.04441
22.......	.06136	.05724	.05347	.05002	.04685
23.......	.06449	.06022	.05631	.05273	.04944
24.......	.06779	.06337	.05932	.0556	.05219
25.......	.07127	.0667	.0625	.05865	.0551
26.......	.07494	.07021	.06587	.06187	.05819
27.......	.07879	.07391	.06941	.06527	.06145
28.......	.08285	.07782	.07317	.06888	.06491
29.......	.08712	.08192	.07712	.07267	.06856
30.......	.0916	.08623	.08127	.07668	.07242
31.......	.09629	.09075	.08563	.08088	.07647
32.......	.1012	.0955	.09021	.0853	.08074
33.......	.10634	.10047	.09501	.08995	.08523
34.......	.11174	.10569	.10007	.09484	.08997
35.......	.11739	.11117	.10538	.09997	.09494
36.......	.1233	.1169	.11093	.10537	.10018
37.......	.12947	.1229	.11677	.11104	.10567
38.......	.13592	.12917	.12287	.11697	.11144
39.......	.14263	.13571	.12924	.12317	.11748
40.......	.14962	.14253	.13588	.12964	.12378
41.......	.15689	.14963	.14281	.13639	.13038
42.......	.16444	.157	.15001	.14343	.13724
43.......	.17229	.16467	.15751	.15077	.14441
44.......	.18043	.17265	.16532	.1584	.15188
45.......	.18889	.18094	.17345	.16637	.15968
46.......	.19768	.18957	.18191	.17467	.16782
47.......	.20678	.19852	.1907	.18329	.17628
48.......	.21623	.20781	.19983	.19227	.1851
49.......	.22599	.21741	.20928	.20157	.19424
50.......	.23606	.22735	.21907	.21121	.20373
51.......	.24645	.2376	.22918	.22117	.21355
52.......	.25717	.24818	.23963	.23147	.22371
53.......	.26824	.25912	.25044	.24215	.23425
54.......	.27971	.27048	.26167	.25326	.24523
55.......	.29163	.2823	.27337	.26485	.25668
56.......	.30402	.29459	.28556	.27692	.26865
57.......	.31687	.30735	.29823	.2895	.28111
58.......	.33012	.32053	.31134	.30251	.29404
59.......	.34374	.33409	.32482	.31592	.30737
60.......	.35766	.34796	.33864	.32968	.32105
61.......	.37186	.36213	.35276	.34375	.33506
62.......	.38636	.37661	.36721	.35815	.34941
63.......	.40117	.39142	.382	.37291	.36414
64.......	.41635	.4066	.39718	.38807	.37928
65.......	.43191	.42218	.41278	.40368	.39488
66.......	.44788	.4382	.42882	.41975	.41095
67.......	.46424	.45462	.44529	.43625	.42748
68.......	.48092	.47139	.46213	.45314	.44442
69.......	.49787	.48843	.47926	.47035	.46169
70.......	.51501	.50569	.49662	.4878	.47922
71.......	.53233	.52315	.5142	.50549	.49701
72.......	.54985	.54081	.53201	.52343	.51506
73.......	.56751	.55864	.55	.54156	.53332
74.......	.58524	.57657	.5681	.55983	.55175
75.......	.60301	.59454	.58627	.57818	.57026
76.......	.62085	.6126	.60453	.59664	.58891
77.......	.63876	.63076	.62292	.61524	.60772
78.......	.65664	.6489	.6413	.63385	.62656
79.......	.67427	.6668	.65946	.65226	.6452
80.......	.6915	.6843	.67723	.67029	.66347
81.......	.70807	.70114	.69434	.68765	.68107
82.......	.72389	.71724	.7107	.70427	.69794
83.......	.73914	.73276	.72648	.72031	.71423
84.......	.75426	.74816	.74216	.73625	.73042
85.......	.76973	.76394	.75824	.75262	.74707
86.......	.78434	.77885	.77344	.7681	.76283
87.......	.79799	.79279	.78766	.78259	.77759
88.......	.8107	.80577	.80091	.7961	.79136
89.......	.82243	.81776	.81315	.80859	.80408
90.......	.83311	.82869	.82431	.81998	.8157
91.......	.84274	.83853	.83437	.83026	.82618
92.......	.85126	.84725	.84329	.83936	.83548

(1)	(2)				
	Yearly rate of return				
Age	6.2%	6.4%	6.6%	6.8%	7%
93.......	.85873	.85489	.8511	.84735	.84363
94.......	.86526	.86158	.85794	.85434	.85077

(1)	(2)				
	Yearly rate of return				
Age	7.2%	7.4%	7.6%	7.8%	8%
0........	.03705	.03604	.03513	.03432	.03359
1........	.01672	.01567	.01472	.01388	.01311
2........	.01631	.01521	.01422	.01333	.01253
3........	.01653	.01538	.01434	.01341	.01258
4........	.017	.01579	.01471	.01374	.01285
5........	.01762	.01636	.01522	.0142	.01326
6........	.01835	.01704	.01584	.01477	.01379
7........	.01922	.01784	.01659	.01546	.01444
8........	.0202	.01875	.01745	.01626	.01518
9........	.0213	.01979	.01841	.01717	.01604
10.......	.02251	.02093	.01949	.01818	.017
11.......	.02383	.02217	.02066	.0193	.01806
12.......	.02526	.02352	.02195	.02051	.01921
13.......	.02676	.02495	.0233	.02179	.02042
14.......	.02835	.02645	.02472	.02315	.02171
15.......	.03001	.02802	.02622	.02457	.02306
16.......	.03172	.02965	.02776	.02604	.02446
17.......	.03351	.03135	.02937	.02757	.02591
18.......	.03537	.03312	.03105	.02917	.02743
19.......	.03733	.03498	.03282	.03085	.02903
20.......	.03941	.03696	.03471	.03264	.03074
21.......	.04162	.03906	.03671	.03455	.03255
22.......	.04395	.04128	.03882	.03657	.03448
23.......	.04641	.04363	.04107	.03871	.03654
24.......	.04904	.04614	.04347	.04101	.03874
25.......	.05182	.04881	.04603	.04345	.04107
26.......	.05478	.05165	.04875	.04606	.04358
27.......	.05792	.05465	.05163	.04883	.04624
28.......	.06124	.05785	.0547	.05179	.04908
29.......	.06476	.06123	.05796	.05492	.0521
30.......	.06847	.06481	.06141	.05824	.0553
31.......	.07238	.06858	.06504	.06175	.05868
32.......	.0765	.07255	.06888	.06546	.06226
33.......	.08084	.07675	.07294	.06937	.06606
34.......	.08542	.08118	.07722	.07352	.07007
35.......	.09024	.08586	.08175	.07792	.07432
36.......	.09532	.09078	.08653	.08255	.07882
37.......	.10066	.09596	.09156	.08744	.08357
38.......	.10626	.10141	.09686	.09259	.08858
39.......	.11214	.10712	.10242	.09799	.09383
40.......	.11828	.11311	.10825	.10368	.09937
41.......	.12471	.11938	.11436	.10963	.10517
42.......	.13141	.12592	.12074	.11586	.11125
43.......	.13841	.13276	.12742	.12238	.11762
44.......	.14573	.13991	.13441	.12922	.1243
45.......	.15336	.14738	.14172	.13637	.1313
46.......	.16134	.15519	.14939	.14387	.13865
47.......	.16964	.16334	.15737	.1517	.14632
48.......	.1783	.17184	.16571	.15989	.15435
49.......	.18729	.18068	.17439	.16842	.16273
50.......	.19662	.18986	.18342	.17729	.17145
51.......	.20629	.19937	.19279	.18651	.18051
52.......	.2163	.20924	.20251	.19608	.18994
53.......	.22671	.21951	.21262	.20605	.19977
54.......	.23755	.23021	.22319	.21647	.21005
55.......	.24888	.24141	.23426	.22741	.22085
56.......	.26073	.25313	.24586	.23888	.23219
57.......	.27309	.26538	.25799	.25089	.24407
58.......	.28591	.2781	.2706	.26339	.25646
59.......	.29914	.29124	.28364	.27632	.26929
60.......	.31275	.30476	.29707	.28965	.28251
61.......	.32668	.31862	.31085	.30335	.29612
62.......	.34098	.33285	.32501	.31744	.31013
63.......	.35566	.34748	.33958	.33194	.32455
64.......	.37078	.36256	.3546	.34691	.33946
65.......	.38636	.37811	.37012	.36239	.3549
66.......	.40244	.39418	.38617	.37841	.37089
67.......	.41898	.41073	.40272	.39496	.38742
68.......	.43595	.42773	.41974	.41198	.40444
69.......	.45328	.44509	.43713	.42939	.42186
70.......	.47087	.46275	.45484	.44714	.43964
71.......	.48875	.4807	.47286	.46521	.45776
72.......	.5069	.49895	.49119	.48362	.47623
73.......	.52529	.51745	.50978	.50231	.49501
74.......	.54385	.53614	.52859	.52123	.51402
75.......	.56252	.55495	.54755	.5403	.53322
76.......	.58135	.57394	.56669	.55959	.55264
77.......	.60035	.59313	.58605	.57911	.57231
78.......	.6194	.61238	.60549	.59874	.5921
79.......	.63826	.63146	.62477	.61821	.61178
80.......	.65676	.65018	.64371	.63735	.63111
81.......	.67461	.66826	.66201	.65586	.64982
82.......	.69171	.68558	.67955	.67362	.66778
83.......	.70823	.70234	.69652	.6908	.68517
84.......	.72468	.71902	.71345	.70795	.70254
85.......	.7416	.7362	.73089	.72564	.72047
86.......	.75763	.7525	.74743	.74244	.7375
87.......	.77265	.76777	.76295	.75819	.7535
88.......	.78666	.78203	.77745	.77293	.76846
89.......	.79963	.79523	.79088	.78658	.78232
90.......	.81148	.80729	.80315	.79906	.79501
91.......	.82216	.81817	.81423	.81033	.80647
92.......	.83164	.82783	.82407	.82034	.81665
93.......	.83995	.83631	.8327	.82913	.82559
94.......	.84723	.84373	.84026	.83682	.83342

[T.D. 7105, 36 FR 6480, April 6, 1971, as amended by 36 FR 9512, May 26, 1971; 36 FR 12290, June 30, 1971; T.D. 7955, 49 FR 19976, May 11, 1984]

§ 1.642(c)–7 Transitional rules with respect to pooled income funds.

(a) In general—(1) Amendment of certain funds. A fund created before May 7, 1971, and not otherwise qualifying as a pooled income fund may be treated as a pooled income fund to which § 1.642(c)–5 applies if on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969, it possessed the initial characteristics described in paragraph (b) of this section and is amended, in the time and manner provided in paragraph (c) of this section, to meet all the requirements of section 642(c)(5) and § 1.642(c)–5. If a fund to which this subparagraph applies is amended in the time and manner provided in paragraph (c) of this section it shall be

treated as provided in paragraph (d) of this section for the period beginning on August 1, 1969, or, if later, on the date of its creation and ending the day before the date on which it meets the requirements of section 642(c)(5) and § 1.642(c)–5.

(2) Severance of a portion of a fund. Any portion of a fund created before May 7, 1971, which consists of property transferred to such fund after July 31, 1969, may be severed from such fund consistently with the principles of paragraph (c)(2) of this section and established before January 1, 1972, as a separate pooled income fund, provided that on and after the date of severance the severed fund meets all the requirements of section 642(c)(5) and § 1.642(c)–5. A separate fund which is established pursuant to this subparagraph shall be treated as provided in paragraph (d) of this section for the period beginning on the day of the first transfer of property which becomes part of the separate fund and ending the day before the day on which the separate fund meets the requirements of section 642(c)(5) and § 1.642(c)–5.

(b) Initial characteristics required. A fund described in paragraph (a)(1) of this section shall not be treated as a pooled income fund to which section 642(c)(5) applies, even though it is amended as provided in paragraph (c) of this section, unless it possessed the following characteristics on July 31, 1969, or on each date of transfer of property to the fund occurring after July 31, 1969:

(1) It satisfied the requirements of section 642(c)(5)(A) other than that the fund be a trust;

(2) It was constituted in a way to attract and contain commingled properties transferred to the fund by more than one donor satisfying such requirements; and

(3) Each beneficiary of a life income interest which was retained or created in any property transferred to the fund was entitled to receive, but not less often than annually, a proportional share of the annual income earned by the fund, such share being based on the fair market value of the property in which such life interest was retained or created.

(c) Amendment requirements. (1) A fund described in paragraph (a)(1) of this section and possessing the initial characteristics described in paragraph (b) of this section on the date prescribed therein shall be treated as a pooled income fund if it is amended to meet all the requirements of section 642(c)(5) and § 1.642(c)–5 before January 1, 1972, or, if later, on or before the 30th day after the date on which any judicial proceedings commenced before January 1, 1972, which are required to amend its governing instrument or any other instrument which does not permit it to meet such requirements, become final. However, see paragraph (d) of this section for limitation on the period in which a claim for credit or refund may be filed.

(2) In addition, if the transferred property described in paragraph (b)(2) of this section is commingled with other property, the transferred property must be separated on or before the date specified in subparagraph (1) of this paragraph from the other property and allocated to the fund in accordance with the transferred property's percentage share of the fair market value of the total commingled property on the date of separation. The percentage share shall be the ratio which the fair market value of the transferred property on the date of separation bears to the fair market value of the total commingled property on that date and shall be computed in a manner consistent with paragraph (c) of § 1.642(c)–5. The property which is so allocated to the fund shall be treated as property received from transfers which meet the requirements of section 642(c)(5), and such transfers shall be treated as made on the dates on which the properties giving rise to such allocation were transferred to the fund by the respective donors. The property so allocated to the fund must be representative of all the commingled property other than securities the income from which is exempt from tax under subtitle A of the Code; compensating increases in other commingled property allocated to the fund shall be made where such tax-exempt securities are not allocated to the fund. The application of this subparagraph may be illustrated by the following example:

Example. (a) The trustees of X fund are in the process of amending it in order to qualify as a pooled income fund. The property transferred to the X fund was commingled with other property transferred to the organization by which the fund was established. After taking into account the various transfers and the appreciation in the fair market value of all the properties, the fair market value of the property allocated to the fund on the various transfer dates is set forth in the following schedule and determined in the manner indicated:

TRANSFERS

Date of transfer	Value of all property before transfer (1)	Trust property (2)	Other property (3)	Value of all property after transfer (4)	Property allocated to fund (5)
January 1, 1968	....	$100,000	$100,000	$200,000	[1]$100,000
September 30, 1968	$300,000	100,000	....	400,000	[2]250,000
January 15, 1969	480,000	60,000	....	540,000	[3]360,000
November 11, 1969	600,000	200,000	....	800,000	[4]600,000

[1] $100,000 = (the amount in column (2)).
[2] $250,000 = ([$100,000/$200,000 × $300,000] + $100,000).
[3] $360,000 = ([$250,000/$400,000 × $480,000] + $60,000).
[4] $600,000 = ([$360,000/$540,000 × $600,000] + $200,000).

(b) On September 30, 1970, the trustees decide to separate the property of X fund from the other property. The fair market value of all the commingled property is $1 million on September 30, 1970, and there were no additional transfers to the fund after November 11, 1969. Accordingly, the fair market value of the property required to be allocated to X fund must be $750,000 ($600,000/$800,000×$1,000,000), and X fund's percentage share of the commingled property is 75 percent ($750,000/$1,000,000). Accordingly, assuming that the commingled property consists of Y stock with a fair market value of $800,000 and Z bonds with a fair market value of $200,000, there must be allocated to X fund at the close of September 30, 1970, Y stock with a value of $600,000 ($800,000×75%) and Z bonds with a value of $150,000 ($200,000×75%).

(d) Transactions before amendment of or severance from fund. (1) A fund which is amended pursuant to paragraph (c) of this section, or is severed from a fund pursuant to paragraph (a)(2) of this section, shall be treated for all purposes, including the allowance of a deduction for any charitable contribution, as if it were before its amendment or severance a pooled income fund to which section 642(c)(5) and § 1.642(c)–5 apply. Thus, for example, where a donor transferred property in trust to such an amended or severed fund on August 1, 1969, but before its amendment or severance under this section, a charitable contributions deduction for the value of the remainder interest may be allowed under section 170, 2055, 2106, or 2522. The deduction may not be allowed, however, until the fund is amended or severed pursuant to this section and shall be allowed only if a claim for credit or refund is filed within the period of limitation prescribed by section 6511(a).

(2) For purposes of determining under paragraph (b)(2) of § 1.642(c)–6 the highest yearly rate of return earned by a fund (which is amended pursuant to paragraph (c) of this section) for the 3 preceding taxable years, taxable years of the fund preceding its taxable year in which the fund is so amended and qualifies as a pooled income fund under this section shall be used provided that the fund did not at any time during such preceding years hold any investments in securities the income from which is exempt from tax under subtitle A of the Code. If any such tax-exempt securities were held during such period by such amended fund, or if the fund consists of a portion of a fund which is severed pursuant to paragraph (a)(2) of this section, the highest yearly rate of return under paragraph (b)(2) of § 1.642(c)–6 shall be determined by treating the fund as a pooled income fund which has been in existence for less than 3 taxable years preceding the taxable year in which the transfer of property to the fund is made.

(3) Property transferred to a fund before its amendment pursuant to paragraph (c) of this section, or before its severance under paragraph (a)(2) of this section, shall be treated as property received from transfers which meet the requirements of section 642(c)(5).

[T.D. 7105, 36 FR 6486, April 6, 1971, as amended by T.D. 7125, 36 FR 11032, June 8, 1971]

§ 1.642(d)–1 Net operating loss deduction.

The net operating loss deduction allowed by section 172 is available to estates and trusts generally, with the following exceptions and limitations:

(a) In computing gross income and deductions for the purposes of section 172, a trust shall exclude that portion of the income and deductions attributable to the grantor or another person under sections 671 through 678 (relating to grantors and others treated as substantial owners).

(b) An estate or trust shall not, for the purposes of section 172, avail itself of the deductions allowed by section 642(c)(relating to charitable contributions deductions) and sections 651 and 661 (relating to deductions for distributions).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(e)–1 Depreciation and depletion.

An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term "beneficiaries" includes charitable beneficiaries. See the regulations under those sections.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, March 24, 1964]

§ 1.642(f)–1 Amortization deductions.

An estate or trust is allowed amortization deductions with respect to an emergency facility as defined in section 168(d), with respect to a certified pollution control facility as defined in section 169(d), with respect to qualified railroad rolling stock as defined in section 184(d), with respect to certified coal mine safety equipment as defined in section 187(d), with respect to on-the-job training and child-care facilities as defined in section 188(b), and with respect to certain rehabilitations of certified historic structures as defined in section 191, in the same manner and to the same extent as in the case of an individual. However, the principles governing the apportionment of the deductions for depreciation and depletion between fiduciaries and the beneficiaries of an estate or trust (see sections 167(h) and 611(b) and the regulations thereunder) shall be applicable with respect to such amortization deductions.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, Mar. 24, 1964; T.D. 7116, 36 FR 9017, May 18, 1971; T.D. 7599, 44 FR 14552, Mar. 13, 1979; T.D. 7700, 45 FR 38055, June 6, 1980]

§ 1.642(g)–1 Disallowance of double deductions; in general.

Amounts allowable under section 2053(a)(2) (relating to administration expenses) or under section 2054 (relating to losses during administration) as deductions in computing the taxable estate of a decedent are not allowed as deductions in computing the taxable income of the estate unless there is filed a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under section 2053 or 2054 and that all rights to have such items allowed at any time as deductions under section 2053 or 2054 are waived. The statement should be filed with the return for the year for which the items are claimed as deductions or with the district director for the internal revenue district in which the return was filed, for association with the return. The statement may be filed at any time before the expiration of the statutory period of limitation applicable to the taxable year for which the deduction is sought. Allowance of a deduction in computing an estate's taxable income is not precluded by claiming a deduction in the estate tax return, so long as the estate tax deduction is not finally allowed and the statement is filed. However, after a statement is filed under section 642(g) with respect to a particular item or portion of an item, the item cannot thereafter be allowed as a deduction for estate tax purposes since the waiver operates as a relinquishment of the right to have the deduction allowed at any time under section 2053 or 2054.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(g)–2 Deductions included.

It is not required that the total deductions, or the total amount of any deduction, to which section 642(g) is applicable be treated in the same way. One deduction or portion of a deduction may be allowed for income tax purposes if the appropriate statement is filed, while another deduction or portion is allowed for estate tax purposes. Section 642(g) has no application to deductions for taxes, interest, business expenses, and other items accrued at the date of a decedent's death so that they are allowable as a deduction under section 2053(a)(3) for estate tax purposes as claims against the estate, and are also allowable under section 691(b) as deductions in respect of a decedent for income tax purposes. However, section 642(g) is applicable to deductions for interest, business expenses, and other items not accrued at the date of the decedent's death so that they are allowable as deductions for estate tax purposes only as administration expenses under section 2053(a)(2). Although deductible under section 2053(a)(3) in determining the value of the taxable estate of a decedent, medical, dental, etc., expenses of a decedent which are paid by the estate of the decedent are not deductible in computing the taxable income of the estate. See section 213(d) and the regulations thereunder for rules relating to the deductibility of such expenses in computing the taxable income of the decedent.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(h)–1 Unused loss carryovers on termination of an estate or trust.

(a) If, on the final termination of an estate or trust, a net operating loss carryover under section 172 or a capital loss carryover under section 1212 would be allowable to the estate or trust in a taxable year subsequent to the taxable year of termination but for the termination, the carryover or carryovers are allowed under section 642(h)(1) to the beneficiaries succeeding to the property of

the estate or trust. See § 1.641(b)–3 for the determination of when an estate or trust terminates.

(b) The net operating loss carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust, except that the capital loss carryover in the hands of a beneficiary which is a corporation is a short-term loss irrespective of whether it would have been a long-term or short-term capital loss in the hands of the estate or trust. The net operating loss carryover and the capital loss carryover are taken into account in computing taxable income, adjusted gross income, and the tax imposed by section 56 (relating to the minimum tax for tax preferences). The first taxable year of the beneficiary to which the loss shall be carried over is the taxable year of the beneficiary in which or with which the estate or trust terminates. However, for purposes of determining the number of years to which a net operating loss, or a capital loss under paragraph (a) of § 1.1212–1, may be carried over by a beneficiary, the last taxable year of the estate or trust (whether or not a short taxable year) and the first taxable year of the beneficiary to which a loss is carried over each constitute a taxable year, and, in the case of a beneficiary of an estate or trust that is a corporation, capital losses carried over by the estate or trust to any taxable year of the estate or trust beginning after December 31, 1963, shall be treated as if they were incurred in the last taxable year of the estate or trust (whether or not a short taxable year). For the treatment of the net operating loss carryover when the last taxable year of the estate or trust is the last taxable year to which such loss can be carried over, see § 1.642(h)–2.

(c) The application of this section may be illustrated by the following examples:

Example (1). A trust distributes all of its assets to A, the sole remainderman, and terminates on December 31, 1954, when it has a capital loss carryover of $10,000 attributable to transactions during the taxable year 1952. A, who reports on the calendar year basis, otherwise has ordinary income of $10,000 and capital gains of $4,000 for the taxable year 1954. A would offset his capital gains of $4,000 against the capital loss of the trust and, in addition, deduct under section 1211(b) $1,000 on his return for the taxable year 1954. The balance of the capital loss carryover of $5,000 may be carried over only to the years 1955 and 1956, in accordance with paragraph (a) of § 1.1212–1 and the rules of this section.

Example (2). A trust distributes all of its assets, one-half to A, an individual, and one-half to X, a corporation, who are the sole remaindermen, and terminates on December 31, 1966, when it has a short-term capital loss carryover of $20,000 attributable to short-term transactions during the taxable years 1964, 1965, and 1966, and a long-term capital loss carryover of $12,000 attributable to long-term transactions during such years. A, who reports on the calendar year basis, otherwise has ordinary income of $15,000, short-term capital gains of $4,000 and long-term capital gains of $6,000, for the taxable year 1966. A would offset his short-term capital gains of $4,000 against his share of the short-term capital loss carryover of the trust, $10,000 (one-half of $20,000), and, in addition deduct under section 1211(b) $1,000 (treated as a short-term gain for purposes of computing capital loss carryovers) on his return for the taxable year 1966. A would also offset his long-term capital gains of $6,000 against his share of the long-term capital loss carryover of the trust, $6,000 (one-half of $12,000). The balance of A's share of the short-term capital loss carryover, $5,000, may be carried over as a short-term capital loss carryover to the succeeding taxable year and treated as a short-term capital loss incurred in such succeeding taxable year in accordance with paragraph (b) of § 1.1212–1. X, which also reports on the calendar year basis, otherwise has capital gains of $4,000 for the taxable year 1966. X would offset its capital gains of $4,000 against its share of the capital loss carryovers of the trust, $16,000 (the sum of one-half of each the short-term carryover and the long-term carryover of the trust), on its return for the taxable year 1966. The balance of X's share, $12,000, may be carried over as a short-term capital loss only to the years 1967, 1968, 1969, and 1970, in accordance with paragraph (a) of § 1.1212–1 and the rules of this section.

[T.D.6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7805, June 17, 1965; T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.642(h)–2 Excess deductions on termination of an estate or trust.

(a) If, on the termination of an estate or trust, the estate or trust has for its last taxable year deductions (other than the deductions allowed under section 642(b) (relating to personal exemption) or section 642(c) (relating to charitable contributions)) in excess of gross income, the excess is allowed under section 642(h)(2) as a deduction to the beneficiaries succeeding to the property of the estate or trust. The deduction is allowed only in computing taxable income and must be taken into account in computing the items of tax preference of the beneficiary; it is not allowed in computing adjusted gross income. The deduction is allowable only in the taxable year of the beneficiary in which or with which the estate or trust terminates, whether the year of termination of the estate or trust is of normal duration or is a short taxable year. For example: Assume that a trust distributes all of its assets to B and terminates on December 31, 1954. As of that date it has excess deductions, for example, because of corpus commissions on termination, of $18,000. B, who reported on the calendar year basis, could claim the $18,000 as a deduction for the taxable year 1954. However, if the deduction (when added to his other deductions) exceeds his gross income, the excess may not be carried over to the year 1955 or subsequent years.

(b) A deduction based upon a net operating loss carryover will never be allowed to beneficiaries under both paragraphs (1) and (2) of section 642(h). Accordingly, a net operating loss deduction which is allowable to beneficiaries succeeding

to the property of the estate or trust under the provisions of paragraph (1) of section 642(h) cannot also be considered a deduction for purposes of paragraph (2) of section 642(h) and paragraph (a) of this section. However, if the last taxable year of the estate or trust is the last year in which a deduction on account of a net operating loss may be taken, the deduction, to the extent not absorbed in that taxable year by the estate or trust, is considered an "excess deduction" under section 642(h)(2) and paragraph (a) of this section.

(c) Any item of income or deduction, or any part thereof, which is taken into account in determining the net operating loss or capital loss carryover of the estate or trust for its last taxable year shall not be taken into account again in determining excess deductions on termination of the trust or estate within the meaning of section 642(h)(2) and paragraph (a) of this section (see example in § 1.642(h)–5).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.642(h)–3 Meaning of "beneficiaries succeeding to the property of the estate or trust".

(a) The phrase "beneficiaries succeeding to the property of the estate or trust" means those beneficiaries upon termination of the estate or trust who bear the burden of any loss for which a carryover is allowed, or of any excess of deductions over gross income for which a deduction is allowed, under section 642(h).

(b) With reference to an intestate estate, the phrase means the heirs and next of kin to whom the estate is distributed, or if the estate is insolvent, to whom it would have been distributed if it had not been insolvent. If a decedent's spouse is entitled to a specified dollar amount of property before any distribution to other heirs and next of kin, and if the estate is less than that amount, the spouse is the beneficiary succeeding to the property of the estate or trust to the extent of the deficiency in amount.

(c) In the case of a testate estate, the phrase normally means the residuary beneficiaries (including a residuary trust), and not specific legatees or devisees, pecuniary legatees, or other nonresiduary beneficiaries. However, the phrase does not include the recipient of a specific sum of money even though it is payable out of the residue, except to the extent that it is not payable in full. On the other hand, the phrase includes a beneficiary (including a trust) who is not strictly a residuary beneficiary but whose devise or bequest is determined by the value of the decedent's estate as reduced by the loss or deductions in question. Thus the phrase includes:

(1) A beneficiary of a fraction of a decedent's net estate after payment of debts, expenses, etc.;

(2) A nonresiduary legatee or devisee, to the extent of any deficiency in his legacy or devise resulting from the insufficiency of the estate to satisfy it in full;

(3) A surviving spouse receiving a fractional share of an estate in fee under a statutory right of election, to the extent that the loss or deductions are taken into account in determining the share. However, the phrase does not include a recipient of dower or curtesy, or any income beneficiary of the estate or trust from which the loss or excess deduction is carried over.

(d) The principles discussed in paragraph (c) of this section are equally applicable to trust beneficiaries. A remainderman who receives all or a fractional share of the property of a trust as a result of the final termination of the trust is a beneficiary succeeding to the property of the trust. For example, if property is transferred to pay the income to A for life and then to pay $10,000 to B and distribute the balance of the trust corpus to C, C and not B is considered to be the succeeding beneficiary except to the extent that the trust corpus is insufficient to pay B $10,000.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(h)–4 Allocation.

The carryovers and excess deductions to which section 642(h) applies are allocated among the beneficiaries succeeding to the property of an estate or trust (see § 1.642(h)–3) proportionately according to the share of each in the burden of the loss or deductions. A person who qualified as a beneficiary succeeding to the property of an estate or trust with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property of the estate or trust as to the amount with respect to which he qualifies. The application of this section may be illustrated by the following example:

Example. A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.642(h)–5 Example.

The application of section 642(h) may be illustrated by the following example:

Example. (a) A decedent dies January 31, 1954, leaving a will which provides for distributing all her estate equally to A and an existing trust for B. The period of administration of the estate terminates on December 31, 1954, at which time all the property of the estate is distributed to A and the trust. A reports his income for tax purposes on a calendar year basis, and the trust reports its income on the basis of a fiscal year ending August 31. During the period of the administration, the estate has the following items of income and deductions:

Taxable interest	$2,500
Business income	3,000
Total	5,500
Business expenses (including administrative expense allocable to business income)	5,000
Administrative expenses and corpus commissions not allocable to business income	9,800
Total deductions	14,800

It also has a capital loss of $5,000

(b) Under section 642(h)(1), an unused net operating loss carryover of the estate on termination of $2,000 will be allowable to: A to the extent of $1,000 for his taxable year 1954 and the next four taxable years in accordance with section 172; and to the trust to the extent of $1,000 for its taxable year ending August 31, 1955, and its next four taxable years. The amount of the net operating loss carryover is computed as follows:

Deductions of estate for 1954	$14,800
Less adjustment under section 172(d)(4) (deductions not attributable to a trade or business ($9,800) allowable only to extent of gross income not derived from such trade or business ($2,500))	7,300
Deductions as adjusted	7,500
Gross income of estate for 1954	5,500
Net operating loss of estate for 1954	2,000
(No deduction for capital loss of $5,000 under section 172(d)(2))	

Neither A nor the trust will be allowed to carry back any part of the net operating loss made available to them under section 642(h)(1).

(c) Under section 642(h)(2), excess deductions of the estate of $7,300 will be allowed as a deduction to A to the extent of $3,650 for the calendar year 1954 and to the trust to the extent of $3,650 for the taxable year ending August 31, 1955. The deduction of $7,300 for administrative expenses and corpus commissions is the only amount which was not taken into account in determining the net operating loss of the estate ($9,800 of such expenses less $2,500 taken into account).

(d) Under section 642(h)(1), there will be allowable to A a capital loss carryover of $2,500 for his taxable year 1954 and for his next 4 taxable years in accordance with paragraph (a) of § 1.1212–1. There will be allowable to the trust a similar capital loss carryover of $2,500 for its taxable year ending August 31, 1955, and its next 4 taxable years (but see paragraph (b) of § 1.643(a)–3), (for taxable years beginning after December 31, 1963, net capital losses may be carried over indefinitely by beneficiaries other than corporations, in accordance with § 1.642(h)–1 and paragraph (b) of § 1.1212–1.)

(e) The carryovers and excess deductions are not allowable directly to B, the trust beneficiary, but to the extent the distributable net income of the trust is reduced by the carryovers and excess deductions B may receive indirect benefit.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7806, June 17, 1965]

§ 1.642(i)–1 Certain distributions by cemetery perpetual care funds.

(a) In general. Section 642 (i) provides that amounts distributed during taxable years ending after December 31, 1963, by a cemetery perpetual care fund trust for the care and maintenance of gravesites shall be treated as distributions solely for purposes of sections 651 and 661. The deduction for such a distribution is allowable only if the fund is taxable as a trust. In addition, the fund must have been created pursuant to local law by a taxable cemetery corporation (as defined in § 1.642 (i)–2 (a)) expressly for the care and maintenance of cemetery property. A care fund will be treated as having been created by a taxable cemetery corporation ("cemetery") if the distributee cemetery is taxable, even though the care fund was created by the distributee cemetery in a year that it was tax-exempt or by a predecessor of such distributee cemetery which was tax-exempt in the year the fund was established. The deduction is the amount of the distributions during the fund's taxable year to the cemetery corporation for such care and maintenance that would be otherwise allowable under section 651 or 661, but in no event is to exceed the limitations described in paragraphs (b) and (c) of this section. The provisions of this paragraph shall not have the effect of extending the period of limitations under section 6511.

(b) Limitation on amount of deduction. The deduction in any taxable year may not exceed the product of $5 multiplied by the aggregate number of gravesites sold by the cemetery corporation before the beginning of the taxable year of the trust. In general, the aggregate number of gravesites sold shall be the aggregate number of interment rights sold by the cemetery corporation (including gravesites sold by the cemetery before a care fund trust law was enacted). In addition, the number of gravesites sold shall include gravesites used to make welfare burials. Welfare burials and pre-trust fund law gravesites shall be included only to the extent that the cemetery cares for and maintain such gravesites. For purposes of this section, a gravesite is sold as of the date on which the purchaser acquires interment rights enforceable under local law. The aggregate number of gravesites includes only those gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance.

(c) Requirements for deductibility of distributions for care and maintenance—(1) Obligation for

care and maintenance. A deduction is allowed only for distributions for the care and maintenance of gravesites with respect to which the fund or taxable cemetery corporation has an obligation for care and maintenance. Such obligation may be established by the trust instrument, by local law, or by the cemetery's practice of caring for and maintaining gravesites, such as welfare burial plots or gravesites sold before the enactment of a care fund trust law.

(2) Distribution actually used for care and maintenance. The amount of a deduction otherwise allowable for care fund distributions in any taxable year shall not exceed the portion of such distributions expended by the distributee cemetery corporation for the care and maintenance of gravesites before the end of the fund's taxable year following the taxable year in which it makes the distributions. A 6-month extension of time for filing the trust's return may be obtained upon request under section 6081. The failure of a cemetery to expend the care fund's distributions within a reasonable time before the due date for filing the return will be considered reasonable grounds for granting a 6-month extension of time for section 6081. For purposes of this paragraph, any amount expended by the care fund directly for the care and maintenance of gravesites shall be treated as an additional care fund distribution which is expended on the day of distribution by the cemetery corporation. The fund shall be allowed a deduction for such direct expenditure in the fund's taxable year during which the expenditure is made.

(3) Example. The application of paragraph (c)(2) of this section is illustrated by the following example:

A, a calendar-year perpetual care fund trust, meeting the requirements of section 642 (i), makes a $10,000 distribution on December 1, 1978 to X, a taxable cemetery corporation operating on a May 31 fiscal year. From this $10,000 distribution, the cemetery makes the following expenditures for the care and maintenance of gravesites: $2,000 on December 20, 1978; $4,000 on June 1, 1979; $2,000 on October 1, 1979; and $1,000 on April 1, 1980. In addition, as authorized by the trust instrument, A itself makes a direct $1,000 payment to a contractor on September 1, 1979 for qualifying care and maintenance work performed. As a result of these transactions, A will be allowed an $8,000 deduction for its 1978 taxable year attributable to the cemetery's expenditures, and a $1,000 deduction for its 1979 taxable year attributable to the fund's direct payment. A will not be allowed a deduction for its 1978 taxable year for the cemetery's expenditure of either the $1,000 expended on April 1, 1980 or the remaining unspent portion of the original $10,000 distribution. The trustee may request a 6-month extension in order to allow the fund until October 15, 1979 to file its return for 1978.

(d) Certified statement made by cemetery officials to fund trustees. A trustee of a cemetery perpetual care fund shall not be held personally liable for civil or criminal penalties resulting from false statements on the trust's tax return to the extent that such false statements resulted from the trustee's reliance on a certified statement made by the cemetery specifying the number of interments sold by the cemetery or the amount of the cemetery's expenditures for care and maintenance. The statement must indicate the basis upon which the cemetery determined what portion of its expenditures were made for the care and maintenance of gravesites. The statement must be certified by an officer or employee of the cemetery who has the responsibility to make or account for expenditures for care and maintenance. A copy of this statement shall be retained by the trustee along with the trust's return and shall be made available for inspection upon request by the Secretary. This paragraph does not relieve the care fund trust of its liability to pay the proper amount of tax due and to maintain adequate records to substantiate each of its deductions, including the deduction provided in section 642(i) and this section.

[T.D. 7651, 44 FR 61596, Oct. 26, 1979]

§ 1.642(i)–2 Definitions.

(a) Taxable cemetery corporation. For purposes of section 642(i) and this section, the meaning of the term "taxable cemetery corporation" is limited to a corporation (within the meaning of section 7701(a)(3)) engaged in the business of owning and operating a cemetery that either (1) is not exempt from Federal tax, or (2) is subject to tax under section 511 with respect to its cemetery activities.

(b) Pursuant to local law. A cemetery perpetual care fund is created pursuant to local law if:

(1) The governing law of the relevant jurisdiction (State, district, county, parish, etc.) requires or expressly permits the creation of such a fund, or

(2) The legally enforceable bylaws or contracts of a taxable cemetery corporation require a perpetual care fund.

(c) Gravesite. A gravesite is any type of interment right that has been sold by a cemetery, including, but not limited to, a burial lot, mausoleum, lawn crypt, niche, or scattering ground. For purposes of § 1.642(i)–1, the term "gravesites" includes only those gravesites with respect to which the care fund or cemetery has an obligation for care and maintenance within the meaning of § 1.642(i)–1(c)(1).

(d) *Care and maintenance.* For purposes of section 642(i) and this section, the term "care and maintenance of gravesite" shall be generally defined in accordance with the definition of such term under the local law pursuant to which the cemetery perpetual care fund is created. If the applicable local law contains no definition, care and maintenance of gravesites may include the upkeep, repair and preservation of those portions of cemetery property in which gravesites (as defined in paragraph (c) of this section) have been sold; including gardening, road maintenance, water line and drain repair and other activities reasonably necessary to the preservation of cemetery property. The costs for care and maintenance include, but are not limited to, expenditures for the maintenance, repair and replacement of machinery, tools, and equipment, compensation of employees performing such work, insurance premiums, reasonable payments for employees' pension and other benefit plans, and the costs of maintaining necessary records of lot ownership, transfers and burials. However, if some of the expenditures of the cemetery corporation, such as officers' salaries, are for both care and maintenance and for other purposes, the expenditures must be properly allocated between care and maintenance of gravesites and the other purposes. Only those expenditures that are properly allocable to those portions of cemetery property in which gravesites have been sold qualify as expenditures for care and maintenance of gravesites.

[T.D. 7651, 44 FR 61596, Oct. 26, 1979]

§ 1.643(a)–0 Distributable net income; deduction for distributions; in general.

The term "distributable net income" has no application except in the taxation of estates and trusts and their beneficiaries. It limits the deductions allowable to estates and trusts for amounts paid, credited, or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in his gross income. It is also used to determine the character of distributions to the beneficiaries. Distributable net income means for any taxable year, the taxable income (as defined in section 63) of the estate or trust, computed with the modifications set forth in §§ 1.643(a)–1 through 1.643(a)–7.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.643(a)–1 Deduction for distributions.

The deduction allowable to a trust under section 651 and to an estate or trust under section 661 for amounts paid, credited, or required to be distributed to beneficiaries is not allowed in the computation of distributable net income.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.643(a)–2 Deduction for personal exemption.

The deduction for personal exemption under section 642(b) is not allowed in the computation of distributable net income.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.643(a)–3 Capital gains and losses.

(a) Except as provided in § 1.643(a)–6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:

(1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,

(2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or

(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

(b) Losses from the sale or exchange of capital assets are excluded in computing distributable net income except to the extent that they enter into the determination of any capital gains that are paid, credited, or required to be distributed to any beneficiary during the taxable year (but see § 1.642(h)–1 with respect to capital loss carryovers in the year of final termination of an estate or trust).

(c) The deduction under section 1202 (relating to capital gains) is taken into account in computing distributable net income to the extent that it is allocable to capital gains which are paid, permanently set aside, or to be used for the purposes specified in section 642(c). See the regulations under section 642(c) to determine the extent to which the amount so paid, permanently set aside, or to be used consists of capital gains. The deduc-

tion for capital gains provided in section 1202 insofar as it is allocable to the remainder of the capital gains is not taken into account.

(d) The application of this section may be illustrated by the following examples:

Example (1). A trust is created to pay the income to A for life, with a discretionary power in the trustee to invade principal for A's benefit. In the taxable year, $10,000 is realized from the sale of securities at a profit, and $10,000 in excess of income is distributed to A. The capital gain is not allocated to A by the trustee. During the taxable year the trustee received and paid out $5,000 of dividends. No other cash was received or on hand during the taxable year. The capital gain will not ordinarily be included in distributable net income. However, if the trustee follows a regular practice of distributing the exact net proceeds of the sale of trust property, capital gains will be included in distributable net income.

Example (2). The result in example (1) would have been the same if the trustee had been directed to pay an annuity of $15,000 a year to A (instead of being directed to pay the income to A with a discretionary power to distribute principal).

Example (3). The trustee of a trust containing Blackacre and other property is directed to hold Blackacre for ten years, and then sell it and distribute its proceeds to A. Any capital gain realized from the sale of Blackacre will be included in distributable net income.

Example (4). A trust instrument directs that the income shall be paid to A, and that the principal shall be distributed to A when he reaches age 35. All capital gains realized in the year of termination will be included in distributable net income. (See § 1.641(b)–3 for the determination of the year of final termination and the taxability of capital gains realized after the terminating event and before final distribution.)

Example (5). If in example (4) the trustee had been directed to distribute half of the principal to A when he reached 35, the capital gain would be included in distributable net income (and in the distribution to A) to the extent the capital gain is allocable to A under the governing instrument and local law. Thus, if the trust assets consisted entirely of 100 shares of corporation M stock and the trustee sold half the shares and distributed the proceeds to A, the entire capital gain would normally be considered as allocated to A. On the other hand, if the trustee sold all the shares and distributed half the proceeds to A, half the capital gain would be considered as allocable to A.

Example (6). If in example (4) the trustee had been directed to pay $10,000 to B before making distribution to A, no portion of the capital gains would be allocable to B since the distribution to B is a gift of a specific sum of money within the meaning of section 663(a)(1).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 731, Jan. 17, 1969; T.D. 7357, 40 FR 23742, June 2, 1975]

§ 1.643(a)–4 Extraordinary dividends and taxable stock dividends.

In the case solely of a trust which qualifies under Subpart B (section 651 and following) as a "simple trust," there are excluded from distributable net income extraordinary dividends (whether paid in cash or in kind) or taxable stock dividends which are not distributed or credited to a beneficiary because the fiduciary in good faith determines that under the terms of the governing instrument and applicable local law such dividends are allocable to corpus. See section 665(e), paragraph (b) of § 1.665(e)–1, and paragraph (b) of § 1.665(e)–1A for the treatment of such dividends upon subsequent distribution.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969; T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.643(a)–5 Tax-exempt interest.

(a) There is included in distributable net income any tax-exempt interest excluded from gross income under section 103, reduced by disbursements allocable to such interest which would have been deductible under section 212 but for the provisions of section 265 (relating to disallowance of deductions allocable to tax-exempt income).

(b) If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)–6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument specifically provides as to the source out of which amounts are paid, permanently set aside, or to be used for such charitable purposes, the specific provisions control. In the absence of specific provisions in the governing instrument, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see examples (1) and (2) of § 1.662(b)–2 and paragraph (e) of § 1.662(c)–4.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.643(a)–6 Income of foreign trust.

(a) **Distributable net income of a foreign trust.** In the case of a foreign trust (see section 7701(a)(31)), the determination of distributable net income is subject to the following rules:

(1) There is included in distributable net income the amounts of gross income from sources without the United States, reduced by disbursements allocable to such foreign income which would have been deductible but for the provisions of section 265 (relating to disallowance of deductions allocable to tax exempt income). See paragraph (b) of § 1.643(a)–5 for rules applicable when an estate or

trust is allowed a charitable contributions deduction under section 642(c).

(2) In the case of a distribution made by a trust before January 1, 1963, for purposes of determining the distributable net income of the trust for the taxable year in which the distribution is made, or for any prior taxable year;

(i) Gross income from sources within the United States is determined by taking into account the provisions of section 894 (relating to income exempt under treaty); and

(ii) Distributable net income is determined by taking into account the provisions of section 643(a)(3) (relating to exclusion of certain gains from the sale or exchange of capital assets).

(3) In the case of a distribution made by a trust after December 31, 1962, for purposes of determining the distributable net income of the trust for any taxable year, whether ending before January 1, 1963, or after December 31, 1962;

(i) Gross income (for the entire foreign trust) from sources within the United States is determined without regard to the provisions of section 894 (relating to income exempt under treaty);

(ii) In respect of a foreign trust created by a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and § 1.643(d)–1), there shall be included in gross income gains from the sale or exchange of capital assets reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges, and the deduction under section 1202 (relating to deduction for capital gains) shall not be taken into account; and

(iii) In respect of a foreign trust created by a person other than a U.S. person (whether such trust constitutes the whole or only a portion of the entire foreign trust) (see section 643(d) and § 1.643(d)–1), distributable net income is determined by taking into account all of the provisions of section 643 except section 643(a)(6)(C) (relating to gains from the sale or exchange of capital assets by a foreign trust created by a U.S. person).

(b) Examples. The application of this section, showing the computation of distributable net income for one of the taxable years for which such a computation must be made, may be illustrated by the following examples:

Example (1). (1) A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The income from the trust corpus is to be accumulated until the beneficiary, a resident citizen of the United States who was born in 1944, reaches the age of 21 years, and upon his reaching that age, the corpus and accumulated income are to be distributed to him. The trust instrument provides that capital gains are to be allocated to corpus and are not to be paid, credited, or required to be distributed to any beneficiary during the taxable year or paid, permanently set aside, or to be used for the purposes specified in section 642(c). Under the terms of a tax convention between the United States and Country X, interest income received by the trust from U.S. sources is exempt from U.S. taxation. In 1965 the corpus and accumulated income are distributed to the beneficiary. During the taxable year 1964, the trust has the following items of income, loss, and expense:

Interest on bonds of a U.S. corporation	$10,000
Net long-term capital gain from U.S. sources	30,000
Gross income from investments in Country X	40,000
Net short-term capital loss from U.S. sources	5,000
Expenses allocable to gross income from investments in Country X	5,000

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is $70,000, computed as follows:

Interest on bonds of a U.S. corporation		$10,000
Gross income from investments in Country X		40,000
Net long-term capital gain from U.S. sources.................	$30,000	
Less: Net short-term capital loss from U.S. sources............	5,000	
Excess of net long-term capital gain over net short-term capital loss		25,000
Total		75,000
Less: Expenses allocable to income from investments in Country X		5,000
Distributable net income................		70,000

(3) In determining the distributable net income of $70,000, the taxable income of the trust is computed with the following modifications: No deduction is allowed for the personal exemption of the trust (section 643(a)(2)); the interest received on bonds of a U.S. corporation is included in the trust gross income despite the fact that such interest is exempt from U.S. tax under the provisions of the tax treaty between Country X and the United States (section 643(a)(6) (see H. Con. Res. (B)); the excess of net long-term capital gain over net short-term capital loss allocable to corpus is included in distributable net income, but such excess is not subject to the deduction under section 1202 (section 643(a)(6)(C)); and the amount representing gross income from investments in Country X is included, but such amount is reduced by the amount of the disbursements allocable to such income (section 643(a)(6)(A)).

Example (2). (1) The facts are the same as in example (1) except that money or property has also been transferred to the trust by a person other than a U.S. person and, pursuant to the provisions of § 1.643(d)–1, during 1964 only 60 percent of the entire trust constitutes a foreign trust created by a U.S. person.

(2) The distributable net income for the taxable year 1964 of the foreign trust created by a U.S. person, determined under section 643(a), is $42,000 computed as follows:

Interest on bonds of a U.S. corporation (60 percent of $10,000)	$6,000

Gross income from investments in Country X (60 percent of $40,000)		$24,000
Net long-term capital gain from U.S. sources (60 percent of $30,000)	$18,000	
Less: Net short-term capital loss from U.S. sources (60 percent of $5,000)	3,000	
		15,000
Total		45,000
Less: Expenses allocable to income from investments in Country X (60 percent of $5,000)		3,000
Distributable net income		42,000

(3) The distributable net income for the taxable year 1964 of the portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person, determined under section 643(a), is $18,000, computed as follows:

Interest on bonds of a U.S. corporation (40 percent of $10,000)	$4,000
Gross income from investments in Country X (40 percent of $40,000)	16,000
Total	20,000
Less: Expenses allocable to income from investments in Country X (40 percent of $5,000)	2,000
Distributable net income	18,000

(4) The distributable net income of the entire foreign trust for the taxable year 1964 is $60,000, computed as follows:

Distributable net income of the foreign trust created by a U.S. person	$42,000
Distributable net income of that portion of the entire foreign trust which does not constitute a foreign trust created by a U.S. person	18,000
Distributable net income of the entire foreign trust	60,000

It should be noted that the difference between the $70,000 distributable net income of the foreign trust in example (1) and the $60,000 distributable net income of the entire foreign trust in this example is due to the $10,000 (40 percent of $25,000) net capital gain (capital gain net income for taxable years beginning after December 31, 1976) which under section 643(a)(3) is excluded from the distributable net income of that portion of the foreign trust in example (2) which does not constitute a foreign trust created by a U.S. person.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 731, Jan. 17, 1969; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.643(a)–7 Dividends.

Dividends excluded from gross income under section 116 (relating to partial exclusion of dividends received) are included in distributable net income. For this purpose, adjustments similar to those required by § 1.643(a)–5 with respect to expenses allocable to tax-exempt income and to income included in amounts paid or set aside for charitable purposes are not made. See the regulations under section 642(c).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23742, June 2, 1975]

§ 1.643(b)–1 Definition of "income".

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Code, the term "income" when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of an estate or trust for the taxable year determined under the terms of its governing instrument and applicable local law. Trust provisions which depart fundamentally from concepts of local law in the determination of what constitutes income are not recognized for this purpose. For example, if a trust instrument directs that all the trust income shall be paid to A, but defines ordinary dividends and interest as corpus, the trust will not be considered one which under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to "simple" trusts).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.643(b)–2 Dividends allocated to corpus.

Extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law are not considered "income" for purposes of Subpart A, B, C, or D, Part I, Subchapter J, Chapter 1 of the Code. See section 643(a)(4), § 1.643(a)–4, § 1.643(d)–2, section 665(e), paragraph (b) of § 1.665(e)–1, and paragraph (b) of § 1.665(e)–1A for the treatment of such items in the computation of distributable net income.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969; T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.643(c)–1 Definition of "beneficiary".

An heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent's will is a beneficiary of the decedent's estate. The following persons are treated as beneficiaries:

(a) Any person with respect to an amount used to discharge or satisfy that person's legal obligation as that term is used in § 1.662(a)–4.

(b) The grantor of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 677(b) out of corpus or out of other than income for the taxable year of the trust.

(c) The trustee or cotrustee of a trust with respect to an amount applied or distributed for the support of a dependent under the circumstances specified in section 678(c) out of corpus or out of other than income for the taxable year of the trust. [T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.643(d)–1 Definition of "foreign trust created by a United States person."

(a) In general. For the purpose of Part I, Subchapter J, Chapter 1 of the Internal Revenue Code, the term "foreign trust created by a United States person" means that portion of a foreign trust (as defined in section 7701(a)(31)) attributable to money or property (including all accumulated earnings, profits, or gains attributable to such money or property) of a U.S. person (as defined in section 7701(a)(30)) transferred directly or indirectly, or under the will of a decedent who at the date of his death was a U.S. citizen or resident, to the foreign trust. A foreign trust created by a person who is not a U.S. person, to which a U.S. person transfers his money or property, is a foreign trust created by a U.S. person to the extent that the fair market value of the entire foreign trust is attributable to money or property of the U.S. person transferred to the foreign trust. The transfer of money or property to the foreign trust may be made either directly or indirectly by a U.S. person. Transfers of money or property to a foreign trust do not include transfers of money or property pursuant to a sale or exchange which is made for a full and adequate consideration. Transfers to which section 643(d) and this section apply are transfers of money or property which establish or increase the corpus of a foreign trust. The rules set forth in this section with respect to transfers by a U.S. person to a foreign trust also are applicable with respect to transfers under the will of a decedent who at the date of his death was a U.S. citizen or resident. For provisions relating to the information returns which are required to be filed with respect to the creation of or transfers to foreign trusts, see section 6048 and § 16.3–1 of this chapter (Temporary Regulations under the Revenue Act of 1962).

(b) Determination of a foreign trust created by a U.S. person—(1) Transfers of money or property only by a U.S. person. If all the items of money or property constituting the corpus of a foreign trust are transferred to the trust by a U.S. person, the entire foreign trust is a foreign trust created by a U.S. person.

(2) Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers required to be treated as separate funds. Where there are transfers of money or property by both a U.S. person and a person other than a U.S. person to a foreign trust, and it is necessary, either by reason of the provisions of the governing instrument of the trust or by reason of some other requirement such as local law, that the trustee treat the entire foreign trust as composed of two separate funds, one consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the U.S. person and the other consisting of the money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred by the person other than the U.S. person, the foreign trust created by a U.S. person shall be the fund consisting of the money or property transferred by the U.S. person. See example (1) in paragraph (c) of this section.

(3) Transfers of money or property by both a U.S. person and a person other than a U.S. person; transfers not required to be treated as separate funds. Where the corpus of a foreign trust consists of money or property transferred to the trust (simultaneously or at different times) by a U.S. person and by a person who is not a U.S. person, the foreign trust created by a U.S. person within the meaning of section 643(d) is that portion of the entire foreign trust which, immediately after any transfer of money or property to the trust, the fair market value of money or property (including all accumulated earnings, profits, or gains attributable to such money or property) transferred to the foreign trust by the U.S. person bears to the fair market value of the corpus (including all accumulated earnings, profits, or gains attributable to the corpus) of the entire foreign trust.

(c) Examples. The provisions of paragraph (b) of this section may be illustrated by the following examples. Example (1) illustrates the application of paragraph (b)(2) of this section. Example (2) illustrates the application of paragraph (b)(3) of this section in a case where there is no provision in the governing instrument of the trust or elsewhere which would require the trustee to treat the corpus of the trust as composed of more than one fund.

Example (1). On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it stock of a U.S. corporation with a fair market value of $50,000. On the same day, a person other than a U.S. person transfers to the trust Country X bonds with a fair market value of $25,000. The governing instrument of the trust provides that the income from the stock of the U.S. corporation is to be accumulated until A, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the stock and income accumulated

thereon are to be distributed to him. The governing instrument of the trust further provides that the income from the Country X bonds is to be accumulated until B, a U.S. beneficiary, reaches the age of 21 years, and upon his reaching that age, the bonds and income accumulated thereon are to be distributed to him. To comply with the provisions of the governing instrument of the trust that the income from the stock of the U.S. corporation be accumulated and distributed to A and that the income from the Country X bonds be accumulated and distributed to B, it is necessary that the trustee treat the transfers as two separate funds. The fund consisting of the stock of the U.S. corporation is a foreign trust created by a U.S. person.

Example (2). On January 1, 1964, the date of the creation of a foreign trust, a U.S. person transfers to it property having a fair market value of $60,000 and a person other than a U.S. person transfers to it property having a fair market value of $40,000. Immediately after these transfers, the foreign trust created by a U.S. person is 60 percent of the entire foreign trust, determined as follows:

$60,000 (Value of property transferred by U.S. person)/$100,000 (Value of entire property transferred to trust)=60 percent

The undistributed net income for the calendar years 1964 and 1965 is $20,000 which increases the value of the entire foreign trust to $120,000 ($100,000 plus $20,000). Accordingly, as of December 31, 1965, the portion of the foreign trust created by the U.S. person is $72,000 (60 percent of $120,000). On January 1, 1966, the U.S. person transfers property having a fair market value of $40,000 increasing the value of the entire foreign trust to $160,000 ($120,000 plus $40,000) and increasing the value of the portion of the foreign trust created by the U.S. person to $112,000 ($72,000 plus $40,000). Immediately, after this transfer, the foreign trust created by the U.S. person is 70 percent of the entire foreign trust, determined as follows:

$112,000 (Value of property transferred by U.S. person)/$160,000 (Value of entire property transferred to the trust)=70 percent

[T.D. 6989, 34 FR 732, Jan. 17, 1969]

§ 1.643(d)–2 Illustration of the provisions of section 643.

(a) The provisions of section 643 may be illustrated by the following example:

Example. (1) Under the terms of the trust instrument, the income of a trust is required to be currently distributed to W during her life. Capital gains are allocable to corpus and all expenses are charges against corpus. During the taxable year the trust has the following items of income and expenses:

Dividends from domestic corporations	$30,000
Extraordinary dividends allocated to corpus by the trustee in good faith	20,000
Taxable interest	10,000
Tax-exempt interest	10,000
Long-term capital gains	10,000
Trustee's commissions and miscellaneous expenses allocable to corpus	5,000

(2) The "income" of the trust determined under section 643(b) which is currently distributable to W is $50,000, consisting of dividends of $30,000, taxable interest of $10,000, and tax-exempt interest of $10,000. The trustee's commissions and miscellaneous expenses allocable to tax-exempt interest amount to $1,000 (10,000/50,000 × $5,000).

(3) The "distributable net income" determined under section 643(a) amounts to $45,000, computed as follows:

Dividends from domestic corporations		$30,000
Taxable interest		10,000
Nontaxable interest	$10,000	
Less: Expenses allocable thereto	1,000	
		9,000
Total		49,000
Less: Expenses ($5,000 less $1,000 allocable to tax-exempt interest)		4,000
Distributable net income		45,000

In determining the distributable net income of $45,000, the taxable income of the trust is computed with the following modifications: No deductions are allowed for distributions to W and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains allocable to corpus are excluded and the deduction allowable under section 1202 is not taken into account (section 643(a)(3)): the extraordinary dividends allocated to corpus by the trustee in good faith are excluded (sections 643(a)(4)); and the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 are included (section 643(a)(5) and (7)).

(b) See paragraph (c) of the example in § 1.661(c)–2 for the computation of distributable net income where there is a charitable contributions deduction.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960. Redesignated by T.D. 6989, 34 FR 732, Jan. 1, 1969]

Trusts Which Distribute Current Income Only

§ 1.651(a)–1 Simple trusts; deduction for distributions; in general.

Section 651 is applicable only to a trust the governing instruments of which:

(a) Requires that the trust distribute all of its income currently for the taxable year, and

(b) Does not provide that any amounts may be paid, permanently set aside, or used in the taxable year for the charitable, etc., purposes specified in section 642(c),

and does not make any distribution other than of current income. A trust to which section 651 applies is referred to in this part as a "simple" trust. Trusts subject to section 661 are referred to as "complex" trusts. A trust may be a simple trust for one year and a complex trust for another year. It should be noted that under section 651 a trust qualifies as a simple trust in a taxable year in

which it is required to distribute all its income currently and makes no other distributions, whether or not distributions of current income are in fact made. On the other hand a trust is not a complex trust by reason of distributions of amounts other than income unless such distributions are in fact made during the taxable year, whether or not they are required in that year.
[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.651(a)–2 Income required to be distributed currently.

(a) The determination of whether trust income is required to be distributed currently depends upon the terms of the trust instrument and the applicable local law. For this purpose, if the trust instrument provides that the trustee in determining the distributable income shall first retain a reserve for depreciation or otherwise make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the retention of current income for that purpose will not disqualify the trust from being a "simple" trust. The fiduciary must be under a duty to distribute the income currently even if, as a matter of practical necessity, the income is not distributed until after the close of the trust's taxable year. For example: Under the terms of the trust instrument, all of the income is currently distributable to A. The trust reports on the calendar year basis and as a matter of practical necessity makes distribution to A of each quarter's income on the fifteenth day of the month following the close of the quarter. The distribution made by the trust on January 15, 1955, of the income for the fourth quarter of 1954 does not disqualify the trust from treatment in 1955 under section 651, since the income is required to be distributed currently. However, if the terms of a trust require that none of the income be distributed until after the year of its receipt by the trust, the income of the trust is not required to be distributed currently and the trust is not a simple trust. For definition of the term "income" see section 643(b) and § 1.643(b)–1.

(b) It is immaterial, for purposes of determining whether all the income is required to be distributed currently, that the amount of income allocated to a particular beneficiary is not specified in the instrument. For example, if the fiduciary is required to distribute all the income currently, but has discretion to "sprinkle" the income among a class of beneficiaries, or among named beneficiaries, in such amount as he may see fit, all the income is required to be distributed currently, even though the amount distributable to a particular beneficiary is unknown until the fiduciary has exercised his discretion.

(c) If in one taxable year of a trust its income for that year is required or permitted to be accumulated, and in another taxable year its income for the year is required to be distributed currently (and no other amounts are distributed), the trust is a simple trust for the latter year. For example, a trust under which income may be accumulated until a beneficiary is 21 years old, and thereafter must be distributed currently, is a simple trust for taxable years beginning after the beneficiary reaches the age of 21 years in which no other amounts are distributed.
[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.651(a)–3 Distribution of amounts other than income.

(a) A trust does not qualify for treatment under section 651 for any taxable year in which it actually distributes corpus. For example, a trust which is required to distribute all of its income currently would not qualify as a simple trust under section 651 in the year of its termination since in that year actual distributions of corpus would be made.

(b) A trust, otherwise qualifying under section 651, which may make a distribution of corpus in the discretion of the trustee, or which is required under the terms of its governing instrument to make a distribution of corpus upon the happening of a specified event, will be disqualified for treatment under section 651 only for the taxable year in which an actual distribution of corpus is made. For example: Under the terms of a trust, which is required to distribute all of its income currently, half of the corpus is to be distributed to beneficiary A when he becomes 30 years of age. The trust reports on the calendar year basis. On December 28, 1954, A becomes 30 years of age and the trustee distributes half of the corpus of the trust to him on January 3, 1955. The trust will be disqualified for treatment under section 651 only for the taxable year 1955, the year in which an actual distribution of corpus is made.

(c) See section 661 and the regulations thereunder for the treatment of trusts which distribute corpus or claim the charitable contributions deduction provided by section 642(c).
[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.651(a)–4 Charitable purposes.

A trust is not considered to be a trust which may pay, permanently set aside, or use any

amount for charitable, etc., purposes for any taxable year for which it is not allowed a charitable, etc., deduction under section 642(c). Therefore, a trust with a remainder to a charitable organization is not disqualified for treatment as a simple trust if either (a) the remainder is subject to a contingency, so that no deduction would be allowed for capital gains or other amounts added to corpus as amounts permanently set aside for a charitable, etc., purpose under section 642 (c), or (b) the trust receives no capital gains or other income added to corpus for the taxable year for which such a deduction would be allowed.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.651(a)–5 Estates.

Subpart B has no application to an estate.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.651(b)–1 Deduction for distributions to beneficiaries.

In computing its taxable income, a simple trust is allowed a deduction for the amount of income which is required under the terms of the trust instrument to be distributed currently to beneficiaries. If the amount of income required to be distributed currently exceeds the distributable net income, the deduction allowable to the trust is limited to the amount of the distributable net income. For this purpose the amount of income required to be distributed currently, or distributable net income, whichever is applicable, does not include items of trust income (adjusted for deductions allocable thereto) which are not included in the gross income of the trust. For determination of the character of the income required to be distributed currently, see § 1.652(b)–2. Accordingly, for the purposes of determining the deduction allowable to the trust under section 651, distributable net income is computed without the modifications specified in paragraphs (5), (6), and (7) of section 643(a), relating to tax-exempt interest, foreign income, and excluded dividends. For example: Assume that the distributable net income of a trust as computed under section 643(a) amounts to $99,000 but includes nontaxable income of $9,000. Then distributable net income for the purpose of determining the deduction allowable under section 651 is $90,000 ($99,000 less $9,000 nontaxable income).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(a)–1 Simple trusts; inclusion of amounts in income of beneficiaries.

Subject to the rules in §§ 1.652(a)–2 and 1.652(b)–1, a beneficiary of a simple trust includes in his gross income for the taxable year the amounts of income required to be distributed to him for such year, whether or not distributed. Thus, the income of a simple trust is includible in the beneficiary's gross income for the taxable year in which the income is required to be distributed currently even though, as a matter of practical necessity, the income is not distributed until after the close of the taxable year of the trust. See § 1.642(a)(3)–2 with respect to time of receipt of dividends. See § 1.652(c)–1 for treatment of amounts required to be distributed where a beneficiary and the trust have different taxable years. The term "income required to be distributed currently" includes income required to be distributed currently which is in fact used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(a)–2 Distributions in excess of distributable net income.

If the amount of income required to be distributed currently to beneficiaries exceeds the distributable net income of the trust (as defined in section 643(a)), each beneficiary includes in his gross income an amount equivalent to his proportionate share of such distributable net income. Thus, if beneficiary A is to receive two-thirds of the trust income and B is to receive one-third, and the income required to be distributed currently is $99,000, A will receive $66,000 and B, $33,000. However, if the distributable net income, as determined under section 643(a) is only $90,000, A will include two-thirds ($60,000) of that sum in his gross income, and B will include one-third ($30,000) in his gross income. See §§ 1.652(b)–1 and 1.652(b)–2, however, for amounts which are not includible in the gross income of a beneficiary because of their tax-exempt character.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(b)–1 Character of amounts.

In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)–1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)–1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the benefi-

ciary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116. Also, to the extent that the amounts specified in § 1.652(a)–1 consist of "earned income" in the hands of the trust under the provisions of section 1348 such amount shall be treated under section 1348 as "earned income" in the hands of the beneficiary. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)–1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 7204, 37 FR 17134, Aug. 25, 1972]

§ 1.652(b)–2 Allocation of income items.

(a) The amounts specified in § 1.652(a)–1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000, and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

(b) The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation. For example:

(1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.

(2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.

(3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(b)–3 Allocation of deductions.

Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

(a) All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See § 1.642(e)–1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.

(b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

(c) Examples of expenses which are considered as not directly attributable to a specific class of income are trustee's commissions, the rental of safe deposit boxes, and State income and personal property taxes.

(d) To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income in the manner provided in paragraph (b) of this section, except that any excess deductions attributable to tax-exempt income (other than dividends excluded under section 116) may not be offset against any other class of income. See section 265 and the regulations thereunder. Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect. However, if the excess deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income in accordance with section 652(a) and (b) is based on the income of the trust for any taxable year or years ending with or within his taxable year. This rule applies to taxable years of normal duration as well as to so-called short taxable years. Income of the trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(c)–2 Death of individual beneficiaries.

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 652 for the taxable year of the trust in which his last taxable year ends. Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)–3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included under section 652(a) in its gross income for its last taxable year is computed with reference to §§ 1.652(c)–1 and 1.652(c)–2 as if the beneficiary

were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.652(c)–4 Illustration of the provisions of sections 651 and 652.

The rules applicable to a trust required to distribute all of its income currently to its beneficiaries may be illustrated by the following example:

Example. (a) Under the terms of a simple trust all of the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. The trust and both beneficiaries file returns on the calendar year basis. No provision is made in the governing instrument with respect to depreciation. During the taxable year 1955, the trust had the following items of income and expense:

Rents	$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents	5,000
Trustee's commissions allocable to income account	2,600
Trustee's commissions allocable to principal account	1,300
Depreciation	5,000

(b) The income of the trust for fiduciary accounting purposes is $92,400, computed as follows:

Rents		$25,000
Dividends		50,000
Tax-exempt interest		25,000
Total		100,000
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions allocable to income account	2,600	
		7,600
Income computed under section 643(b)		92,400

One-half ($46,200) of the income of $92,400 is currently distributable to each beneficiary.

(c) The distributable net income of the trust computed under section 643(a) is $91,100, determined as follows (cents are disregarded in the computation):

Rents		$25,000
Dividends		50,000
Tax-exempt interest	$25,000	
Less: Expenses allocable thereto (25,000/100,000 × $3,900)	975	
		24,025
Total		99,025
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions ($3,900 less $975 allocable to tax-exempt interest)	2,925	
		7,925
Distributable net income		91,100

In computing the distributable net income of $91,100, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to the beneficiaries and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50-percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 were included (section 643(a)(5) and (7)). Since all of the income of the trust is required to be currently distributed, no deduction is allowable for depreciation in the absence of specific provisions in the governing instrument providing for the keeping of the trust corpus intact. See section 167(h) and the regulations thereunder.

(d) The deduction allowable to the trust under section 651(a) for distributions to the beneficiaries is $67,025, computed as follows:

Distributable net income computed under section 643(a) (see paragraph (c))		$91,100
Less:		
Tax-exempt interest as adjusted	$24,025	
Dividend exclusion	50	
		24,075
Distributable net income as determined under section 651(b)		67,025

Since the amount of the income ($92,400) required to be distributed currently by the trust exceeds the distributable net income ($67,025) as computed under section 651(b), the deduction allowable under section 651(a) is limited to the distributable net income of $67,025.

(e) The taxable income of the trust is $7,200 computed as follows:

Rents		$25,000
Dividends ($50,000 less $50 exclusion)		49,950
Long-term capital gains		15,000
Gross income		89,950
Deductions:		
Rental expenses	$5,000	
Trustee's commissions	2,925	
Capital gain deduction	7,500	
Distributions to beneficiaries	67,025	
Personal exemption	300	
		82,750
Taxable income		7,200

The trust is not allowed a deduction for the portion ($975) of the trustee's commissions allocable to tax-exempt interest in computing its taxable income.

(f) In determining the character of the amounts includible in the gross income of A and B, it is assumed that the trustee elects to allocate to rents the expenses not directly attributable to a specific item of income other than the portion ($975) of such expenses allocated to tax-exempt interest. The allocation of expenses among the items of income is shown below:

	Rents	Dividends	Tax-exempt interest	Total
Income for trust accounting purposes	$25,000	$50,000	$25,000	$100,000
Less:				
Rental expenses	5,000	....	....	5,000
Trustee's commissions	2,925	....	975	3,900
Total deductions	7,925	0	975	8,900
Character of amounts in the hands of the beneficiaries	17,075	50,000	24,025	[1]91,100

[1] Distributable net income.

Inasmuch as the income of the trust is to be distributed equally to A and B, each is deemed to have received one-half of each item of income; that is, rents of $8,537.50, dividends of $25,000, and tax-exempt interest of $12,012.50. The dividends of $25,000 allocated to each beneficiary are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion provided by section 116 and the dividend received credit allowed under section 34. Also, each beneficiary is allowed a deduction of $2,500 for depreciation of rental property attributable to the portion (one-half) of the income of the trust distributed to him.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3655, March 24, 1964]

Estates and Trusts Which May Accumulate Income or Which Distribute Corpus

§ 1.661(a)–1 Estates and trusts accumulating income or distributing corpus; general.

Subpart C, Part I, Subchapter J, Chapter 1 of the Code, is applicable to all decedents' estates and their beneficiaries, and to trusts and their beneficiaries other than trusts subject to the provisions of Subpart B of such Part I (relating to trusts which distribute current income only, or "simple" trusts). A trust which is required to distribute amounts other than income during the taxable year may be subject to Subpart B, and not Subpart C, in the absence of an actual distribution of amounts other than income during the taxable year. See §§ 1.651(a)–1 and 1.651(a)–3. A trust to which Subpart C is applicable is referred to as a "complex" trust in this part. Section 661 has no application to amounts excluded under section 663(a).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.661(a)–2 Deduction for distributions to beneficiaries.

(a) In computing the taxable income of an estate or trust there is allowed under section 661(a) as a deduction for distributions to beneficiaries the sum of:

(1) The amount of income for the taxable year which is required to be distributed currently, and

(2) Any other amounts properly paid or credited or required to be distributed for such taxable year.

However, the total amount deductible under section 661(a) cannot exceed the distributable net income as computed under section 643(a) and as modified by section 661(c). See § 1.661(c)–1.

(b) The term "income required to be distributed currently" includes any amount required to be distributed which may be paid out of income or corpus (such as an annuity), to the extent it is paid out of income for the taxable year. See § 1.651(a)–2 which sets forth additional rules which are applicable in determining whether income of an estate or trust is required to be distributed currently.

(c) The term "any other amounts properly paid, credited, or required to be distributed" includes all amounts properly paid, credited, or required to be distributed by an estate or trust during the taxable year other than income required to be distributed currently. Thus, the term includes the payment of an annuity to the extent it is not paid out of income for the taxable year, and a distribution of property in kind (see paragraph (f) of this section). However, see section 663(a) and regulations thereunder for distributions which are not included. Where the income of an estate or trust may be accumulated or distributed in the discretion of the fiduciary, or where the fiduciary has a power to distribute corpus to a beneficiary, any such discretionary distribution would qualify under section 661(a)(2). The term also includes an amount applied or distributed for the support of a dependent of a grantor or of a trustee or cotrustee under the circumstances described in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year.

(d) The terms "income required to be distributed currently" and "any other amounts properly

paid or credited or required to be distributed" also include any amount used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.

(e) The terms "income required to be distributed currently" and "any other amounts properly paid or credited or required to be distributed" include amounts paid, or required to be paid, during the taxable year pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate. The term "any other amounts properly paid or credited or required to be distributed" does not include the value of any interest in real estate owned by a decedent, title to which under local law passes directly from the decedent to his heirs or devisees.

(f) If property is paid, credited, or required to be distributed in kind:

(1) No gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.

(2) In determining the amount deductible by the trust or estate and includible in the gross income of the beneficiary the property distributed in kind is taken into account at its fair market value at the time it was distributed, credited, or required to be distributed.

(3) The basis of the property in the hands of the beneficiary is its fair market value at the time it was paid, credited, or required to be distributed, to the extent such value is included in the gross income of the beneficiary. To the extent that the value of property distributed in kind is not included in the gross income of the beneficiary, its basis in the hands of the beneficiary is governed by the rules in sections 1014 and 1015 and the regulations thereunder. For this purpose, if the total value of cash and property distributed, credited, or required to be distributed in kind to a beneficiary in any taxable year exceeds the amount includible in his gross income for that year, the value of the property other than cash is normally considered as includible in his gross income only to the extent that the amount includible exceeds the cash paid, credited, or required to be distributed to the beneficiary in that year. Further, to the extent that the value of different items of property other than cash is includible in the gross income of a beneficiary in accordance with the preceding sentence, a pro rata portion of the total value of each item of property distributed, credited, or required to be distributed is normally considered as includible in the beneficiary's gross income.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26912, Sept. 27, 1973]

§ 1.661(b)–1 Character of amounts distributed; in general.

In the absence of specific provisions in the governing instrument for the allocation of different classes of income, or unless local law requires such an allocation, the amount deductible for distributions to beneficiaries under section 661(a) is treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income. For example, if a trust has distributable net income of $20,000, consisting of $10,000 each of taxable interest and royalties and distributes $10,000 to beneficiary A, the deduction of $10,000 allowable under section 661(a) is deemed to consist of $5,000 each of taxable interest and royalties, unless the trust instrument specifically provides for the distribution or accumulation of different classes of income or unless local law requires such an allocation. See also § 1.661(c)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.661(b)–2 Character of amounts distributed when charitable contributions are made.

In the application of the rule stated in § 1.661(b)–1, the items of deduction which enter into the computation of distributable net income are allocated among the items of income which enter into the computation of distributable net income in accordance with the rules set forth in § 1.652(b)–3, except that, in the absence of specific provisions in the governing instrument, or unless local law requires a different apportionment, amounts paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) are first ratably apportioned among each class of items of income entering into the computation of the distributable net income of the estate or trust, in accordance with the rules set out in paragraph (b) of § 1.643(a)–5.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.661(c)–1 Limitation on deduction.

An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964]

§ 1.661(c)–2 Illustration of the provisions of section 661.

The provisions of section 661 may be illustrated by the following example:

Example. (a) Under the terms of a trust, which reports on the calendar year basis, $10,000 a year is required to be paid out of income to a designated charity. The balance of the income may, in the trustee's discretion, be accumulated or distributed to beneficiary A. Expenses are allocable against income and the trust instrument requires a reserve for depreciation. During the taxable year 1955 the trustee contributes $10,000 to charity and in his discretion distributes $15,000 of income to A. The trust has the following items of income and expense for the taxable year 1955:

Dividends	$10,000
Partially tax-exempt interest	10,000
Fully tax-exempt interest	10,000
Rents	20,000
Rental expenses	2,000
Depreciation of rental property	3,000
Trustee's commissions	5,000

(b) The income of the trust for fiduciary accounting purposes is $40,000, computed as follows:

Dividends		$10,000
Partially tax-exempt interest		10,000
Fully tax-exempt interest		10,000
Rents		20,000
Total		50,000
Less:		
Rental expenses	$2,000	
Depreciation	3,000	
Trustee's commissions	5,000	
		10,000
Income as computed under section 643(b)		40,000

(c) The distributable net income of the trust as computed under section 643(a) is $30,000, determined as follows:

Rents			$20,000
Dividends			10,000
Partially tax-exempt interest			10,000
Fully tax-exempt interest		$10,000	
Less:			
Expenses allocable thereto (10,000/50,000 × $5,000)	$1,000		
Charitable contributions allocable thereto (10,000/50,000 × $10,000)	2,000		
		3,000	
			7,000
Total			47,000
Deductions:			
Rental expenses		2,000	
Depreciation of rental property		3,000	
Trustee's commissions ($5,000 less $1,000 allocated to tax-exempt interest)		4,000	
Charitable contributions ($10,000 less $2,000 allocated to tax-exempt interests)		8,000	
			17,000
Distributable net income (section 643(a))			30,000

(d) The character of the amounts distributed under section 661(a), determined in accordance with the rules prescribed in §§ 1.661(b)–1 and 1.661(b)–2 is shown by the following table (for the purpose of this allocation, it is assumed that the trustee elected to allocate the trustee's commissions to rental income except for the amount required to be allocated to tax-exempt interest):

	Rental income	Taxable dividends	Excluded dividends	Partially Tax-exempt interest	Tax-exempt interest	Total
Trust income	$20,000	$9,950	$50	$10,000	$10,000	$50,000
Less:						
Charitable contributions	4,000	2,000	....	2,000	2,000	10,000
Rental expenses	2,000	....	....	....	....	2,000
Depreciation	3,000	....	....	....	....	3,000
Trustee's commissions	4,000	....	....	....	1,000	5,000

	Rental income	Taxable dividends	Excluded dividends	Partially Tax-exempt interest	Tax-exempt interest	Total
Total deductions	13,000	2,000	0	2,000	3,000	20,000
Distributable net income	7,000	7,950	50	8,000	7,000	30,000
Amounts deemed distributed under section 661(a) before applying the limitation of section 661(c)	3,500	3,975	25	4,000	3,500	15,000

In the absence of specific provisions in the trust instrument for the allocation of different classes of income, the charitable contribution is deemed to consist of a pro rata portion of the gross amount of each items of income of the trust (except dividends excluded under section 116) and the trust is deemed to have distributed to A a pro rata portion (one-half) of each item of income included in distributable net income.

(e) The taxable income of the trust is $11,375 computed as follows:

Rental income		$20,000
Dividends ($10,000 less $50 exclusion)		9,950
Partially tax-exempt interest		10,000
Gross income		39,950
Deductions:		
Rental expenses	$2,000	
Depreciation of rental property	3,000	
Trustee's commissions	4,000	
Charitable contributions	8,000	
Distributions to A	11,475	
Personal exemption	100	
		28,575
Taxable income		11,375

In computing the taxable income of the trust no deduction is allowable for the portions of the charitable contributions deduction ($2,000) and trustee's commissions ($1,000) which are treated under section 661(b) as attributable to the tax-exempt interest excludable from gross income. Also, of the dividends of $4,000 deemed to have been distributed to A under section 661(a), $25 25/150ths of $50) is deemed to have been distributed from the excluded dividends and is not an allowable deduction to the trust. Accordingly, the deduction allowable under section 661 is deemed to be composed of $3,500 rental income, $3,975 of dividends, and $4,000 partially tax-exempt interest. No deduction is allowable for the portion of tax-exempt interest or for the portion of the excluded dividends deemed to have been distributed to the beneficiary.

(f) The trust is entitled to the credit allowed by section 34 with respect to dividends of $5,975 ($9,950 less $3,975 distributed to A) included in gross income. Also, the trust is allowed the credit provided by section 35 with respect to partially tax-exempt interest of $6,000 ($10,000 less $4,000 deemed distributed to A) included in gross income.

(g) Dividends of $4,000 allocable to A are to be aggregated with his other dividends (if any) for purposes of the dividend exclusion under section 116 and the dividend received credit under section 84.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(a)–1 Inclusion of amounts in gross income of beneficiaries of estates and complex trusts; general.

There is included in the gross income of a beneficiary of an estate or complex trust the sum of:

(a) Amounts of income required to be distributed currently to him, and

(b) All other amounts properly paid, credited, or required to be distributed to him

by the estate or trust. The preceding sentence is subject to the rules contained in § 1.662(a)–2 (relating to currently distributable income), § 1.662(a)–3 (relating to other amounts distributed), and §§ 1.662(b)–1 and 1.662(b)–2 (relating to character of amounts). Section 662 has no application to amounts excluded under section 663(a). [T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(a)–2 Currently distributable income.

(a) There is first included in the gross income of each beneficiary under section 662(a)(1) the amount of income for the taxable year of the estate or trust required to be distributed currently to him, subject to the provisions of paragraph (b) of this section. Such amount is included in the beneficiary's gross income whether or not it is actually distributed.

(b) If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (as defined in section 643(a) but computed without taking into account the payment, crediting, or setting aside of an amount for which a charitable contributions deduction is allowable under section 642(c)) of the estate or trust, then there is included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to the beneficiary bears to the amount required to be distributed currently to all beneficiaries.

(c) The phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent the amount is satisfied out of income for the taxable year. Thus, an annuity required to be paid in all events (either out of income or corpus) would qualify as income required to be distributed currently to the extent there is income (as defined in section 643(b)) not paid, credited, or required to be distributed to

other beneficiaries for the taxable year. If an annuity or a portion of an annuity is deemed under this paragraph to be income required to be distributed currently, it is treated in all respects in the same manner as an amount of income actually required to be distributed currently. The phrase "the amount of income for the taxable year required to be distributed currently" also includes any amount required to be paid during the taxable year in all events (either out of income or corpus) pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate to the extent there is income (as defined in section 643(b)) of the estate for the taxable year not paid, credited, or required to be distributed to other beneficiaries.

(d) If an annuity is paid, credited, or required to be distributed tax free, that is, under a provision whereby the executor or trustee will pay the income tax of the annuitant resulting from the receipt of the annuity, the payment of or for the tax by the executor or trustee will be treated as income paid, credited, or required to be distributed currently to the extent it is made out of income.

(e) The application of the rules stated in this section may be illustrated by the following examples:

Example (1). (1) Assume that under the terms of the trust instrument $5,000 is to be paid to X charity out of income each year; that $20,000 of income is currently distributable to A; and that an annuity of $12,000 is to be paid to B out of income or corpus. All expenses are charges against income and capital gains are allocable to corpus. During the taxable year the trust had income of $30,000 (after the payment of expenses) derived from taxable interest and made the payments to X charity and distributions to A and B as required by the governing instrument.

(2) The amounts treated as distributed currently under section 662(a)(1) total $25,000 ($20,000 to A and $5,000 to B). Since the charitable contribution is out of income the amount of income available for B's annuity is only $5,000. The distributable net income of the trust computed under section 643(a) without taking into consideration the charitable contributions deduction of $5,000 as provided by section 661(a)(1), is $30,000. Since the amounts treated as distributed currently of $25,000 do not exceed the distributable net income (as modified) of $30,000, A is required to include $20,000 in his gross income and B is required to include $5,000 in his gross income under section 662(a)(1).

Example (2). Assume the same facts as in paragraph (1) of example (1), except that the trust has, in addition, $10,000 of administration expenses, commissions, etc., chargeable to corpus. The amounts treated as distributed currently under section 662(a)(1) total $25,000 ($20,000 to A and $5,000 to B), since trust income under section 643(b) remains the same as in example (1). Distributable net income of the trust computed under section 643(a) but without taking into account the charitable contributions deduction of $5,000 as provided by section 662(a)(1) is only $20,000. Since the amounts treated as distributed currently of $25,000 exceed the distributable net income (as so computed) of $20,000, A is required to include $16,000 (20,000/25,000 of $20,000) in his gross income and B is required to include $4,000 (5,000/25,000 of $20,000) in his gross income under section 662(a)(1). Because A and B are beneficiaries of amounts of income required to be distributed currently, they do not benefit from the reduction of distributable net income by the charitable contributions deduction.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26912, Sept. 27, 1973]

§ 1.662(a)–3 Other amounts distributed.

(a) There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)–2, (2) amounts excluded under section 663(a) and the regulations thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

(b) Some of the payments to be included under paragraph (a) of this section are: (1) A distribution made to a beneficiary in the discretion of the fiduciary; (2) a distribution required by the terms of the governing instrument upon the happening of a specified event; (3) an annuity which is required to be paid in all events but which is payable only out of corpus; (4) a distribution of property in kind (see paragraph (f) of § 1.661(a)–2); (5) an amount applied or distributed for the support of a dependent of a grantor or a trustee or cotrustee under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year; and (6) an amount required to be paid during the taxable year pursuant to a court order or decree or under local law, by a decedent's estate as an allowance or award for the support of the decedent's widow or other dependent for a limited period during the administration of the estate which is payable only out of corpus of the estate under the order or decree or local law.

(c) If the sum of the amounts of income required to be distributed currently (as determined under § 1.662(a)–2) and other amounts properly paid, credited, or required to be distributed (as determined under paragraph (a) of this section) exceeds distributable net income (as defined in section 643(a)), then such other amounts properly paid, credited, or required to be distributed are

included in gross income of the beneficiary but only to the extent of the excess of such distributable net income over the amounts of income required to be distributed currently. If the other amounts are paid, credited, or required to be distributed to more than one beneficiary, each beneficiary includes in gross income his proportionate share of the amount includible in gross income pursuant to the preceding sentence. The proportionate share is an amount which bears the same ratio to distributable net income (reduced by amounts of income required to be distributed currently) as the other amounts (as determined under paragraphs (a) and (d) of this section) distributed to the beneficiary bear to the other amounts distributed to all beneficiaries. For treatment of excess distributions by trusts, see sections 665 to 668, inclusive, and the regulations thereunder.

(d) The application of the rules stated in this section may be illustrated by the following example:

Example. The terms of a trust require the distribution annually of $10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has $20,000 of income after the deduction of all expenses. Distributable net income is $20,000. The trustee distributes $10,000 of income to A. Of the remaining $10,000 of income, he distributes $3,000 each to B, C, and D, and also distributes an additional $5,000 to A. A includes $10,000 in income under section 662(a)(1). The "other amounts distributed" amount of $14,000, includible in the income of the recipients to the extent of $10,000, distributable net income less the income currently distributable to A. A will include an additional $3,571 (5,000/14,000×$10,000) in income under this section, and B, C, and D will each include $2,143 (3,000/14,000×$10,000).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7287, 38 FR 26913, Sept. 27, 1973]

§ 1.662(a)–4 Amounts used in discharge of a legal obligation.

Any amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under section 662(a)(1) or (2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which section 71 (relating to alimony payments) or section 682 (relating to income of a trust in case of divorce, etc.) applies. The term "legal obligation" includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources. For example, a parent has a "legal obligation" within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him. On the other hand, if under local law a mother may use the resources of a child for the child's support in lieu of supporting him herself, no obligation of support exists within the meaning of this paragraph, whether or not income is actually used for support. Similarly, since under local law a child ordinarily is obligated to support his parent only if the parent's earnings and resources are insufficient for the purpose, no obligation exists whether or not the parent's earnings and resources are sufficient. In any event the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law. In the case of a parent's obligation to support his child, to the extent that the parent's legal obligation of support, including education, is determined under local law by the family's station in life and by the means of the parent, it is to be determined without consideration of the trust income in question.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(b)–1 Character of amounts; when no charitable contributions are made.

In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)–1 through 1.662(a)–4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)–1 shall apply.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(b)–2 Character of amounts; when charitable contributions are made.

When a charitable contribution is made, the principles contained in §§ 1.652(b)–1 and 1.662(b)–1 generally apply. However, before the allocation of other deductions among the items of distributable net income, the charitable contributions deduction allowed under section 642(c) is (in

the absence of specific allocation under the terms of the governing instrument or the requirement under local law of a different allocation) allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of § 1.643(a)–5. In the application of the preceding sentence, for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently. The application of this section may be illustrated by the following examples (of which example (1) is illustrative of the preceding sentence):

Example (1). (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.

(b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).

(c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.

(d) Under section 662(a)(1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.

(e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.

(f) See subpart D (section 665 and following), part 1, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

Example (2). The net income of a trust is payable to A for life, with the remainder to a charitable organization. Under the terms of the trust instrument and local law capital gains are added to corpus. During the taxable year the trust receives dividends of $10,000 and realized a long-term capital gain of $10,000, for which a long-term capital gain deduction of $5,000 is allowed under section 1202. Since under the trust instrument and local law the capital gains are allocated to the charitable organization, and since the capital gain deduction is directly attributable to the capital gain, the charitable contributions deduction and the capital gain deduction are both allocable to the capital gain, and dividends in the amount of $10,000 are allocable to A.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(c)–1 Different taxable years.

If a beneficiary has a different taxable year (as defined in section 441 or 442) from the taxable year of an estate or trust, the amount he is required to include in gross income in accordance with section 662(a) and (b) is based upon the distributable net income of the estate or trust and the amounts properly paid, credited, or required to be distributed to the beneficiary for any taxable year or years of the estate or trust ending with or within his taxable year. This rule applies as to so-called short taxable years as well as taxable years of normal duration. Income of an estate or trust for its taxable year or years is determined in accordance with its method of accounting and without regard to that of the beneficiary.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(c)–2 Death of individual beneficiary.

If an amount specified in section 662(a)(1) or (2) is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under section 662 for the taxable year of the estate or trust in which his last taxable year ends. Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)–3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(c)–3 Termination of existence of other beneficiaries.

If the existence of a beneficiary which is not an individual terminates, the amount to be included

under section 662(a) in its gross income for the last taxable year is computed with reference to §§ 1.662(c)–1 and 1.662(c)–2 as if the beneficiary were a deceased individual, except that income required to be distributed prior to the termination but actually distributed to the beneficiary's successor in interest is included in the beneficiary's income for its last taxable year.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.662(c)–4 Illustration of the provisions of sections 661 and 662.

The provisions of sections 661 and 662 may be illustrated in general by the following example:

Example. (a) Under the terms of a testamentary trust one-half of the trust income is to be distributed currently to W, the decedent's wife, for her life. The remaining trust income may, in the trustee's discretion, either be paid to D, the grantor's daughter, paid to designated charities, or accumulated. The trust is to terminate at the death of W and the principal will then be payable to D. No provision is made in the trust instrument with respect to depreciation of rental property. Capital gains are allocable to the principal account under the applicable local law. The trust and both beneficiaries file returns on the calendar year basis. The records of the fiduciary show the following items of income and deduction for the taxable year 1955:

Rents	$50,000
Dividends of domestic corporations	50,000
Tax-exempt interest	20,000
Partially tax-exempt interest	10,000
Capital gains (long term)	20,000
Depreciation of rental property	10,000
Expenses attributable to rental income	15,400
Trustee's commissions allocable to income account	2,800
Trustee's commissions allocable to principal account	1,100

(b) The income for trust accounting purposes is $111,800, and the trustee distributes one-half ($55,900) to W and in his discretion makes a contribution of one-quarter ($27,950) to charity X and distributes the remaining one-quarter ($27,950) to D. The total of the distributions to beneficiaries is $83,850, consisting of (1) income required to be distributed currently to W of $55,900 and (2) other amounts properly paid or credited to D of $27,950. The income for trust accounting purposes of $111,800 is determined as follows:

Rents		$50,000
Dividends		50,000
Tax-exempt interest		20,000
Partially tax-exempt interest		10,000
Total		130,000
Less:		
Rental expenses	$15,400	
Trustee's commissions allocable to income account	2,800	
		18,200
Income as computed under section 643(b)		111,800

(c) The distributable net income of the trust as computed under section 643(a) is $82,750, determined as follows:

Rents			$50,000
Dividends			50,000
Partially tax-exempt interest			10,000
Tax-exempt interest		$20,000	
Less:			
Trustee's commissions allocable thereto (20,000/130,000 of $3,900)	$600		
Charitable contributions allocable thereto (20,000/130,000 of $27,950)	4,300		
		4,900	
			15,100
Total			125,100
Deductions:			
Rental expenses		15,400	
Trustee's commissions ($3,900 less $600 allocated to tax-exempt interest)		3,300	
Charitable deduction ($27,950 less $4,300 attributable to tax-exempt interest)		23,650	
			42,350
Distributable net income			82,750

In computing the distributable net income of $82,750, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to beneficiaries and for personal exemption of the trust (section 643(a)(1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); and the tax-exempt interest (as adjusted for expenses and charitable contributions) and the dividend exclusion of $50 were included (section 643(a)(5) and (7)).

(d) Inasmuch as the distributable net income of $82,750 as determined under section 643(a) is less than the sum of the amounts distributed to W and D of $83,850, the deduction allowable to the trust under section 661(a) is such distributable net income as modified under section 661(c) to exclude therefrom the items of income not included in the gross income of the trust, as follows:

Distributable net income		$82,750
Less:		
Tax-exempt interest (as adjusted for expenses and the charitable contributions)	$15,100	
Dividend exclusion allowable under section 116	50	
		15,150
Deduction allowable under section 661(a)		67,600

(e) For the purpose of determining the character of the amounts deductible under section 642(c) and section 661(a), the trustee elected to offset the trustee's commissions (other than the portion required to be allocated to tax-exempt interest) against the rental income. The following table shows the determination of the character of the amounts deemed distributed to beneficiaries and contributed to charity.

	Rents	Taxable dividends	Excluded dividends	Tax exempt interest	Partially tax exempt interest	Total
Trust income	$50,000	$49,950	$50	$20,000	$10,000	$130,000
Less:						
Charitable contribution	10,750	10,750	....	4,300	2,150	27,950
Rental expenses	15,400	....	....	....	....	15,400
Trustee's commissions	3,300	....	....	600	....	3,900
Total deductions	29,450	10,750	0	4,900	2,150	47,250
Amounts distributable to beneficiaries	20,550	39,200	50	15,100	7,850	82,750

The character of the charitable contribution is determined by multiplying the total charitable contribution ($27,950) by a fraction consisting of each item of trust income, respectively, over the total trust income, except that no part of the dividends excluded from gross income are deemed included in the charitable contribution. For example, the charitable contribution is deemed to consist of rents of $10,750 (50,000/130,000 × $27,-950).

(f) The taxable income of the trust is $9,900 determined as follows:

Rental income		$50,000
Dividends ($50,000 less $50 exclusion)		49,950
Partially tax-exempt interest		10,000
Capital gains		20,000
Gross income		129,950
Deductions:		
Rental expenses	15,400	
Trustee's commissions	3,300	
Charitable contributions	23,650	
Capital gain deductions	10,000	
Distributions to beneficiaries	67,600	
Personal exemption	100	
		$120,050
Taxable income		9,900

(g) In computing the amount includible in W's gross income under section 662(a)(1), the $55,900 distribution to her is deemed to be composed of the following proportions of the items of income deemed to have been distributed to the beneficiaries by the trust (see paragraph (e) of this example):

Rents (20,550/82,750 × $55,900)	$13,882
Dividends (39,250/82,750 × $55,900)	26,515
Partially tax-exempt interest (7,850/82,750 × $55,900)	5,303
Tax-exempt interest (15,100/82,750 × $55,900)	10,200
Total	55,900

Accordingly, W will exclude $10,200 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-half of the total depreciation deduction, or $5,000.

(h) Inasmuch as the sum of the amount of income required to be distributed currently to W ($55,900) and the other amounts properly paid, credited, or required to be distributed to D ($27,950) exceeds the distributable net income ($82,750) of the trust as determined under section 643(a), D is deemed to have received $26,850 ($82,750 less $55,900) for income tax purposes. The character of the amounts deemed distributed to her is determined as follows:

Rents (20,550/82,750 × $26,850)	$6,668
Dividends (39,250/82,750 × $26,850)	12,735
Partially tax-exempt interest (7,850/82,750 × $26,850)	2,547
Tax-exempt interest (15,100/82,750 × $26,850)	4,900
Total	26,850

Accordingly, D will exclude $4,900 of tax-exempt interest from gross income and will receive the credits and exclusion for dividends received and for partially tax-exempt interest provided in sections 34, 116, and 35, respectively, with respect to the dividends and partially tax-exempt interest deemed to have been distributed to her, her share of the dividends being aggregated with other dividends received by her for purposes of the dividend credit and exclusion. In addition, she may deduct a share of the depreciation deduction proportionate to the trust income allocable to her; that is, one-fourth of the total depreciation deduction, or $2,500.

(i) [Reserved]

(j) The remaining $2,500 of the depreciation deduction is allocated to the amount distributed to charity X and is hence nondeductible by the trust, W, or D. (See § 1.642(e)–1.)

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.663(a)–1 Special rules applicable to sections 661 and 662; exclusions; gifts, bequests, etc.

(a) In general. A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments. Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see para-

graph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

(b) **Definition of a gift or bequest of a specific sum of money or of specific property.** (1) In order to qualify as a gift or bequest of a specific sum of money or of specific property under section 663(a), the amount of money or the identity of the specific property must be ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust. For example, bequests to a decedent's son of the decedent's interest in a partnership and to his daughter of a sum of money equal to the value of the partnership interest are bequests of specific property and of a specific sum of money, respectively. On the other hand, a bequest to the decedent's spouse of money or property, to be selected by the decedent's executor, equal in value to a fraction of the decedent's "adjusted gross estate" is neither a bequest of a specific sum of money or of specific property. The identity of the property and the amount of money specified in the preceding sentence are dependent both on the exercise of the executor's discretion and on the payment of administration expenses and other charges, neither of which are facts existing on the date of the decedent's death. It is immaterial that the value of the bequest is determinable after the decedent's death before the bequest is satisfied (so that gain or loss may be realized by the estate in the transfer of property in satisfaction of it).

(2) The following amounts are not considered as gifts or bequests of a sum of money or of specific property within the meaning of this paragraph:

(i) An amount which can be paid or credited only from the income of an estate or trust, whether from the income for the year of payment or crediting, or from the income accumulated from a prior year;

(ii) An annuity, or periodic gifts of specific property in lieu of or having the effect of an annuity;

(iii) A residuary estate or the corpus of a trust; or

(iv) A gift or bequest paid in a lump sum or in not more than three installments, if the gift or bequest is required to be paid in more than three installments under the terms of the governing instrument.

(3) The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples, in which it is assumed that the gift or bequest is not required to be made in more than three installments (see paragraph (c)):

Example (1). Under the terms of a will, a legacy of $5,000 was left to A, 1,000 shares of X company stock was left to W, and the balance of the estate was to be divided equally between W and X. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $25,000 during the taxable year 1954, which was accumulated and added to corpus for estate accounting purposes. During the taxable year, the executor paid the legacy of $5,000 in a lump sum to A and transferred the X company stock to W. No other distributions to beneficiaries were made during the taxable year. The distributions to A and W qualify as exclusions within the meaning of section 663(a)(1).

Example (2). Under the terms of a will, the testator's estate was to be divided equally between A and B. No provision was made in the will for the disposition of income of the estate during the period of administration. The estate had income of $50,000 for the taxable year 1954. In accordance with an agreement among the beneficiaries that part of the assets of the estate would be distributed in kind to the beneficiaries, stock in corporation X was distributed to A during 1954. The fair market value of the stock was $40,000 on the date of distribution. No other distribution was made during the year. The distribution does not qualify as an exclusion within the meaning of section 663(a)(1), since it is not a specific gift to A required by the terms of the will. Accordingly, the fair market value of the property ($40,000) represents a distribution within the meaning of section 661(a) and section 662(a) (see paragraph (c) of § 1.661(a)–2).

Example (3). Under the terms of a trust instrument, income is to be accumulated during the minority of A. Upon A's reaching the age of 21, $10,000 is to be distributed to B out of income or corpus. Also at that time, $10,000 is to be distributed to C out of the accumulated income and the remainder of the accumulations are to be paid to A. A is then to receive all the income until he is 25, when the trust is to terminate. Only the distribution to B would qualify for exclusion under section 663(a)(1).

(4) A gift or bequest of a specific sum of money or of specific property is not disqualified under this paragraph solely because its payment is subject to a condition. For example, provision for a payment by a trust to beneficiary A of $10,000 when he reaches age 25, and $10,000 when he reaches age 30, with payment over to B of any amount not paid to A because of his death, is a gift to A of a specific sum of money payable in two installments, within the meaning of this paragraph, even though the exact amount payable to A cannot be ascertained with certainty under the terms of the trust instrument.

(c) **Installment payments.** (1) In determining whether a gift or bequest of a specific sum of money or of specific property, as defined in paragraph (b) of this section, is required to be paid or credited to a particular beneficiary in more than three installments—

(i) Gifts or bequests of articles for personal use (such as personal and household effects, automobiles, and the like) are disregarded.

(ii) Specifically devised real property, the title to which passes directly from the decedent to the devisee under local law, is not taken into account, since it would not constitute an amount paid, credited, or required to be distributed under section 661 (see paragraph (e) of § 1.661(a)–2).

(iii) All gifts and bequests under a decedent's will (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) for which no time of payment or crediting is specified, and which are to be paid or credited in the ordinary course of administration of the decedent's estate, are considered as required to be paid or credited in a single installment.

(iv) All gifts and bequests (which are not disregarded pursuant to subdivisions (i) and (ii) of this subparagraph) payable at any one specified time under the terms of the governing instrument are taken into account as a single installment.

For purposes of determining the number of installments paid or credited to a particular beneficiary, a decedent's estate and a testamentary trust shall each be treated as a separate entity.

(2) The application of the rules stated in subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) Under the terms of a decedent's will, $10,000 in cash, household furniture, a watch, an automobile, 100 shares of X company stock, 1,000 bushels of grain, 500 head of cattle, and a farm (title to which passed directly to A under local law) are bequeathed or devised outright to A. The will also provides for the creation of a trust for the benefit of A, under the terms of which there are required to be distributed to A, $10,000 in cash and 100 shares of Y company stock when he reaches 25 years of age, $25,000 in cash and 200 shares of Y company stock when he reaches 30 years of age, and $50,000 in cash and 300 shares of Y company stock when he reaches 35 years of age.

(ii) The furniture, watch, automobile, and the farm are excluded in determining whether any gift or bequest is required to be paid or credited to A in more than three installments. These items qualify for the exclusion under section 663(a)(1) regardless of the treatment of the other items of property bequeathed to A.

(iii) The $10,000 in cash, the shares of X company stock, the grain, the cattle and the assets required to create the trust, to be paid or credited by the estate to A and the trust are considered as required to be paid or credited in a single installment to each, regardless of the manner of payment or distribution by the executor, since no time of payment or crediting is specified in the will. The $10,000 in cash and shares of Y company stock required to be distributed by the trust to A when he is 25 years old are considered as required to be paid or distributed as one installment under the trust. Likewise, the distributions to be made by the trust to A when he is 30 and 35 years old are each considered as one installment under the trust. Since the total number of installments to be made by the estate does not exceed three, all of the items of money and property distributed by the estate qualify for the exclusion under section 663(a)(1). Similarly, the three distributions by the trust qualify.

Example (2). Assume the same facts as in example (1), except that another distribution of a specified sum of money is required to be made by the trust to A when he becomes 40 years old. This distribution would also qualify as an installment, thus making four installments in all under the trust. None of the gifts to A under the trust would qualify for the exclusion under section 663(a)(1). The situation as to the estate, however, would not be changed.

Example (3). A trust instrument provides that A and B are each to receive $75,000 in installments of $25,000, to be paid in alternate years. The trustee distributes $25,000 to A in 1954, 1956, and 1958, and to B in 1955, 1957, and 1959. The gifts to A and B qualify for exclusion under section 663(a)(1), although a total of six payments is made. The gifts of $75,000 to each beneficiary are to be separately treated.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.663(a)–2 Charitable, etc., distributions.

Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income and private foundations).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.663(a)–3 Denial of double deduction.

No amount deemed to have been distributed to a beneficiary in a preceding year under section 651 or 661 is included in amounts falling within section 661(a) or 662(a). For example, assume that all of the income of a trust is required to be distributed currently to beneficiary A and both the trust and A report on the calendar year basis. For administrative convenience, the trustee distributes in January and February 1956 a portion of the income of the trust required to be distributed in 1955. The portion of the income for 1955 which was distributed by the trust in 1956 may not be claimed as a deduction by the trust for 1956

since it is deductible by the trust and includible in A's gross income for the taxable year 1955.
[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.663(b)–1 Distributions in first 65 days of taxable year; scope.

(a) **Taxable years beginning after December 31, 1968—(1) General rule.** With respect to taxable years beginning after December 31, 1968, the fiduciary of a trust may elect under section 663(b) to treat any amount or portion thereof that is properly paid or credited to a beneficiary within the first 65 days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year.

(2) **Effect of election.** (i) An election is effective only with respect to the taxable year for which the election is made. In the case of distributions made after May 8, 1972, the amount to which the election applies shall not exceed—

(a) The amount of income of the trust (as defined in § 1.643(b)–1) for the taxable year for which the election is made, or

(b) The amount of distributable net income of the trust (as defined in §§ 1.643(a)–1 through 1.643(a)–7) for such taxable year, if greater,

reduced by any amounts paid, credited, or required to be distributed in such taxable year other than those amounts considered paid or credited in a preceding taxable year by reason of section 663(b) and this section. An election shall be made for each taxable year for which the treatment is desired. The application of this paragraph may be illustrated by the following example:

Example. X Trust, a calendar year trust, has $1,000 of income (as defined in § 1.643(b)–1) and $800 of distributable net income (as defined in §§ 1.643(a)–1 through 1.643(a)–7) in 1972. The trust properly pays $550 to A, a beneficiary, on January 15, 1972, which the trustee elects to treat under section 663(b) as paid on December 31, 1971. The trust also properly pays to A $600 on July 19, 1972, and $450 on January 17, 1973. For 1972, the maximum amount that may be elected under this subdivision to be treated as properly paid or credited on the last day of 1972 is $400 ($1,000–$600). The $550 paid on January 15, 1972, does not reduce the maximum amount to which the election may apply, because that amount is treated as properly paid on December 31, 1971.

(ii) If an election is made with respect to a taxable year of a trust, this section shall apply only to those amounts which are properly paid or credited within the first 65 days following such year and which are so designated by the fiduciary in his election. Any amount considered under section 663(b) as having been distributed in the preceding taxable year shall be so treated for all purposes. For example, in determining the beneficiary's tax liability, such amount shall be considered as having been received by the beneficiary in his taxable year in which or with which the last day of the preceding taxable year of the trust ends.

(b) **Taxable years beginning before January 1, 1969.** With respect to taxable years of a trust beginning before January 1, 1969, the fiduciary of the trust may elect under section 663(b) to treat distributions within the first 65 days following such taxable year as amounts which were paid or credited on the last day of such taxable year, if:

(1) The trust was in existence prior to January 1, 1954;

(2) An amount in excess of the income of the immediately preceding taxable year may not (under the terms of the governing instrument) be distributed in any taxable year; and

(3) The fiduciary elects (as provided in § 1.663(b)–2) to have section 663(b) apply.
[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§ 1.663(b)–2 Election.

(a) **Manner and time of election; irrevocability—(1) When return is required to be filed.** If a trust return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in the appropriate place on such return. The election under this subparagraph shall be made not later than the time prescribed by law for filing such return (including extensions thereof). Such election shall become irrevocable after the last day prescribed for making it.

(2) **When no return is required to be filed.** If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office with which a return by such trust would be filed if such trust were required to file a return for such taxable year. See section 6091 and the regulations thereunder for place for filing returns. The election under this subparagraph shall be made not later than the time prescribed by law for filing a return if such trust were required to file a return for such taxable year. Such election shall become irrevocable after the last day prescribed for making it.

(b) **Elections under prior law.** Elections made pursuant to section 663(b) prior to its amendment by section 331(b) of the Tax Reform Act of 1969 (83 Stat. 598), which, under prior law, were irrev-

ocable for the taxable year for which the election was made and all subsequent years, are not effective for taxable years beginning after December 31, 1968. In the case of a trust for which an election was made under prior law, the fiduciary shall make the election for each taxable year beginning after December 31, 1968, for which the treatment provided by section 663(b) is desired.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§ 1.663(c)–1 Separate shares treated as separate trusts; in general.

(a) If a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts. In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663(c) does not affect the principles of applicable law in situations in which a single trust instrument creates not one but several separate trusts, as opposed to separate shares in the same trust within the meaning of this section.

(b) The separate share rule does not permit the treatment of separate shares as separate trusts for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts for purposes of:

(1) The filing of returns and payment of tax,

(2) The exclusion of dividends under section 116,

(3) The deduction of personal exemption under section 642(b), and

(4) The allowance to beneficiaries succeeding to the trust property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust under section 642(h).

(c) The separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust, and even though no physical segregation of assets is made or required.

(d) Separate share treatment is not elective. Thus, if a trust is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.663(c)–2 Computation of distributable net income.

The amount of distributable net income for any share under section 663(c) is computed for each share as if each share constituted a separate trust. Accordingly, any deduction or any loss which is applicable solely to one separate share of the trust is not available to any other share of the same trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.663(c)–3 Applicability of separate share rule.

(a) The applicability of the separate share rule provided by section 663(c) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

(b) Separate share treatment will not be applied to a trust or portion of a trust subject to a power to:

(1) Distribute, apportion, or accumulate income, or

(2) Distribute corpus

to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

(c) A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

(d) Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

(e) For taxable years ending before December 31, 1978, the separate share rule may also be applicable to successive interests in point of time, as for instance in the case of a trust providing for a life estate to A and a second life estate or outright remainder to B. In such a case, in the taxable year of a trust in which a beneficiary dies items of income and deduction properly allocable under trust accounting principles to the period before a beneficiary's death are attributed to one share, and those allocable to the period after the beneficiary's death are attributed to the other share. Separate share treatment is not available to a succeeding interest, however, with respect to distributions which would otherwise be deemed distributed in a taxable year of the earlier interest under the throwback provisions of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code. The application of this paragraph may be illustrated by the following example:

Example. A trust instrument directs that the income of a trust is to be paid to A for her life. After her death income may be distributed to B or accumulated. A dies on June 1, 1956. The trust keeps its books on the basis of the calendar year. The trust instrument permits invasions of corpus for the benefit of A and B, and an invasion of corpus was in fact made for A's benefit in 1956. In determining the distributable net income of the trust for the purpose of determining the amounts includible in A's income, income and deductions properly allocable to the period before A's death are treated as income and deductions of a separate share; and for that purpose no account is taken of income and deductions allocable to the period after A's death.

(f) Separate share treatment is not applicable to an estate.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7633, 44 FR 57926, Oct. 9, 1979]

§ 1.663(c)–4 Example.

Section 663(c) may be illustrated by the following example:

Example. (a) A single trust was created in 1940 for the benefit of A, B, and C, who were aged 6, 4, and 2, respectively. Under the terms of the instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income is to be accumulated until he becomes 21 years of age. When a beneficiary reaches the age of 21, his share of the income may thereafter be either accumulated or distributed to him in the discretion of the trustee. The trustee also has discretion to invade corpus for the benefit of any beneficiary to the extent of his share of the trust estate, and the trust instrument requires that the beneficiary's right to future income and corpus will be proportionately reduced. When each beneficiary reaches 35 years of age, his share of the trust estate shall be paid over to him. The interest in the trust estate of any beneficiary dying without issue and before he has attained the age of 35 is to be equally divided between the other beneficiaries of the trust. All expenses of the trust are allocable to income under the terms of the trust instrument.

(b) No distributions of income or corpus were made by the trustee prior to 1955, although A became 21 years of age on June 30, 1954. During the taxable year of 1955, the trust has income from royalties of $20,000 and expenses of $5,000. The trustee in his discretion distributes $12,000 to A. Both A and the trust report on the calendar year basis.

(c) The trust qualifies for the separate share treatment under section 663(c) and the distributable net income must be divided into three parts for the purpose of determining the amount deductible by the trust under section 661 and the amount includible in A's gross income under section 662.

(d) The distributable net income of each share of the trust is $5,000 ($6,667 less $1,667). Since the amount ($12,000) dis-

tributed to A during 1955 exceeds the distributable net income of $5,000 allocated to his share, the trust is deemed to have distributed to him $5,000 of 1955 income and $7,000 of amounts other than 1955 income. Accordingly, the trust is allowed a deduction of $5,000 under section 661. The taxable income of the trust for 1955 is $9,900, computed as follows:

Royalties		$20,000
Deductions:		
Expenses	$5,000	
Distribution to A	5,000	
Personal exemption	100	
		10,100
Taxable income		9,900

(e) In accordance with section 662, A must include in his gross income for 1955 an amount equal to the portion ($5,000) of the distributable net income of the trust allocated to his share. Also, the excess distribution of $7,000 made by the trust is subject to the throwback provisions of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code, and the regulations thereunder.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.664–1 Charitable remainder trusts.

(a) In general—(1) Introduction—(i) General description of a charitable remainder trust. Generally, a charitable remainder trust is a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity. The specified distribution to be paid at least annually must be a sum certain which is not less than 5 percent of the initial net fair market value of all property placed in trust (in the case of a charitable remainder annuity trust) or a fixed percentage which is not less than 5 percent of the net fair market value of the trust assets, valued annually (in the case of a charitable remainder unitrust). A trust created after July 31, 1969, which is a charitable remainder trust is exempt from all of the taxes imposed by Subtitle A of the Code for any taxable year of the trust except a taxable year in which it has unrelated business taxable income.

(ii) Scope. This section provides definitions, general rules governing the creation and administration of a charitable remainder trust, and rules governing the taxation of the trust and its beneficiaries. For the application of certain foundation rules to charitable remainder trusts, see paragraph (b) of this section. If the trust has unrelated business taxable income, see paragraph (c) of this section. For the treatment of distributions to recipients, see paragraph (d) of this section. For the treatment of distributions to charity, see paragraph (e) of this section. For the time limitations for amendment of governing instruments, see paragraph (f) of this section. For transitional rules under which particular requirements are inapplicable to certain trusts, see paragraph (g) of this section. Section 1.664–2 provides rules relating solely to a charitable remainder annuity trust. Section 1.664–3 provides rules relating solely to a charitable remainder unitrust. Section 1.664–4 provides rules governing the calculation of the fair market value of the remainder interest in a charitable remainder unitrust. For rules relating to the filing of returns for a charitable remainder trust, see paragraph (a)(6) of § 1.6012–3 and section 6034 and the regulations thereunder.

(iii) Definitions. As used in this section and §§ 1.664–2, 1.664–3, and 1.664–4:

(a) Charitable remainder trust. The term "charitable remainder trust" means a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522 and which meets the description of a charitable remainder annuity trust (as described in § 1.664–2) or a charitable remainder unitrust (as described in § 1.664–3).

(b) Annuity amount. The term "annuity amount" means the amount described in paragraph (a)(1) of § 1.664–2 which is payable, at least annually, to the beneficiary of a charitable remainder annuity trust.

(c) Unitrust amount. The term "unitrust amount" means the amount described in paragraph (a)(1) of § 1.664–3 which is payable, at least annually, to the beneficiary of a charitable remainder unitrust.

(d) Recipient. The term "recipient" means the beneficiary who receives the possession or beneficial enjoyment of the annuity amount or unitrust amount.

(e) Governing instrument. The term "governing instrument" has the same meaning as in section 508(e) and the regulations thereunder.

(2) Requirement that the trust must be either a charitable remainder annuity trust or a charitable remainder unitrust. A trust is a charitable remainder trust only if it is either a charitable remainder annuity trust in every respect or a charitable remainder unitrust in every respect. For example, a trust which provides for the payment each year to a noncharitable beneficiary of the greater of a sum certain or a fixed percentage of the annual value of the trust assets is not a charitable remainder trust inasmuch as the trust is neither a charitable remainder annuity trust (for the reason that the payment for the year may be a fixed percentage of the annual value of the trust

assets which is not a "sum certain") nor a charitable remainder unitrust (for the reason that the payment for the year may be a sum certain which is not a "fixed percentage" of the annual value of the trust assets).

(3) **Restrictions on investments.** A trust is not a charitable remainder trust if the provisions of the trust include a provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. In the case of transactions with, or for the benefit of, a disqualified person, see section 4941(d) and the regulations thereunder for rules relating to the definition of self-dealing.

(4) **Requirement that trust must meet definition of and function exclusively as a charitable remainder trust from its creation.** In order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. Solely for the purposes of section 664 and the regulations thereunder, the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under Subpart E, Part 1, Subchapter J, Chapter 1, Subtitle A of the Code (relating to grantors and others treated as substantial owners), but in no event prior to the time property is first transferred to the trust. For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient. See examples 1 through 3 of subparagraph (6) of this paragraph for illustrations of the foregoing rule.

(5) **Rules applicable to testamentary transfers—(i) Deferral of annuity or unitrust amount.** Notwithstanding subparagraph (4) of this paragraph and §§ 1.664–2 and 1.664–3, for purposes of sections 2055 and 2106 a charitable remainder trust shall be deemed created at the date of death of the decedent (even though the trust is not funded until the end of a reasonable period of administration or settlement) if the obligation to pay the annuity or unitrust amount with respect to the property passing in trust at the death of the decedent begins as of the date of death of the decedent, even though the requirement to pay such amount is deferred in accordance with the rules provided in this subparagraph. If permitted by applicable local law or authorized by the provisions of the governing instrument, the requirement to pay such amount may be deferred until the end of the taxable year of the trust in which occurs the complete funding of the trust. Within a reasonable period after such time, the trust must pay (in the case of an underpayment) or must receive from the recipient (in the case of an overpayment) the difference between—

(a) Any annuity or unitrust amounts actually paid, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, and

(b) The annuity or unitrust amounts payable, plus interest on such amounts computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually.

The amounts payable shall be retroactively determined by using the taxable year, valuation method, and valuation dates which are ultimately adopted by the charitable remainder trust. See subdivision (ii) of this subparagraph for rules relating to retroactive determination of the amount payable under a charitable remainder unitrust. See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient.

(ii) For purposes of retroactively determining the amount under subdivision (i)(b) of this subparagraph, the governing instrument of a charitable remainder unitrust may provide that the amount described in subdivision (i)(b) of this subparagraph with respect to property passing in trust at the death of the decedent for the period which begins on the date of death of the decedent and ends on the earlier of the date of death of the last recipient or the end of the taxable year of the trust in which occurs the complete funding of the trust shall be computed by multiplying—

(a) The sum of (1) the value, on the earlier of the date of death of the last recipient or the last day in such taxable year, of the property held in trust which is attributable to property passing to the trust at the death of the decedent, (2) any distributions in respect of unitrust amounts made by the trust or estate before such date, and (3) interest on such distributions computed at the rate of interest specified in paragraph (a)(5)(iv) of this section, compounded annually, from the date of distribution to such date by—

(b) A factor equal to 1.0 less the factor under the appropriate payout rate in column 2 of Table D in § 1.664–4(b)(5) opposite the number of years

in column 1 between the date of death of the decedent and the date of the earlier of the death of the last recipient or the last day in such taxable year.

If the number of years between the date of death and the date of the earlier of the death of the last recipient or end of such taxable year is between periods for which factors are provided in Table D, a linear interpolation must be made.

(iii) Treatment of distributions. The treatment of a distribution to a charitable remainder trust, or to a recipient in respect of an annuity or unitrust amount, paid, credited, or required to be distributed by an estate, or by a trust which is not a charitable remainder trust, shall be governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664. In the case of a charitable remainder trust which is partially or fully funded during the period of administration of an estate or settlement of a trust (which is not a charitable remainder trust), the treatment of any amount paid, credited, or required to be distributed by the charitable remainder trust shall be governed by the rules of section 664.

(iv) Rate of interest. The following rates of interest shall apply for purposes of paragraphs (a)(5)(i) through (iii) of this section:

(a) 10 percent for instruments executed or amended on or after August 9, 1984;

(b) 6 percent or 10 percent for instruments executed or amended after October 24, 1983, and before August 9, 1984; and

(c) 6 percent for instruments executed before October 25, 1983, and not subsequently amended.

(6) Examples. The application of the rules in subparagraphs (4) and (5) of this paragraph may be illustrated by the following examples:

Example (1). On September 19, 1971, H transfers property to a trust over which he retains an inter vivos power of revocation. The trust is to pay W 5 percent of the value of the trust assets, valued annually, for her life, remainder to charity. The trust would satisfy all of the requirements of section 664 if it were irrevocable. For purposes of section 664, the trust is not deemed created in 1971 because H is treated as the owner of the entire trust under subpart E. On May 26, 1975, H predeceases W at which time the trust becomes irrevocable. For purposes of section 664, the trust is deemed created on May 26, 1975, because that is the earliest date on which H is not treated as the owner of the entire trust under subpart E. The trust becomes a charitable remainder trust on May 26, 1975, because it meets the definition of a charitable remainder trust from its creation.

Example (2). The facts are the same as in example (1), except that H retains the inter vivos power to revoke only one-half of the trust. For purposes of section 664, the trust is deemed created on September 19, 1971, because on that date the grantor is not treated as the owner of the entire trust under subpart E. Consequently, a charitable deduction is not allowable either at the creation of the trust or at H's death because the trust does not meet the definition of a charitable remainder trust from the date of its creation. The trust does not meet the definition of a charitable remainder trust from the date of its creation because the trust is subject to a partial power to revoke on such date.

Example (3). The facts are the same as in example (1), except that the residue of H's estate is to be paid to the trust and the trust is required to pay H's debts. The trust is not a charitable remainder trust at H's death because it does not function exclusively as a charitable remainder trust from the date of its creation which, in this case, is the date it becomes irrevocable.

Example (4). (i) In 1971, H transfers property to Trust A over which he retains an inter vivos power of revocation. Trust A, which is not a charitable remainder trust, is to provide income or corpus to W until the death of H. Upon H's death the trust is required by its governing instrument to pay the debts and administration expenses of H's estate, and then to terminate and distribute all of the remaining assets to a separate Trust B which meets the definition of a charitable remainder annuity trust.

(ii) Trust B will be charitable remainder trust from the date of its funding because it will function exclusively as a charitable remainder trust from its creation. For purposes of section 2055, Trust B will be deemed created at H's death if the obligation to pay the annuity amount begins on the date of H's death. For purposes of section 664, Trust B becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless Trust B has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by Trust A, including distributions to a recipient in respect of annuity amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (5). In 1973, H dies testate leaving the net residue of his estate (after payment by the estate of all debts and administration expenses) to a trust which meets the definition of a charitable remainder unitrust. For purposes of section 2055, the trust is deemed created at H's death if the requirement to pay the unitrust amount begins on H's death and is a charitable remainder trust even though the estate is obligated to pay debts and administration expenses.

For purposes of section 664, the trust becomes a charitable remainder trust as soon as it is partially or completely funded. Consequently, unless the trust has unrelated business taxable income, the income of the trust is exempt from all taxes imposed by subtitle A of the Code, and any distributions by the trust, even before it is completely funded, are governed by the rules of section 664. Any distributions made by H's estate, including distributions to a recipient in respect of unitrust amounts, are governed by the rules of subchapter J, chapter 1, subtitle A of the Code other than section 664.

Example (6). (i) On January 1, 1974, H dies testate leaving the residue of his estate to a charitable remainder unitrust. The governing instrument provides that, beginning at H's death, the trustee is to make annual payments to W, on December 31 of each year of 5 percent of the net fair market value of the trust assets, valued as of December 31 of each year, for W's life and to pay the remainder to charity at the death of W. The governing instrument also provides that the actual payment of the unitrust amount need not be made until the end of the taxable year of the trust in which occurs the complete

funding of the trust. The governing instrument also provides that the amount payable with respect to the period between the date of death and the end of such taxable year shall be computed under the special method provided in subparagraph (5)(ii) of this paragraph. The governing instrument provides that, within a reasonable period after the end of the taxable year of the trust in which occurs the complete funding of the trust, the trustee shall pay (in the case of an underpayment) or shall receive from the recipient (in the case of an overpayment) the difference between the unitrust amounts paid (plus interest at 6 percentage compounded annually) and the amount computed under the special method. The trust is completely funded on September 20, 1976. No amounts were paid before June 30, 1977. The trust adopts a fiscal year of July 1 to June 30. The net fair market value of the trust assets on June 30, 1977, is $100,000.

(ii) Because no amounts were paid prior to the end of the taxable year in which the trust was completely funded, the amount payable at the end of such taxable year is equal to the net fair market value of the trust assets on the last day of such taxable year (June 30, 1977) multiplied by a factor equal to 1.0 minus the factor in Table D corresponding to the number of years in the period between the date of death and the end of such taxable year. The adjusted payout rate (determined under § 1.664–4(b)(2)) is 5 percent. Because the last day of the taxable year in which the trust is completely funded is June 30, 1977, there are 3 181/365 years in such period. Because there is no factor given in Table D for such a period, a linear interpolation must be made:

1.0 minus 0.814506 (factor at 5 percent for 4 years)	0.185494
1.0 minus 0.857375 (factor at 5 percent for 3 years)	.142625
Difference	.042869

$$181 \div 365 = X \div 0.042869$$
$$X = 0.021258$$

1.0 minus 0.857375 (factor at 5 percent for 3 years)	0.142625
Plus: X	.021258
Interpolated factor	.163883

Thus, the amount payable for the period from January 1, 1974, to June 30, 1977, is $16,388.30 ($100,000×0.163883). Thereafter, the trust assets must be valued on December 31 of each year and 5 percent of such value paid annually to W for her life.

(b) Application of certain foundation rules to charitable remainder trusts. See section 4947(a)(2) and section 4947(b)(3)(B) and the regulations thereunder for the application to charitable remainder trusts of certain provisions relating to private foundations. See section 508(e) for rules relating to required provisions in governing instruments prohibiting certain activities specified in section 4947(a)(2).

(c) Taxation of nonexempt charitable remainder trusts. If the charitable remainder trust has any unrelated business taxabie income (within the meaning of section 512 and the regulations thereunder, determined as if part III, subchapter F, chapter 1, subtitle A of the Code applied to such trust) for any taxable year, the trust is subject to all of the taxes imposed by subtitle A of the Code for such taxable year. For taxable years beginning after December 31, 1969, unrelated business taxable income includes debt-financed income. The taxes imposed by subtitle A of the Code upon a nonexempt charitable remainder trust shall be computed under the rules prescribed by subparts A and C, part 1, subchapter J, chapter 1, subtitle A of the Code for trusts which may accumulate income or which distribute corpus. The provisions of subpart E, part 1 of such subchapter J are not applicable with respect to a nonexempt charitable remainder trust. The application of the above rules may be illustrated by the following example:

Example. In 1975, a charitable remainder trust which has a calendar year as its taxable year has $1,000 of ordinary income, including $100 of unrelated business taxable income, and no deductions other than under sections 642(b) and 661(a). The trust is required to pay out $700 for 1975 to a noncharitable recipient. Because the trust has some unrelated business taxable income in 1975, it is not exempt for such year. Consequently, the trust is taxable on all of its income as a complex trust. Under section 661(a) of the Code, the trust is allowed a deduction of $700. Under section 642(b) of the Code, the trust is allowed a deduction of $100. Consequently, the taxable income of the trust for 1975 is $200 ($1,000–$700–$100).

(d) Treatment of annual distributions to recipients—(1) Character of distributions—(i) Order of distributions. Annuity and unitrust amounts shall be treated as having the following characteristics in the hands of the recipients (whether or not the trust is exempt) without credit for any taxes which are imposed by subtitle A of the Code on the trust:

(a) Ordinary income. First, as ordinary income to the extent of the sum of the trust's ordinary income for the taxable year of the trust and its undistributed ordinary income for prior years. An ordinary loss for the current year shall be used to reduce undistributed ordinary income for prior years and any excess shall be carried forward indefinitely to reduce ordinary income for future years. For purposes of this section, the amount of current and prior years' income shall be computed without regard to the deduction for net operating losses provided by sections 172 or 642(d).

(b) Capital gain. Second, as capital gain to the extent of the trust's undistributed capital gains. Undistributed capital gains of the trust are determined on a cumulative net basis under the rules of this subdivision without regard to the provisions of section 1212.

(1) Long- and short-term capital gains. If, in any taxable year of the trust, the trust has both undistributed short-term capital gain and undistributed long-term capital gain, then the short-

term capital gain shall be deemed distributed prior to any long-term capital gain.

(2) Capital losses in excess of capital gains. If the trust has for any taxable year capital losses in excess of capital gains, any excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year and any excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(3) Capital gains in excess of capital losses. If the trust has for any taxable year capital gains in excess of capital losses, any excess of the net short-term capital gain over the net long-term capital loss for such year shall be, to the extent not deemed distributed, a short-term capital gain in the succeeding taxable year and any excess of the net long-term capital gain over the net short-term capital loss for such year shall be, to the extent not deemed distributed, a long-term capital gain in the succeeding taxable year.

The application of the rules in this subdivision (b) may be illustrated by the following example:

Example. (i) The X Trust is a charitable remainder trust created on January 1, 1975, and has the calendar year as its taxable year. During the years indicated, it has the following capital transactions:

1975:	
Long-term capital loss	$10
Short-term capital gain	5
1976:	
Short-term capital gain	20
Short-term capital loss	5
1977:	
Long-term capital gain	15

Distributions for 1975 and 1976 were not in excess of current and accumulated ordinary income for those years. In 1977, distributions exceeded current and accumulated ordinary income by $5.

(ii) The treatment of the 1975 and 1976 transactions is as follows:

1975:	
Long-term capital loss recognized	$(10)
Short-term capital gain recognized	5
Net long-term capital loss carried forward to 1976	(5)
1976:	
Short-term capital gain recognized	20
Short-term capital loss recognized	(5)
Long-term capital loss carried forward from 1975	(5)
Net short-term capital gain carried forward to 1977	$10
1977:	
Long-term capital gain recognized	$15
Net short-term capital gain carried forward from 1976	10

(iii) In 1977, the trust has long-term capital gain of $15 and short-term capital gain of $10. If the trust has both short-term capital gain and long-term capital gain for the same taxable year, the short-term capital gain is deemed distributed prior to the long-term capital gain. Therefore, the distribution of $5 in 1977 is deemed to be short-term capital gain. The undistributed net short-term capital gain of $5 is a short-term capital gain carried forward to 1978. The undistributed net long-term capital gain of $15 is a long-term capital gain carried forward to 1978.

(c) Other income. Third, as other income (including income excluded under part III, subchapter B, chapter 1, subtitle A of the Code) to the extent of the sum of the trust's other income for the taxable year and its undistributed other income for prior years. A loss in this category for the current year shall be used to reduce undistributed income in such category for prior years and any excess shall be carried forward indefinitely to reduce such income for future years.

(d) Corpus. Finally, as a distribution of trust corpus. For purposes of this section, the term "corpus" means the net fair market value of the trust assets less the total undistributed income (but not loss) in each of the above categories.

(ii) **Rules relating to character of distributions.** The determination of the character of amounts distributed shall be made as of the end of the taxable year of the trust. Amounts treated as paid from one of the categories of income described in (a), (b), or (c) of subdivision (i) of this subparagraph shall be treated as consisting of the same proportion of each class of items included in such category as the total of the current and accumulated income of each class of items bears to the total of the current and accumulated income for that category. A loss in one of such categories may not be used to reduce a gain in any other category. The provisions of subparts D and E, part 1, subchapter J, chapter 1, subtitle A of the Code are not applicable with respect to a charitable remainder trust (regardless of whether the trust is exempt).

(2) **Allocation of deductions.** Items of deduction of the trust for a taxable year of the trust which are deductible in determining taxable income (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) which are directly attributable to one or more classes of items within a category of income or to corpus (determined under subparagraph (1)(i) of this paragraph) shall be allocated to such classes of items or to corpus. All other allowable deduc-

tions for such taxable year which are not directly attributable to one or more classes of items within a category of income or to corpus (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) shall be allocated among the classes of items within the category (excluding classes of items with net losses) on the basis of the gross income of such classes for such taxable year reduced by the deductions allocated thereto under the first sentence of this subparagraph, but in no event shall the amount of expenses allocated to any class of items exceed such income of such class for the taxable year. Items of deduction which are not allocable under the above two sentences (other than the deductions permitted by sections 642(b), 642(c), 661, and 1202) may be allocated in any manner. All taxes imposed by subtitle A of the Code for which the trust is liable because it has unrelated business taxable income and all taxes imposed by chapter 42 of the Code shall be allocated to corpus. Any expense which is not deductible in determining taxable income and which is not allocable to any class of items described in subparagraph (1)(i)(c) of this paragraph shall be allocated to corpus. The deductions allowable to a trust under sections 642(b), 642(c), 661, and 1202 are not allowed in determining the amount or character of any class of items within a category of income or corpus in the categories described in subparagraph (1) of this paragraph.

(3) **Allocation of income among recipients.** If there are two or more recipients, each will be treated as receiving his pro rata portion of the categories of income and corpus. The application of this rule may be illustrated by the following example:

Example. X transfers $40,000 to a charitable remainder annuity trust which is to pay $3,000 per year to X and $2,000 per year to Y for a term of 5 years. During the first taxable year the trust has $3,000 of ordinary income, $500 of capital gain, and $500 of tax-exempt income after allocation of all expenses. X is treated as receiving ordinary income of $1,800 ($3,000/$5,000×$3,000), capital gain of $300 ($3,000/$5,-000×$500), tax exempt income of $300 ($3,000/$5,-000×$500), and corpus of $600 ($3,000/$5,000×[$5,000–$4,-000]). Y is treated as receiving ordinary income of $1,200 ($2,000/$5,000×$3,000), capital gain of $200 ($2,000/$5,-000×$500), tax exempt income of $200 ($2,000/$5,-000×$500), and corpus of $400 ($2,000/$5,000×[$5,000–$4,-000]).

(4) **Year of inclusion—(i) General rule.** To the extent required by this paragraph, the annuity or unitrust amount is includible in the recipient's gross income for the taxable year in which the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the taxable year of the trust. If a recipient has a different taxable year (as defined in section 441 or 442) from the taxable year of the trust, the amount he is required to include in gross income to the extent required by this paragraph shall be included in his taxable year in which or with which ends the taxable year of the trust in which such amount is required to be distributed.

(ii) **Payments resulting from incorrect valuations.** Notwithstanding subdivision (i) of this subparagraph, any payments which are made or required to be distributed by a charitable remainder trust pursuant to paragraph (a)(5) of this section, under paragraph (f)(3) of this section because of an amendment to the governing instrument, or under paragraphs (a)(1) of §§ 1.664–2 and 1.664–3 because of an incorrect valuation, shall, to the extent required by this paragraph, be included in the gross income of the recipient in his taxable year in which or with which ends the taxable year of the trust in which the amount is paid, credited, or required to be distributed. For rules relating to required adjustments of underpayments and overpayments of the annuity or unitrust amounts in respect of payments made prior to the amendment of a governing instrument, see paragraph (f)(3) of this section. There is allowable to a recipient a deduction from gross income for any amounts repaid to the trust because of an overpayment during the reasonable period of administration or settlement or until the trust is fully funded, because of an amendment, or because of an incorrect valuation, to the extent such amounts were included in his gross income. See section 1341 and the regulations thereunder for rules relating to the computation of tax where a taxpayer restores substantial amounts held under a claim of right.

(iii) **Rules applicable to year of recipient's death.** If the taxable year of the trust does not end with or within the last taxable year of the recipient because of the recipient's death, the extent to which the annuity or unitrust amount required to be distributed to him is included in the gross income of the recipient for his last taxable year, or in the gross income of his estate, is determined by making the computations required under this paragraph for the taxable year of the trust in which his last taxable year ends. (The last sentence of subdivision (i) of this subparagraph does not apply to such amounts.) The gross income for the last taxable year of a recipient on the cash basis includes (to the extent required by this paragraph) amounts actually distributed to the recipient before his death. Amounts required to be distributed which are distributed to his estate,

are included (to the extent required by this paragraph) in the gross income of the estate as income in respect of a decedent under section 691.

(5) Distributions in kind. The annuity or unitrust amount may be paid in cash or in other property. In the case of a distribution made in other property, the amount paid, credited, or required to be distributed shall be considered as an amount realized by the trust from the sale or other disposition of property. The basis of the property in the hands of the recipient is its fair market value at the time it was paid, credited, or required to be distributed. The application of these rules may be illustrated by the following example:

Example. On January 1, 1971, X creates a charitable remainder annuity trust, whose taxable year is the calendar year, under which X is to receive $5,000 per year. During 1971, the trust receives $500 of ordinary income. On December 31, 1971, the trust distributed cash of $500 and a capital asset of the trust having a fair market value of $4,500 and a basis of $2,200. The trust is deemed to have realized a capital gain of $2,300. X treats the distribution of $5,000 as being ordinary income of $500, capital gain of $2,300 and trust corpus of $2,200. The basis of the distributed property is $4,500 in the hands of X.

(e) Other distributions—(1) Character of distributions. An amount distributed by the trust to an organization described in section 170(c) other than the annuity or unitrust amount shall be considered as a distribution of corpus and of those categories of income specified in paragraph (d)(1) of this section in an order inverse to that prescribed in such paragraph. The character of such amount shall be determined as of the end of the taxable year of the trust in which the distribution is made after the character of the annuity or unitrust amount has been determined.

(2) Distributions in kind. In the case of a distribution of an amount to which subparagraph (1) of this paragraph applies, no gain or loss is realized by the trust by reason of a distribution in kind unless such distribution is in satisfaction of a right to receive a distribution of a specific dollar amount or in specific property other than that distributed.

(f) Effective date—(1) General rule. The provisions of this section are effective with respect to transfers in trust made after July 31, 1969. Any trust created (within the meaning of applicable local law) prior to August 1, 1969, is not a charitable remainder trust even if it otherwise satisfies the definition of a charitable remainder trust.

(2) Transfers to pre-1970 trusts. Property transferred to a trust created (within the meaning of applicable local law) before August 1, 1969, whose governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust, shall, for purposes of subparagraphs (1) and (3) of this paragraph, be deemed transferred to a trust created on the date of such transfer provided that the transfer occurs after July 31, 1969, and prior to October 18, 1971, and the transferred property and any undistributed income therefrom is severed and placed in a separate trust before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings begun before December 31, 1972, which are required to sever such property, become final.

(3) Amendment of post-1969 trusts. A trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, which is not a charitable remainder trust at the date of its creation, may be treated as a charitable remainder trust from the date it would be deemed created under § 1.664–1(a)(4) and (5)(i) for all purposes: *Provided,* That all the following requirements are met:

(i) At the time of the creation of the trust, the governing instrument provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust.

(ii) The governing instrument of the trust is amended so that the trust will meet the definition of a charitable remainder trust and, if applicable, will meet the requirement of paragraph (a)(5)(i) of this section that obligation to make payment of the annuity or unitrust amount with respect to property passing at death begin as of the date of death, before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. In the case of a trust created (within the meaning of applicable local law) subsequent to July 31, 1969, and prior to December 31, 1972, the provisions of section 508(d)(2)(A) shall not apply if the governing instrument of the trust is amended so as to comply with the requirements of section 508(e) before December 31, 1972, or if later, on or before the 30th day after the date on which any judicial proceedings which are begun before December 31, 1972, and which are required to amend its governing instrument, become final. Notwithstanding the provisions of paragraphs (a)(3) and (a)(4) of §§ 1.664–2 and 1.664–3, the governing instrument may grant to the trustee a power to amend the governing instrument for the sole purpose of com-

plying with the requirements of this section and § 1.664–2 or § 1.664–3: Provided, That at the creation of the trust, the governing instrument (a) provides for the payment of a unitrust amount described in § 1.664–3(a)(1)(i) or an annuity which meets the requirements of paragraph (a)(2) of § 1.664–2 or § 1.664–3, (b) designates the recipients of the trust and the period for which the amount described in (a) of this subdivision (ii) is to be paid, and (c) provides that an organization described in section 170(c) receives an irrevocable remainder interest in such trust. The mere granting of such a power is not sufficient to meet the requirements of this subparagraph that the governing instrument be amended in the manner and within the time limitations of this subparagraph.

(iii)(a) Where the amount of the distributions which would have been made by the trust to a recipient if the amended provisions of such trust had been in effect from the time of creation of such trust exceeds the amount of the distributions made by the trust prior to its amendment, the trust pays an amount equal to such excess to the recipient.

(b) Where the amount of distributions made to the recipient prior to the amendment of the trust exceeds the amount of the distributions which would have been made by such trust if the amended provisions of such trust had been in effect from the time of creation of such trust, such excess is repaid to the trust by the recipient.

See paragraph (d)(4) of this section for rules relating to the year of inclusion in the case of an underpayment to a recipient and the allowance of a deduction in the case of an overpayment to a recipient. A deduction for a transfer to a charitable remainder trust shall not be allowed until the requirements of this paragraph are met and then only if the deduction is claimed on a timely filed return (including extensions) or on a claim for refund filed within the period of limitations prescribed by section 6511(a).

(g) Transitional effective date. Notwithstanding any other provision of this section, § 1.664–2 or § 1.664–3, the requirement of paragraph (a)(5)(i) of this section that interest accrue on overpayments and underpayments, the requirement of paragraph (a)(5)(ii) of this section that the unitrust amount accruing under the formula provided therein cease with the death of the last recipient, and the requirement that the governing instrument of the trust contain the provisions specified in paragraph (a)(1)(iv) of § 1.664–2 (relating to computation of the annuity amount in certain circumstances), paragraph (a)(1)(v) of § 1.664–3 (relating to computation of the unitrust amount in certain circumstances), paragraphs (b) of §§ 1.664–2 and 1.664–3 (relating to additional contributions), and paragraph (a)(1)(iii) of § 1.664–3 (relating to incorrect valuations), paragraphs (a)(6)(iv) of §§ 1.664–2 and 1.664–3 (relating to alternative remaindermen) shall not apply to:

(1) A will executed on or before December 31, 1972, if:

(i) The testator dies before December 31, 1975, without having republished the will after December 31, 1972, by codicil or otherwise,

(ii) The testator at no time after December 31, 1972, had the right to change the provisions of the will which pertain to the trust, or

(iii) The will is not republished by codicil or otherwise before December 31, 1975, and the testator is on such date and at all times thereafter under a mental disability to republish the will by codicil or otherwise, or

(2) A trust executed on or before December 31, 1972, if:

(i) The grantor dies before December 31, 1975, without having amended the trust after December 31, 1972,

(ii) The trust is irrevocable on December 31, 1972, or

(iii) The trust is not amended before December 31, 1975, and the grantor is on such date and at all times thereafter under a mental disability to change the terms of the trust.

[T.D. 7202, 37 FR 16913, Aug. 23, 1972; 37 FR 28288, Dec. 22, 1972; T.D. 7955, 49 FR 19983, May 11, 1984]

§ 1.664–2 Charitable remainder annuity trust.

(a) Description. A charitable remainder annuity trust is a trust which complies with the applicable provisions of § 1.664–1 and meets all of the following requirements:

(1) Required payment of annuity amount—(i) Payment of sum certain at least annually. The governing instrument provides that the trust shall pay a sum certain not less often than annually to a person or persons described in subparagraph (3) of this paragraph for each taxable year of the period specified in subparagraph (5) of this paragraph. The trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income

(within the meaning of section 514), to have received an additional contribution (within the meaning of § 1.664–2(b)), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because payment of the annuity amount is made after the close of the taxable year: Provided, That such payment is made within a reasonable time after the close of such taxable year. For purposes of the preceding sentence, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 1041–B (including extensions) for such year.

(ii) Definition of sum certain. A sum certain is a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period. For example, a provision for an amount which is the same every year to A until his death and concurrently an amount which is the same every year to B until his death, with the amount to each recipient to terminate at his death, would satisfy the above rule. Similarly, provisions for an amount to A and B for their joint lives and then to the survivor would satisfy the above rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the stated amount payable after such a distribution: Provided, That:

(a) The reduced amount payable is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) Sum certain stated as a fraction or percentage. The stated dollar amount may be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes. If the stated dollar amount is so expressed and such market value is incorrectly determined by the fiduciary, the requirement of this subparagraph will be satisfied if the governing instrument provides that in such event the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of § 1.664–1. See paragraph (d)(4) of § 1.664–1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to future contributions. For rules relating to required adjustments for underpayments or overpayments of the amount described in this paragraph in respect of payments made during a reasonable period of administration, see paragraph (a)(5) of § 1.664–1. The application of the rule permitting the stated dollar amount to be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes may be illustrated by the following example:

Example. The will of X provides for the transfer of one-half of his residuary estate to a charitable remainder annuity trust which is required to pay to W for life an annuity equal to 5 percent of the initial net fair market value of the interest passing in trust as finally determined for Federal tax purposes. The annuity is to be paid on December 31 of each year computed from the date of X's death. The will also provides that if such initial net fair market value is incorrectly determined, the trust shall pay to W, in the case of an undervaluation, or be repaid by W, in the case of an overvaluation, an amount equal to the difference between the amount which the trust should have paid if the correct value were used and the amount which the trust actually paid. X dies on March 1, 1971. The executor files an estate tax return showing the value of the residuary estate as $250,000 before reduction for taxes and expenses of $50,000. The executor paid to W $4,192 ([$250,000–$50,000]×1/2×5 percent×306/365) on December 31, 1971. On January 1, 1972, the executor transfers one-half of the residue of the estate to the trust. The trust adopts the calendar year as its taxable year. The value of the residuary estate is finally determined for Federal tax purposes to be $240,000 ($290,000–$50,000). Accordingly, the amount which the executor should have paid to W is $5,030 ([$290,000–$50,-000]×1/2×5 percent×306/365). Consequently, an additional amount of $838 ($5,030–$4,192) must be paid to W within a reasonable period after the final determination of value for Federal tax purposes.

(iv) Computation of annuity amount in certain circumstances—(a) Short taxable years. The governing instrument provides that, in the case of a taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount determined under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of

which is 365 (366 if February 29 is a day included in the numerator).

(b) Last taxable year of period. The governing instrument provides that, in the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph, the annuity amount which must be distributed under subdivision (i) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of which is 365 (366 if February 29 is a day included in the numerator). See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the annuity amount with the regular payment next preceding the termination of the period specified therein.

(2) Minimum annuity amount—(i) General rule. The total amount payable under subparagraph (1) of this paragraph is not less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes.

(ii) Reduction of annuity amount in certain cases. A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the stated amount payable upon the death of a recipient or the expiration of a term of years provided that:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total amounts payable each year under subparagraph (1) of this paragraph after such distribution are not less than a stated dollar amount which bears the same ratio to 5 percent of the initial net fair market value of the trust assets as the net fair market value of the trust assets immediately after such distribution bears to the net fair market value of the trust assets immediately before such distribution.

(iii) Rule applicable to inter vivos trust which does not provide for payment of minimum annuity amount. In the case where the grantor of an inter vivos trust underestimates in good faith the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes and specifies a fixed dollar amount for the annuity which is less than 5 percent of the initial net fair market value of the property placed in trust as finally determined for Federal tax purposes, the trust will be deemed to have met the 5 percent requirement if the grantor or his representative consents, by appropriate agreement with the District Director, to accept an amount equal to 20 times the annuity as the fair market value of the property placed in trust for purposes of determining the appropriate charitable contributions deduction.

(3) Permissible recipients—(i) General rule. The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of the creation of the trust. A named person or persons may include members of a named class provided that, in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the annuity amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that an amount shall be paid to his children living at his death.

(ii) Power to alter amount paid to recipients. A trust is not a charitable remainder annuity trust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if Subpart E, Part 1, Subchapter J, Chapter 1, Subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the annuity among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) Other payments. No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization described in section 170(c) if the amount is transferred for full and adequate consideration. The

trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) Period of payment of annuity amount—(i) General rules. The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of an annuity amount to A for his life and then to B for a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of an annuity amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) Relationship to 5 percent requirement. The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A and B for their joint lives and then to the survivor for his life;

(b) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) An amount equal to at least 5 percent of the initial net fair market value of the property placed in trust to A for a term of years not longer than 20 years and then to B for life (provided B was living at the date of creation of the trust);

(d) An amount to A for his life and concurrently an amount to B for his life (the amount to each recipient to terminate at his death) if the amount given to each individual is not less than 5 percent of the initial net fair market value of the property placed in trust; or

(e) An amount to A for his life and concurrently an equal amount to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c), if the total of the amounts given to A and B is not less than 5 percent of the initial net fair market value of the property placed in trust.

(6) Permissible remaindermen—(i) General rule. At the end of the period specified in subparagraph (5) of this paragraph the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use.

(ii) Treatment of trust. If all of the trust corpus is to be retained for such use, the taxable year

of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charitable remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as sections 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) Concurrent or successive remaindermen. Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) Alternative remaindermen. The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of one or more alternative organizations which are described in section 170(c) at such time or retained for such use. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) Additional contributions. A trust is not a charitable remainder annuity trust unless its governing instrument provides that no additional contributions may be made to the charitable remainder annuity trust after the initial contribution. For purposes of this section, all property passing to a charitable remainder annuity trust by reason of death of the grantor shall be considered one contribution.

(c) Calculation of the fair market value of the remainder interest of a charitable remainder annuity trust. For purposes of sections 170, 2055, 2106, and 2522, the fair market value of the remainder interest of a charitable remainder annuity trust (as described in this section) is the net fair market value (as of the appropriate valuation date) of the property placed in trust less the present value of the annuity. For purposes of this section, the term "appropriate valuation date" means the date on which the property is transferred to the trust by the donor except that, for purposes of section 2055 or 2106, it means the date of death unless the alternate valuation date is elected in accordance with section 2032 and the regulations thereunder in which event it means the alternate valuation date. The present value of an annuity is computed under § 20.2031–7 or § 20.2031–10, whichever is appropriate, of the Estate Tax Regulations regardless of when the trust was created.

(d) Deduction for transfers to a charitable remainder annuity trust. For rules relating to a deduction for transfers to a charitable remainder annuity trust, see sections 170, 2055, 2106, or 2522 and the regulations thereunder. Any claim for deduction on any return for the value of a remainder interest in a charitable remainder annuity trust must be supported by a full statement attached to the return showing the computation of the present value of such interest. The deduction allowed by section 170 is limited to the fair market value of the remainder interest of a charitable remainder annuity trust regardless of whether an organization described in section 170(c) also receives a portion of the annuity. For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see sections 170(e)(1)(A) or 170(e)(1)(B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

[T.D. 7202, 37 FR 16918, Aug. 23, 1972, as amended by T.D. 7955, 49 FR 19983, May 11, 1984]

§ 1.664–3 Charitable remainder unitrust.

(a) Description. A charitable remainder unitrust is a trust which complies with the applicable provisions of § 1.664–1 and meets all of the following requirements:

(1) Required payment of unitrust amount—(i) Payment of fixed percentage at least annually—(a) General rule. The governing instrument provides that the trust shall pay not less often than annually a fixed percentage of the net fair market value of

the trust assets determined annually to a person or persons described in subparagraph (3) of this paragraph for each taxable year of the period specified in subparagraph (5) of this paragraph. The trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 4941), to have received an additional contribution (within the meaning of § 1.664–3(b)), or to have failed to function exclusively as a charitable remainder trust (within the meaning of § 1.664–1(a)(4)) merely because payment of the unitrust amount is made after the close of the taxable year: Provided, That such payment is made within a reasonable time after the close of such taxable year. For purposes of the preceding sentence, a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 1041–B (including extensions) for such year.

(b) Income exception. Instead of the amount described in (a) of this subdivision (i), the governing instrument may provide that the trust shall pay for any year either the amount described in (1) or the total of the amounts described in (1) and (2) of this subdivision (b).

(1) The amount of trust income (as defined in section 643(b) and the regulations thereunder), for a taxable year to the extent that such amount is not more than the amount required to be distributed under (a) of this subdivision (i).

(2) An amount of trust income for a taxable year which is in excess of the amount required to be distributed under (a) of this subdivision (i) for such year, to the extent that (by reason of (1)) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(ii) Definition of fixed percentage. The fixed percentage may be expressed either as a fraction or as a percentage and must be payable each year in the period specified in subparagraph (5) of this paragraph. A percentage is fixed if the percentage is the same either as to each recipient or as to the total percentage payable each year of such period. For example, provision for a fixed percentage which is the same every year to A until his death and concurrently a fixed percentage which is the same every year to B until his death, the fixed percentage to each recipient to terminate at his death, would satisfy the rule. Similarly, provision for a fixed percentage to A and B for their joint lives and then to the survivor would satisfy the rule. In the case of a distribution to an organization described in section 170(c) at the death of a recipient or the expiration of a term of years, the governing instrument may provide for a reduction of the fixed percentage payable after such distribution Provided That:

(a) The reduced fixed percentage is the same either as to each recipient or as to the total amount payable for each year of the balance of such period, and

(b) The requirements of subparagraph (2)(ii) of this paragraph are met.

(iii) Rules applicable to incorrect valuations. The governing instrument provides that in the case where the net fair market value of the trust assets is incorrectly determined by the fiduciary, the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient. Such payments or repayments must be made within a reasonable period after the final determination of such value. Any payment due to a recipient by reason of such incorrect valuation shall be considered to be a payment required to be distributed at the time of such final determination for purposes of paragraph (d)(4)(ii) of § 1.664–1. See paragraph (d)(4) of § 1.664–1 for rules relating to the year of inclusion of such payments and the allowance of a deduction for such repayments. See paragraph (b) of this section for rules relating to additional contributions.

(iv) Rules applicable to valuation. In computing the net fair market value of the trust assets there shall be taken into account all assets and liabilities without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date during the taxable year of the trust, or by taking the average of valuations made on more than one date during the taxable year of the trust, so long as the same valuation date or dates and valuation methods are used each year. If the governing instrument does not specify the valuation date or dates, the trustee shall select such date or dates and shall indicate his selection on the first return on Form 1041–B which the trust is required to file. The amount described in subdivision (i)(a) of this subparagraph which must be paid each year must be based upon the valuation for such year.

(v) Computation of unitrust amount in certain circumstances—(a) Short taxable years. The governing instrument provides that, in the case of a

taxable year which is for a period of less than 12 months other than the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(1) The amount determined under subdivision (i)(a) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator),

(2) The amount determined under subdivision (i)(b) of this subparagraph shall be computed by using the amount determined under subdivision (a)(1) of this subdivision (v), and

(3) If no valuation date occurs before the end of the taxable year of the trust, the trust assets shall be valued as of the last day of the taxable year of the trust.

(b) Last taxable year of period. (1) The governing instrument provides that, in the case of the taxable year in which occurs the end of the period specified in subparagraph (5) of this paragraph:

(i) The unitrust amount which must be distributed under subdivision (i)(a) of this subparagraph shall be the amount otherwise determined under that subdivision multiplied by a fraction the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the last day of the period specified in subparagraph (5) of this paragraph and the denominator of which is 365 (366 if February 29 is a day included in the numerator),

(ii) The amount determined under subdivision (i)(b) of this subparagraph shall be computed by using the amount determined under (b)(1)(i) of this subdivision (v), and

(iii) If no valuation date occurs before the end of such period, the trust assets shall be valued as of the last day of such period.

(2) See subparagraph (5) of this paragraph for a special rule allowing termination of payment of the unitrust amount with the regular payment next preceding the termination of the period specified therein.

(2) Minimum unitrust amount—(i) General rule. The fixed percentage described in subparagraph (1)(i) of this paragraph with respect to all beneficiaries taken together is not less than 5 percent.

(ii) Reduction of unitrust amount in certain cases. A trust will not fail to meet the requirements of this subparagraph by reason of the fact that it provides for a reduction of the fixed percentage payable upon the death of a recipient or the expiration of a term of years Provided That:

(a) A distribution is made to an organization described in section 170(c) at the death of such recipient or the expiration of such term of years, and

(b) The total of the percentage payable under subparagraph (1) of this paragraph after such distribution is not less than 5 percent.

(3) Permissible recipients—(i) General rule. The amount described in subparagraph (1) of this paragraph is payable to or for the use of a named person or persons, at least one of which is not an organization described in section 170(c). If the amount described in subparagraph (1) of this paragraph is to be paid to an individual or individuals, all such individuals must be living at the time of creation of the trust. A named person or persons may include members of a named class except in the case of a class which includes any individual, all such individuals must be alive and ascertainable at the time of the creation of the trust unless the period for which the unitrust amount is to be paid to such class consists solely of a term of years. For example, in the case of a testamentary trust, the testator's will may provide that the required amount shall be paid to his children living at his death.

(ii) Power to alter amount paid to recipients. A trust is not a charitable remainder unitrust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if Subpart E, Part 1, Subchapter J, Chapter 1, Subtitle A of the Code were applicable to such trust. See paragraph (a)(4) of this section for a rule permitting the retention by a grantor of a testamentary power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). For example, the governing instrument may not grant the trustee the power to allocate the fixed percentage among members of a class unless such power falls within one of the exceptions to section 674(a).

(4) Other payments. No amount other than the amount described in subparagraph (1) of this paragraph may be paid to or for the use of any person other than an organization described in section 170(c). An amount is not paid to or for the use of any person other than an organization

described in section 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c). The governing instrument may provide that any amount other than the amount described in subparagraph (1) of this paragraph shall be paid (or may be paid in the discretion of the trustee) to an organization described in section 170(c) provided that, in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in section 170(c).

(5) Period of payment of unitrust amount—(i) General rules. The period for which an amount described in subparagraph (1) of this paragraph is payable begins with the first year of the charitable remainder trust and continues either for the life or lives of a named individual or individuals or for a term of years not to exceed 20 years. Only an individual or an organization described in section 170(c) may receive an amount for the life of an individual. If an individual receives an amount for life, it must be solely for his life. Payment of the amount described in subparagraph (1) of this paragraph may terminate with the regular payment next preceding the termination of the period described in this subparagraph. The fact that the recipient may not receive such last payment shall not be taken into account for purposes of determining the present value of the remainder interest. In the case of an amount payable for a term of years, the length of the term of years shall be ascertainable with certainty at the time of the creation of the trust, except that the term may be terminated by the death of the recipient or by the grantor's exercise by will of a retained power to revoke or terminate the interest of any recipient other than an organization described in section 170(c). In any event, the period may not extend beyond either the life or lives of a named individual or individuals or a term of years not to exceed 20 years. For example, the governing instrument may not provide for the payment of a unitrust amount to A for his life and then to B for a term of years because it is possible for the period to last longer than either the lives of recipients in being at the creation of the trust or a term of years not to exceed 20 years. On the other hand, the governing instrument may provide for the payment of a unitrust amount to A for his life and then to B for his life or a term of years (not to exceed 20 years), whichever is shorter (but not longer), if both A and B are in being at the creation of the trust because it is not possible for the period to last longer than the lives of recipients in being at the creation of the trust.

(ii) Relationship to 5 percent requirement. The 5 percent requirement provided in subparagraph (2) of this paragraph must be met until the termination of all of the payments described in subparagraph (1) of this paragraph. For example, the following provisions would satisfy the above rules:

(a) A fixed percentage of at least 5 percent to A and B for their joint lives and then to the survivor for his life;

(b) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years, whichever is longer (or shorter);

(c) A fixed percentage of at least 5 percent to A for life or for a term of years not longer than 20 years and then to B for life (provided B was living at the creation of the trust);

(d) A fixed percentage to A for his life and concurrently a fixed percentage to B for his life (the percentage to each recipient to terminate at his death) if the percentage given to each individual is not less than 5 percent;

(e) A fixed percentage to A for his life and concurrently an equal percentage to B for his life, and at the death of the first to die, the trust to distribute one-half of the then value of its assets to an organization described in section 170(c) if the total of the percentages is not less than 5 percent for the entire period described in this subparagraph.

(6) Permissible remaindermen—(i) General rule. At the end of the period specified in subparagraph (5) of this paragraph, the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use.

(ii) Treatment of trust. If all of the trust corpus is to be retained for such use, the taxable year of the trust shall terminate at the end of the period specified in subparagraph (5) of this paragraph and the trust shall cease to be treated as a charita-

ble remainder trust for all purposes. If all or any portion of the trust corpus is to be transferred to or for the use of such organization or organizations, the trustee shall have a reasonable time after the period specified in subparagraph (5) of this paragraph to complete the settlement of the trust. During such time, the trust shall continue to be treated as a charitable remainder trust for all purposes, such as section 664, 4947(a)(2), and 4947(b)(3)(B). Upon the expiration of such period, the taxable year of the trust shall terminate and the trust shall cease to be treated as a charitable remainder trust for all purposes. If the trust continues in existence, it will be subject to the provisions of section 4947(a)(1) unless the trust is exempt from taxation under section 501(a). For purposes of determining whether the trust is exempt under section 501(a) as an organization described in section 501(c)(3), the trust shall be deemed to have been created at the time it ceases to be treated as a charitable remainder trust.

(iii) Concurrent or successive remaindermen. Where interests in the corpus of the trust are given to more than one organization described in section 170(c) such interests may be enjoyed by them either concurrently or successively.

(iv) Alternative remaindermen. The governing instrument shall provide that if an organization to or for the use of which the trust corpus is to be transferred or for the use of which the trust corpus is to be retained is not an organization described in section 170(c) at the time any amount is to be irrevocably transferred to or for the use of such organization, such amount shall be transferred to or for the use of or retained for the use of one or more alternative organizations which are described in section 170(c) at such time. Such alternative organization or organizations may be selected in any manner provided by the terms of the governing instrument.

(b) Additional contributions. A trust is not a charitable remainder annuity trust unless its governing instrument either prohibits additional contributions to the trust after the initial contribution or provides that for the taxable year of the trust in which the additional contribution is made:

(1) Where no valuation date occurs after the time of the contribution and during the taxable year in which the contribution is made, the additional property shall be valued as of the time of contribution; and

(2) The amount described in paragraph (a)(1)(i)(a) of this section shall be computed by multiplying the fixed percentage by the sum of (i) the net fair market value of the trust assets (excluding the value of the additional property and any earned income from and any appreciation on such property after its contribution), and (ii) that proportion of the value of the additional property (that was excluded under subdivision (i) of this paragraph), which the number of days in the period which begins with the date of contribution and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section bears to the number of days in the period which begins with the first day of such taxable year and ends with the earlier of the last day of such taxable year or the last day of the period described in paragraph (a)(5) of this section.

For purposes of this section, all property passing to a charitable remainder unitrust by reason of death of the grantor shall be considered one contribution. The application of the preceding rules may be illustrated by the following examples:

Example (1). On March 2, 1971, X makes an additional contribution of property to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is January 1 of each year. For purposes of computing the required payout with respect to the additional contribution for the year of contribution, the additional contribution is valued on March 2, 1971, the time of contribution. The property had a value on that date of $5,000. Income from such property in the amount of $250 was received on December 31, 1971. The required payout with respect to the additional contribution for the year of contribution is $208 (5 percent × $5,000 × 305/365). The income earned after the date of the contribution and after the regular valuation date does not enter into the computation.

Example (2). On July 1, 1971, X makes an additional contribution of $10,000 to a charitable remainder unitrust. The taxable year of the trust is the calendar year and the regular valuation date is December 31 of each year. The fixed percentage is 5 percent. Between July 1, 1971, and December 31, 1971, the additional property appreciates in value to $12,500 and earns $500 of income. Because the regular valuation date for the year of contribution occurs after the date of the additional contribution, the additional contribution including income earned by it is valued on the regular valuation date. Thus, the required payout with respect to the additional contribution is $325.87 (5 percent × [$12,500 + $500] × 183/365).

(c) Calculation of the fair market value of the remainder interest of a charitable remainder unitrust. See § 1.664–4 for rules relating to the calculation of the fair market value of the remainder interest of a charitable remainder unitrust.

(d) Deduction for transfers to a charitable remainder unitrust. For rules relating to a deduction for transfers to a charitable remainder unitrust, see sections 170, 2055, 2106, or 2522 and the regulations thereunder. The deduction allowed by section 170 for transfers to charity is limited to the fair market value of the remainder interest of a

charitable remainder unitrusts regardless of whether an organization described in section 170(c) also receives a portion of the amount described in § 1.664–3(a)(1). For a special rule relating to the reduction of the amount of a charitable contribution deduction with respect to a contribution of certain ordinary income property or capital gain property, see section 170(e)(1)(A) or (B)(i) and the regulations thereunder. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder.

[T.D. 7202, 37 FR 16920, Aug. 23, 1972]

§ 1.664–4 Calculation of the fair market value of the remainder interest in a charitable remainder unitrust.

(a) General rule—(1) Rules for determining present value. Except as otherwise provided in paragraph (a)(2) of this section, for purposes of section 170, 2055, 2106, or 2522, the fair market value of a remainder interest in a charitable remainder unitrust (as described in § 1.664–3) is its present value determined under this section. The present value determined under this section shall be computed on the basis of—

(i) Life contingencies determined as to each life involved, from the values of lx set forth in column 2 of Table LN, paragraph (f) of § 20.2031–7 (columns 2 and 3, respectively, of Table LN of paragraph (f) of § 20.2031–10 for transfers made before December 1, 1983);

(ii) Interest at the rate of 10 percent (6 percent for transfers to charitable remainder unitrusts made before December 1, 1983); and

(iii) The assumption that the amount described in paragraph (a)(1)(i)(*a*) of § 1.664–3 shall be distributed in accordance with the payout sequence described in the governing instrument.

If the governing instrument does not prescribe when the distribution shall be made during the period for which the payment is made, for purposes of this section, the distribution shall be considered payable on the first day of the period for which the payment is made.

(2) Rules for determining present value for testamentary transfers where the decedent dies after November 30, 1983, and before August 9, 1984. For purposes of section 2055 or 2106, if—

(i) the decedent dies after November 30, 1983, and before August 9, 1984, or

(ii) on December 1, 1983, the decedent is under a mental disability such that the disposition of the property cannot be changed, and such decedent dies any time on or after December 1, 1983 without ever regaining competency to dispose of such decedent's property, or dies within 90 days of the date on which such decedent first regains competency, paragraph (a)(1)(ii) of this section shall be applied by substituting the phrase "6 percent or 10 percent, whichever is most beneficial to the taxpayer" for "10 percent." However, if the taxpayer uses 6 percent, the life contingencies under Table LN of § 20.2031–10(f) must be used.

(3) Valuation of charitable remainder unitrusts having certain payout sequences. The method of applying these principles to charitable remainder unitrusts which have certain payout sequences is set forth in paragraph (b) of this section.

(4) Commissioner may supply factor. If the computation of the value of the remainder interest of a charitable remainder unitrust requires the use of a factor which is not provided in paragraph (b) of this section, the Commissioner may, if conditions permit, supply the factor upon request. The request must be accompanied by a statement of the date of birth and sex of each individual the duration of whose life may affect the value of the remainder interest and by copies of the relevant instruments. If the Commissioner furnishes the factor, a copy of the letter supplying the factor shall be attached to the tax return in which the deduction is claimed. A copy of the publication containing many such special factors, may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, D.C. 20402. If the Commissioner does not furnish the factor, the taxpayer must furnish a factor computed in accordance with the principles set forth in subparagraph (1) of this paragraph.

(5) Statement supporting deduction required. Any claim for deduction on any return for the value of a remainder interest in a charitable remainder unitrust must be supported by a full statement attached to the return showing the computation of the present value of such interest.

(b) Valuation of charitable remainder unitrusts having certain payout sequences; for transfers made after November 30, 1983—(1) In general. Except as otherwise provided in paragraph (c) of this section, for transfers made after November 30, 1983, the present value determined under this section of a remainder interest which is dependent on a term of years or the termination of the life of one individual shall be determined under para-

graphs (b)(1) through (5) of this section provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount which the trust could distribute on such date under paragraph (a)(1)(v) of § 1.664–3 if the taxable year of the trust were to end on such date. The present value of the remainder interest in such trust shall be determined by computing the adjusted payout rate (as defined in paragraph (b)(2) of this section) and following the procedure outlined in paragraph (b)(3) or (b)(4) of this section, whichever is applicable. The present value of a remainder interest which is dependent on a term of years is computed under paragraph (b)(3) of this section. The present value of a remainder interest which is dependent on the termination of the life of one individual is computed under paragraph (b)(4) of this section. See paragraph (c) of this section for testamentary transfers occurring after November 30, 1983, and before August 9, 1984. For transfers made before December 1, 1983, see paragraphs (d)(1) through (5) of this section.

(2) **Adjusted payout rate.** The adjusted payout rate is determined by multiplying the fixed percentage described in paragraph (a)(1)(i)(*a*) of § 1.664–3 by the figure in column (2) of Table F(1) which describes the payout sequence of the trust opposite the number in column (1) of Table F(1) which corresponds to the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution shall be made during the taxable year of the trust, see paragraph (a)(4) of this section. In the case of a trust having a payout sequence for which no figures have been provided by Table F(1) and in the case of a trust which determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see paragraph (a)(3) of this section.

(3) **Period is a term of years.** If the period described in paragraph (a)(5) of § 1.664–3 is a term of years, the factor which is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table D in paragraph (b)(5) of this section opposite the number in column (1) of Table D which corresponds to the number of years in the term. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (b)(3). For purposes of this section, the term "appropriate valuation date" means the date on which the property is transferred to the trust by the donor except that, for purposes of section 2055 or 2106, it means the date of death unless the alternate valuation date is elected in accordance with section 2032 and the regulations thereunder in which event it means the alternate valuation date. If the adjusted payout rate is greater than 15 percent, see paragraph (a)(4) of this section. The application of this paragraph (b)(3) may be illustrated by the following example:

Example. D transfers $100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to D semiannually (on June 30 and December 31) 10 percent of the fair market value of the trust assets as of June 30th for a term of 15 years. The adjusted payout rate is 9.767 percent (10% x 0.976731). The present value of the remainder interest is $21,404.90, computed as follows:

Factor at 9.6 percent for 15 years	0.220053
Factor at 9.8 percent for 15 years	.212862
Difference	.007191

$$\frac{9.767\% - 9.6\%}{0.2\%} = \frac{X}{.007191}$$

0.2% = .007191

X = .006004

Factor at 9.6 percent for 15 years	0.220053
Less: X	.006004
Interpolated factor	.214049

Present value of remainder interest = $100,000 × 0.214049 = $21,404.90

(4) **Period is the life of one individual.** If the period described in paragraph (a)(5) of § 1.664–3 is the life of one individual, the factor which is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table E in paragraph (b)(5) of this section opposite the number in column (1) which corresponds to the age of the individual whose life measures the period. For purposes of the computations described in this paragraph (b)(4), the age of an individual is to be taken as the age of that individual at the individual's nearest birthday. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided for in Table E, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this paragraph (b)(4). If the adjusted payout rate is greater than 14 percent, see

paragraph (a)(4) of this section. The application of this paragraph may be illustrated by the following example:

Example. A, who will be 50 years old on April 15, 1985, transfers $100,000 to a charitable remainder unitrust on January 1, 1985. The trust instrument requires that the trust pay to A at the end of each taxable year of the trust 10 percent of the fair market value of the trust assets as of the beginning of each taxable year of the trust. The adjusted payout rate is 9.091 percent (10 percent × .909091). The present value of the remainder interest is $15,259.00 computed as follows:

Factor at 9 percent at age 50	0.15472
Factor at 9.2 percent at age 50	.15003
Difference	.00469

$$9.091\% - 9\% \div 0.2\% = X \div 0.00469$$
$$x = 0.00213$$

Factor at 9 percent at age 50	.15472
Less: X	.00213
Interpolated factor	.15259

Present value of remainder interest = $100,000 × 0.15259 = $15,259.00

(5) Actuarial Tables. The following tables shall be used in the application of the provisions of this section:

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN

(1) Years	(2) Adjusted payout rate				
	2.2%	2.4%	2.6%	2.8%	3.0%
1	.978000	.976000	.974000	.972000	.970000
2	.956484	.952576	.948676	.944784	.940900
3	.935441	.929714	.924010	.918330	.912673
4	.914862	.907401	.899986	.892617	.885293
5	.894735	.885623	.876587	.867624	.858734
6	.875051	.864368	.853795	.843330	.832972
7	.855799	.843624	.831597	.819717	.807983
8	.836972	.823377	.809975	.796765	.783743
9	.818558	.803616	.788916	.774455	.760231
10	.800550	.784329	.768404	.752771	.737424
11	.782938	.765505	.748425	.731693	.715301
12	.765713	.747133	.728966	.711206	.693842
13	.748868	.729202	.710013	.691292	.673027
14	.732393	.711701	.691553	.671936	.652836
15	.716280	.694620	.673573	.653121	.633251
16	.700522	.677949	.656060	.634834	.614254
17	.685110	.661678	.639002	.617059	.595826
18	.670038	.645798	.622388	.599781	.577951
19	.655297	.630299	.606206	.582987	.560613
20	.640881	.615172	.590445	.566664	.543794

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
1	.968000	.966000	.964000	.962000	.960000
2	.937024	.933156	.929296	.925444	.921600
3	.907039	.901429	.895841	.890277	.884736
4	.878014	.870780	.863591	.856447	.849347
5	.849918	.841174	.832502	.823902	.815373
6	.822720	.812574	.802532	.792593	.782758
7	.796393	.784946	.773641	.762475	.751447
8	.770909	.758258	.745790	.733501	.721390
9	.746239	.732477	.718941	.705628	.692534
10	.722360	.707573	.693059	.678814	.664833
11	.699244	.683516	.668109	.653019	.638239
12	.676868	.660276	.644057	.628204	.612710
13	.655209	.637827	.620871	.604332	.588201
14	.634242	.616141	.598520	.581368	.564673
15	.613946	.595192	.576973	.559276	.542086
16	.594300	.574955	.556202	.538023	.520403
17	.575282	.555407	.536179	.517578	.499587
18	.556873	.536523	.516876	.497911	.479603
19	.539053	.518281	.498269	.478990	.460419
20	.521804	.500660	.480331	.460788	.442002

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
1	.958000	.956000	.954000	.952000	.950000
2	.917764	.913936	.910116	.906304	.902500
3	.879218	.873723	.868251	.862801	.857375
4	.842291	.835279	.828311	.821387	.814506
5	.806915	.798527	.790209	.781960	.773781
6	.773024	.763392	.753859	.744426	.735092
7	.740557	.729802	.719182	.708694	.698337
8	.709454	.697691	.686099	.674677	.663420
9	.679657	.666993	.654539	.642292	.630249
10	.651111	.637645	.624430	.611462	.598737
11	.623764	.609589	.595706	.582112	.568800
12	.597566	.582767	.568304	.554170	.540360
13	.572469	.557125	.542162	.527570	.513342
14	.548425	.532611	.517222	.502247	.487675
15	.525391	.509177	.493430	.478139	.463291
16	.503325	.486773	.470732	.455188	.440127
17	.482185	.465355	.449079	.433339	.418120
18	.461933	.444879	.428421	.412539	.397214
19	.442532	.425304	.408714	.392737	.377354
20	.423946	.406591	.389913	.373886	.358486

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
1	.948000	.946000	.944000	.942000	.940000
2	.898704	.894916	.891136	.887364	.883600
3	.851971	.846591	.841232	.835897	.830584
4	.807669	.800875	.794123	.787415	.780749
5	.765670	.757627	.749652	.741745	.733904
6	.725855	.716716	.707672	.689724	.689870
7	.688111	.678013	.668042	.658198	.648478
8	.652329	.641400	.630632	.620022	.609569
9	.618408	.606765	.595317	.584061	.572995
10	.586251	.573999	.561979	.550185	.538615
11	.555766	.543003	.530508	.518275	.506298
12	.526866	.513681	.500800	.488215	.475920
13	.499469	.485942	.472755	.459898	.447365
14	.473496	.459701	.446281	.433224	.420523
15	.448875	.434878	.421289	.408097	.395292
16	.425533	.411394	.397697	.384427	.371574
17	.403405	.389179	.375426	.362131	.349280

(1) Years	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
18	.382428	.368163	.354402	.341127	.328323
19	.362542	.348282	.334555	.321342	.308624
20	.343690	.329475	.315820	.302704	.290106

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
1	.938000	.936000	.934000	.932000	.930000
2	.879844	.876096	.872356	.868624	.864900
3	.825294	.820026	.814781	.809558	.804357
4	.774125	.767544	.761005	.754508	.748052
5	.726130	.718421	.710779	.703201	.695688
6	.681110	.672442	.663867	.655383	.646990
7	.638881	.629406	.620052	.610817	.601701
8	.599270	.589124	.579129	.569282	.559582
9	.562115	.551420	.540906	.530571	.520411
10	.527264	.516129	.505206	.494492	.483982
11	.494574	.483097	.471863	.460866	.450104
12	.463910	.452179	.440720	.429527	.418596
13	.435148	.423239	.411632	.400320	.389295
14	.408169	.396152	.384465	.373098	.362044
15	.382862	.370798	.359090	.347727	.336701
16	.359125	.347067	.335390	.324082	.313132
17	.336859	.324855	.313254	.302044	.291213
18	.315974	.304064	.292579	.281505	.270828
19	.296383	.284604	.273269	.262363	.251870
20	.278008	.266389	.255233	.244522	.234239

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTEO PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
1	.928000	.926000	.924000	.922000	.920000
2	.861184	.857476	.853776	.850084	.846400
3	.799179	.794023	.788889	.783777	.778688
4	.741638	.735265	.728933	.722643	.716393
5	.688240	.680855	.673535	.666277	.659082
6	.638687	.630472	.622346	.614307	.606355
7	.592701	.583817	.575048	.566391	.557847
8	.550027	.540615	.531344	.522213	.513219
9	.510425	.500609	.490962	.481480	.472161
10	.473674	.463564	.453649	.443925	.434388
11	.439570	.429260	.419171	.409298	.399637
12	.407921	.397495	.387314	.377373	.367666
13	.378550	.368081	.357879	.347938	.338253
14	.351295	.340843	.330680	.320799	.311193
15	.326002	.315620	.305548	.295777	.286297
16	.302529	.292264	.282326	.272706	.263394
17	.280747	.270637	.260870	.251435	.242322
18	.260533	.250610	.241044	.231823	.222936
19	.241775	.232065	.222724	.213741	.205101
20	.224367	.214892	.205797	.197069	.188693

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
1	.918000	.916000	.914000	.912000	.910000
2	.842724	.839056	.835396	.831744	.828100
3	.773621	.768575	.763552	.758551	.753571
4	.710184	.704015	.697886	.691798	.685750
5	.651949	.644878	.637868	.630920	.624032
6	.598489	.590708	.583012	.575399	.567869
7	.549413	.541089	.532873	.524764	.516761
8	.504361	.495637	.487046	.478585	.470253
9	.463003	.454004	.445160	.436469	.427930
10	.425037	.415867	.406876	.398060	.389416
11	.390184	.380934	.371885	.363031	.354369
12	.358189	.348936	.339902	.331084	.322475
13	.328817	.319625	.310671	.301949	.293453
14	.301854	.292777	.283953	.275377	.267042
15	.277102	.268184	.259533	.251144	.243008
16	.254380	.245656	.237213	.229043	.221137
17	.233521	.225021	.216813	.208887	.201235
18	.214372	.206119	.198167	.190505	.183124
19	.196794	.188805	.181125	.173741	.166643
20	.180657	.172946	.165548	.158452	.151645

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	9.2%	9.4%	9.6%	9.8%	10.0%
1	.908000	.906000	.904000	.902000	.900000
2	.824464	.820836	.817216	.813604	.810000
3	.748613	.743677	.738763	.733871	.729000
4	.679741	.673772	.667842	.661951	.656100
5	.617205	.610437	.603729	.597080	.590490
6	.560422	.553056	.545771	.538566	.531441
7	.508863	.501069	.493377	.485787	.478297
8	.462048	.453968	.446013	.438180	.430467
9	.419539	.411295	.403196	.395238	.387420
10	.380942	.372634	.364489	.356505	.348678
11	.345895	.337606	.329498	.321567	.313811
12	.314073	.305871	.297866	.290054	.282430
13	.285178	.277119	.269271	.261628	.254187
14	.258942	.251070	.243421	.235989	.228768
15	.235119	.227469	.220053	.212862	.205891
16	.213488	.206087	.198928	.192001	.185302
17	.193847	.186715	.179830	.173185	.166772
18	.176013	.169164	.162567	.156213	.150095
19	.159820	.153262	.146960	.140904	.135085
20	.145117	.138856	.132852	.127096	.121577

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
1	.898000	.896000	.894000	.892000	.890000
2	.806404	.802816	.799236	.795664	.792100
3	.724151	.719323	.714517	.709732	.704969
4	.650287	.644514	.638778	.633081	.627422
5	.583958	.577484	.571068	.564708	.558406
6	.524394	.517426	.510535	.503720	.496981

(1) Years	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
7	.470906	.463613	.456418	.448318	.442313
8	.422874	.415398	.408038	.400792	.393659
9	.379741	.372196	.364786	.357506	.350356
10	.341007	.333488	.326118	.318896	.311817
11	.306224	.298805	.291550	.284455	.277517
12	.274989	.267729	.260645	.253734	.246990
13	.246941	.239886	.233017	.226331	.219821
14	.221753	.214937	.208317	.201887	.195841
15	.199134	.192584	.186236	.180083	.174121
16	.178822	.172555	.166495	.160634	.154967
17	.160582	.154609	.148846	.143286	.137921
18	.144203	.138530	.133069	.127811	.122750
19	.129494	.124123	.118963	.114007	.109247
20	.116286	.111214	.106353	.101694	.097230

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
1	.888000	.886000	.884000	.882000	.880000
2	.788544	.784996	.781456	.777924	.774400
3	.700227	.695506	.690807	.686129	.681472
4	.621802	.616219	.610673	.605166	.599695
5	.552160	.545970	.539835	.533756	.527732
6	.490318	.483729	.477214	.470773	.464404
7	.435402	.428584	.421858	.415222	.408676
8	.386637	.379726	.372922	.366226	.359635
9	.343334	.336437	.329663	.323011	.316478
10	.304881	.298083	.291422	.284896	.278501
11	.270734	.264102	.257617	.251278	.245081
12	.240412	.233994	.227734	.221627	.215671
13	.213486	.207319	.201317	.195475	.189791
14	.189575	.183684	.177964	.172409	.167016
15	.168343	.162744	.157320	.152065	.146974
16	.149488	.144191	.139071	.134121	.129337
17	.132746	.127754	.122939	.118295	.113817
18	.117878	.113190	.108678	.104336	.100159
19	.104676	.100286	.096071	.092024	.088140
20	.092952	.088853	.084927	.081166	.077563

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
1	.878000	.876000	.874000	.872000	.870000
2	.770884	.767376	.763876	.760384	.756900
3	.676836	.672221	.667628	.663055	.658503
4	.594262	.588866	.583507	.578184	.572898
5	.521762	.515847	.509985	.504176	.498421
6	.458107	.451882	.445727	.439642	.433626
7	.402218	.395848	.389565	.383368	.377255
8	.353147	.346763	.340480	.334297	.328212
9	.310063	.303764	.297579	.291507	.285544
10	.272236	.266098	.260084	.254194	.248423
11	.239023	.233102	.227314	.221657	.216128
12	.209862	.204197	.198672	.193285	.188032
13	.184259	.178877	.173640	.168544	.163588
14	.161779	.156696	.151761	.146971	.142321
15	.142042	.137266	.132639	.128158	.123819
16	.124713	.120245	.115927	.111754	.107723
17	.109498	.105334	.101320	.097450	.093719
18	.096139	.092273	.088554	.084976	.081535
19	.084410	.080831	.077396	.074099	.070936
20	.074112	.070808	.067644	.064614	.061714

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
1	.868000	.866000	.864000	.862000	.860000
2	.753424	.749956	.746496	.743044	.739600
3	.653972	.649462	.644973	.640504	.636056
4	.567648	.562434	.557256	.552114	.547008
5	.492718	.487068	.481469	.475923	.470427
6	.427679	.421801	.415990	.410245	.404567
7	.371226	.365279	.359415	.353631	.347928
8	.322224	.316332	.310535	.304830	.299218
9	.279690	.274944	.268302	.262764	.257327
10	.242771	.237235	.231813	.226502	.221302
11	.210725	.205446	.200286	.195245	.190319
12	.182910	.177916	.173047	.168301	.163675
13	.158766	.154075	149513	.145076	.140760
14	.137809	.133429	.129179	.125055	.121054
15	.119618	.115550	.111611	.107798	.104106
16	.103828	.100066	.096432	.092922	.089531
17	.090123	.086657	.083317	.080098	.076997
18	.078227	.075045	.071986	.069045	.066217
19	.067901	.064989	.062196	.059517	.056947
20	.058938	.056280	.053737	.051303	.048974

TABLE D.—TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

	(1) Years				
(2) Adjusted payout rate	14.2%	14.4%	14.6%	14.8%	15.0%
1	.858000	.856000	.854000	.852000	.850000
2	.736164	.732736	.729316	.725904	.722500
3	.631629	.627222	.622836	.618470	.614125
4	.541937	.536902	.531902	.526937	.522006
5	.464982	.459588	.454244	.448950	.443705
6	.398955	.393407	.387925	.382505	.377150
7	.342303	.336757	.331288	.325895	.320577
8	.293696	.288264	.282920	.277662	.274291
9	.251991	.246754	.241613	.236568	.231617
10	.216209	.211221	.206338	.201556	.196874
11	.185507	.180805	.176212	.171726	.167343
12	.159165	.154769	.150485	.146310	.142242
13	.136564	.132483	.128515	.124656	.120905
14	.117172	.113405	.109751	.106207	.102770
15	.100533	.097075	.093728	.090489	.087354
16	.086257	.083096	.080043	.077096	.074251
17	.074009	.071130	.068357	.065686	.063113
18	.063500	.060887	.058377	.055965	.053646
19	.054483	.052120	.049854	.047682	.045599
20	.046746	.044614	.042575	.040625	.038760

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN

(1) Age	(2) Adjusted payout rate				
	2.2%	2.4%	2.6%	2.8%	3.0%
0	.23253	.20635	.18364	.16394	.14683
1	.22196	.19506	.17170	.15139	.13372
2	.22597	.19884	.17523	.15468	.13676
3	.23039	.20304	.17920	.15840	.14024
4	.23503	.20747	.18340	.16237	.14397
5	.23988	.21211	.18783	.16656	.14793
6	.24489	.21693	.19243	.17094	.15207
7	.25004	.22189	.19718	.17546	.15637
8	.25534	.22701	.20209	.18016	.16084
9	.26080	.23230	.20718	.18503	.16549
10	.26640	.23774	.21243	.19006	.17031
11	.27217	.24335	.21786	.19530	.17532
12	.27807	.24911	.22344	.20068	.18049
13	.28407	.25497	.22913	.20618	.18579
14	.29013	.26089	.23489	.21175	.19115
15	.29621	.26684	.24067	.21735	.19655
16	.30229	.27279	.24647	.22296	.20196
17	.30838	.27876	.25228	.22859	.20739
18	.31451	.28477	.25813	.23427	.21287
19	.32070	.29085	.26407	.24003	.21844
20	.32699	.29704	.27012	.24591	.22413
21	.33339	.30335	.27629	.25192	.22996
22	.33991	.30977	.28259	.25807	.23592
23	.34655	.31634	.28904	.26437	.24205
24	.35334	.32306	.29566	.27085	.24836
25	.36031	.32998	.30248	.27754	.25490
26	.36746	.33710	.30952	.28446	.26167
27	.37481	.34443	.31678	.29161	.26869
28	.38236	.35197	.32427	.29901	.27596
29	.39006	.35968	.33194	.30660	.28344
30	.39793	.36757	.33980	.31439	.29113
31	.40594	.37561	.34783	.32237	.29902
32	.41410	.38383	.35605	.33054	.30711
33	.42240	.39220	.36444	.33890	.31541
34	.43084	.40072	.37299	.34744	.32389
35	.43942	.40941	.38172	.35617	.33258
36	.44813	.41824	.39061	.36508	.34146
37	.45696	.42720	.39966	.37416	.35053
38	.46591	.43630	.40885	.38339	.35977
39	.47496	.44552	.41818	.39278	.36917
40	.48412	.45486	.42765	.40232	.37875
41	.49338	.46432	.43725	.41201	.38849
42	.50275	.47391	.44700	.42187	.39840
43	.51221	.48360	.45686	.43186	.40847
44	.52175	.49340	.46685	.44199	.41870
45	.53136	.50327	.47693	.45223	.42905
46	.54104	.51323	.48712	.46259	.43953
47	.55077	.52327	.49739	.47305	.45013
48	.56058	.53339	.50777	.48363	.46087
49	.57043	.54358	.51823	.49432	.47173
50	.58035	.55384	.52879	.50510	.48271
51	.59029	.56415	.53940	.51597	.49379
52	.60027	.57450	.55008	.52692	.50496
53	.61026	.58488	.56080	.53793	.51620
54	.62025	.59528	.57154	.54897	.52750
55	.63022	.60567	.58230	.56004	.53884
56	.64018	.61606	.59306	.57113	.55021
57	.65012	.62644	.60384	.58225	.56163
58	.66004	.63681	.61461	.59337	.57306
59	.66993	.64717	.62538	.60452	.58453
60	.67979	.65751	.63615	.61567	.59602
61	.68963	.66784	.64692	.62683	.60754
62	.69944	.67815	.65769	.63801	.61908
63	.70922	.68844	.66843	.64918	.63063
64	.71893	.69868	.67915	.66032	.64217
65	.72859	.70886	.68982	.67144	.65369
66	.73817	.71897	.70043	.68250	.66517
67	.74766	.72901	.71096	.69350	.67660
68	.75706	.73896	.72142	.70443	.68796
69	.76637	.74882	.73181	.71530	.69928
70	.77559	.75861	.74212	.72610	.71053
71	.78475	.76833	.75237	1.73685	1.72176
72	.79383	.77799	.76257	.74756	.73294
73	.80279	.78753	.77266	.75816	.74403
74	.81158	.79689	.78256	.76858	.75494
75	.82013	.80602	.79223	.77876	.76561
76	.82844	.81488	.80163	.78867	.77599
77	.83648	.82347	.81075	.79829	.78609
78	.84428	.83182	.81961	.80764	.79592
79	.85187	.83994	.82824	.81677	.80552
80	.85927	.84787	.83668	.82569	.81491
81	.86645	.85556	.84487	.83437	.82404
82	.87336	.86299	.85278	.84275	.83288
83	.88003	.87014	.86042	.85084	.84142
84	.88648	.87708	.86782	.85870	.84971
85	.89273	.88381	.87501	.86633	.85778
86	.89868	89021	.88185	.87360	.86547
87	.90417	.89613	.88818	.88034	.87260
88	.90923	.90158	.89402	.88655	.87917
89	.91396	.90668	.89948	.89237	.88533
90	.91849	.91156	.90471	.89794	.89124
91	.92278	.91620	.90968	.90324	.89686
92	.92673	.92046	.91426	.90812	.90204
93	.93027	.92429	.91837	.91251	.90670
94	.93341	.92768	.92201	.91639	.91082
95	.93612	.93062	.92516	.91976	.91440
96	.93841	.93309	.92782	.92259	.91740
97	.94044	.93529	.93018	.92512	.92009
98	.94223	.93723	.93226	.92733	.92244
99	.94392	.93905	.93421	.92942	.92466
100	.94559	.94086	.93615	.93149	.92685
101	.94709	.94248	.93790	.93334	.92882
102	.94873	.94424	.93979	.93536	.93096
103	.95077	.94645	.94216	.93789	.93365
104	.95278	.94862	.94449	.94037	.93628
105	.95570	.95178	.94787	.94399	.94012
106	.96017	.95662	.95309	.94957	.94607
107	.96616	.96313	.96010	.95709	.95408
108	.97515	.97291	.97067	.96843	.96620
109	.98900	.98800	.98700	.98600	.98500

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
0	.13196	.11901	.10774	.09791	.08933
1	.11834	.10493	.09324	.08303	.07410
2	.12113	.10749	.09557	.08514	.07601
3	.12437	.11050	.09835	.08770	.07837
4	.12787	.11376	.10138	.09052	.08098
5	.13159	.11725	.10465	.09357	.08382
6	.13549	.12092	.10810	.09680	.08684
7	.13956	.12476	.11171	.10019	.09002
8	.14380	.12877	.11549	.10376	.09337
9	.14822	.13296	.11946	.10751	.09691
10	.15282	.13734	.12361	.11144	.10063
11	.15761	.14190	.12795	.11556	.10454
12	.16257	.14663	.13247	.11986	.10863
13	.16764	.15149	.13711	.12428	.12283

(1) Years	(2) Adjusted payout rate				
	3.2%	3.4%	3.6%	3.8%	4.0%
14	.17279	.15643	.14182	.12878	.11712
15	.17798	.16140	.14657	.13331	.12143
16	.18318	.16638	.15133	.13785	.12576
17	.18840	.17138	.15611	.14241	.13010
18	.19367	.17643	.16094	.14702	.13449
19	.19903	.18157	.16586	.15172	.13897
20	.20452	.18685	.17092	.15655	.14358
21	.21014	.19226	.17612	.16153	.14833
22	.21591	.19783	.18146	.16665	.15324
23	.22185	.20356	.18698	.17195	.15832
24	.22798	.20949	.19270	.17746	.16361
25	.23434	.21565	.19866	.18321	.16914
26	.24094	.22207	.20489	.18922	.17494
27	.24780	.22875	.21138	.19551	.18102
28	.25492	.23570	.21814	.20208	.18739
29	.26226	.24288	.22514	.20889	.19400
30	.26982	.25029	.23239	.21596	.20088
31	.27759	.25792	.23985	.22324	.20798
32	.28557	.26577	.24755	.23078	.21533
33	.29377	.27385	.25548	.23855	.22293
34	.30217	.28214	.26364	.24656	.23077
35	.31079	.29065	.27203	.25481	.23887
36	.31961	.29939	.28065	.26330	.24721
37	.32863	.30833	.28950	.27202	.25579
38	.33784	.31747	.29855	.28096	.26460
39	.34722	.32680	.30780	.29011	.27363
40	.35679	.33633	.31727	.29948	.28290
41	.36654	.34606	.32693	.30908	.29239
42	.37648	.35599	.33683	.31890	.30213
43	.38659	.36610	.34691	.32894	.31209
44	.39687	.37640	.35720	.33918	.32227
45	.40728	.38685	.36765	.34961	.33265
46	.41785	.39746	.37828	.36023	.34323
47	.42856	.40823	.38908	.37103	.35400
48	.43941	.41917	.40006	.38202	.36499
49	.45040	.43025	.41121	.39320	.37617
50	.46153	.44149	.42252	.40457	.38756
51	.47277	.45286	.43398	.41609	.39911
52	.48412	.46435	.44558	.42776	.41084
53	.49556	.47595	.45731	.43958	.42272
54	.50707	.48763	.46913	.45151	.43473
55	.51864	.49939	.48104	.46354	.44685
56	.53026	.51121	.49303	.47567	.45908
57	.54192	.52310	.50510	.48789	.47143
58	.55363	.53503	.51723	.50019	.48387
59	.56538	.54703	.52945	.51258	.49642
60	.57717	.55909	.54173	.52506	.50906
61	.58901	.57120	.55408	.53763	.52181
62	.60087	.58336	.56650	.55028	.53466
63	.61277	.59556	.57898	.56300	.54760
64	.62467	.60778	.59149	.57577	.56060
65	.63655	.62000	.60402	.58857	.57365
66	.64842	.63221	.61654	.60139	.58672
67	.66023	.64439	.62905	.61420	.59980
68	.67200	.65653	.64154	.62699	.61289
69	.68373	.66865	.65400	.63978	.62598
70	.69541	.68072	.66645	.65257	.63908
71	.70708	.69279	.67890	.66538	.65222
72	.71870	.70484	.69134	.67819	.66538
73	.73025	.71682	.70372	.69095	.67850
74	.74163	.72863	.71595	.70356	.69147
75	.75275	.74019	.72792	.71593	.70421
76	.76360	.75147	.73962	.72802	.71667
77	.77415	.76246	.75102	.73981	.72883
78	.78443	.77318	.76214	.75133	.74073
79	.79448	.78365	.77303	.76261	.75238
80	.80432	.79392	.78371	.77369	.76384
81	.81390	.80393	.79413	.78450	.77504
82	.82317	.81362	.80423	.79499	.78590
83	.83214	.82301	.81402	.80517	.79645
84	.84086	.83214	.82355	.81508	.80674
85	.84935	.84104	.83284	.82476	.81679
86	.85745	.84953	.84172	.83401	.82640
87	.86496	.85741	.84996	.84260	.83533
88	.87189	.86468	.85757	.85054	.84359
89	.87838	.87150	.86471	.85799	.85135
90	.88461	.87806	.87157	.86516	.85881
91	.89055	.88430	.87812	.87200	.86594
92	.89602	.89006	.88416	.87831	.87252
93	.90094	.89524	.88959	.88400	.87846
94	.90530	.89983	.89441	.88904	.88372
95	.90908	.90381	.89359	.89341	.88828
96	.91226	.90716	.90211	.89709	.89212
97	.91510	.91015	.90525	.90038	.89555
98	.91759	.91277	.90800	.90326	.89855
99	.91993	.91524	.91058	.90596	.90137
100	.92225	.91768	.91315	.90865	.90417
101	.92433	.91987	.91544	.91104	.90667
102	.92659	.92225	.91793	.91364	.90938
103	.92943	.92524	.92107	.91692	.91280
104	.93221	.92816	.92413	.92012	.91614
105	.93627	.93244	.92863	.92483	.92105
106	.94257	.93909	.93562	.93217	.92872
107	.95107	.94808	.94509	.94211	.93914
108	.96396	.96173	.95950	.95728	.95505
109	.98400	.98300	.98200	.98100	.98000

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
0	.08183	.07527	.06952	.06448	.06005
1	.06629	.05945	.05344	.04817	.04354
2	.06801	.06098	.05481	.04939	.04460
3	.07017	.06297	.05663	.05104	.04611
4	.07259	.06520	.05868	.05294	.04786
5	.07523	.06765	.06096	.05505	.04982
6	.07805	.07029	.06342	.05734	.05195
7	.08103	.07307	.06603	.05978	.05423
8	.08418	.07603	.06880	.06238	.05666
9	.08752	.07917	.07175	.06516	.05928
10	.09103	.08249	.07488	.06811	.06206
11	.09473	.08600	.07820	.07125	.06503
12	.09861	.08968	.08169	.07456	.06817
13	.10261	.09348	.08530	.07799	.07142
14	.10669	.09735	.08899	.08148	.07474
15	.11080	.10126	.09269	.08500	.07808
16	.11491	.10516	.09640	.08852	.08142
17	.11903	.10908	.10012	.09204	.08475
18	.12321	.11304	.10387	.09560	.08812
19	.12747	.11709	.10771	.09923	.09156
20	.13186	.12126	.11168	.10300	.09513
21	.13639	.12558	.11578	.10690	.09883
22	.14108	.13005	.12004	.11094	.10268
23	.14594	.13469	.12446	.11516	.10669
24	.15101	.13954	.12910	.11958	.11091
25	.15632	.14464	.13398	.12426	.11537
26	.16191	.15001	.13914	.12920	.12011
27	.16778	.15567	.14459	.13444	.12514
28	.17394	.16162	.15032	.13997	.13046
29	.18035	.16782	.15632	.14575	.13604
30	.18702	.17429	.16259	.15181	.14189
31	.19393	.18100	.16909	.15811	.14799
32	.20109	.18797	.17586	.16468	.15436
33	.20851	.19520	.18290	.17152	.16100

(1) Age	(2) Adjusted payout rate				
	4.2%	4.4%	4.6%	4.8%	5.0%
34	.21618	.20268	.19018	.17861	.16789
35	.22411	.21043	.19775	.18599	.17508
36	.23228	.21844	.20558	.19363	.18253
37	.24071	.22670	.21367	.20154	.19026
38	.24938	.23521	.22201	.20971	.19825
39	.25827	.24396	.23060	.21814	.20650
40	.26741	.25295	.23945	.22682	.21502
41	.27679	.26220	.24855	.23577	.22381
42	.28642	.27172	.25793	.24501	.23289
43	.29629	.28147	.26756	.25450	.24224
44	.30639	.29147	.27745	.26426	.25186
45	.31669	.30169	.28756	.27426	.26173
46	.32722	.31213	.29791	.28450	.27185
47	.33795	.32280	.30849	.29498	.28222
48	.34890	.33370	.31932	.30573	.29287
49	.36007	.34482	.33039	.31672	.30377
50	.37144	.35617	.34170	.32797	.31494
51	.38301	.36773	.35322	.33944	.32635
52	.39476	.37948	.36495	.35113	.33799
53	.40668	.39141	.37688	.36304	.34986
54	.41874	.40350	.38897	.37512	.36191
55	.43093	.41574	.40123	.38739	.37416
56	.44324	.42811	.41364	.39980	.38657
57	.45568	.44062	.42620	.41240	.39918
58	.46823	.45325	.43890	.42514	.41194
59	.48091	.46603	.45175	.43805	.42489
60	.49370	.47893	.46475	.45112	.43802
61	.50661	.49198	.47790	.46436	.45133
62	.51963	.50515	.49120	.47776	.46481
63	.53275	.51844	.50463	.49131	.47846
64	.54596	.53182	.51817	.50498	.49225
65	.55922	.54528	.53180	.51877	.50616
66	.57253	.55880	.54551	.53264	.52018
67	.58586	.57235	.55926	.54657	.53427
68	.59921	.58594	.57306	.56057	.54845
69	.61258	.59956	.58692	.57463	.56270
70	.62597	.61322	.60082	.58877	.57704
71	.63941	.62695	.61481	.60300	.59149
72	.65289	.64073	.62887	.61731	.60605
73	.66635	.65449	.64293	.63165	.62064
74	.67976	.66814	.65688	.64588	.63514
75	.69275	.68156	.67061	.65990	.64944
76	.70557	.69470	.68407	.67368	.66348
77	.71809	.70756	.69724	.68714	.67724
78	.73033	.72014	.71015	.70036	.69075
79	.74235	.73251	.72284	.71336	.70405
80	.75417	.74468	.73535	.72619	.71718
81	.76573	.75659	.74759	.73875	.73006
82	.77696	.76816	.75951	.75099	.74261
83	.78787	.77942	.77110	.76291	.75484
84	.79852	.79042	.78243	.77457	.76681
85	.80893	.80118	.79353	.78599	.77858
86	.81889	.81148	.80417	.79695	.78983
87	.82816	.82107	.81408	.80716	.80034
88	.83673	.82994	.82324	.81662	.81007
89	.84478	.83829	.83186	.82551	.81923
90	.85253	.84632	.84018	.83410	.82808
91	.85994	.85401	.84813	.84232	.83656
92	.86679	.86111	.85549	.84993	.84441
93	.87296	.86752	.86213	.85679	.85150
94	.87844	.87321	.86803	.86289	.85780
95	.88319	.87815	.87314	.86818	.86327
96	.88719	.88230	.87745	.87264	.86787
97	.89076	.88601	.88129	.87661	.87197
98	.89388	.88925	.88465	.88009	.87556
99	.89682	.89230	.88781	.88336	.87894
100	.89973	.89533	.89095	.88660	.88228
101	.90233	.89802	.89374	.88948	.88526
102	.90515	.90094	.89676	.89260	.88848
103	.90871	.90464	.90059	.89656	.89256
104	.91217	.90823	.90431	.90040	.89652
105	.91729	.91354	.90981	.90610	.90240
106	.92529	.92187	.91846	.91507	.91169
107	.93617	.93322	.93027	.92732	.92439
108	.95283	.95062	.94840	.94619	.94398
109	.97900	.97800	.97700	.97600	.97500

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
0	.05615	.05272	.04969	.04701	.04464
1	.03945	.03585	.03268	.02986	.02737
2	.04039	.03667	.03337	.03046	.02787
3	.04176	.03791	.03450	.03147	.02879
4	.04336	.03938	.03585	.03272	.02993
5	.04518	.04107	.03741	.03416	.03127
6	.04717	.04292	.03914	.03577	.03276
7	.04929	.04490	.04099	.03750	.03438
8	.05158	.04704	.04300	.03938	.03615
9	.05404	.04936	.04518	.04143	.03808
10	.05666	.05183	.04751	.04364	.04016
11	.05947	.05449	.05003	.04602	.04242
12	.06245	.05731	.05271	.04856	.04484
13	.06554	.06025	.05549	.05121	.04735
14	.06869	.06324	.05834	.05391	.04992
15	.07186	.06625	.06119	.05662	.05250
16	.07502	.06924	.06403	.05931	.05504
17	.07817	.07223	.06685	.06199	.05757
18	.08136	.07524	.06970	.06468	.06012
19	.08462	.07832	.07261	.06743	.06272
20	.08800	.08152	.07564	.07029	.06542
21	.09151	.08485	.07879	.07327	.06824
22	.09516	.08831	.08207	.07638	.07119
23	.09897	.09193	.08551	.07964	.07428
24	.10299	.09576	.08915	.08310	.07756
25	.10725	.09982	.09302	.08679	.08108
26	.11179	.10416	.09717	.09075	.08486
27	.11661	.10878	.10160	.09500	.08892
28	.12173	.11370	.10632	.09953	.09328
29	.12710	.11888	.11130	.10432	.09788
30	.13276	.12433	.11656	.10938	.10276
31	.13865	.13002	.12205	.11469	.10787
32	.14482	.13599	.12783	.12026	.11326
33	.15126	.14223	.13387	.12612	.11892
34	.15796	.14874	.14018	.13223	.12485
35	.16494	.15553	.14678	.13864	.13107
36	.17221	.16260	.15366	.14533	.13757
37	.17975	.16996	.16082	.15231	.14435
38	.18756	.17758	.16826	.15955	.15142
39	.19563	.18547	.17597	.16708	.15875
40	.20397	.19364	.18395	.17488	.16638
41	.21259	.20209	.19223	.18298	.17430
42	.22152	.21084	.20082	.19140	.18254
43	.23071	.21988	.20969	.20010	.19107
44	.24019	.22920	.21885	.20910	.19991
45	.24992	.23878	.22828	.21837	.20902
46	.25991	.24864	.23799	.22793	.21842
47	.27016	.25876	.24798	.23777	.22812
48	.28070	.26918	.25826	.24792	.23812
49	.29150	.27987	.26883	.25837	.24843
50	.30258	.29084	.27970	.26911	.25905
51	.31391	.30208	.29084	.28014	.26996
52	.32548	.31358	.30224	.29144	.28115

(1) Age	(2) Adjusted payout rate				
	5.2%	5.4%	5.6%	5.8%	6.0%
53	.33729	.32532	.31390	.30302	.29263
54	.34931	.33728	.32579	.31482	.30434
55	.36152	.34945	.33790	.32686	.31631
56	.37392	.36181	.35022	.33912	.32850
57	.38652	.37438	.36276	.35162	.34093
58	.39929	.38715	.37550	.36432	.35359
59	.41226	.40013	.38847	.37727	.36650
60	.42542	.41331	.40165	.39044	.37965
61	.43878	.42670	.41506	.40386	.39306
62	.45233	.44029	.42869	.41750	.40671
63	.46606	.45409	.44253	.43138	.42060
64	.47994	.46805	.45656	.44545	.43471
65	.49397	.48217	.47076	.45971	.44902
66	.50811	.49642	.48510	.47413	.46350
67	.52235	.51079	.49957	.48869	.47814
68	.53668	.52525	.51416	.50339	.49293
69	.55110	.53983	.52888	.51823	.50788
70	.56563	.55453	.54373	.53322	.52299
71	.58029	.56938	.55875	.54839	.53830
72	.59507	.58436	.57392	.56374	.55380
73	.60990	.59941	.58917	.57918	.56942
74	.62465	.61439	.60437	.59458	.58502
75	.63920	.62919	.61940	.60983	.60046
76	.65351	.64375	.63419	.62484	.61568
77	.66755	.65804	.64873	.63961	.63066
78	.68133	.67209	.66303	.65414	.64542
79	.69492	.68595	.67714	.66850	.66001
80	.70834	.69965	.69111	.68272	.67448
81	.72151	.71311	.70484	.69671	.68872
82	.73436	.72624	.71825	.71039	.70265
83	.74689	.73906	.73135	.72376	.71627
84	.75917	.75163	.74421	.73688	.72967
85	.77122	.76398	.75685	.74980	.74286
86	.78280	.77586	.76901	.76224	.75556
87	.79359	.78693	.78036	.77386	.76744
88	.80360	.79720	.79088	.78463	.77846
89	.81302	.80688	.80081	.79480	.78886
90	.82213	.81624	.81041	.80465	.79894
91	.83086	.82522	.81963	.81410	.80862
92	.83895	.83354	.82818	.82287	.81762
93	.84626	.84106	.83591	.83081	.82575
94	.85275	.84774	.84278	.83787	.83299
95	.85839	.85355	.84876	.84400	.83929
96	.86313	.85844	.85378	.84916	.84458
97	.86737	.86280	.85826	.85377	.84930
98	.87107	.86661	.86218	.85779	.85343
99	.87455	.87019	.86586	.86157	.85730
100	.87800	.87374	.86951	.86532	.86115
101	.88106	.87689	.87275	.86863	.86455
102	.88437	.88030	.87625	.87222	.86822
103	.88858	.88463	.88070	.87679	.87290
104	.89266	.88882	.88500	.88120	.87741
105	.89872	.89506	.89141	.88778	.88417
106	.90832	.90496	.90161	.89828	.89496
107	.92146	.91854	.91562	.91271	.90981
108	.94177	.93956	.93736	.93516	.93296
109	.97400	.97300	.97200	.97100	.97000

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted Payout Rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
0	.04253	.04066	.03899	.03751	.03618
1	.02516	.02320	.02145	.01989	.01850
2	.02557	.02353	.02171	.02008	.01862
3	.02640	.02427	.02237	.02067	.01915
4	.02744	.02523	.02325	.02147	.01988
5	.02868	.02638	.02431	.02246	.02080
6	.03008	.02767	.02552	.02359	.02185
7	.03159	.02909	.02685	.02483	.02302
8	.03325	.03065	.02831	.02621	.02432
9	.03507	.03236	.02993	.02774	.02576
10	.03704	.03423	.03170	.02941	.02735
11	.03918	.03626	.03363	.03125	.02910
12	.04148	.03845	.03571	.03323	.03099
13	.04387	.04073	.03788	.03531	.03297
14	.04632	.04305	.04010	.03742	.03499
15	.04876	.04538	.04231	.03953	.03699
16	.05118	.04767	.04449	.04159	.03896
17	.05357	.04994	.04663	.04362	.04088
18	.05598	.05221	.04878	.04565	.04280
19	.05843	.05453	.05097	.04772	.04476
20	.06099	.05694	.05325	.04988	.04679
21	.06365	.05946	.05564	.05213	.04893
22	.06644	.06210	.05813	.05449	.05116
23	.06937	.06488	.06076	.05699	.05352
24	.07249	.06784	.06357	.05965	.05605
25	.07584	.07103	.06660	.06254	.05879
26	.07945	.07447	.06989	.06567	.06178
27	.08334	.07819	.07345	.06907	.06503
28	.08751	.08219	.07729	.07275	.06856
29	.09194	.08645	.98137	.07667	.07233
30	.09563	.09096	.08572	.08088	.07635
31	.10156	.09572	.09030	.08527	.08060
32	.10677	.10074	.09515	.08995	.08512
33	.11224	.10604	.10027	.09490	.08990
34	.11798	.11159	.10564	.10010	.09494
35	.12401	.11744	.11131	.10580	.10026
36	.13033	.12357	.11727	.11137	.10586
37	.13693	.12999	.12350	.11743	.11175
38	.14380	.13668	.13002	.12377	.11791
39	.15096	.14366	.13681	.13038	.12436
40	.15841	.15092	.14390	.13729	.13109
41	.16615	.15848	.15128	.14450	.13812
42	.17421	.16637	.15899	.15204	.14549
43	.18257	.17456	.16700	.15988	.15316
44	.19124	.18306	.17533	.16804	.16115
45	.20018	.19184	.18395	.17649	.16943
46	.20943	.20092	.19287	.18524	.17802
47	.21897	.21030	.20209	.19431	.18692
48	.22883	.22001	.21165	.20371	.19616
49	.23900	.23004	.22152	.21343	.20573
50	.24948	.24039	.23173	.22349	.21565
51	.26027	.25104	.24225	.23387	.22589
52	.27135	.26200	.25308	.24457	.23645
53	.28271	.27325	.26421	.25558	.24733
54	.29433	.28476	.27561	.26686	.25848
55	.30621	.29654	.28728	.27842	.26993
56	.31832	.30856	.29921	.29025	.28165
57	.33068	.32085	.31142	.30236	.29367
58	.34329	.33339	.32388	.31474	.30595
59	.35615	.34620	.33662	.32741	.31855
60	.36927	.35927	.34964	.34037	.33143
61	.38265	.37262	.36295	.35362	.34463
62	.39630	.38625	.37655	.36718	.35814
63	.41020	.40014	.39043	.38104	.37196
64	.42432	.41428	.40456	.39516	.38606
65	.43866	.42864	.41893	.40953	.40042
66	.45320	.44321	.43353	.42414	.41503
67	.46790	.45796	.44832	.43896	.42967
68	.48277	.47289	.46330	.45398	.44492
69	.49781	.48802	.47849	.46923	.46021
70	.51303	.50333	.49389	.48470	.47574

(1) Age	(2) Adjusted Payout Rate				
	6.2%	6.4%	6.6%	6.8%	7.0%
71	.52847	.51888	.50954	.50044	.49156
72	.54412	.53466	.52544	.51644	.50766
73	.55990	.55059	.54151	.52363	.52396
74	.57566	.56652	.55758	.54885	.54030
75	.59129	.58232	.57354	.56496	.55655
76	.60671	.59792	.58932	.58089	.57263
77	.62189	.61330	.60487	.59661	.58851
78	.63687	.62847	.62024	.61215	.60422
79	.65168	.64349	.63546	.62756	.61981
80	.66637	.65841	.65058	.64289	.63532
81	.68085	.67312	.66551	.65802	.65066
82	.69503	.68753	.68014	.67287	.66571
83	.70890	.70164	.69448	.68743	.68048
84	.72255	.71553	.70661	.70179	.69506
85	.73600	.72924	.72257	.71598	.70948
86	.74897	.7446	.73693	.72969	.72342
87	.76109	.75483	.74864	.74252	.73647
88	.77235	.76631	.76035	.75445	.74862
89	.78298	.77717	.77142	.76573	.76011
90	.79329	.78770	.78217	.77669	.77127
91	.80320	.79783	.79252	.78725	.78204
92	.81241	.80725	.80214	.79708	.79206
93	.82074	.81578	.81086	.80598	.80115
94	.82816	.82337	.81862	.81391	.80924
95	.83461	.82997	.82537	.82081	.81629
96	.84003	.83552	.82105	.82661	.82221
97	.84487	.84048	.83612	.82179	.82750
98	.84910	.84481	.84054	.83631	.83211
99	.85307	.84887	.84469	.84055	.83644
100	.85701	.85290	.84882	.84476	.84073
101	.86049	.85645	.85244	.84846	.84451
102	.86424	.86029	.85637	.85247	.84859
103	.86904	.86520	.86138	.85758	.85381
104	.87365	.86991	.86619	.86249	.85880
105	.88058	.87700	.87343	.86988	.86635
106	.89165	.88835	.88506	.88179	.87852
107	.90692	.90404	.90116	.89829	.89542
108	.93077	.92858	.92639	.92420	.92201
109	.96900	.96800	.96700	.96600	.96500

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
0	.03499	.03392	.03296	.03209	.03130
1	.01725	.01613	.01513	.01422	.01340
2	.01732	.01615	.01509	.01414	.01329
3	.01778	.01656	.01545	.01446	.01356
4	.01846	.01717	.01601	.01497	.01402
5	.01930	.01796	.01674	.01574	.01465
6	.02029	.01888	.01761	.01645	.01541
7	.02138	.01991	.01857	.01736	.01627
8	.02261	.02106	.01966	.01839	.01724
9	.02397	.02236	.02089	.01956	.01835
10	.02548	.02379	.02225	.02086	.01959
11	.02715	.02538	.02377	.02231	.02098
12	.02895	.02710	.02542	.02389	.02250
13	.03085	.02892	.02716	.02556	.02410
14	.03278	.03076	.02893	.02725	.02572
15	.03469	.03259	.03067	.02892	.02732
16	.03656	.03437	.03237	.03054	.02886
17	.03938	.03610	.03401	.03210	.03035
18	.04020	.03782	.03564	.03364	.03181
19	.04204	.03956	.03729	.03520	.03328
20	.04397	.04138	.03901	.03683	.03483
21	.04599	.04329	.04081	.03853	.03644
22	.04810	.04529	.04270	.04032	.03813
23	.05033	.04740	.04470	.04222	.03992
24	.05273	.04968	.04686	.04427	.04187
25	.05534	.05216	.04922	.04651	.04400
26	.05819	.05488	.05182	.04898	.04636
27	.06130	.05785	.05466	.05170	.04896
28	.06468	.06109	.05777	.05468	.05182
29	.06830	.06457	.06110	.05789	.05490
30	.07217	.06829	.06469	.06134	.05822
31	.07627	.07224	.06849	.06500	.06174
32	.08062	.07644	.07254	.06891	.06552
33	.08524	.08090	.07686	.07308	.06955
34	.09012	.08562	.08142	.07749	.07382
35	.09528	.09062	.08626	.08218	.07836
36	.10071	.09589	.09137	.08714	.08317
37	.10643	.10144	.09676	.09237	.08825
38	.11242	.10727	.10243	.09788	.09361
39	.11869	.11337	.10837	.10366	.09923
40	.12526	.11977	.11460	.10973	.10514
41	.13212	.12646	.12113	.11609	.11135
42	.13931	.13349	.12799	.12279	.11789
43	.14681	.14082	.13515	.12980	.12473
44	.15463	.14847	.14264	.13712	.13189
45	.16274	.15642	.15042	.14474	.13935
46	.17117	.16468	.15853	.15268	.14713
47	.17991	.17326	.16694	.16094	.15523
48	.18900	.18219	.17571	.16955	.16368
49	.19841	.19145	.18481	.17850	.17248
50	.20818	.20106	.19428	.18781	.18163
51	.21827	.21101	.20407	.19745	.19113
52	.22869	.22129	.21421	.20745	.20098
53	.23944	.23190	.22468	.21778	.21117
54	.25047	.24280	.23545	.22841	.22167
55	.26180	.25400	.24653	.23936	.23249
56	.27341	.26550	.25790	.25061	.24361
57	.28532	.27729	.26959	.26218	.25505
58	.29751	.28938	.28157	.27405	.26681
59	.31001	.30180	.29388	.28626	.27892
60	.32282	.31452	.30652	.29880	.29136
61	.33595	.32758	.31950	.31169	.30416
62	.34941	.34097	.33282	.32494	.31733
63	.36318	.35469	.34648	.33854	.33085
64	.37725	.36872	.36046	.35246	.34472
65	.39159	.38304	.37474	.36670	.35891
66	.40620	.39763	.38931	.38124	.37340
67	.42104	.41247	.40414	.39605	.38819
68	.43611	.42755	.41923	.41113	.40326
69	.45144	.44290	.43459	.42650	.41863
70	.46702	.45852	.45025	.44218	.43432
71	.48291	.47447	.46623	.45820	.45037
72	.49909	.49072	.48255	.47458	.46679
73	.51549	.50721	.49912	.49912	.48349
74	.53195	.52377	.51578	.50796	.50031
75	.54832	.54027	.53238	.52466	.51710
76	.56454	.55661	.54884	.54123	.53377
77	.58057	.57278	.56514	.55765	.55030
78	.59644	.58879	.58129	.58393	.56670
79	.61219	.60471	.59736	.59013	.58304
80	.62788	.62057	.61338	.60632	.59936
81	.64341	.63628	.62926	.62236	.61556
82	.65866	.65172	.64488	.63815	.63151
83	.67364	.66689	.66024	.65369	.64723
84	.68843	.68189	.67544	.66907	.66279
85	.70307	.69674	.69050	.68433	.67825
86	.71723	.71112	.70508	.69912	.69323
87	.73050	.72460	.71877	.71300	.70731

(1) Age	(2) Adjusted payout rate				
	7.2%	7.4%	7.6%	7.8%	8.0%
88	.74285	.73715	.73151	.72593	.72042
89	.75454	.74903	.74358	.73819	.73286
90	.76591	.76060	.75534	.75014	.74499
91	.77688	.77176	.76670	.76169	.75672
92	.78709	.78217	.77729	.77245	.76766
93	.79635	.79160	.78690	.78223	.77761
94	.80461	.80002	.79547	.79096	.78648
95	.81180	.80735	.80394	.79856	.79421
96	.81784	.81351	.80921	.80494	.80071
97	.82324	.81901	.81481	.81065	.80651
98	.82794	.82380	.81969	.81562	.81157
99	.83235	.82830	.83427	.82028	.81631
100	.83674	.83276	.82882	.82490	.82101
101	.84058	.83668	.83280	.82895	.82512
102	.84474	.84091	.83710	.83332	.82956
103	.85006	.84633	.84262	.83893	.83526
104	.85514	.85150	.84787	.84427	.84068
105	.86284	.85934	.85585	.85239	.84893
106	.87527	.87204	.86881	.86559	.86239
107	.89257	.88972	.88688	.88404	.88121
108	.91983	.91765	.91547	.91330	.91113
109	.96400	.96300	.96200	.96100	.96000

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
0	.03059	.02995	.02936	.02882	.02833
1	.01267	.01200	.01139	.01084	.01033
2	.01251	.01181	.01117	.01059	.01006
3	.01274	.01200	.01133	.01072	.01016
4	.01316	.01239	.01168	.01103	.01044
5	.01375	.01293	.01218	.01150	.01088
6	.01446	.01360	.01281	.01209	.01144
7	.01527	.01436	.01353	.01277	.01208
8	.01619	.01523	.01436	.01356	.01283
9	.01725	.01624	.01532	.01448	.01370
10	.01843	.01737	.01640	.01551	.01470
11	.01976	.01865	.01763	.01669	.01583
12	.02122	.02005	.01898	.01800	.01709
13	.02276	.02153	.02041	.01937	.01842
14	.02432	.02303	.02185	.02077	.01977
15	.02585	.02451	.02327	.02213	.02108
16	.02732	.02591	.02462	.02342	.02232
17	.02874	.02726	.02590	.02465	.02349
18	.03013	.02858	.02715	.02584	.02462
19	.03152	.02990	.02841	.02703	.02575
20	.03298	.03128	.02971	.02826	.02692
21	.03451	.03272	.03108	.02956	.02815
22	.03611	.03424	.03251	.03091	.02944
23	.03781	.03585	.03404	.03236	.03081
24	.03965	.03760	.03570	.03393	.03230
25	.04168	.03953	.03753	.03568	.03396
26	.04393	.04168	.03958	.03764	.03583
27	.04642	.04406	.04186	.03982	.03792
28	.04916	.04669	.04439	.04224	.04025
29	.05212	.04953	.04712	.04487	.04277
30	.05531	.05260	.05008	.04772	.04552
31	.05871	.05588	.05324	.05077	.04846
32	.06236	.05940	.05663	.05405	.05163
33	.06625	.06316	.06027	.05756	.05502
34	.07038	.06716	.06414	.06131	.05865
35	.07478	.07142	.06827	.06531	.06253
36	.07944	.07595	.07266	.06957	.06667
37	.08438	.08074	.07732	.07410	.07106
38	.08958	.08580	.08223	.07888	.07571
39	.09506	.09112	.08742	.08392	.08061
40	.10081	.09673	.09288	.08924	.08580
41	.10687	.10263	.09863	.09484	.09126
42	.11325	.10886	.10471	.10078	.09705
43	.11993	.11539	.11109	.10701	.10314
44	.12694	.12224	.11779	.11356	.10955
45	.13424	.12939	.12478	.12040	.11624
46	.14186	.13686	.13210	.12757	.12326
47	.14980	.14464	.13973	.13505	.13059
48	.15810	.15278	.14772	.14289	.13828
49	.16674	.16127	.15605	.15107	.14631
50	.17574	.17012	.16475	.15962	.15472
51	.18510	.17932	.17381	.16853	.16348
52	.19480	.18888	.18322	.17779	.17260
53	.20484	.19678	.19298	.18741	.18208
54	.21520	.20901	.20306	.19735	.19188
55	.22589	.21955	.21347	.20763	.20202
56	.23688	.23041	.22420	.21822	.21248
57	.24820	.24161	.23527	.22917	.22329
58	.25984	.25313	.24667	.24044	.23444
59	.27184	.26501	.25843	.25209	.24596
60	.28417	.27724	.27055	.26409	.25786
61	.29688	.28985	.28306	.27650	.27015
62	.30996	.30284	.29596	.28929	.28285
63	.32341	.31621	.30924	.30249	.29595
64	.33721	.32994	.32289	.31605	.30943
65	.35134	.34401	.33689	.32999	.32329
66	.36580	.35841	.35124	.34427	.33750
67	.38055	.37312	.36590	.35889	.35206
68	.39559	.38814	.38089	.37383	.36696
69	.41096	.40349	.39622	.38913	.38222
70	.42665	.41918	.41190	.40480	.39787
71	.44273	.43527	.42799	.42089	.41395
72	.45919	.45176	.44450	.43741	.43049
73	.47594	.46856	.46134	.45428	.44738
74	.49283	.48550	.47834	.47132	.46446
75	.50969	.50244	.49534	.48838	.48157
76	.52646	.51929	.51226	.50537	.49862
77	.54309	.53601	.52907	.52226	.51558
78	.55960	.55263	.54579	.53907	.53247
79	.57606	.56921	.56248	.55586	.54935
80	.59253	.58580	.57919	.57269	.56629
81	.60887	.60229	.59581	.58943	.58315
82	.62498	.61855	.61221	.60597	.59982
83	.64086	.63459	.62840	.62230	.61629
84	.65660	.65049	.64447	.63852	.63266
85	.67224	.66631	.66046	.65468	.64898
86	.68742	.68167	.67600	.67040	.66486
87	.70168	.69611	.69061	.68518	.67980
88	.71497	.70958	.70425	.69897	.69376
89	.72758	.72236	.71720	.71208	.70702
90	.73989	.73484	.72985	.72490	.72000
91	.75180	.74693	.74210	.73732	.73259
92	.76292	.75821	.75355	.74894	.74436
93	.77302	.76848	.76397	.75951	.75508
94	.78204	.77764	.77328	.76895	.76466
95	.78991	.78563	.78139	.77719	.77302
96	.79651	.79234	.78821	.78411	.78003
97	.80241	.79834	.79430	.79029	.78630
98	.80755	.80356	.79960	.79567	.79176
99	.81236	.80845	.80456	.80071	.79687
100	.81715	.81331	.80949	.80571	.80195
101	.82132	.81754	.81379	.81006	.80636
102	.82582	.82211	.81842	.81476	.81111
103	.83162	.82799	.82439	.82080	.81724
104	.83711	.83356	.83003	.82652	.82302

(1) Age	(2) Adjusted payout rate				
	8.2%	8.4%	8.6%	8.8%	9.0%
105	.84550	.84208	.83867	.83528	.83191
106	.85920	.85602	.85285	.84969	.84655
107	.87839	.87558	.87277	.86997	.86718
108	.90896	.90679	.90463	.90246	.90030
109	.95900	.95800	.95700	.95600	.95500

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate				
	9.2%	9.4%	9.6%	9.8%	10.0%
0	.02788	.02747	.02709	.02673	.02641
1	.00987	.00945	.00906	.00871	.00838
2	.00957	.00913	.00872	.00835	.00800
3	.00965	.00918	.00875	.00836	.00799
4	.00991	.00941	.00896	.00854	.00815
5	.01031	.00979	.00931	.00887	.00846
6	.01084	.01028	.00978	.00931	.00888
7	.01144	.01086	.01032	.00983	.00937
8	.01216	.01154	.01097	.01044	.00996
9	.01299	.01234	.01174	.01118	.01067
10	.01395	.01326	.01262	.01204	.01149
11	.01504	.01432	.01364	.01302	.01245
12	.01626	.01549	.01478	.01413	.01352
13	.01755	.01674	.01599	.01530	.01466
14	.01885	.01800	.01721	.01648	.01581
15	.02011	.01922	.01839	.01762	.01691
16	.02130	.02036	.01949	.01869	.01794
17	.02243	.02144	.02052	.01967	.01888
18	.02350	.02246	.02150	.02061	.01978
19	.02457	.02348	.02247	.02153	.02065
20	.02569	.02454	.02347	.02248	.02156
21	.02685	.02564	.02452	.02347	.02250
22	.02806	.02679	.02561	.02451	.02348
23	.02936	.02802	.02677	.02561	.02453
24	.03078	.02937	.02805	.02683	.02569
25	.03236	.03087	.02949	.02820	.02699
26	.03415	.03258	.03112	.02975	.02848
27	.03615	.03450	.03295	.03151	.03017
28	.03838	.03664	.03502	.03350	.03208
29	.04081	.03898	.03727	.03567	.03416
30	.04346	.04154	.03973	.03804	.03646
31	.04630	.04427	.04237	.04059	.03892
32	.04936	.04723	.04523	.04335	.04159
33	.05264	.05041	.04831	.04633	.04448
34	.05615	.05381	.05160	.04952	.04757
35	.05992	.05746	.05514	.05296	.05090
36	.06393	.06135	.05892	.05663	.05447
37	.06820	.06550	.06295	.06055	.05828
38	.07272	.06990	.06723	.06471	.06233
39	.07749	.07454	.07175	.06912	.06662
40	.08254	.07946	.07655	.07379	.07117
41	.08787	.08466	.08162	.07073	.07599
42	.09352	.09018	.08700	.08399	.08112
43	.09947	.09599	.09268	.08953	.08654
44	.10573	.10211	.09866	.09539	.09227
45	.11229	.10852	.10494	.10152	.09827
46	.11916	.11525	.11153	.10798	.10459
47	.12634	.12229	.11843	.11474	.11122
48	.13388	.12969	.12568	.12186	.11820
49	.14177	.13743	.13329	.12932	.12553
50	.15003	.14555	.14126	.13716	.13322
51	.15865	.15402	.14959	.14534	.14127
52	.16763	.16286	.15828	.15390	.14969
53	.17696	.17205	.16734	.16281	.15847
54	.18662	.18157	.17672	.17206	.16758
55	.19662	.19144	.18645	.18165	.17703
56	.20695	.20163	.19651	.19157	.18682
57	.21763	.21218	.20693	.20186	.19698
58	.22865	.22307	.21769	.21250	.20749
59	.24005	.23435	.22885	.22353	.21839
60	.25183	.24601	.24038	.23494	.22969
61	.26401	.25808	.25234	.24678	.24141
62	.27661	.27056	.26471	.25905	.25356
63	.28961	.28347	.27752	.27175	.26615
64	.30300	.29677	.29072	.28486	.27916
65	.31678	.31046	.30433	.29837	.29259
66	.33093	.32454	.31832	.31228	.30641
67	.34542	.33897	.33268	.32657	.32062
68	.36027	.35376	.34742	.34124	.33522
69	.37550	.36894	.36255	.35632	.35024
70	.39111	.38452	.37809	.37182	.36570
71	.40719	.40058	.39412	.38782	.38166
72	.42372	.41710	.41064	.40432	.39814
73	.44062	.43402	.42756	.42124	.41506
74	.45774	.45116	.44471	.43840	.43223
75	.47489	.46834	.46193	.45565	.44949
76	.49199	.48550	.47913	.47288	.46675
77	.50902	.50258	.49626	.49006	.48397
78	.52598	.51962	.51336	.50721	.50117
79	.54295	.53667	.53049	.52441	.51843
80	.55999	.55380	.54771	.54171	.53581
81	.57697	.57088	.56489	.55899	.55317
82	.59375	.58778	.58190	.57610	.57039
83	.61036	.60451	.59875	.59306	.58746
84	.62687	.62116	.61553	.60997	.60448
85	.64335	.63779	.63230	.62688	.62152
86	.65939	.65398	.64864	.64337	.63816
87	.67449	.66924	.66405	.65892	.65384
88	.68860	.68350	.67845	.67346	.66852
89	.70202	.69706	.69216	.68731	.68250
90	.71515	.71035	.70559	.70088	.69622
91	.72790	.72325	.71865	.71409	.70957
92	.73982	.73533	.73087	.72646	.72208
93	.75069	.74634	.74202	.73774	.73350
94	.76040	.75618	.75199	.74784	.74372
95	.76888	.76477	.76070	.75666	.75265
96	.77599	.77199	.76801	.76406	.76014
97	.78235	.77843	.77454	.77067	.76684
98	.78789	.78404	.78022	.77642	.77266
99	.79307	.78929	.78554	.78181	.77811
100	.79821	.79450	.79081	.78715	.78351
101	.80268	.79902	.79539	.79178	.78819
102	.80749	.80389	.80031	.79676	.79322
103	.81370	.81018	.80668	.80319	.79973
104	.81955	.81609	.81265	.80923	.80582
105	.82855	.82520	.82187	.81856	.81526
106	.84341	.84029	.83718	.83408	.83099
107	.86439	.86162	.85884	.85608	.85332
108	.89815	.89599	.89384	.89169	.88955
109	.95400	.95300	.95200	.95100	.95000

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate				
	10.2%	10.4%	10.6%	10.8%	11.0%
0	.02610	.02582	.02556	.02531	.02508
1	.00807	.00779	.00753	.00729	.00707
2	.00769	.00739	.00712	.00686	.00663
3	.00766	.00735	.00706	.00679	.00654

(1) Age	(2) Adjusted payout rate 10.2%	10.4%	10.6%	10.8%	11.0%
4	.00780	.00747	.00716	.00688	.00662
5	.00808	.00773	.00741	.00711	.00683
6	.00848	.00811	.00776	.00744	.00715
7	.00894	.00855	.00819	.00785	.00753
8	.00951	.00909	.00871	.00835	.00801
9	.01019	.00975	.00934	.00896	.00860
10	.01099	.01052	.01008.	.00967	.00930
11	.01191	.01142	.01095	.01052	.01012
12	.01295	.01243	.01194	.01148	.01106
13	.01406	.01351	.01299	.01251	.01206
14	.01518	.01459	.01405	.01354	.01306
15	.01625	.01563	.01506	.01452	.01402
16	.01724	.01659	.01599	.01542	.01489
17	.01815	.01747	.01683	.01624	.01568
18	.01901	.01829	.01761	.01699	.01640
19	.01984	.01908	.01837	.01771	.01709
20	.02070	.01990	.01915	.01846	.01780
21	.02160	.02075	.01996	.01923	.01854
22	.02253	.02164	.02080	.02003	.01930
23	.02352	.02258	.02170	.02088	.02010
24	.02462	.02362	.02269	.02182	.02100
25	.02586	.02481	.02382	.02289	.02203
26	.02729	.02617	.02512	.02414	.02322
27	.02891	.02772	.02662	.02558	.02460
28	.03074	.02949	.02832	.02722	.02618
29	.03276	.03143	.03019	.02902	.02792
30	.03497	.03357	.03225	.03102	.02985
31	.03735	.03587	.03448	.03317	.03193
32	.03993	.03837	.03690	.03551	.03420
33	.04273	.04108	.03952	.03806	.03667
34	.04572	.04399	.04234	.04079	.03933
35	.04896	.04713	.04539	.04376	.04221
36	.05243	.05049	.04867	.04694	.04530
37	.05613	.05410	.05217	.05035	.04862
38	.06007	.05793	.05591	.05399	.05217
39	.06425	.06200	.05987	.05785	.05593
40	.06869	.06633	.06409	.06197	.05995
41	.07339	.07092	.06857	.06634	.06421
42	.07840	.07581	.07335	.07101	.06878
43	.08370	.08099	.07841	.07595	.07361
44	.08930	.08646	.08377	.08119	.07874
45	.09517	.09222	.08940	.08670	.08413
46	.10136	.09828	.09533	.09252	.08983
47	.10786	.10464	.10157	.09864	.09582
48	.11470	.11136	.10816	.10510	.10216
49	.12189	.11842	.11509	.11190	.10884
50	.12946	.12585	.12239	.11907	.11588
51	.13737	.13363	.13003	.12659	.12327
52	.14565	.14177	.13805	.13447	.13103
53	.15429	.15028	.14642	.14271	.13914
54	.16327	.15912	.15513	.15129	.14759
55	.17259	.16831	.16419	.16022	.15639
56	.18225	.17784	.17358	.16948	.16553
57	.19227	.18773	.18335	.17912	.17503
58	.20265	.19798	.19347	.18911	.18490
59	.21343	.20863	.20400	.19951	.19518
60	.22460	.21968	.21492	.21032	.20586
61	.23620	.23117	.22629	.22156	.21698
62	.24824	.24309	.23810	.23325	.22856
63	.26073	.25546	.25036	.24540	.24060
64	.27364	.26827	.26306	.25800	.25308
65	.28696	.28150	.27619	.27103	.26601
66	.30070	.29515	.28974	.28449	.27937
67	.31483	.30919	.30371	.29836	.29316
68	.32936	.32365	.31808	.31266	.30737
69	.34432	.33854	.33290	.32741	.32204
70	.35972	.35389	.34820	.34264	.33721
71	.37565	.36977	.36403	.35842	.35294
72	.39210	.38619	.38042	.37477	.36924
73	.40900	.40308	.39728	.39161	.38605
74	.42618	.42025	.41444	.40876	.40318
75	.44345	.43753	.43173	.42604	.42046
76	.46073	.45483	.44904	.44336	.43779
77	.47799	.47212	.46635	.46069	.45513
78	.49524	.48941	.48368	.47805	.47252
79	.51256	.50678	.50110	.49551	.49001
80	.53001	.52429	.51867	.51313	.50769
81	.54745	.54181	.53626	.53079	.52541
82	.56476	.55921	.55374	.54835	.54303
83	.58193	.57648	.57110	.56579	.56056
84	.59907	.59373	.58845	.58325	.57811
85	.61624	.61102	.60586	.60077	.59574
86	.63300	.62791	.62289	.61791	.61300
87	.64883	.64387	.63896	.63411	.62932
88	.66363	.65880	.65402	.64929	.64461
89	.67775	.67304	.66838	.66377	.65921
90	.69160	.68703	.68250	.67802	.67357
91	.70509	.70066	.69626	.69191	.68760
92	.71775	.71345	.70919	.70496	.70078
93	.72929	.72512	.72099	.71689	.71282
94	.73964	.73559	.73157	.72758	.72362
95	.74867	.74472	.74081	.73692	.73306
96	.75625	.75239	.74856	.74476	.74099
97	.76303	.75925	.75550	.75177	.74807
98	.76892	.76521	.76152	.75786	.75422
99	.77443	.77078	.76715	.76355	.75998
100	.77990	.77631	.77275	.76921	.76569
101	.78463	.78109	.77757	.77407	.77060
102	.78971	.78622	.78275	.77930	.77587
103	.79629	.79287	.78947	.78608	.78272
104	.80244	.79907	.79572	.79239	.78907
105	.81198	.80871	.80546	.88222	.79900
106	.82792	.82485	.82180	.81876	.81572
107	.85057	.84783	.84509	.84237	.83964
108	.88740	.88526	.88312	.88098	.87885
109	.94900	.94800	.94700	.94600	.94500

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate 11.2%	11.4%	11.6%	11.8%	12.0%
0	.02487	.02466	.02447	.02429	.02412
1	.00686	.00666	.00648	.00631	.00615
2	.00641	.00620	.00601	.00583	.00566
3	.00631	.00609	.00589	.00570	.00552
4	.00637	.00614	.00593	.00573	.00554
5	.00657	.00633	.00610	.00588	.00568
6	.00687	.00661	.00637	.00614	.00593
7	.00724	.00696	.00670	.00646	.00623
8	.00770	.00740	.00713	.00687	.00663
9	.00827	.00795	.00766	.00739	.00713
10	.00894	.00861	.00830	.00800	.00773
11	.00974	.00939	.00906	.00875	.00846
12	.01066	.01029	.00993	.00961	.00929
13	.01164	.01124	.01087	.01052	.01019
14	.01262	.01220	.01181	.01144	.01109
15	.01355	.01311	.01270	.01231	.01194
16	.01440	.01394	.01350	.01309	.01271
17	.01516	.01467	.01421	.01378	.01337
18	.01585	.01534	.01485	.01440	.01397
19	.01651	.01597	.01546	.01498	.01453
20	.01719	.01662	.01608	.01557	.01510
21	.01789	.01728	.01672	.01618	.01568

(1) Age	(2) Adjusted payout rate				
	11.2%	11.4%	11.6%	11.8%	12.0%
22	.01861	.01797	.01737	.01680	.01627
23	.01938	.01870	.01806	.01746	.01689
24	.02023	.01951	.01883	.01819	.01759
25	.02121	.02045	.01973	.01905	.01841
26	.02236	.02155	.02078	.02006	.01938
27	.02368	.02282	.02200	.02124	.02051
28	.02521	.02429	.02342	.02261	.02183
29	.02689	.02591	.02499	.02412	.02330
30	.02875	.02772	.02674	.02581	.02494
31	.03076	.02966	.02863	.02764	.02671
32	.03297	.03180	.03070	.02965	.02866
33	.03536	.03412	.03295	.03184	.03079
34	.03794	.03663	.03539	.03421	.03309
35	.04074	.03935	.03803	.03678	.03559
36	.04375	.04228	.04089	.03956	.03830
37	.04699	.04543	.04395	.04255	.04122
38	.05044	.04879	.04723	.04575	.04433
39	.05411	.05238	.5073	.04916	.04766
40	.05802	.05620	.05445	.05279	.05121
41	.06219	.06026	.05843	.05668	.05550
42	.06665	.06462	.06269	.06084	.05908
43	.07138	.06924	.06721	.06526	.06341
44	.07639	.07415	.07202	.06997	.06801
45	.08168	.07933	.07708	.07493	.07287
46	.08726	.08480	.08244	.08018	.07802
47	.09313	.09056	.08809	.08572	.08345
48	.09935	.09666	.09408	.09160	.08922
49	.10591	.10309	.10039	.09780	.09531
50	.11282	.10989	.10707	.10436	.10176
51	.12009	.11703	.11409	.11127	.10855
52	.12772	.12454	.12147	.11853	.11569
53	.13571	.13340	.12922	.12615	.12319
54	.14403	.14060	.13729	.13410	.13102
55	.15270	.14914	.14571	.14240	.13920
56	.16171	.15802	.15447	.15103	.14771
57	.17109	.16728	.16360	.16004	.15660
58	.18083	.17690	.17309	.16941	.16585
59	.19098	.18692	.18299	.17919	.17551
60	.20154	.19736	.19331	.18938	.18558
61	.21254	.20824	.20407	.20003	.19610
62	.22400	.21958	.21530	.21113	.20709
63	.23593	.23139	.22699	.22272	.21856
64	.24830	.24366	.23915	.23476	.23050
65	.26113	.25638	.25176	.24727	.24290
66	.27439	.26955	.26483	.26023	.25576
67	.28808	.28314	.27833	.27364	.26906
68	.30221	.29718	.29228	.28750	.28283
69	.31681	.31170	.30672	.30185	.29710
70	.33190	.32673	.32167	.31672	.31189
71	.34758	.34234	.33721	.33220	.32731
72	.36384	.35855	.35337	.34831	.34335
73	.38061	.37529	.37007	.36496	.35996
74	.39772	.39237	.38713	.38199	.37695
75	.41499	.40962	.40436	.39920	.39413
76	.43232	.42695	.42168	.41650	.41142
77	.44967	.44431	.43904	.43386	.42878
78	.46708	.46173	.45647	.45130	.44622
79	.48460	.47928	.47405	.46890	.46383
80	.50232	.49705	.49185	.48673	.48169
81	.52010	.51487	.50973	.50465	.49965
82	.53779	.53263	.52754	.52252	.51757
83	.55540	.55031	.54529	.54033	.53544
84	.57304	.56804	.56309	.55822	.55340
85	.59077	.58586	.58102	.57623	.57150
86	.60815	.60335	.59860	.59392	.58928
87	.62458	.61989	.61525	.61066	.60613
88	.63998	.63540	.63086	.62638	.62194
89	.65469	.65022	.64579	.64141	.63707
90	.66918	.66482	.66050	.65623	.65199
91	.68332	.67909	.67489	.67073	.66661
92	.69662	.69251	.68843	.68439	.68038
93	.70879	.70479	.70082	.69689	.69299
94	.71970	.71581	.71195	.70812	.70432
95	.72924	.72544	.72167	.71793	.71422
96	.73724	.73353	.72984	.72618	.72254
97	.74440	.74076	.73714	.73354	.72998
98	.75061	.74703	.74347	.73994	.73643
99	.75642	.75290	.74939	.74591	.74245
100	.76219	.75872	.75527	.75184	.74844
101	.76715	.76372	.76031	.75692	.75356
102	.77246	.76908	.76571	.76236	.75904
103	.77937	.77605	.77274	.76945	.76618
104	.78577	.78249	.77923	.77598	.77275
105	.79579	.79259	.78941	.78625	.78310
106	.81270	.80969	.80670	.80371	.80073
107	.83693	.83422	.83152	.82883	.82614
108	.87672	.87459	.87246	.87034	.86822
109	.94400	.94300	.94200	.94100	.94000

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate				
	12.2%	12.4%	12.6%	12.8%	13.0%
0	.02396	.02380	.02366	.02352	.02338
1	.00600	.00585	.00572	.00559	.00547
2	.00550	.00535	.00521	.00508	.00495
3	.00536	.00520	.00505	.00491	.00478
4	.00536	.00519	.00504	.00489	.00475
5	.00549	.00532	.00515	.00499	.00484
6	.00572	.00554	.00536	.00519	.00503
7	.00602	.00582	.00563	.00545	.00528
8	.00640	.00618	.00598	.00579	.00561
9	.00688	.00665	.00644	.00623	.00604
10	.00747	.00723	.00699	.00678	.00657
11	.00818	.00792	.00767	.00744	.00722
12	.00900	.00873	.00846	.00822	.00798
13	.00988	.00959	.00931	.00905	.00880
14	.01077	.01046	.01017	.00989	.00963
15	.01160	.01127	.01097	.01067	.01040
16	.01234	.01200	.01167	.01137	.01108
17	.01299	.01263	.01229	.01197	.01166
18	.01357	.01319	.01283	.01249	.01217
19	.01410	.01370	.01332	.01297	.01263
20	.01465	.01422	.01382	.01345	.01309
21	.01520	.01475	.01433	.01393	.01355
22	.01576	.01529	.01484	.01442	.01402
23	.01636	.01586	.01538	.01493	.01450
24	.01703	.01649	.01599	.01551	.01505
25	.01781	.01724	.01670	.01619	.01571
26	.01874	.01813	.01756	.01701	.01650
27	.01983	.01918	.01857	.01799	.01744
28	.02111	.02042	.01976	.01915	.01856
29	.02253	.02179	.02110	.02044	.01981
30	.02411	.02333	.02259	.02188	.02121
31	.02583	.02500	.02421	.02345	.02274
32	.02772	.02683	.02599	.02519	.02443
33	.02979	.02885	.02795	.02709	.02628
34	.03203	.03102	.03006	.02915	.02829
35	.03447	.03340	.03238	.03141	.03048
36	.03710	.03597	.03488	.03385	.03286
37	.03995	.03874	.03758	.03649	.03544
38	.04299	.04170	.04048	.03931	.03820

(1) Age	(2) Adjusted payout rate 12.2%	12.4%	12.6%	12.8%	13.0%
39	.04623	.04487	.04358	.04234	.04115
40	.04970	.04826	.04689	.04558	.04432
41	.05341	.05189	.05043	.04904	.04771
42	.05739	.05578	.05424	.05277	.05136
43	.06163	.05993	.05830	.05674	.05525
44	.06614	.06435	.06263	.06099	.05941
45	.07090	.06901	.06720	.06547	.06380
46	.07595	.07396	.07206	.07023	.06847
47	.08128	.07919	.07718	.07525	.07340
48	.08693	.08474	.08263	.08061	.07866
49	.09291	.09061	.08840	.08627	.08423
50	.09925	.09684	.09452	.09229	.09014
51	.10593	.10341	.10098	.09864	.09638
52	.11296	.11032	.10778	.10534	.10297
53	.12034	.11759	.11494	.11238	.10991
54	.12805	.12519	.12243	.11976	.11718
55	.13611	.13313	.13025	.12747	.12478
56	.14451	.14141	.13841	.13551	.13271
57	.15327	.15005	.14694	.14393	.14101
58	.16240	.15906	.15583	.15270	.14967
59	.17194	.16848	.16513	.16189	.15874
60	.18189	.17831	.17485	.17148	.16822
61	.19230	.18860	.18502	.18154	.17816
62	.20317	.19936	.19566	.19207	.18857
63	.21453	.21060	.20679	.20308	.19947
64	.22635	.22231	.21839	.21457	.21085
65	.23864	.23450	.23046	.22653	.22271
66	.25140	.24715	.24301	.23898	.23505
67	.26461	.26026	.25602	.25188	.24785
68	.27828	.27384	.26950	.26527	.26114
69	.29246	.28793	.28350	.27918	.27496
70	.30718	.30256	.29805	.29364	.28933
71	.32251	.31783	.31324	.30876	.30437
72	.33850	.33375	.32910	.32455	.32009
73	.35506	.35026	.34555	.34094	.33642
74	.37201	.36716	.36241	.35776	.35319
75	.38916	.38429	.37950	.37481	.37020
76	.40644	.40154	.39673	.39200	.38737
77	.42378	.41887	.41404	.40930	.40464
78	.44123	.43631	.43148	.42673	.42205
79	.45885	.45394	.44911	.44436	.43969
80	.47673	.47184	.46703	.46229	.45763
81	.49473	.48987	.48509	.48037	.47573
82	.51269	.50787	.50313	.49845	.49383
83	.53062	.52586	.52116	.51653	.51195
84	.54864	.54395	.53931	.53473	.53021
85	.56683	.56221	.55765	.55314	.54869
86	.58470	.58017	.57570	.57127	.56689
87	.60164	.59720	.59281	.58847	.58417
88	.61754	.61320	.60889	.60464	.60042
89	.63277	.62851	.62430	.62013	.61600
90	.64780	.64064	.63953	.63545	.63141
91	.66252	.65848	.65446	.65049	.64655
92	.67640	.67246	.66858	.66468	.66084
93	.68912	.68528	.68148	.67770	.67396
94	.70055	.69680	.69309	.68941	.68576
95	.71054	.70689	.70326	.69966	.69609
96	.71893	.71535	.71180	.70827	.70476
97	.72643	.72292	.71943	.71596	.71252
98	.73294	.72948	.72604	.72263	.71924
99	.73902	.73561	.73222	.72886	.72551
100	.74506	.74170	.73836	.73504	.73174
101	.75021	.74689	.74359	.74030	.73704
102	.75573	.75244	.74918	.74593	.74270
103	.76293	.75970	.75649	.75329	.75011
104	.76954	.76634	.76316	.76000	.75685
105	.77996	.77684	.77373	.77064	.76756
106	.79777	.79481	.79187	.78894	.78602
107	.82346	.82078	.81812	.81546	.81281
108	.86610	.86398	.86187	.85976	.85765
109	.93900	.93800	.93700	.93600	.93500

TABLE E.—TABLE, SINGLE LIFE, UNISEX, SHOWING THE PRESENT WORTH OF THE REMAINDER INTEREST IN PROPERTY TRANSFERRED TO A UNITRUST HAVINO THE ADJUSTED PAYOUT RATE SHOWN—Continued

(1) Age	(2) Adjusted payout rate 13.2%	13.4%	13.6%	13.8%	14.0%
0	.02325	.02313	.02301	.02290	.02279
1	.00536	.00525	.00514	.00505	.00495
2	.00484	.00472	.00462	.00451	.00442
3	.00465	.00453	.00442	.00431	.00421
4	.00461	.00449	.00437	.00426	.00415
5	.00470	.00457	.00444	.00432	.00421
6	.00488	.00474	.00460	.00447	.00435
7	.00512	.00496	.00482	.00468	.00455
8	.00543	.00527	.00512	.00497	.00483
9	.00585	.00568	.00551	.00536	.00521
10	.00637	.00619	.00601	.00584	.00568
11	.00701	.00681	.00662	.00644	.00627
12	.00776	.00755	.00735	.00716	.00697
13	.00857	.00734	.00813	.00793	.00773
14	.00938	.00914	.00892	.00870	.00850
15	.01014	.00989	.00965	.00942	.00921
16	.01080	.01054	.01029	.01005	.00983
17	.01137	.01109	.01083	.01058	.01035
18	.01186	.01157	.01130	.01103	.01078
19	.01230	.01300	.01171	.01143	.01117
20	.01275	.01243	.01212	.01183	.01155
21	.01319	.01285	.01253	.01222	.01193
22	.01364	.01328	.01293	.01261	.01230
23	.01410	.01372	.01336	.01301	.01268
24	.01463	.01422	.01383	.01347	.01312
25	.01525	.01482	.01441	.01401	.01364
26	.01601	.01555	.01511	.01469	.01430
27	.01692	.01643	.01596	.01551	.01509
28	.01800	.01748	.01697	.01650	.01604
29	.01922	.01865	.01812	.01760	.01712
30	.02058	.01998	.01940	.01886	.01833
31	.02206	.02142	.02080	.02022	.01966
32	.02370	.02301	.02236	.02173	.02113
33	.02550	.02477	.02407	.02340	.02276
34	.02746	.02667	.02592	.02521	.02452
35	.02960	.02876	.02796	.02719	.02646
36	.03193	.03103	.03017	.02936	.02858
37	.03444	.03348	.03257	.03170	.03087
38	.03714	.03612	.03515	.03422	.03333
39	.04002	.03894	.03791	.03692	.03597
40	.04312	.04197	.04087	.03891	.03880
41	.04643	.04521	.04404	.04292	.04185
42	.05001	.04871	.04747	.04628	.04514
43	.05382	.05245	.05113	.04987	.04865
44	.05789	.05644	.05505	.05371	.05242
45	.06220	.06067	.05919	.05777	.05641
46	.06678	.06516	.06360	.06210	.06065
47	.07162	.06991	.06826	.06668	.06515
48	.07678	.07498	.07324	.07157	.06996
49	.08225	.08035	.07852	.07676	.07506
50	.08807	.08607	.08415	.08229	.08050
51	.09421	.09211	.09009	.08814	.08625
52	.10070	.09850	.09637	.09432	.09234
53	.10753	.10523	.10300	.10085	.09877
54	.11468	.11227	.10994	.10769	.10551
55	.12218	.11966	.11722	.11487	.11258
56	.12999	.12737	.12483	.12236	.11998

(1) Age	(2) Adjusted payout rate				
	13.2%	13.4%	13.6%	13.8%	14.0%
57	.13818	.13545	.13279	.13022	.12773
58	.14673	.14388	.14112	.13844	.13584
59	.15568	.15272	.14985	.14706	.14435
60	.16505	.16198	.15899	.15609	.15327
61	.17488	.17169	.16859	.16558	.16265
62	.18518	.18187	.17866	.17554	.17251
63	.19596	.19255	.18923	.18600	.18285
64	.20723	.20371	.20028	.19694	.19368
65	.21898	.21535	.21181	.20836	.20500
66	.23121	.22748	.22383	.22028	.21681
67	.24392	.24008	.23633	.23267	.22910
68	.25711	.25317	.24932	.24556	.24189
69	.27083	.26680	.26285	.25900	.25523
70	.28512	.28100	.27697	.27302	.26916
71	.30007	.29587	.29176	.28773	.28378
72	.31572	.31145	.30726	.30315	.29913
73	.33199	.32765	.32340	.31923	.31514
74	.34871	.34431	.34000	.33577	.33162
75	.36568	.36124	.35688	.35260	.34840
76	.38281	.37833	.37393	.36961	.36537
77	.40006	.39555	.39113	.38677	.38249
78	.41745	.41293	.40848	.40410	.39980
79	.43508	.43055	.42609	.42170	.41737
80	.45303	.44850	.44404	.43964	.43531
81	.47115	.46663	.46218	.45779	.45347
82	.48928	.48479	.48036	.47599	.47168
83	.50744	.50298	.49858	.49424	.48995
84	.52575	.52134	.51698	.51268	.50843
85	.54429	.53994	.53564	.53139	.52720
86	.56257	.55829	.55406	.54988	.54574
87	.57993	.57572	.57156	.56745	.56338
88	.59625	.59212	.58804	.58399	.57999
89	.61191	.60786	.60384	.59987	.59594
90	.62741	.62344	.61952	.61562	.61177
91	.64264	.63877	.63493	.63113	.62736
92	.65703	.65326	.64951	.64580	.64212
93	.67024	.66656	.66291	.65928	.65568
94	.68213	.67854	.67497	.67142	.66791
95	.69255	.68903	.68554	.68207	.67863
96	.70128	.69783	.69440	.69100	.68762
97	.70910	.70570	.70233	.69899	.69566
98	.71587	.71252	.70920	.70590	.70263
99	.72219	.71889	.71562	.71236	.70913
100	.72847	.72522	.72189	.71877	.71558
101	.73380	.73058	.72738	.72420	.72104
102	.73949	.73630	.73313	.72998	.72685
103	.74695	.74381	.74068	.73758	.73449
104	.75372	.75060	.74751	.74442	.74136
105	.76449	.76144	.75840	.75538	.75237
106	.78311	.78021	.77732	.77444	.77157
107	.81016	.80752	.80489	.80227	.79965
108	.85554	.85344	.85134	.84924	.84715
109	.93400	.93300	.93200	.93100	.93000

TABLE F(1).—TABLE, 10 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATIONS AND PAYOUT SEQUENCES

(1) Number of months by which the valuation date precedes the first payout		(2) Factors for payout at the end of each			
At least	But less than	Annual period	Semi-annual period	Quarterly period	Monthly period
	1		.976731	.965232	.957616
1	2	.992089	.969004	.957596	.950041
2	3	.984240	.961338	.950021	
3	4	.976454	.953733	.942505	
4	5	.968729	.946188		
5	6	.961066	.938703		
6	7	.953463	.931277		
7	8	.945920			
8	9	.938436			
9	10	.931012			
10	11	.923647			
11	12	.916340			
12		.909091			

(c) Valuation of charitable remainder unitrusts having certain payout sequences; for testamentary transfers made after November 30, 1983, and before August 9, 1984. For purposes of section 2055 or 2106, if—

(1) the testamentary transfer occurred after November 30, 1983, and before August 9, 1984, or

(2) on December 1, 1983, a decedent was under a mental disability such that the disposition of the property could not be changed, and the testamentary transfer occurs any time on or after December 1, 1983 without such decedent ever having regained competency to dispose of such decedent's property, or having died within 90 days of the date on which such decedent first regains competency,

the present value determined under this section of a remainder interest shall be determined in accordance with paragraphs (b)(1) through (5) or (d)(1) through (5) of this section, whichever is most beneficial to the taxpayer.

(d) Valuation of charitable remainder unitrusts having certain payout sequences; for transfer made before December 1, 1983—(1) In general. For transfers made before December 1, 1983, the present value determined under this section of a remainder interest which is dependent on a term of years or the termination of the life of one individual shall be determined under paragraphs (d)(1) through (5) of this section provided that the amount of the payout as of any payout date during any taxable year of the trust is not larger than the amount which the trust could distribute on such date under paragraph (a)(1)(v) of § 1.644–3 if the taxable year of the trust were to end on such date. The present value of the remainder interest in such trust shall be determined by computing the adjusted payout rate (as defined in subparagraph (2) of this paragraph) and following the procedure outlined in subparagraph (3) or (4) of this paragraph, whichever is applicable. The present value of a

remainder interest which is dependent on a term of years is computed under subparagraph (3) of this paragraph. The present value of a remainder interest which is dependent on the termination of the life of one individual is computed under subparagraph (4) of this paragraph. For transfers made after November 30, 1983, see paragraphs (b)(1) through (5) and (c) of this section.

(2) Adjusted payout rate. The adjusted payout rate is determined by multiplying the fixed percentage described in paragraph (a)(1)(i)(a) of § 1.664–3 by the figure in column (2) of Table F which describes the payout sequence of the trust opposite the number in column (1) of Table F which corresponds to the number of months by which the valuation date for the first full taxable year of the trust precedes the first payout date for such taxable year. If the governing instrument does not prescribe when the distribution shall be made during the taxable year of the trust, see paragraph (a)(4) of this section. In the case of a trust having a payout sequence for which no figures have been provided by Table F and in the case of a trust which determines the fair market value of the trust assets by taking the average of valuations on more than one date during the taxable year, see paragraph (a)(3) of this section.

(3) Period is a term of years. If the period described in paragraph (a)(5) of § 1.664–3 is a term of years, the factor which is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table D in subparagraph (5) of this paragraph opposite the number in column (1) of Table D which corresponds to the number of years in the term. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided in Table D, a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this subparagraph. For purposes of this section, the term "appropriate valuation date" means the date on which the property is transferred to the trust by the donor except that, for purposes of section 2055 or 2106, it means the date of death unless the alternate valuation date is elected in accordance with section 2032 and the regulations thereunder in which event it means the alternate valuation date. If the adjusted payout rate is greater than 9 percent, see paragraph (a)(4) of this section. The application of this paragraph may be illustrated by the following example:

Example. D transfers $100,000 to a charitable remainder unitrust on January 1, 1970. The trust instrument requires that the trust pay to D semiannually (on June 30 and December 31) 5 percent of the fair market value of the trust assets as of June 30th for a term of 15 years. The adjusted payout rate is 4.928 percent ($5\% \times 0.985643$). The present value of the remainder interest is $46,863.60, computed as follows:

Factor at 4.8 percent for 15 years	0.478139
Factor at 5.0 percent for 15 years	.463291
Difference	.014848

$$4.928\% - 4.8\% \div 0.2\% = X \div 0.014848$$
$$X = 0.009503$$

Factor at 4.8 percent for 15 years	.478139
Less: X	.009503
Interpolated factor	.468636

Present value of remainder interest = $100,000 × 0.468636 = $46,863.60.

(4) Period is the life of one individual. If the period described in paragraph (a)(5) of § 1.664–3 is the life of one individual, the factor which is used in determining the present value of the remainder interest is the factor under the appropriate adjusted payout rate in column (2) of Table E(1) or E(2) in paragraph (5) of this paragraph opposite the number in column (1) which corresponds to the age of the individual whose life measures the period. Table E(1) is to be used when the individual upon whose life the remainder interest is based is a male and Table E(2) is to be used when such individual is a female whose age is less than 95 years. In the case of a female whose age is more than 94 years, Table E(1) is to be used. For purposes of the computations described in this paragraph, the age of an individual is to be taken as the age of that individual at his nearest birthday. If the adjusted payout rate is an amount which is between adjusted payout rates for which factors are provided in Table E(1) or E(2), a linear interpolation must be made. The present value of the remainder interest is determined by multiplying the net fair market value (as of the appropriate valuation date) of the property placed in trust by the factor determined under this subparagraph. If the adjusted payout rate is greater than 9 percent, see paragraph (a)(4) of this section. The application of this paragraph may be illustrated by the following example:

Example. D, a male who will be 50 years old on April 15, 1970, transfers $100,000 to a charitable remainder unitrust on January 1, 1970. The trust instrument requires that the trust pay to D at the end of each taxable year of the trust 5 percent of the fair market value of the trust assets as of the beginning of each taxable year of the trust. The adjusted payout rate is 4.717 percent (5 percent × .943396). The present value of the remainder interest is $37,816, computed as follows:

Factor at 4.6 percent for male aged 50	0.38623
Factor at 4.8 percent for male aged 50	.37244
Difference	.01379

$$4.717\% - 4.6\% \div 0.2\% = X \div 0.01379$$
$$X = 0.00807$$

Factor at 4.6 percent for male aged 50	.38623
Less: X	.00807
Interpolated factor	.37816

Present value of remainder interest = $100,000 × 0.37816 = $37,816.

(5) The following tables shall be used in the application of the provisions of this section:

TABLE D

TABLE SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST POSTPONED FOR A TERM OF YEARS IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN

(1)	(2) Adjusted payout rate				
Years	4.6%	4.8%	5.0%	5.2%	5.4%
1........	.954000	.952000	.950000	.948000	.946000
2........	.910116	.906304	.902500	.898704	.894916
3........	.868251	.862801	.857375	.851917	.846591
4........	.828311	.821387	.814506	.807669	.800875
5........	.790209	.781960	.773781	.765670	.757627
6........	.753859	.744426	.735092	.725855	.716716
7........	.719182	.708694	.698337	.688111	.678013
8........	.686099	.674677	.663420	.652329	.641400
9........	.654539	.642292	.632049	.618408	.606765
10.......	.624430	.611462	.598737	.586251	.573999
11.......	.595706	.582112	.568800	.555766	.543003
12.......	.568304	.554170	.540360	.526866	.513681
13.......	.542162	.527570	.513342	.499469	.485942
14.......	.517222	.502247	.487675	.473496	.459701
15.......	.493430	.478139	.463291	.448875	.434878
16.......	.470732	.455188	.440127	.425533	.411394
17.......	.449079	.433339	.418120	.403405	.389179
18.......	.428421	.412539	.397214	.382428	.368163
19.......	.408714	.392737	.377354	.362542	.348282
20.......	.389913	.373886	.358486	.343690	.329475

(1)	(2) Adjusted payout rate				
Years	5.6%	5.8%	6.0%	6.2%	6.4%
1........	.944000	.942000	.940000	.938000	.936000
2........	.891136	.887364	.883600	.879844	.876096
3........	.841232	.835897	.830584	.825294	.820026
4........	.794123	.787415	.780749	.774125	.767544
5........	.749652	.741745	.733904	.726130	.718421
6........	.707672	.698721	.689870	.681110	.672442
7........	.668042	.658198	.648478	.638881	.629406
8........	.630632	.620022	.609569	.599270	.589124
9........	.595317	.584061	.572995	.562115	.551420
10.......	.561979	.550185	.538615	.527264	.516129
11.......	.530508	.518275	.506298	.494574	.483097
12.......	.500800	.488215	.475920	.463910	.452179
13.......	.472755	.459898	.447365	.435148	.423239
14.......	.446281	.433224	.420523	.408169	.396152
15.......	.421289	.408097	.395292	.382862	.370798
16.......	.397697	.384427	.371574	.359125	.347067
17.......	.375426	.362131	.349280	.336859	.324855
18.......	.354402	341127	.328323	.315974	.304064
19.......	.334555	.321342	.308624	.296383	.284604
20.......	.315820	.302704	.290106	.278008	.266389

(1)	(2) Adjusted payout rate				
Years	6.6%	6.8%	7.0%	7.2%	7.4%
1........	.934000	.932000	.930000	.928000	.926000
2........	.872356	.868624	.864900	.861184	.857476
3........	.814781	.809558	.804357	.799179	.794023
4........	.761005	.754508	.748052	.741638	.735265
5........	.710779	.703201	.695688	.688240	.680855
6........	.663867	.655383	.646990	.638687	.630472
7........	.620052	.610817	.601701	.592701	.583817
8........	.579129	.569282	.559582	.550027	.540615
9........	.540906	.530571	.520411	.510425	.500609
10.......	.505206	.494492	.483982	.473674	.463564
11.......	.471863	.460866	.450104	.439570	.429260
12.......	.440720	.429527	.418596	.407921	.397495
13.......	.411632	.400320	.389295	.378550	.368081
14.......	.384465	.373098	.362044	.351295	.340843
15.......	.359090	.347727	.336701	.326002	.315620
16.......	.335390	.324082	.313132	.302529	.292264
17.......	.313254	.302044	.291213	.280747	.270637
18.......	.292579	.281505	.270828	.260533	.250610
19.......	.273269	.262363	.251870	.241775	.232065
20.......	.255233	.244522	.234239	.224367	.214892

(1)	(2) Adjusted payout rate				
Years	7.6%	7.8%	8.0%	8.2%	8.4%
1........	.924000	.922000	.920000	.918000	.916000
2........	.853776	.850084	.846400	.842724	.839056
3........	.788889	.783777	.778688	.773621	.768575
4........	.728933	.722643	.716393	.710184	.704015
5........	.673535	.666277	.659082	.651949	.644878
6........	.622346	.614307	.606355	.598489	.590708
7........	.575048	.566391	.557847	.549413	.541089
8........	.531344	.522213	.513219	.504361	.495637
9........	.490962	.481480	.472161	.463003	.454004
10.......	.453649	.443925	.434388	.425037	.415867
11.......	.419171	.409298	.399637	.390184	.380934
12.......	.387314	.377373	.367666	.358189	.348936
13.......	.357879	.347938	.338253	.328817	.319625
14.......	.330680	.320799	.311193	.301854	.292777
15.......	.305548	.295777	.286297	.277102	.268184
16.......	.282326	.272706	.263394	.254380	.245656
17.......	.260870	.251435	.242322	.233521	.225021
18.......	.241044	.231823	.222936	.214372	.206119
19.......	.222724	.213741	.205101	.196794	.188805
20.......	.205797	.197069	.188693	.180657	.172946

(1)	(2) Adjusted payout rate		
Years	8.6%	8.8%	9.0%
1........	.914000	.912000	.910000
2........	.835396	.831744	.828100
3........	.763552	.758551	.753571
4........	.697886	.691798	.685750
5........	.637868	.630920	.624032
6........	.583012	.575399	.567869
7........	.532873	.524764	.516761
8........	.487046	.478585	.470253
9........	.445160	.436469	.427930
10.......	.406876	.398060	.389416
11.......	.371885	.363031	.354369
12.......	.339902	.331084	.322475
13.......	.310671	.301949	.293453
14.......	.283953	.275377	.267042
15.......	.259533	.251144	.243008
16.......	.237213	.229043	.221137
17.......	.316813	.208887	.201235
18.......	.198167	.190505	.183124
19.......	.181125	.173741	.166643
20.......	.165548	158452	.151645

TABLE E(1)

TABLE, SINGLE LIFE, MALE, SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN

(1)..... Age	(2) Adjusted payout rate 4.6%	4.8%	5.0%	5.2%	5.4%
0........	.08579	.08028	.07541	.07110	.06728
1........	.06190	.05610	.05097	.04642	.04240
2........	.06314	.05717	.05188	.04719	.04303
3........	.06509	.05895	.05350	.04866	.04436
4........	.06738	.06106	.05545	.05046	.04602
5........	.06993	.06344	.05766	.05252	.04793
6........	.07268	.06601	.06006	.05476	.05003
7........	.07561	.06876	.06265	.05718	.05230
8........	.07874	.07171	.06542	.05979	.05475
9........	.08206	.07484	.06837	.06258	.05738
10.......	.08558	.07817	.07153	.06556	.06020
11.......	.08930	.08170	.07488	.06874	.06322
12.......	.09319	.08540	.07839	.07208	.06640
13.......	.09722	.08924	.08205	.07556	.06971
14.......	.10133	.09316	.08578	.07912	.07309
15.......	.10550	.09713	.08957	.08272	.07652
16.......	.10970	.10113	.09338	.08635	.07997
17.......	.11396	.10519	.09724	.09002	.08346
18.......	.11826	.10929	.10114	.09373	.08699
19.......	.12267	.11349	.10513	.09753	.09060
20.......	.12718	.11779	.10923	.10143	.09431
21.......	.13180	.12220	.11344	.10544	.09813
22.......	.13656	.12674	.11777	.10957	.10206
23.......	.14150	.13147	.12229	.11388	.10617
24.......	.14668	.13643	.12704	.11842	.11051
25.......	.15217	.14171	.13210	.12327	.11516
26.......	.15800	.14732	.13751	.12847	.12015
27.......	.16416	.15327	.14325	.13400	.12547
28.......	.17064	.15955	.14932	.13987	.13113
29.......	.17745	.16616	.15571	.14606	.13712
30.......	.18454	.17305	.16240	.15254	.14341
31.......	.19193	.18024	.16940	.15934	.15000
32.......	.19963	.18775	.17671	.16645	.15692
33.......	.20763	.19556	.18433	.17388	.16415
34.......	.21595	.20369	.19228	.18164	.17172
35.......	.22457	.21215	.20056	.18974	.17963
36.......	.23350	.22091	.20915	.19815	.18786
37.......	.24274	.22999	.21807	.20690	.19643
38.......	.25227	.23938	.22729	.21596	.20533
39.......	.26209	.24907	.23683	.22535	.21455
40.......	.27219	.25903	.24666	.23502	.22407
41.......	.28254	.26927	.25677	.24499	.23390
42.......	.29315	.27977	.26715	.25525	.24402
43.......	.30401	.29054	.27781	.26579	.25443
44.......	.31512	.30156	.28874	.27661	.26513
45.......	.32647	.31284	.29993	.28770	.27611
46.......	.33806	.32437	.31139	.29907	.28738
47.......	.34988	.33615	.32310	.31071	.29894
48.......	.36188	.34811	.33502	.32257	.31073
49.......	.37401	.36023	.34710	.33460	.32269
50.......	.38623	.37244	.35929	.34675	.33479
51.......	.39851	.38473	.37156	.35899	.34699
52.......	.41086	.39709	.38392	.37134	.35930
53.......	.42329	.40955	.39639	.38380	.37174
54.......	.43586	.42216	.40903	.39644	.38437

(1)..... Age	(2) Adjusted payout rate 5.6%	5.8%	6.0%	6.2%	6.4%
0........	.06390	.06089	.05821	.05583	.05369
1........	.03883	.03565	.03282	.03031	.02806
2........	.03933	.03604	.03311	.03049	.02815
3........	.04053	.03712	.03408	.03136	.02893
4........	.04206	.03853	.03537	.03254	.03001
5........	.04383	.04017	.03690	.03396	.03133
6........	.04579	.04200	.03860	.03556	.03282
7........	.04792	.04400	.04047	.03731	.03446
8........	.05022	.04616	.04251	.03923	.03627
9........	.05271	.04851	.04473	.04132	.03824
10.......	.05538	.05104	.04712	.04359	.04039
11.......	.05824	.05375	.04970	.04604	.04272
12.......	.06126	.05663	.05244	.04864	.04520
13.......	.06442	.05963	.05530	.05137	.04780
14.......	.06764	.06270	.05822	.05415	.05046
15.......	.07090	.06581	.06118	.05697	.05314
16.......	.07418	.06893	.06415	.05979	.05583
17.......	.07750	.07208	.06714	.06264	.05854
18.......	.08086	.07526	.07017	.06551	.06126
19.......	.08429	.07853	.07326	.06845	.06405
20.......	.08781	.08187	.07644	.07147	.06692
21.......	.09144	.08532	.07972	.07458	.06987
22.......	.09518	.08887	.08309	.07779	.07291
23.......	.09909	.09260	.08664	.08116	.07611
24.......	.10324	.09655	.09040	.08474	.07953
25.......	.10769	.10081	.09447	.08863	.08324
26.......	.11248	.10540	.09888	.09285	.08728
27.......	.11760	.11033	.10362	.09740	.09165
28.......	.12306	.11559	.10868	.10228	.09635
29.......	.12885	.12119	.11408	.10749	.10137
30.......	.13493	.12707	.11977	.11299	.10668
31.......	.14133	.13327	.12577	.11880	.11231
32.......	.14805	.13979	.13210	.12494	.11826
33.......	.15509	.14664	.13876	.13140	.12453
34.......	.16247	.15382	.14575	.13821	.13115
35.......	.17018	.16135	.15309	.14536	.13812
36.......	.17823	.16922	.16077	.15285	.14543
37.......	.18662	.17743	.16880	.16070	.15309
38.......	.19535	.18597	.17717	.16889	.16110
39.......	.20440	.19486	.18588	.17742	.16946
40.......	.21377	.20406	.19491	.18628	.17815
41.......	.22344	.21357	.20426	.19547	.18717
42.......	.23341	.22339	.21392	.20498	.19651
43.......	.24368	.23352	.22391	.21480	.20618
44.......	.25425	.24396	.23420	.22495	.21618
45.......	.26512	.25470	.24481	.23543	.22651
46.......	.27629	.26575	.25574	.24622	.23718
47.......	.28775	.27711	.26698	.25734	.24817
48.......	.29945	.28871	.27848	.26873	.25944
49.......	.31134	.30052	.29019	.28034	.27094
50.......	.32337	.31247	.30206	.29212	.28261
51.......	.33552	.32455	.31406	.30403	.29444
52.......	.34778	.33676	.32620	.31610	.30642
53.......	.36019	.34912	.33851	.32834	.31858
54.......	.37280	.36169	.35104	.34081	.33099

(1)..... Age	(2) Adjusted payout rate 6.6%	6.8%	7.0%	7.2%	7.4%
0........	.05179	.05008	.04854	.04716	.0459
1........	.02605	.02425	.02263	.02118	.0198
2........	.02606	.02418	.02250	.02098	.0196
3........	.02674	.02479	.02303	.02144	.0200

(1)..... Age	(2) Adjusted payout rate 6.6%	6.8%	7.0%	7.2%	7.4%
4........	.02774	.02570	.02386	.02220	.0207
5........	.02896	.02683	.02491	.02318	.0216
6........	.03035	.02813	.02613	.02432	.0226
7........	.03189	.02958	.02749	.02559	.0238
8........	.03360	.03118	.02900	.02702	.0252
9........	.03546	.03295	.03067	.02861	.0267
10.......	.03750	.03489	.03251	.03036	.0284
11.......	.03972	.03700	.03452	.03227	.0302
12.......	.04208	.03925	.03667	.03433	.0321
13.......	.04456	.04162	.03894	.03649	.0342
14.......	.04710	.04404	.04125	.03870	.0363
15.......	.04966	.04648	.04358	.04093	.0385
16.......	.05221	.04891	.04590	.04314	.0406
17.......	.05479	.05136	.04823	.04536	.0427
18.......	.05738	.05382	.05056	.04757	.0448
19.......	.06003	.05633	.05295	.04984	.0469
20.......	.06274	.05891	.05539	.05216	.0491
21.......	.06554	.06157	.05791	.05455	.0514
22.......	.06843	.06430	.06051	.05701	.0537
23.......	.07147	.06719	.06325	.05961	.0562
24.......	.07472	.07028	.06619	.06240	.0589
25.......	.07826	.07366	.06941	.06548	.0618
26.......	.08213	.07737	.07296	.06887	.0650
27.......	.08633	.08139	.07682	.07257	.06863
28.......	.09085	.08574	.08100	.07659	.07249
29.......	.09569	.09041	.08550	.08093	.07667
30.......	.10082	.09536	.09028	.08554	.08113
31.......	.10626	.10062	.09537	.09046	.08588
32.......	.11202	.10621	.10077	.09570	.09095
33.......	.11812	.11212	.10651	.10126	.09634
34.......	.12455	.11837	.11258	.10716	.10207
35.......	.13133	.12497	.11900	.11340	.10814
36.......	.13846	.13192	.12577	.11999	.11456
37.......	.14594	.13922	.13289	.12694	.12134
38.......	.15377	.14687	.14037	.13425	.12847
39.......	.16195	.15488	.14821	.14191	.13596
40.......	.17047	.16322	.15638	.14991	.14380
41.......	.17932	.17190	.16489	.15825	.15197
42.......	.18850	.18092	.17374	.16694	.16049
43.......	.19802	.19027	.18293	.17597	.16936
44.......	.20786	.19997	.19247	.18535	.17858
45.......	.21805	.21000	.20235	.19508	.18815
46.......	.22857	.22038	.21259	.20516	.19809
47.......	.23943	.23111	.22318	.21561	.20840
48.......	.25058	.24213	.23406	.22636	.21901
49.......	.26196	.25339	.24520	.23737	.22989
50.......	.27353	.26485	.25654	.24859	.24098
51.......	.28525	.27646	.26804	.25998	.25225
52.......	.29714	.28825	.27973	.27155	.26371
53.......	.30922	.30024	.29162	.28334	.27539
54.......	.32156	.31249	.30379	.29542	.28737

(1)..... Age	(2) Adjusted payout rate 7.6%	7.8%	8.0%	8.2%	8.4%
0........	.04480	.04378	.04285	.04201	.04125
1........	.01870	.01763	.01667	.01580	.01500
2........	.01838	.01727	.01626	.01534	.01451
3........	.01872	.01755	.01649	.01553	.01466
4........	.01935	.01813	.01702	.01601	.01509
5........	.02020	.01891	.01774	.01668	.01571
6........	.02119	.01984	.01862	.01750	.01648
7........	.02232	.02091	.01962	.01845	.01738
8........	.02360	.02212	.02077	.01953	.01841
9........	.02503	.02347	.02205	.02076	.01958
10.......	.02661	.02498	.02350	.02214	.02089
11.......	.02836	.02665	.02510	.02367	.02236
12.......	.03024	.02846	.02682	.02533	.02396
13.......	.03222	.03036	.02865	.02708	.02564
14.......	.03425	.03230	.03051	.02887	.02736
15.......	.03628	.03424	.03238	.03066	.02908
16.......	.03829	.03617	.03421	.03242	.03076
17.......	.04031	.03809	.03605	.03417	.03243
18.......	.04231	.03999	.03786	.03589	.03408
19.......	.04435	.04193	.03970	.03765	.03575
20.......	.04644	.04392	.04159	.03943	.03744
21.......	.04859	.04595	.04352	.04126	.03918
22.......	.05080	.04804	.04550	.04314	.04096
23.......	.05314	.05026	.04760	.04514	.04285
24.......	.05566	.05266	.04988	.04730	.04490
25.......	.05846	.05533	.05242	.04972	.04721
26.......	.06156	.05829	.05525	.05243	.04980
27.......	.06497	.06156	.05839	.05544	.05269
28.......	.06868	.06513	.06182	.05874	.05586
29.......	.07271	.06901	.06556	.06234	.05933
30.......	.07700	.07316	.06956	.06620	.06305
31.......	.08160	.07760	.07385	.07035	.06706
32.......	.08651	.08235	.07845	.07480	.07137
33.......	.09173	.08741	.08336	.07956	.07599
34.......	.09730	.09281	.08860	.08465	.08093
35.......	.10320	.09856	.09419	.09008	.08620
36.......	.10945	.10464	.10011	.09584	.09182
37.......	.11606	.11108	.10639	.10196	.09778
38.......	.12302	.11788	.11303	.10844	.10410
39.......	.13035	.12504	.12002	.11527	.11078
40.......	.13801	.13254	.12735	.12245	.11779
41.......	.14602	.14038	.13504	.12997	.12516
42.......	.15438	.14857	.14307	.13784	.13287
43.......	.16308	.15712	.15145	.14607	.14094
44.......	.17214	.16602	.16020	.15466	.14938
45.......	.18156	.17529	.16931	.16361	.15818
46.......	.19135	.18493	.17880	.17295	.16737
47.......	.20151	.19494	.18866	.18267	.17694
48.......	.21199	.20527	.19886	.19272	.18685
49.......	.22273	.21588	.20933	.20305	.19704
50.......	.23369	.22671	.22003	.21362	.20747
51.......	.24484	.23773	.23092	.22438	.21810
52.......	.25618	.24896	.24202	.23536	.22895
53.......	.26776	.26042	.25336	.24658	.24005
54.......	.27963	.27218	.26502	.25812	.25148

(1)..... Age	(2) Adjusted payout rate 8.6%	8.8%	9.0%
0........	.04055	.03991	.03932
1........	.01428	.01362	.01302
2........	.01375	.01306	.01243
3........	.01386	.01314	.01247
4........	.01425	.01348	.01278
5........	.01483	.01402	.01329
6........	.01556	.01470	.01392
7........	.01640	.01550	.01468
8........	.01738	.01643	.01556
9........	.01849	.01749	.01658
10.......	.01975	.01870	.01774
11.......	.02116	.02006	.01904
12.......	.02270	.02154	.02047

(1).....	(2) Adjusted payout rate		
Age	8.6%	8.8%	9.0%
13.......	.02432	.02310	.02198
14.......	.02597	.02469	.02351
15.......	.02762	.02628	.02504
16.......	.02924	.02783	.02653
17.......	.03083	.02936	.02799
18.......	.03240	.03085	.02942
19.......	.03399	.03237	.03086
20.......	.03560	.03390	.03232
21.......	.03725	.03546	.03380
22.......	.03894	.03706	.03531
23.......	.04073	.03876	.03692
24.......	.04268	.04061	.03868
25.......	.04488	.04270	.04068
26.......	.04735	.04507	.04294
27.......	.05012	.04773	.04549
28.......	.05317	.05066	.04831
29.......	.05651	.05388	.05142
30.......	.06011	.05735	.05476
31.......	.06398	.06110	.05839
32.......	.06815	.06513	.06229
33.......	.07263	.06947	.06650
34.......	.07742	.07413	.07102
35.......	.08255	.07911	.07587
36.......	.08802	.08443	.08105
37.......	.09383	.09010	.08657
38.......	.10000	.09612	.09244
39.......	.10652	.10249	.09866
40.......	.11338	.10920	.10522
41.......	.12059	.11625	.11213
42.......	.12815	.12366	.11939
43.......	.13607	.13142	.12700
44.......	.14435	.13955	.13498
45.......	.15300	.14806	.14334
46.......	.16204	.15694	.15208
47.......	.17147	.16623	.16122
48.......	.18123	.17585	.17070
49.......	.19129	.18577	.18048
50.......	.20158	.19592	.19050
51.......	.21208	.20629	.20073
52.......	.22280	.21688	.21119
53.......	.23378	.22773	.22192
54.......	.24508	.23892	.23298

(1).....	(2) Adjusted payout rate				
Age	4.6%	4.8%	5.0%	5.2%	5.4%
55.......	.44859	.43495	.42186	.40929	.39723
56.......	.46150	.44793	.43489	.42237	.41032
57.......	.47458	.46110	.44813	.43565	.42365
58.......	.48776	.47438	.46150	.44909	.43713
59.......	.50097	.48770	.47492	.46259	.45069
60.......	.51414	.50101	.48833	.47609	.46427
61.......	.52726	.51426	.50170	.48956	.47783
62.......	.54032	.52748	.51505	.50302	.49138
63.......	.55334	.54065	.52837	.51647	.50493
64.......	.56633	.55381	.54168	.52991	.51850
65.......	.57929	.56696	.55499	.54337	.53208
66.......	.59221	.58007	.56828	.55682	.54568
67.......	.60510	.59317	.58156	.57027	.55928
68.......	.61796	.60624	.59483	.58372	.57290
69.......	.63082	.61933	.60813	.59721	.58657
70.......	.64369	.63244	.62146	.61075	.60030
71.......	.65659	.64559	.63485	.62436	.61411
72.......	.66950	.65877	.64828	.63802	.62799
73.......	.68243	.67198	.66175	.65174	.64194
74.......	.69534	.68517	.67522	.66547	.65591
75.......	.70820	.69834	.68867	.67919	.66990
76.......	.72103	.71148	.70211	.69292	.68389
77.......	.73381	.72459	.71553	.70663	.69789
78.......	.74650	.73761	.72888	.72029	.71184
79.......	.75897	.75043	.74202	.73374	.72560
80.......	.77113	.76292	.75484	.74689	.73905
81.......	.78273	.77486	.76710	.75946	.75192
82.......	.79361	.78606	.77861	.77126	.76401
83.......	.80383	.79659	.78943	.78237	.77540
84.......	.81371	.80676	.79990	.79312	.78642
85.......	.82363	.81699	.81043	.80395	.79753
86.......	.83324	.82691	.82065	.81446	.80833
87.......	.84255	.83653	.83057	.82466	.81882
88.......	.85152	.84580	.84013	.83451	.82895
89.......	.85997	.85453	.84914	.84380	.83851
90.......	.86771	.86254	.85741	.85232	.84728
91.......	.87471	.86978	.86489	.86005	.85523
92.......	.88104	.87633	.87166	.86703	.86243
93.......	.88671	.88220	.87773	.87329	.86889
94.......	.89177	.88745	.88316	.87889	.87466
95.......	.89639	.89224	.88811	.88400	.87992
96.......	.90091	.89692	.89295	.88900	.88508
97.......	.90522	.90138	.89757	.89378	.89001
98.......	.90932	.90564	.90197	.89833	.89470
99.......	.91324	.90970	.90617	.90267	.89919
100......	.91697	.91357	.91018	.90682	.90347
101......	.92054	.91727	.91402	.91078	.90756
102......	.92398	.92084	.91772	.91461	.91152
103......	.92735	.92434	.92135	.91836	.91539
104......	.93076	.92788	.92501	.92215	.91930
105......	.93443	.93169	.92896	.92623	.92352
106......	.93886	.93628	.93372	.93116	.92860
107......	.94513	.94280	.94047	.93815	.93583
108......	.95579	.95389	.95200	.95010	.94821
109......	.97700	.97600	.97500	.97400	.97300

(1).....	(2) Adjusted payout rate				
Age	5.6%	5.8%	6.0%	6.2%	6.4%
55.......	.38565	.37452	.36383	.35356	.34369
56.......	.39875	.38761	.37690	.36660	.35669
57.......	.41209	.40096	.39025	.37993	.36998
58.......	.42561	.41451	.40380	.39347	.38351
59.......	.43922	.42814	.41746	.40714	.39718
60.......	.45285	.44182	.43117	.42087	.41091
61.......	.46648	.45551	.44489	.43463	.42469
62.......	.48012	.46921	.45865	.44842	.43851
63.......	.49376	.48293	.47243	.46225	.45238
64.......	.50743	.49669	.48626	.47615	.46633
65.......	.52113	.51049	.50015	.49011	.48035
66.......	.53485	.52432	.51408	.50412	.49444
67.......	.54859	.53818	.52806	.51820	.50860
68.......	.56236	.55209	.54208	.53233	.52283
69.......	.57619	.56606	.55619	.54656	.53717
70.......	.59009	.58013	.57041	.56091	.55164
71.......	.60409	.59431	.58474	.57540	.56626
72.......	.61818	.60858	.59920	.59002	.58103
73.......	.63234	.62295	.61375	.60475	.59593
74.......	.64655	.63738	.62839	.61957	.61094
75.......	.66078	.65183	.64306	.63445	.62601
76.......	.67503	.66633	.65779	.64940	.64117

Age	5.6%	5.8%	6.0%	6.2%	6.4%
77.......	.68930	.68086	.67256	.66441	.65640
78.......	.70353	.69536	.68732	.67942	.67164
79.......	.71758	.70969	.70192	.69428	.68675
80.......	.73133	.72372	.71622	.70884	.70157
81.......	.74449	.73716	.72994	.72282	.71580
82.......	.75686	.74981	.74285	.73598	.72920
83.......	.76852	.76172	.75501	.74838	.74184
84.......	.77981	.77327	.76681	.76043	.75412
85.......	.79120	.78493	.77873	.77260	.76654
86.......	.80226	.79627	.79033	.78446	.77865
87.......	.81303	.80730	.80163	.79602	.79046
88.......	.82343	.81798	.81257	.80721	.80190
89.......	.83326	.82806	.82291	.81780	.81274
90.......	.84228	.83733	.83241	.82754	.82270
91.......	.85046	.84573	.84103	.83637	.83175
92.......	.85787	.85334	.84884	.84438	.83995
93.......	.86451	.86017	.85585	.85157	.84732
94.......	.87045	.86627	.86212	.85800	.85390
95.......	.87587	.87185	.86785	.86387	.85993
96.......	.88119	.87731	.87346	.86964	.86581
97.......	.88626	.88253	.87883	.87514	.87143
98.......	.89110	.88751	.88395	.88040	.87688
99.......	.89572	.89227	.88884	.88542	.88208
100......	.90013	.89681	.89351	.89022	.88693
101......	.90436	.90116	.89799	.89482	.89168
102......	.90843	.90536	.90231	.89926	.89628
103......	.91243	.90948	.90654	.90361	.90073
104......	.91646	.91363	.91082	.90801	.90520
105......	.92081	.91811	.91542	.91274	.91001
106......	.92606	.92352	.92099	.91846	.91597
107......	.93352	.93121	.92891	.92661	.92434
108......	.94631	.94442	.94254	.94065	.93872
109......	.97200	.97100	.97000	.96900	.96806

(1).....	(2) Adjusted payout rate				
Age	6.6%	6.8%	7.0%	7.2%	7.4%
55.......	.33419	.32506	.31627	.30782	.29968
56.......	.34714	.33795	.32910	.32057	.31235
57.......	.36040	.35117	.34226	.33367	.32539
58.......	.37391	.36463	.35569	.34705	.33870
59.......	.38755	.37826	.36928	.36060	.35221
60.......	.40129	.39198	.38298	.37427	.36584
61.......	.41507	.40576	.39675	.38802	.37956
62.......	.42891	.41961	.41059	.40185	.39338
63.......	.44281	.43353	.42452	.41578	.40729
64.......	.45680	.44754	.43855	.42982	.42133
65.......	.47087	.46165	.45269	.44398	.43551
66.......	.48502	.47585	.46693	.45825	.44980
67.......	.49925	.49015	.48128	.47264	.46423
68.......	.51356	.50453	.49573	.48715	.47878
69.......	.52800	.51906	.51033	.50182	.49350
70.......	.54259	.53375	.52511	.51667	.50842
71.......	.55733	.54861	.54007	.53172	.52356
72.......	.57224	.56364	.55522	.54698	.53892
73.......	.58730	.57884	.57055	.56244	.55448
74.......	.60247	.59417	.58603	.57805	.57022
75.......	.61773	.60960	.60162	.59379	.58611
76.......	.63308	.62514	.61734	.60967	.60215
77.......	.64852	.64078	.63317	.62569	.61834
78.......	.66399	.65647	.64907	.64178	.63462
79.......	.67934	.67204	.66485	.65778	.65081
80.......	.69440	.68734	.68038	.67352	.66676
81.......	.70888	.70205	.69532	.68868	.68213
82.......	.72251	.71591	.70940	.70297	.69663
83.......	.73538	.72900	.72270	.71648	.71033
84.......	.74789	.74173	.73564	.72963	.72368
85.......	.76055	.75463	.74877	.74298	.73725
86.......	.77291	.76722	.76159	.75602	.75051
87.......	.78496	.77951	.77412	.76878	.76349
88.......	.79665	.79144	.78628	.78117	.77611
89.......	.80772	.80274	.79781	.79293	.78808
90.......	.81791	.81315	.80844	.80376	.79913
91.......	.82716	.82261	.81810	.81362	.80917
92.......	.83555	.83119	.82686	.82256	.81829
93.......	.84309	.83890	.83474	.83060	.82650
94.......	.84984	.84580	.84179	.83780	.83384
95.......	.85600	.85210	.84823	.84438	.84056
96.......	.86205	.85830	.85456	.85085	.84716
97.......	.86784	.86422	.86062	.85704	.85348
98.......	.87337	.86988	.86641	.86295	.85952
99.......	.87865	.87529	.87194	.86861	.86530
100......	.88370	.88046	.87724	.87403	.87084
101......	.88854	.88542	.88231	.87922	.87614
102......	.89321	.89021	.88722	.88424	.88127
103......	.89779	.89490	.89202	.88915	.88629
104......	.90242	.89964	.89688	.89412	.89137
105......	.90741	.90475	.90211	.89947	.89684
106......	.91343	.91093	.90843	.90594	.90345
107......	.92203	.91975	.91747	.91519	.91292
108......	.93688	.93500	.93312	.93125	.92937
109......	.96700	.96600	.96500	.96400	.96300

(1).....	(2) Adjusted payout rate				
Age	7.6%	7.8%	8.0%	8.2%	8.4%
55.......	.29185	.28430	.27703	.27003	.26328
56.......	.30443	.29680	.28944	.28233	.27548
57.......	.31739	.30968	.30223	.29504	.28809
58.......	.33065	.32286	.31534	.30807	.30104
59.......	.34410	.33625	.32867	.32132	.31422
60.......	.35768	.34979	.34214	.33474	.32757
61.......	.37137	.36343	.35574	.34828	.34105
62.......	.38516	.37719	.36945	.36195	.35467
63.......	.39906	.39106	.38330	.37576	.36843
64.......	.41309	.40508	.39730	.38973	.38237
65.......	.42727	.41926	.41146	.40387	.39649
66.......	.44158	.43357	.42577	.41818	.41078
67.......	.45603	.44803	.44025	.43265	.42525
68.......	.47061	.46265	.45488	.44730	.43990
69.......	.48538	.47746	.46972	.46217	.45478
70.......	.50037	.49250	.48480	.47728	.46993
71.......	.51558	.50777	.50014	.49266	.48535
72.......	.53103	.52330	.51573	.50832	.50107
73.......	.54669	.53906	.53158	.52435	.51706
74.......	.56255	.55502	.54764	.54040	.53330
75.......	.57857	.57116	.56390	.55676	.54976
76.......	.59475	.58749	.58035	.57334	.56645
77.......	.61111	.60400	.59701	.59013	.58337
78.......	.62756	.62062	.61379	.60707	.60046
79.......	.64395	.63719	.63054	.62398	.61753
80.......	.66010	.65354	.64707	.64069	.63440
81.......	.67567	.66930	.66301	.65682	.65070
82.......	.69037	.68419	.67809	.67206	.66612
83.......	.70426	.69827	.69235	.68650	.68072
84.......	.71781	.71200	.70626	.70059	.69498
85.......	.73158	.72598	.72044	.71495	.70953
86.......	.74506	.73966	.73432	.72903	.72380

(1)..... Age	(2) Adjusted payout rate 7.6%	7.8%	8.0%	8.2%	8.4%
87.......	.75825	.75307	.74793	.74285	.73781
88.......	.77109	.76612	.76119	.75631	.75148
89.......	.78328	.77852	.77380	.76912	.76448
90.......	.79453	.78997	.78544	.78096	.77651
91.......	.80476	.80039	.79604	.79173	.78746
92.......	.81406	.80985	.80568	.80154	.79742
93.......	.82242	.81837	.81435	.81036	.80639
94.......	.82991	.82600	.82212	.81827	.81444
95.......	.83676	.83298	.82922	.82550	.82179
96.......	.84349	.83984	.83622	.83261	.82903
97.......	.84994	.84642	.84292	.83944	.83598
98.......	.85611	.85271	.84933	.84597	.84263
99.......	.86201	.85873	.85547	.85222	.84900
100......	.86766	.86450	.86135	.85822	.85510
101......	.87308	.87003	.86699	.86397	.86096
102......	.87832	.87537	.87244	.86953	.86662
103......	.88345	.88061	.87779	.87497	.87217
104......	.88863	.88591	.88319	.88048	.87778
105......	.89422	.89161	.88900	.88641	.88382
106......	.90097	.89850	.89604	.89358	.89113
107......	.91065	.90839	.90614	.90388	.90163
108......	.92750	.92563	.92376	.92189	.92003
109......	.96200	.96100	.96000	.95900	.95800

(1)..... Age	(2) Adjusted payout rate 8.6%	8.8%	9.0%
55.......	.25677	.25049	.24444
56.......	.26887	.26249	.25632
57.......	.28138	.27490	.26864
58.......	.29424	.28767	.28131
59.......	.30734	.30069	.29424
60.......	.32062	.31389	.30736
61.......	.33404	.32723	.32064
62.......	.34760	.34074	.33407
63.......	.36132	.35440	.34768
64.......	.37522	.36826	.36149
65.......	.38931	.38231	.37550
66.......	.40358	.39656	.38971
67.......	.41803	.41100	.40413
68.......	.43268	.42564	.41876
69.......	.44758	.44053	.43365
70.......	.46274	.45571	.44884
71.......	.47820	.47120	.46435
72.......	.49396	.48700	.48019
73.......	.51002	.50311	.49634
74.......	.52633	.51950	.51279
75.......	.54288	.53613	.52949
76.......	.55967	.55302	.54648
77.......	.57672	.57018	.56375
78.......	.59394	.58753	.58122
79.......	.61117	.60490	.59873
80.......	.62820	.62209	.61607
81.......	.64467	.63872	.63285
82.......	.66025	.65446	.64874
83.......	.67501	.66938	.66381
84.......	.68944	.68396	.67854
85.......	.70417	.69886	.69361
86.......	.71862	.71350	.70843
87.......	.73283	.72789	.72300
88.......	.74668	.74194	.73723
89.......	.75989	.75533	.75081
90.......	.77209	.76771	.76337
91.......	.78322	.77901	.77483
92.......	.79334	.78929	.78526
93.......	.80246	.79855	.79466
94.......	.81063	.80685	.80310
95.......	.81811	.81444	.81081
96.......	.82547	.82193	.81841
97.......	.83254	.82911	.82571
98.......	.83930	.83600	.83271
99.......	.84578	.84259	.83941
100......	.85200	.84891	.84583
101......	.85796	.85498	.85201
102......	.86373	.86085	.85798
103......	.86938	.86660	.86383
104......	.87509	.87241	.86974
105......	.88124	.87867	.87611
106......	.88868	.88624	.88381
107......	.89939	.89715	.89492
108......	.91816	.91630	.91444
109......	.95700	.95600	.95500

TABLE E(2)

TABLE, SINGLE LIFE, FEMALE, SHOWING THE PRESENT WORTH OF A REMAINDER INTEREST IN A CHARITABLE REMAINDER UNITRUST HAVING THE ADJUSTED PAYOUT RATE SHOWN

(1)..... Age	(2) Adjusted payout rate 4.6%	4.8%	5.0%	5.2%	5.4%
0........	.06451	.05997	.05602	.05256	.04954
1........	.04555	.04079	.03664	.03301	.02984
2........	.04619	.04128	.03700	.03324	.02996
3........	.04751	.04245	.03802	.03414	.03074
4........	.04911	.04389	.03932	.03531	.03179
5........	.05090	.04552	.04081	.03666	.03301
6........	.05284	.04731	.04244	.03815	.03437
7........	.05496	.04926	.04424	.03981	.03590
8........	.05723	.05136	.04617	.04160	.03755
9........	.05965	.05361	.04826	.04353	.03935
10.......	.06222	.05600	.05049	.04561	.04128
11.......	.06493	.05853	.05286	.04782	.04334
12.......	.06779	.06121	.05536	.05016	.04553
13.......	.07076	.06400	.05797	.05261	.04783
14.......	.07385	.06690	.06070	.05517	.05022
15.......	.07705	.06991	.06353	.05782	.05272
16.......	.08035	.07301	.06644	.06056	.05530
17.......	.08376	.07622	.06947	.06341	.05797
18.......	.08728	.07955	.07260	.06636	.06075
19.......	.09094	.08300	.07586	.06944	.06365
20.......	.09476	.08662	.07928	.07267	.06670
21.......	.09874	.09038	.08285	.07604	.06989
22.......	.10288	.09431	.08658	.07958	.07324
23.......	.10719	.09842	.09047	.08328	.07675
24.......	.11170	.10271	.09456	.08716	.08045
25.......	.11640	.10720	.09884	.09124	.08432
26.......	.12130	.11188	.10331	.09551	.08840
27.......	.12640	.11677	.10798	.09997	.09266
28.......	.13173	.12188	.11288	.10466	.09715
29.......	.13726	.12719	.11798	.19055	.10184
30.......	.14302	.13273	.12331	.11467	.10675
31.......	.14898	.13848	.12884	.12000	.11187
32.......	.15518	.14446	.13461	.12555	.11722
33.......	.16161	.15068	.14061	.13135	.12280
34.......	.16828	.15714	.14687	.13739	.12864
35.......	.17521	.16385	.15337	.14368	.13473

(1).....	(2) Adjusted payout rate				
Age	4.6%	4.8%	5.0%	5.2%	5.4%
36.......	.18238	.17083	.16014	.15024	.14108
37.......	.18982	.17806	.16717	.15707	.14770
38.......	.19751	.18556	.17446	.16416	.15459
39.......	.20546	.19331	.18201	.17151	.16174
40.......	.21366	.20132	.18984	.17914	.16917
41.......	.22212	.20960	.19793	.18704	.17685
42.......	.23084	.21814	.20628	.19520	.18481
43.......	.23982	.22695	.21492	.20365	.19316
44.......	.24907	.23604	.22383	.21239	.20163
45.......	.25861	.24542	.23305	.22143	.21051
46.......	.26843	.25509	.24256	.23079	.21970
47.......	.27852	.26505	.25237	.24044	.22920
48.......	.28890	.27531	.26249	.25040	.23901
49.......	.29955	.28583	.27289	.26066	.24913
50.......	.31046	.29664	.27358	.27122	.25954
51.......	.32163	.30772	.29454	.28207	.27023
52.......	.33306	.31907	.30579	.29321	.21826
53.......	.34478	.33072	.31736	.30467	.29261
54.......	.35682	.34270	.32928	.31650	.30434

(1).....	(2) Adjusted payout rate				
Age	5.6%	5.8%	6.0%	6.2%	6.4%
0........	.04690	.04458	.04255	.04076	.03918
1........	.02706	.02463	.02249	.02061	.01895
2........	.02708	.02455	.02232	.02037	.01864
3........	.02775	.02512	.02281	.02077	.01897
4........	.02869	.02596	.02355	.02143	.01955
5........	.02979	.02696	.02445	.02224	.02028
6........	.03104	.02809	.02549	.02318	.02113
7........	.03244	.02938	.02667	.02427	.02213
8........	.03397	.03079	.02797	.02547	.02324
9........	.03563	.03234	.02941	.02680	.02448
10.......	.03743	.03401	.03096	.02825	.02583
11.......	.03935	.03581	.03264	.02982	.02729
12.......	.04140	.03772	.03444	.03150	.02887
13.......	.04356	.03974	.03633	.03327	.03053
14.......	.04581	.04185	.03831	.03513	.03228
15.......	.04815	.04405	.04038	.03708	.03411
16.......	.05057	.04633	.04252	.03909	.03600
17.......	.05309	.04869	.04474	.04118	.03797
18.......	.05570	.05116	.04706	.04336	.04002
19.......	.05844	.05373	.04948	.04564	.04217
20.......	.06131	.05645	.05205	.04806	.04445
21.......	.06433	.05930	.05474	.05061	.04686
22.......	.06750	.06230	.05758	.05329	.04940
23.......	.07083	.06546	.06057	.05613	.05209
24.......	.07434	.06879	.06374	.05913	.05494
25.......	.07803	.07230	.06707	.06231	.05796
26.......	.08191	.07600	.07060	.06566	.06115
27.......	.08599	.07989	.07431	.06920	.06453
28.......	.09028	.08399	.07823	.07295	.06811
29.......	.09477	.08829	.08234	.07689	.07187
30.......	.09948	.09281	.08668	.08104	.07585
31.......	.10440	.09753	.09121	.08539	.08002
32.......	.10955	.10248	.09597	.08996	.08442
33.......	.11493	.10766	.10096	.09476	.08903
34.......	.12056	.11309	.10619	.09980	.09389
35.......	.12644	.11878	.11168	.10510	.09900
36.......	.13259	.12472	.11743	.11065	.10437
37.......	.13901	.13094	.12344	.11648	.11000
38.......	.14569	.13742	.12973	.12257	.11590
39.......	.15264	.14417	.13628	.12893	.12207
40.......	.15987	.15120	.14312	.13556	.12851
41.......	.16738	.15851	.15023	.14248	.13523
42.......	.17516	.16610	.15762	.14968	.14224
43.......	.18323	.17398	.16530	.15717	.14954
44.......	.19160	.18216	.17329	.16497	.15715
45.......	.20028	.19065	.18160	.17309	.16508
46.......	.20929	.19948	.19024	.18154	.17335
47.......	.21860	.20862	.19920	.19033	.18195
48.......	.22825	.21809	.20850	.19945	.19089
49.......	.23820	.22788	.21812	.20889	.20016
50.......	.24846	.23799	.22807	.21867	.20977
51.......	.25904	.24841	.23834	.22878	.21971
52.......	.26992	.25915	.24893	.23922	.22998
53.......	.28115	.27025	.25988	.25002	.24064
54.......	.29277	.28175	.27125	.26125	.25172

(1).....	(2) Adjusted payout rate				
Age	6.6%	6.8%	7.0%	7.2%	7.4%
0........	.03778	.03665	.03546	.03448	.03362
1........	.01749	.01620	.01506	.01404	.01314
2........	.01711	.01576	.01457	.01351	.01256
3........	.01737	.01596	.01471	.01360	.01261
4........	.01788	.01641	.01509	.01393	.01289
5........	.01854	.01700	.01562	.01440	.01331
6........	.01932	.01770	.01626	.01498	.01383
7........	.02023	.01845	.01704	.01569	.01448
8........	.02126	.01949	.01791	.01650	.01523
9........	.02241	.02056	.01890	.01742	.01609
10.......	.02367	.02173	.02000	.01844	.01705
11.......	.02504	.02301	.02120	.01957	.01811
12.......	.02652	.02440	.02250	.02080	.01926
13.......	.02808	.02587	.02388	.02210	.02048
14.......	.02972	.02741	.02534	.02347	.02177
15.......	.03144	.02903	.02686	.02490	.02313
16.......	.03321	.03070	.02843	.02638	.02453
17.......	.03507	.03245	.03008	.02793	.02598
18.......	.03700	.03427	.03179	.02954	.02751
19.......	.03903	.03618	.03359	.03124	.02911
20.......	.04118	.03821	.03551	.03305	.03082
21.......	.04345	.04036	.03754	.03498	.03264
22.......	.04586	.04263	.03970	.03702	.03457
23.......	.04840	.04505	.04198	.03918	.03663
24.......	.05111	.04762	.04442	.04150	.03883
25.......	.05398	.05035	.04702	.04397	.04118
26.......	.05702	.05324	.04978	.04660	.04368
27.......	.06024	.05631	.05271	.04939	.04635
28.......	.06366	.05958	.05583	.05237	.04920
29.......	.06727	.06303	.05912	.05553	.05221
30.......	.07108	.06668	.06262	.05888	.05542
31.......	.07508	.07052	.06630	.06241	.05881
32.......	.07930	.07457	.07019	.06614	.06240
33.......	.08374	.07884	.07430	.07009	.06619
34.......	.08842	.08334	.07864	.07427	.07022
35.......	.09335	.08809	.08322	.07869	.07447
36.......	.09853	.09310	.08805	.08335	.07897
37.......	.10397	.09836	.09314	.08827	.08373
38.......	.10969	.10389	.09849	.09345	.08874
39.......	.11566	.10969	.10411	.09889	.09401
40.......	.12192	.11576	.10999	.10460	.09955
41.......	.12845	.12211	.11616	.11058	.10536
42.......	.13527	.12873	.12260	.11685	.11144
43.......	.14238	.13566	.12934	.12340	.11782
44.......	.14980	.14289	.13639	.13027	.12451

(1).....	(2) Adjusted payout rate				
Age	6.6%	6.8%	7.0%	7.2%	7.4%
45.......	.15754	.15044	.14376	.13746	.13151
46.......	.16563	.15834	.15147	.14499	.13887
47.......	.17404	.16657	.15952	.15285	.14655
48.......	.18280	.17515	.16792	.16107	.15459
49.......	.19190	.18407	.17665	.16963	.16297
50.......	.20133	.19333	.18574	.17853	.17170
51.......	.21110	.20292	.19516	.18778	.18077
52.......	.22121	.21287	.20493	.19738	.19020
53.......	.23171	.22320	.21510	.20739	.20003
54.......	.24264	.23398	.22572	.21784	.21032

(1).....	(2) Adjusted payout rate				
Age	7.6%	7.8%	8.0%	8.2%	8.4%
0........	.03284	.03215	.03153	.03097	.0304
1........	.01234	.01162	.01098	.01040	.00989
2........	.01172	.01097	.01029	.00969	.00915
3........	.01172	.01093	.01023	.00959	.00902
4........	.01196	.01113	.01038	.00972	.00912
5........	.01233	.01146	.01067	.00997	.00933
6........	.01281	.01189	.01106	.01032	.00965
7........	.01340	.01244	.01157	.01078	.01007
8........	.01410	.01308	.01216	.01133	.01058
9........	.01490	.01382	.01285	.01198	.01119
10.......	.01579	.01466	.01364	.01272	.01189
11.......	.01679	.01560	.01452	.01355	.01267
12.......	.01787	.01662	.01549	.01446	.01354
13.......	.01903	.01771	.01652	.01544	.01446
14.......	.02025	.01886	.01761	.01647	.01543
15.......	.02152	.02007	.01875	.01755	.01646
16.......	.02284	.02131	.01992	.01866	.01751
17.......	.02422	.02261	.02115	.01982	.01861
18.......	.02565	.02397	.02243	.02103	.01975
19.......	.02717	.02540	.02378	.02231	.02096
20.......	.02878	.02693	.02523	.02368	.02226
21.......	.03050	.02855	.02677	.02514	.02364
22.......	.03233	.03029	.02842	.02670	.02513
23.......	.03429	.03214	.03018	.02837	.02671
24.......	.03638	.03413	.03207	.03017	.02843
25.......	.03861	.03626	.03409	.03210	.03026
26.......	.04100	.03853	.03626	.03417	.03224
27.......	.04354	.04096	.03858	.03638	.03436
28.......	.04627	.04356	.04107	.03877	.03664
29.......	.04915	.04633	.04372	.04130	.03907
30.......	.05223	.04928	.04654	.04401	.04167
31.......	.05548	.05239	.04953	.04688	.04442
32.......	.05892	.05570	.05272	.04994	.04736
33.......	.06258	.05922	.05609	.05319	.05049
34.......	.06645	.06295	.05969	.05665	.05382
35.......	.07055	.06690	.06350	.06033	.05737
36.......	.07490	.07110	.06755	.06424	.06115
37.......	.07949	.07554	.07184	.06839	.06516
38.......	.08434	.08023	.07638	.07278	.06941
39.......	.08944	.08517	.08117	.07742	.07390
40.......	.09481	.09038	.08622	.08231	.07865
41.......	.10045	.09585	.09153	.08747	.08365
42.......	.10637	.10160	.09711	.09289	.08892
43.......	.11257	.10763	.10298	.09859	.09446
44.......	.11908	.11397	.10914	.10460	.10030
45.......	.12591	.12062	.11563	.11092	.10646
46.......	.13308	.12762	.12246	.11757	.11295
47.......	.14059	.13495	.12961	.12456	.11977
48.......	.14845	.14264	.13713	.13190	.12694
49.......	.15665	.15066	.14498	.13958	.13445
50.......	.16520	.15904	.15318	.14761	.14231
51.......	.17410	.16776	.16173	.15599	.15052
52.......	.18336	.17685	.17064	.16473	.15909
53.......	.19302	.18634	.17996	.17388	.16807
54.......	.20315	.19629	.18975	.18350	.17752

(1).....	(2) Adjusted payout rate		
Age	8.6%	8.8%	9.0%
0........	.03001	.02959	.02921
1........	.00942	.00900	.00862
2........	.00866	.00822	.00782
3........	.00851	.00804	.00763
4........	.00857	.00808	.00764
5........	.00876	.00825	.00778
6........	.00904	.00850	.00800
7........	.00944	.00886	.00833
8........	.00991	.00930	.00874
9........	.01048	.00983	.00924
10.......	.01113	.01045	.00982
11.......	.01187	.01115	.01048
12.......	.01269	.01192	.01122
13.......	.01357	.01275	.01201
14.......	.01449	.01363	.01285
15.......	.01546	.01455	.01372
16.......	.01646	.01550	.01462
17.......	.01750	.01648	.01556
18.......	.01858	.01751	.01653
19.......	.01973	.01860	.01756
20.......	.02096	.01976	.01867
21.......	.02227	.02101	.01985
22.......	.02368	.02235	.02112
23.......	.02519	.02379	.02249
24.......	.02682	.02534	.02397
25.......	.02857	.02701	.02557
26.......	.03046	.02881	.02729
27.......	.03248	.03075	.02914
28.......	.03467	.03284	.03115
29.......	.03699	.03507	.03329
30.......	.03949	.03747	.03559
31.......	.04214	.04001	.03803
32.......	.04496	.04273	.04065
33.......	.04797	.04563	.04344
34.......	.05118	.04872	.04643
35.......	.05461	.05203	.04962
36.......	.05825	.05555	.05302
37.......	.06213	.05930	.05665
38.......	.06625	.06328	.06050
39.......	.07060	.06750	.06459
40.......	.07520	.07196	.06892
41.......	.08006	.07668	.07349
42.......	.08517	.08165	.07832
43.......	.09057	.08689	.08342
44.......	.09625	.09242	.08880
45.......	.10225	.09826	.09449
46.......	.10858	.10444	.10051
47.......	.11523	.11093	.10685
48.......	.12224	.11778	.11354
49.......	.12958	.12496	.12056
50.......	.13728	.13248	.12792
51.......	.14531	.14036	.13563
52.......	.15372	.14859	.14370

(1)..... Age	(2) Adjusted payout rate 8.6%	8.8%	9.0%
53.......	.16253	.15723	.15218
54.......	.17181	.16635	.16113

(1)..... Age	(2) Adjusted payout rate 4.6%	4.8%	5.0%	5.2%	5.4%
55.......	.36923	.35507	.34159	.32874	.31650
56.......	.38200	.36783	.35430	.34140	.32908
57.......	.39513	.38095	.36741	.35447	.34209
58.......	.40857	.39441	.38086	.36790	.35549
59.......	.42227	.40814	.39461	.38164	.36920
60.......	.43618	.42210	.40860	.39564	.38320
61.......	.45027	.43626	.42280	.40987	.39744
62.......	.46456	.45063	.43724	.42435	.41194
63.......	.47905	.46523	.45192	.43909	.42672
64.......	.49378	.48009	.46688	.45413	.44182
65.......	.50877	.49522	.48214	.46949	.45727
66.......	.52403	.51066	.49772	.48519	.47308
67.......	.53954	.52636	.51358	.50121	.48922
68.......	.55525	.54228	.52970	.51749	.50565
69.......	.57108	.55835	.54598	.53396	.52229
70.......	.58699	.57451	.56237	.55056	.53908
71.......	.60296	.59075	.57886	.56729	.55601
72.......	.61899	.60707	.59546	.58413	.57309
73.......	.63504	.62344	.61211	.60105	.59026
74.......	.65106	.63979	.62877	.61800	.60747
75.......	.66700	.65607	.64538	.63491	.62468
76.......	.68289	.67233	.66197	.65183	.64190
77.......	.69876	.68857	.67857	.66878	.65917
78.......	.71448	.70468	.69506	.68562	.67635
79.......	.72990	.72050	.71126	.70219	.69327
80.......	.74488	.73588	.72703	.71833	.70977
81.......	.75921	.75061	.74215	.73381	.72561
82.......	.77285	.76464	.75655	.74857	.74071
83.......	.78593	.77810	.77038	.76276	.75525
84.......	.79883	.79139	.78404	.77679	.76963
85.......	.81194	.80491	.79796	.79109	.78431
86.......	.82427	.81763	.81106	.80457	.79815
87.......	.83573	.82947	.82327	.81714	.81107
88.......	.84637	.84046	.83461	.82881	.82307
89.......	.85614	.85057	.84504	.83957	.83414
90.......	.86502	.85975	.85453	.84935	.84421
91.......	.87300	.86800	.86305	.85814	.85327
92.......	.88004	.87530	.87059	.86592	.86129
93.......	.88621	.88168	.87719	.87273	.86831
94.......	.89159	.88726	.88296	.87869	.87445

(1)..... Age	(2) Adjusted payout rate 5.6%	5.8%	6.0%	6.2%	6.4%
55.......	.30482	.29369	.28308	.27295	.26328
56.......	.31732	.30610	.29537	.28513	.27534
57.......	.33027	.31896	.30814	.29779	.28789
58.......	.34361	.33223	.32133	.31090	.30089
59.......	.35728	.34586	.33489	.32438	.31429
60.......	.37125	.35978	.34877	.33819	.32803
61.......	.38549	.37399	.36294	.35231	.34209
62.......	.40000	.38850	.37742	.36676	.35648
63.......	.41481	.40331	.39223	.38155	.37124
64.......	.42995	.41848	.40741	.39672	.38640
65.......	.44546	.43404	.42300	.41233	.40200
66.......	.46135	.45000	.43901	42837	.41807
67.......	.47760	.46634	.45542	.44484	.43458
68.......	.49416	.48301	.47219	.46168	.45149
69.......	.51095	.49993	.48922	.47882	46870
70.......	.52791	.51704	.50647	.49618	.48617
71.......	.54503	.53434	.52392	.51377	.50388
72.......	.56232	.55182	.54157	.53158	.52184
73.......	.57972	.56943	.55939	.54958	.54000
74.......	59719	.58713	.57730	.56769	.55829
75.......	.61466	.60485	.59526	.58586	.57667
76.......	.63217	.62263	.61329	.60414	.59517
77.......	.64974	.64050	.63143	.62254	.61382
78.......	.66725	.65832	.64955	.64093	.63247
79.......	.68451	.67589	.66743	.65911	.65093
80.......	.70135	.69306	.68491	.67689	.66899
81.......	.71752	.70956	.70173	.69401	.68641
82.......	.73296	.72533	.71780	.71038	.70307
83.......	.74783	.74052	.73330	.72618	.71916
84.......	.76255	.75557	.74868	.74187	.73515
85.......	.77760	.77098	.76443	.75796	.75157
86.......	.79180	.78553	.77932	.77318	.76710
87.......	.80506	.79912	.79323	.78741	.78164
88.......	.81739	.81177	.80619	.80067	.79521
89.......	.82876	.82344	.81816	.81292	.80774
90.......	.83912	.83407	.82906	.82410	.81918
91.......	.84844	.84364	.83889	.83417	.82949
92.......	.85669	.85212	.84759	.84309	.83863
93.......	.86391	.85955	.85522	.85092	.84665
94.......	.87024	.86605	.86189	.85776	.85366

(1)..... Age	(2) Adjusted payout rate 6.6%	6.8%	7.0%	7.2%	7.4%
55.......	.25406	.24525	.23684	.22881	.22113
56.......	.26598	.25704	.24848	.24030	.23247
57.......	.27841	.26934	.26065	.25233	.24436
58.......	.29131	.28212	.27331	.26486	.25675
59.......	.30460	.29531	.28639	.27782	.26959
60.......	.31826	.30887	.29984	.29117	.28282
61.......	.33225	.32277	.31366	.30488	.29643
62.......	.34658	.33704	.32785	.31898	.31043
63.......	.36129	.35170	.34244	.33350	.32487
64.......	.37643	.36679	.35748	.34848	.33978
65.......	.39202	.38236	.37301	.36397	.35522
66.......	.40810	.39843	.38907	.38000	.37121
67.......	.42463	.41498	.40563	.39655	.38774
68.......	.44158	.43197	.42263	.41357	.40476
69.......	.45887	.44931	.44002	.43098	.42219
70.......	.47642	.46694	.45771	.44872	.43996
71.......	.49424	.48485	.47570	.46678	.45808
72.......	.51233	.50305	.49400	.48517	.47655
73.......	.53064	.52150	51257	.50384	.49532
74.......	.54911	.54012	.53133	.52274	.51433
75.......	.56767	.55886	.55023	.54179	.53352
76.......	.58638	.57777	.56932	.56105	.55293
77.......	.60526	.59686	.58862	.58054	.57261
78.......	.62417	.61601	.60799	.60012	.59239
79.......	.64288	.63498	.62720	.61956	.61205
80.......	.66123	.65359	.64606	.63866	.63138
81.......	.67892	.67154	.66428	.65712	.65007
82.......	.69586	.68875	.68174	.67484	.66802
83.......	.71223	.70539	.69864	.69198	.68541
84.......	.72851	.72195	.71548	.70908	.70277
85.......	.74525	.73900	.73283	.72672	.72069
86.......	.76110	.75515	.74928	.74346	.73771
87.......	.77594	.77029	.76470	.75917	.75369
88.......	.78979	.78443	.77912	.77386	.76865
89.......	.80260	.79751	.79246	.78746	.78250
90.......	.81430	.80946	.80466	.79990	.79518

(1)..... Age	(2) Adjusted payout rate 6.6%	6.8%	7.0%	7.2%	7.4%
91.......	.82484	.82024	.81567	.81113	.80663
92.......	.83420	.82980	.82544	.82111	.81681
93.......	.84241	.83820	.83402	.82986	.82574
94.......	.84959	.84554	.84153	.83753	.83357

(1)..... Age	(2) Adjusted payout rate 7.6%	7.8%	8.0%	8.2%	8.4%
55.......	.21379	.20678	.20007	.19365	.18751
56.......	.22498	.21781	.21094	.20437	.19806
57.......	.23672	.22940	.22238	.21565	.20919
58.......	.24897	.24151	.23434	.22746	.22086
59.......	.26168	.25408	.24678	.23975	.23300
60.......	.27479	.26706	.25963	.25248	.24559
61.......	.28829	.28045	.27289	.26561	.25859
62.......	.30219	.29424	.28657	.27917	.27203
63.......	.31654	.30849	.30072	.29321	.28595
64.......	.33137	.32324	.31538	.30777	.30041
65.......	.34674	.33854	.33060	.32291	.31546
66.......	.36269	.35444	.34643	.33867	.33115
67.......	.37919	.37090	.36285	.35503	.34745
68.......	.39620	.38789	.37981	.37196	.36432
69.......	.41364	.40532	.39723	.38936	.38170
70.......	.43144	.42314	.41505	.40718	.39950
71.......	.44960	.44133	.43327	.42541	.41774
72.......	.46813	.45992	.45190	.44407	.43643
73.......	.48699	.47885	.47089	.46312	.45552
74.......	.50611	.49806	.49019	.48249	.47495
75.......	.52542	.51749	.50972	.50211	.49465
76.......	.54498	.53718	.52954	.52204	.51469
77.......	.56482	.55718	.54968	.54232	.53510
78.......	.58480	.57733	.57000	.56280	.55572
79.......	.60466	.59739	.59025	.58322	.57631
80.......	.62421	.61715	.61021	.60337	.59664
81.......	.64313	.63629	.62955	.62291	.61636
82.......	.66131	.65468	.64815	.64171	.63536
83.......	.67892	.67252	.66621	.65997	.65382
84.......	.69653	.69037	.68428	.67827	.67233
85.......	.71473	.70884	.70301	.69725	.69156
86.......	.73202	.72640	.72083	.71532	.70987
87.......	.74827	.74291	.73759	.73233	.72713
88.......	.76348	.75837	.75331	.74829	.74332
89.......	.77759	.77272	.76789	.76311	.75836
90.......	.79050	.78586	.78126	.77669	.77217
91.......	.80217	.79774	.79335	.78899	.78466
92.......	.81254	.80831	.80410	.79993	.79578
93.......	.82165	.81758	.81355	.80954	.80556
94.......	.82963	.82572	.82183	.81797	.81413

(1)..... Age	(2) Adjusted payout rate 8.6%	8.8%	9.0%
55.......	.18164	.17601	.17062
56.......	.19203	.18624	.18069
57.......	.20300	.19705	.19134
58.......	.21451	.20841	.20255
59.......	.22651	.22026	.21425
60.......	.23895	.23256	.22641
61.......	.25182	.24529	.23900
62.......	.26514	.25848	.25205
63.......	.27894	.27216	.26561
64.......	.29329	.28640	.27973
65.......	.30825	.30125	.29448
66.......	.32385	.31677	.30990
67.......	.34008	.33293	.32598

(1)..... Age	(2) Adjusted payout rate 8.6%	8.8%	9.0%
68.......	.35691	.34969	.34268
69.......	.37424	.36698	.35992
70.......	.39203	.38474	.37764
71.......	.41026	.40297	.39585
72.......	.42897	.42168	.41456
73.......	.44809	.44083	.43373
74.......	.46757	.46036	.45329
75.......	.48735	.48020	.47319
76.......	.50748	.50041	.49348
77.......	.52801	.52104	.51421
78.......	.54877	.54194	.53522
79.......	.56951	.56283	.55625
80.......	.59001	.58349	.57706
81.......	.60992	.60356	.59730
82.......	.62910	.62292	.61683
83.......	.64775	.64175	.63584
84.......	.66647	.66067	.65495
85.......	.68593	.68036	.67486
86.......	.70448	.69915	.69387
87.......	.72197	.71687	.71182
88.......	.73839	.73351	.72868
89.......	.75366	.74900	.74438
90.......	.76768	.76322	.75881
91.......	.78037	.77611	.77189
92.......	.79167	.78759	.78353
93.......	.80161	.79768	.79378
94.......	.81032	.80653	.80277

TABLE F

TABLE, 6 PERCENT, SHOWING FACTORS FOR COMPUTATION OF THE ADJUSTED PAYOUT RATE FOR CERTAIN VALUATION AND PAYOUT SEQUENCES

(1) Number of months by which the valuation date precedes the first payout: At least	But less than	(2) Factors for payout at the end of each: Annual period	Semiannual period	Quarterly period	Monthly period
0	1	1.000000	.985643	.978516	.973784
1	2	.995156	.980869	.973776	.969067
2	3	.990336	.976117	.969059	
3	4	.985538	.971389	.964365	
4	5	.980764	.966684		
5	6	.976014	.962001		
6	7	.971286	.957341		
7	8	.966581			
8	9	.961899			
9	10	.957239			
10	11	.952603			
11	12	.947988			
12		.943396			

[T.D. 7202, 37 FR 16922, Aug. 23, 1972; 38 FR 12918, May 17, 1973; 38 FR 14370, June 1, 1973; T.D. 7955, 49 FR 19983, May 11, 1984]

§ 1.665(a)–0A Excess distributions by trusts; scope of subpart D.

(a) In general. (1) Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the

Code as amended by the Tax Reform Act of 1969, is designed to tax the beneficiary of a trust that accumulates, rather than distributes, all or part of its income currently (*i.e.*, an accumulation trust), in most cases, as if the income had been currently distributed to the beneficiary instead of accumulated by the trusts. Accordingly, subpart D provides special rules for the treatment of amounts paid, credited, or required to be distributed by a complex trust (one that is subject to subpart C (section 661 and following) of such part I) in any year in excess of "distributable net income" (as defined in section 643(a)) for that year. Such an excess distribution is an "accumulation distribution" (as defined in section 665(b)). The special rules of subpart D are generally inapplicable to amounts paid, credited, or required to be distributed by a trust in a taxable year in which it qualifies as a simple trust (one that is subject to subpart B (section 651 and following) of such part I). However, see § 1.665(e)–1A(b) for rules relating to the treatment of a simple trust as a complex trust.

(2) An accumulation distribution is deemed to consist of, first, "undistributed net income" (as defined in section 665(a)) of the trust from preceding taxable years, and, after all the undistributed net income for all preceding taxable years has been deemed distributed, "undistributed capital gain" (as defined in section 665(f)) of the trust for all preceding taxable years commencing with the first year such amounts were accumulated. An accumulation distribution of undistributed capital gain is a "capital gain distribution" (as defined in section 665(g)). To the extent an accumulation distribution exceeds the "undistributed net income" and "undistributed capital gain" so determined, it is deemed to consist of corpus.

(3) The accumulation distribution is "thrown back" to the earliest "preceding taxable year" of the trust, which, in the case of distributions made for a taxable year beginning after December 31, 1973, from a trust (other than a foreign trust created by a U.S. person), is any taxable year beginning after December 31, 1968. Special transitional rules apply for distributions made in taxable years beginning before January 1, 1974. In the case of a foreign trust created by a U.S. person, a "preceding taxable year" is any year of the trust to which the Code applies.

(4) A distribution of undistributed net income (included in an accumulation distribution) and a capital gain distribution will be included in the income of the beneficiary in the year they are actually paid, credited, or required to be distributed to him. The tax on the distribution will be approximately the amount of tax the beneficiary would have paid with respect to the distribution had the income and capital gain been distributed to the beneficiary in the year earned by the trust. An additional amount equal to the "taxes imposed on the trust" for the preceding year is also deemed distributed. To prevent double taxation, however, the beneficiary receives a credit for such taxes.

(b) Effective dates. All regulations sections under subpart D (sections 665 through 669) which have an "A" suffix (such as § 1.665(a)A and § 1.666(b)–1A) are applicable to taxable years beginning on or after January 1, 1969, and all references therein to sections 665 through 669 are references to such sections as amended by the Tax Reform Act of 1969. Sections without the "A" suffix (such as § 1.666(b)–1) are applicable only to taxable years beginning before January 1, 1969, and all references therein to sections 665 through 669 are references to such sections before amendment by the Tax Reform Act of 1969.

(c) Examples. Where examples contained in the regulations under subpart D refer to tax rates for years after 1968, such tax rates are not necessarily the actual rates for such years, but are only used for example purposes.

(d) Applicability to estates. Subpart D does not apply to any estate.

[T.D. 7204, 37 FR 17135, Aug. 25, 1972]

§ 1.665(a)–1A Undistributed net income.

(a) Domestic trusts. The term "undistributed net income", in the case of a trust (other than a foreign trust created by a U.S. person) means, for any taxable year beginning after December 31, 1968, the distributable net income of the trust for that year (as determined under section 643(a)), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on the trust attributable to such distributable net income, as defined in § 1.665(d)–1A. The application of the rule in this paragraph to a taxable year of a trust in which income is accumulated may be illustrated by the following example:

Example. Under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the

taxable year 1971 the trust had distributable net income of $30,100 derived from royalties and the trustee made distributions of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,190 is paid. The undistributed net income of the trust for the taxable year 1971 is $7,910, computed as follows:

Distributable net income		$30,100
Less:		
Income currently distributable to A	$10,000	
Other amounts distributed to A	10,000	
Taxes imposed on the trust attributable to the undistributed net income (see § 1.665(d)–1A)	2,190	
Total		22,190
Undistributed net income		7,910

(b) Foreign trusts. The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see § 1.643(a)–6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in section 661(a), and

(2) The amount of taxes imposed on such trust by chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income.

For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust for any taxable year by chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to section 871 (relating to tax on non-resident alien individuals) which is properly allocable to the undistributed portion of the distributable net income. See § 1.665(d)–1A. The amount of taxes imposed pursuant to section 871 is the difference between the total tax imposed pursuant to that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in this paragraph may be illustrated by the following examples:

Example (1). A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that $7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1973 the trust had income of $10,000 from dividends of a U.S. corporation (on which Federal income taxes of $3,000 were imposed pursuant to section 871 and withheld under section 1441, resulting in the receipt by the trust of cash in the amount of $7,000), $20,000 in capital gains from the sale of stock of a Country Y corporation and $30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. No income taxes were required to be paid to Country X or Country Y in 1973. The trustee did not file a U.S. income tax return for the taxable year 1973. The distributable net income of the trust before distributions to the beneficiary for 1973 is $60,000 ($57,000 of which is cash). During 1973 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income. Thus, the U.S. beneficiary is treated as having had distributed to him $5,000 (composed of $3,500 as a cash distribution and $1,500 as the tax imposed pursuant to section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; $10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and $15,000 in cash, representing one-half of the income from Country X sources for a total of $30,000. The undistributed net income of the trust at the close of taxable year 1973 is $28,500 computed as follows:

Distributable net income		$60,000
Less:		
(1) Amounts distributed to the beneficiary:		
Income currently distributed to the beneficiary	$7,000	
Other amounts distributed to the beneficiary	21,500	
Taxes under sec. 871 deemed distributed to the beneficiary	1,500	
Total amounts distributed to the beneficiary	80,000	
(2) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See § 1.665(d)–1A) $3,000 less $1,500)	$1,500	
Total		$31,500
Undistributed net income		28,500

Example (2). The facts are the same as in example (1) except that property has been transferred to the trust by a person other than a U.S. person, and during 1973 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X or Country Y in 1973.

(1) The undistributed net income of the portion of the entire trust which is a foreign trust created by a U.S. person for 1973 is $17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):		
60% of $10,000 U.S. dividends		$6,000
60% of $20,000 Country X capital gains		12,000
60% of $30,000 Country X dividends		18,000
Total		36,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (60% of $7,000)	$4,200	

Other amounts distributed to the beneficiary (60% of $21,500)	$12,900	
Taxes under sec. 871 deemed distributed to the beneficiary (60% of $1,500)	900	
Total amounts distributed to the beneficiary	18,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (see § 1.665(d)–1A) (60% of $1,500)	900	
Total		18,900
Undistributed net income		17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1973 is $11,400, computed as follows:

Distributable net income (40% of each item of gross income of entire trust)		
40% of $10,000 U.S. dividends		$4,000
40% of $20,000 Country X capital gains		8,000
40% of $30,000 Country X dividends		12,000
Total		24,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (40% of $7,000)	$2,800	
Other amounts distributed to the beneficiary (40% of $21,500)	8,600	
Taxes under sec. 871 deemed distributed to the beneficiary (40% of $1,500)	600	
Total amounts distributed to the beneficiary	12,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code attributable to the undistributed net income (See § 1.665(d)–1A) (40% of $1,500)	600	
Total		12,600
Undistributed net income		11,400

(c) Effect of prior distributions. The undistributed net income for any year to which an accumulation distribution for a later year may be thrown back will be reduced by accumulation distributions in intervening years that are required to be thrown back to such year. For example, if a trust has undistributed net income for 1975, and an accumulation distribution is made in 1980, there must be taken into account the effect on undistributed net income for 1975 of any accumulation distribution made in 1976, 1977, 1978, or 1979. However, undistributed net income for any year will not be reduced by any distributions in any intervening years that are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (d) of § 1.666(a)–1A for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution.

(d) Distributions made in taxable years beginning before January 1, 1974. For special rules relating to accumulation distributions of undistributed net income made in taxable years of the trust beginning before January 1, 1974, see § 1.665(b)–2A.

[T.D. 7204, 37 FR 17136, Aug. 25, 1972]

§ 1.665(b)–1A Accumulation distributions.

(a) In general. (1) For any taxable year of a trust the term "accumulation distribution" means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) (*i.e.,* all amounts properly paid, credited, or required to be distributed to the beneficiary other than income required to be distributed currently within the meaning of section 661(a)(1)) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. To the extent provided in section 663(b) and the regulations thereunder, distributions made within the first 65 days following a taxable year may be treated as having been distributed on the last day of such taxable year.

(2) An accumulation distribution also includes, for a taxable year of the trust, any amount to which section 661(a)(2) and the preceding paragraph are inapplicable and which is paid, credited, or required to be distributed during the taxable year of the trust by reason of the exercise of a power to appoint, distribute, consume, or withdraw corpus of the trust or income of the trust accumulated in a preceding taxable year. No accumulation distribution is deemed to be made solely because the grantor or any other person is treated as owner of a portion of the trust by reason of an unexercised power to appoint, distribute, consume, or withdraw corpus or accumulated income of the trust. Nor will an accumulation distribution be deemed to have been made by reason of the exercise of a power that may affect only taxable income previously attributed to the holders of such power under subpart E (section 671 and following). See example 4 of paragraph (d) of this section for an example of an accumulation distribution occurring as a result of the exercise of a power of withdrawal.

(3) Although amounts properly paid or credited under section 661(a) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if the amounts properly paid or credited under section 661(a)(2) exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently under section 661(a)(1). This may occur, for example, when expenses, interest, taxes, or other items allocable to corpus are taken into account in determining taxable income and hence causing distributable net income to be less than the trust's income.

(b) Payments that are accumulation distributions. The following are some instances in which an accumulation distribution may arise:

(1) One trust to another. A distribution from one trust to another trust is generally an accumulation distribution. See § 1.643(c)–1. This general rule will apply regardless of whether the distribution is to an existing trust or to a newly created trust and regardless of whether the trust to which the distribution is made was created by the same person who created the trust from which the distribution is made or a different person. However, a distribution made from one trust to a second trust will be deemed an accumulation distribution by the first trust to an ultimate beneficiary of the second trust if the primary purpose of the distribution to the second trust is to avoid the capital gain distribution provisions (see section 669 and the regulations thereunder). An amount passing from one separate share of a trust to another separate share of the same trust is not an accumulation distribution. See § 1.665(g)–2A. For rules relating to the computation of the beneficiary's tax under section 668 by reason of an accumulation distribution from the second trust, see paragraphs (b)(1) and (c)(1)(i) of § 1.668(b)–1A and paragraphs (b)(1) and (c)(1)(i) of § 1.669(b)–1A.

(2) Income accumulated during minority. A distribution of income accumulated during the minority of the beneficiary is generally an accumulation distribution. For example, if a trust accumulates income until the beneficiary's 21st birthday, and then distributes the income to the beneficiary, such a distribution is an accumulation distribution. However, see § 1.665(b)–2A for rules governing income accumulated in taxable years beginning before January 1, 1969.

(3) Amounts paid for support. To the extent that amounts forming all or part of an accumulation distribution are applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) or are used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4, such amounts will be considered as having been distributed directly to the person whose obligation is being satisfied.

(c) Payments that are not accumulation distributions—(1) Gifts, bequests, etc., described in section 663(a)(1). A gift or bequest of a specific sum of money or of specific property described in section 663(a)(1) is not an accumulation distribution.

(2) Charitable payments. Any amount paid, permanently set aside, or used for the purposes specified in section 642(c) is not an accumulation distribution, even though no charitable deduction is allowed under such section with respect to such payment.

(3) Income required to be distributed currently. No accumulation distribution will arise by reason of a payment of income required to be distributed currently even though such income exceeds the distributable net income of the trust because the payment is an amount specified in section 661(a)(1).

(d) Examples. The provisions of this section may be illustrated by the following examples:

Example (1). A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1976, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently (section 661(a)(1))		10,000
Other amounts distributed (section 661(a)(2))		10,000
Distributable net income	$15,000	
Less: Income required to be distributed currently	10,000	
Balance of distributable net income		5,000
Accumulation distribution		5,000

Example (2). Under the terms of the trust instrument, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643(b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and, in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution	$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))	15,000

Other amounts distributed (section 661(a)(2))		$5,000
Distributable net income	$13,000	
Less: Income required to be distributed currently to A	15,000	
Balance of distributable net income		0
Accumulation distribution to B		5,000

Example (3). Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently		0
Other amounts distributed (section 661(a)(2))		20,000
Distributable net income	$17,000	
Less: Income required to be distributed currently	0	
Balance of distributable net income		17,000
Accumulation distribution		3,000

Example (4). A dies in 1974 and bequeaths one-half the residue of his estate in trust. His widow, W, is given a power, exercisable solely by her, to require the trustee to pay her each year of the trust $5,000 from corpus. W's right to exercise such power was exercisable at any time during the year but was not cumulative, so that, upon her failure to exercise it before the end of any taxable year of the trust, her right as to that year lapsed. The trust's taxable year is the calendar year. During the calendar years 1975 and 1976, W did not exercise her right and it lapsed as to those years. In the calendar years 1977 and 1978, in which years the trust had no distributable net income, she exercised her right and withdrew $4,000 in 1977 and $5,000 in 1978. No accumulation distribution was made by the trust in the calendar years 1975 and 1976. An accumulation distribution of $4,000 was made in 1977 and an accumulation distribution of $5,000 was made in 1978. The accumulation distribution for the years 1977 and 1978 is not reduced by any amount of income of the trust attributable to her under section 678 by reason of her power of withdrawal.
[T.D. 7204, 37 FR 17137, Aug. 25, 1972]

§ 1.665(b)–2A Special rules for accumulation distributions made in taxable years beginning before January 1, 1974.

(a) General rule. Section 331(d)(2)(A) of the Tax Reform Act of 1969 excludes certain accumulated income from the tax imposed by section 668(a)(2) by providing certain exceptions from the definition of an "accumulation distribution." Any amount paid, credited, or required to be distributed by a trust (other than a foreign trust created by a U.S. person) during a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, shall not be subject to the tax imposed by section 668(a)(2) to the extent of the portion of such amount that (1) would be allocated under section 666(a) to a preceding taxable year of the trust beginning before January 1, 1969, and (2) would not have been deemed an accumulation distribution because of the provisions of paragraphs (1), (2), (3), or (4) of section 665(b) as in effect on December 31, 1968, had the trust distributed such amounts on the last day of its last taxable year beginning before January 1, 1969. However, the $2,000 *de minimis* exception formerly in section 665(b) does not apply in the case of any distribution made in a taxable year of a trust beginning after December 31, 1968. Amounts to which this exclusion applies shall reduce the undistributed net income of the trust for the preceding taxable year or years to which such amounts would be allocated under section 666(a). However, since section 668(a)(2) does not apply to such amounts, no amount of taxes imposed on the trust allocable to such undistributed net income is deemed distributed under section 666(b) and (c).

(b) Application of general rule. The rule expressed in paragraph (a) of this section is applied to the exceptions formerly in section 665(b) as follows:

(1) Distributions from amounts accumulated while beneficiary is under 21. (i) Paragraph (1) of section 665(b) as in effect on December 31, 1968, provided that amounts paid, credited, or required to be distributed to a beneficiary as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21 were not to be considered to be accumulation distributions. If an accumulation distribution is made in a taxable year of the trust beginning after December 31, 1968, and before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) to the extent the income earned by the trust for such preceding taxable year would be deemed under § 1.665(b)–2(b)(1) to have been accumulated before the beneficiary's birth or before his 21st birthday. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on the calendar year basis was established on January 1, 1965, to accumulate the income during the minority of B, and to pay the accumulated income over to B upon his attaining the age of 21. B's 21st birthday is January 1, 1973. On January 2, 1973, the trustee pays over to B all the accumulated income of the trust. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in § 1.665(e)–1A). To the extent the distribution is allocated to 1968, no tax is imposed under section 668(a)(2).

(ii) As indicated in paragraph (a) of this section, a distribution of an amount excepted from the tax otherwise imposed under section 668(a)(2) will reduce undistributed net income for the purpose of determining the effect of a future distribution. Thus, under the facts of the example in subdivision (i) of this subparagraph, the undistributed net income for the trust's taxable year 1968 would be reduced by the amount of the distribution allocated to that year under section 666(a).

(2) Emergency distributions. Paragraph (2) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary to meet his emergency needs. Therefore, if an accumulation distribution is made from a trust in a taxable year beginning before January 1, 1974, and under section 666(a) such accumulation distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, no tax shall be imposed under section 668(a)(2) if such distribution would have been considered an emergency distribution under § 1.665(b)–2(b)(2) had it been made in a taxable year of the trust beginning before January 1, 1969. For example, assume a trust on a calendar year basis in 1972 makes an accumulation distribution which under § 1.665(b)–2(b)(2) would be considered an emergency distribution and under section 666(a) the distribution would be allocated to the years 1967, 1968, and 1969. To the extent such amount is allocated to 1967 and 1968, no tax would be imposed under section 668(a)(2).

(3) Certain distributions at specified ages. Paragraph (3) of section 665(b) as in effect on December 31, 1968, provided an exclusion (in the case of certain trusts created before January 1, 1954) from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary upon his attaining a specified age or ages, subject to certain restrictions (see § 1.665(b)–2(b)(3)). Therefore, a distribution from a trust in a taxable year beginning after December 31, 1968, will not be subject to the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such distribution would have qualified under the provisions of § 1.665(b)–2(b)(3) had it been made in a taxable year of the trust to which such section was applicable.

(4) Certain final distributions. Paragraph (4) of section 665(b) as in effect on December 31, 1968, provided an exclusion from the definition of an accumulation distribution for amounts properly paid or credited to a beneficiary as a final distribution of the trust if such final distribution was made more than 9 years after the date of the last transfer to such trust. Therefore, amounts properly paid or credited to a beneficiary as a final distribution of a trust in a taxable year of a trust beginning after December 31, 1968, and before January 1, 1974, will not be subject to the tax imposed under section 668(a)(2) to the extent such distribution would be allocated to a preceding taxable year of the trust beginning before January 1, 1969, if such final distribution was made more than 9 years after the date of the last transfer to such trust. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust on a calendar year basis was established on January 1, 1958, and no additional transfers were made to it. On January 1, 1973, the trustee terminates the trust and on the same day he makes a final distribution to the beneficiary, B. The distribution is an accumulation distribution that may be allocated under section 666(a) to 1968, 1969, 1970, 1971, and 1972 (the 5 preceding taxable years as defined in § 1.665(e)–1A). Because more than 9 years elapsed between the date of the last transfer to the trust and the date of final distribution, the distribution is not taxed under section 668(a)(2) to the extent it would be allocated to 1968 under section 666(a).

[T.D. 7204, 37 FR 17138, Aug. 25, 1972]

§ 1.665(c)–1A Special rule applicable to distributions by certain foreign trusts.

(a) In general. Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening

foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) Limitation. In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

[T.D. 7204, 37 FR 17139 Aug. 25, 1972]

§ 1.665(d)–1A Taxes imposed on the trust.

(a) In general. **(1)** For purposes of subpart D, the term "taxes imposed on the trust" means the amount of Federal income taxes properly imposed for any taxable year on the trust that are attributable to the undistributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. Except as provided in paragraph (c)(2) of this section, the minimum tax for tax preferences imposed by section 56 is not a tax attributable to the undistributed portions of distributable net income and gains in excess of losses from the sales or exchanges of capital assets. See section 56 and the regulations thereunder.

(2) In the case of a trust that has received an accumulation distribution from another trust, the term "taxes imposed on the trust" also includes the amount of taxes deemed distributed under §§ 1.666(b)–1A, 1.666(c)–1A, 1.669(d)–1A, and 1.669(e)–1A (whichever are applicable) as a result of such accumulation distribution, to the extent that they were taken into account under paragraphs (b)(2) or (c)(1)(vi) of § 1.668(b)–1A and (b)(2) or (c)(1)(vi) of § 1.669(b)–1A in computing the partial tax on such accumulation distribution. For example, assume that trust A, a calendar year trust, makes an accumulation distribution in 1975 to trust B, also on the calendar year basis, in connection with which $500 of taxes are deemed under § 1.666(b)–1A to be distributed to trust B. The partial tax on the accumulation distribution is computed under paragraph (b) of § 1.668(b)–1A (the exact method) to be $600 and all of the $500 is used under paragraph (b)(2) of § 1.668(b)–1A to reduce the partial tax to $100. The taxes imposed on trust B for 1975 will, in addition to the $100 partial tax, also include the $500 used to reduce the partial tax.

(b) Taxes imposed on the trust attributable to undistributed net income. **(1)** For the purpose of subpart D, the term "taxes imposed on the trust attributable to the undistributed net income" means the amount of Federal income taxes for the taxable year properly allocable to the undistributed portion of the distributable net income for such taxable year. This amount is (i) an amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax for tax preferences imposed by section 56), computed after the allowance of credits under section 642(a), as (a) the taxable income of the trust, other than the capital gains not included in distributable net income less their share of section 1202 deduction, bears to (b) the total taxable income of the trust for such year or, (ii) if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, an amount equal to such total taxes less the amount of the alternative tax imposed on the trust and attributable to the capital gain. Thus, for the purposes of subpart D, in determining the amount of taxes imposed on the trust attributable to the undistributed net income, that portion of the taxes paid by the trust attributable to capital gain allocable to corpus is excluded. The rule stated in this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. (1) Under the terms of a trust, which reports on the calendar year basis, the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1974, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribution of $10,000 to A. The taxes imposed on the trust for such year attributable to the undistributed net income are $2,319, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is $18,000 (royalties of $20,000 less expenses of $2,000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gain allocable to corpus		10,000
Gross income		30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		12,900
Total income taxes		3,787

(3) Taxable income other than capital gains less the section 1202 deduction is $7,900 ($12,900–($10,000–$5,000)). Therefore, the amount of taxes imposed on the trust attributable to the undistributed net income is $2,319, computed as follows:

$3,787 (total taxes) × $7,900 (taxable income other than capital gains not included in d.n.i. less the 1202 deduction) divided by $12,900 (taxable income)	$2,319

(2) If in any taxable year an accumulation distribution of undistributed net income is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed net income of such prior year are the taxes prescribed in subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 666(b) or (c). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1975 the trust makes an accumulation distribution, of which an amount of undistributed net income is deemed distributed in 1974. Taxes imposed on the trust (in the amount of $1,000) attributable to the undistributed net income are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust subsequent to the 1975 distribution attributable to the remaining undistributed net income are $1,319 ($2,319 less $1,000).

(c) Taxes imposed on the trust attributable to undistributed capital gain—(1) Regular tax. For the purpose of subpart D the term "taxes imposed on the trust attributable to undistributed capital gain" means the amount of Federal income taxes for the taxable year properly attributable to that portion of the excess of capital gains over capital losses of the trust that is allocable to corpus for such taxable year. Such amount is the total of—

(i) The amount computed under subparagraph (2) of this paragraph (the minimum tax), plus

(ii) The amount that bears the same relationship to the total taxes of the trust for the year (other than the minimum tax), computed after the allowance of credits under section 642(a), as (a) the excess of capital gains over capital losses for such year that are not included in distributable net income, computed after its share of the deduction under section 1202 (relating to the deduction for capital gains) has been taken into account, bears to the greater of (b) the total taxable income of the trust for such year, or (c) the amount of capital gains computed under (a) of this subdivision.

However, if the alternative tax computation under section 1201(b) is used and there are no net short-term gains, the amount is the amount of the alternative tax imposed on the trust and attributable to the capital gain. The application of this subparagraph may be illustrated by the following example, which assumes that the alternative tax computation is not used:

Example. Assume the same facts as in the example in paragraph (b)(1). The capital gains not included in d.n.i. are $10,000, and the deduction under section 1202 is $5,000. The amount of taxes imposed on the trust attributable to undistributed capital gain is $1,468, computed as follows:

$3,787 (total taxes)× $5,000 (capital gains not included in d.n.i. less section 1202 deductions) divided by $12,900 (taxable income)	$1,468

(2) Minimum tax. The term "taxes imposed on the trust attributable to the undistributed capital gain" also includes the minimum tax for tax preferences imposed on the trust by section 56 with respect to the undistributed capital gain. The amount of such minimum tax so included bears the same relation to the total amount of minimum tax imposed on the trust by section 56 for the taxable year as one-half the net capital gain (net section 1201 gain for taxable years beginning before January 1, 1977) (as defined in section 1222(11)) from such taxable year bears to the sum of the items of tax preference of the trust for such taxable year which are apportioned to the trust in accordance with § 1.58–3(a)(1).

(3) Reduction for prior distribution. If in any taxable year a capital gain distribution is made by the trust which results in a throwback to a prior year, the taxes of the prior year imposed on the trust attributable to any remaining undistributed capital gain of the prior year are the taxes prescribed in subparagraph (1) of this paragraph reduced by the taxes of the prior year deemed distributed under section 669(d) or (e). The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the same facts as in the example in subparagraph (1) of this paragraph. In 1976, the trust makes a capital gain distribution, of which an amount of undistributed capital gain is deemed distributed in 1974. Taxes imposed on the trust (in the amount of $500) attributable to the undistributed capital gain are therefore deemed distributed in such year. Consequently, the taxes imposed on the trust attributable to the remaining undistributed capital gain are $968 ($1,468 less $500).

[T.D. 7204, 37 FR 17139, Aug. 25, 1972, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.665(e)–1A Preceding taxable year.

(a) Definition—(1) Domestic trusts—(i) In general. For purposes of subpart D, in the case of a trust other than a foreign trust created by a U.S. person, the term "preceding taxable year" serves to identify and limit the taxable years of a trust to which an accumulation distribution consisting of

undistributed net income or undistributed capital gain may be allocated (or "thrown back") under sections 666(a) and 669(a). An accumulation distribution consisting of undistributed net income or undistributed capital gain may not be allocated or "thrown back" to a taxable year of a trust if such year is not a "preceding taxable year."

(ii) **Accumulation distributions.** In the case of an accumulation distribution consisting of undistributed net income made in a taxable year beginning before January 1, 1974, any taxable year of the trust that precedes by more than 5 years the taxable year of the trust in which such accumulation distribution was made is not a "preceding taxable year." Thus, for a domestic trust on a calendar year basis, calendar year 1967 is not a "preceding taxable year" with respect to an accumulation distribution made in calendar year 1973, whereas calendar year 1968 is a "preceding taxable year." In the case of an accumulation distribution made during a taxable year beginning after December 31, 1973, any taxable year of the trust that begins before January 1, 1969, is not a "preceding taxable year." Thus, for a domestic trust on a calendar year basis, calendar year 1968 is not a "preceding taxable year" with respect to an accumulation distribution made in calendar year 1975, whereas calendar year 1969 is a "preceding taxable year."

(iii) **Capital gain distributions.** In the case of an accumulation distribution that is a capital gain distribution, any taxable year of the trust that (a) begins before January 1, 1969, or (b) is prior to the first year in which income is accumulated, whichever occurs later, is not a "preceding taxable year." Thus, for the purpose of capital gain distributions and section 669, only taxable years beginning after December 31, 1968, can be "preceding taxable years." See § 1.688(a)–1A(c).

(2) **Foreign trusts created by U.S. persons.** For purposes of Subpart D, in the case of a foreign trust created by a U.S. person, the term "preceding taxable year" does not include any taxable year to which Part I of Subchapter J does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of Subpart D may not, in the case of a foreign trust created by a U.S. person, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a foreign trust created by a U.S. person (reporting on the calendar year basis) makes a distribution during the calendar year 1970 of income accumulated during prior years, the earliest year of the trust to which the accumulation distribution may be allocated under such Subpart D is 1954, but it may not be allocated to 1953 and prior years, since the Internal Revenue Code of 1939 applies to those years.

(b) **Simple trusts.** A taxable year of a trust during which the trust was a simple trust (that is, was subject to Subpart B) for the entire year shall not be considered a "preceding taxable year" unless during such year the trust received "outside income" or unless the trustee did not distribute all of the income of the trust that was required to be distributed currently for such year. In such event, undistributed net income for such year shall not exceed the greater of the "outside income" or income not distributed during such year. For purposes of this paragraph, the term "outside income" means amounts that are included in distributable net income of the trust for the year but that are not "income" of the trust as that term is defined in § 1.643(b)–1. Some examples of "outside income" are:

(1) Income taxable to the trust under section 691;

(2) Unrealized accounts receivable that were assigned to the trust; and

(3) Distributions from another trust that include distributable net income or undistributed net income of such other trust.

The term "outside income," however, does not include amounts received as distributions from an estate, other than income specified in (1) and (2), for which the estate was allowed a deduction under section 661(a). The application of this paragraph may be illustrated by the following examples:

Example (1). By his will D creates a trust for his widow W. The terms of the trust require that the income be distributed currently (*i.e.*, it is a simple trust), and authorize the trustee to make discretionary payments of corpus to W. Upon W's death the trust corpus is to be distributed to D's then living issue. The executor of D's will makes a $10,000 distribution of corpus to the trust that carries out estate income consisting of dividends and interest to the trust under section 662(a)(2). The trust reports this income as its only income on its income tax return for its taxable year in which ends the taxable year of the estate in which the $10,000 distribution was made, and pays a tax thereon of $2,106. Thus, the trust has undistributed net income of $7,894 ($10,000–$2,106). Several years later the trustee makes a discretionary corpus payment of $15,000 to W. This payment is an accumulation distribution under section 665(b). However, since the trust had no "outside income" in the year of the estate distribution, such year is not a preceding taxable year. Thus, W is not treated as receiving undistributed net income of $7,894 and taxes thereon of $2,106 for the purpose of including the same in her gross income under section 668. The result would be the same if the invasion power were not exercised and the accumulation distribution occurred as a result of the distribution of the corpus to D's issue upon the death of W.

Example (2). Trust A, a simple trust on the calendar year basis, received in 1972 extraordinary dividends or taxable stock dividends that the trustee in good faith allocated to corpus, but that are determined in 1974 to have been currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)–4. Trust A would qualify for treatment under Subpart C for 1974, the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and is treated as another amount properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a)(2). Also, the distribution in 1974 qualifies as an accumulation distribution for the purposes of Subpart D. For purposes only of such Subpart D, trust A would be treated as subject to the provisions of such Subpart C for 1972, the preceding taxable year in which the extraordinary or taxable stock dividends were received, and, in computing undistributed net income for 1972, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence would also apply if the distribution in 1974 was made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

[T.D. 7204, 37 FR 17141, Aug. 25, 1972]

§ 1.665(f)–1A Undistributed capital gain.

(a) Domestic trusts. (1) The term "undistributed capital gain" means (in the case of a trust other than a foreign trust created by a U.S. person), for any taxable year of the trust beginning after December 31, 1968, the gains in excess of losses for that year from the sale or exchange of capital assets of the trust less:

(i) The amount of such gains that are included in distributable net income under section 643(a)(3) and § 1.643(a)–3.

(ii) The amount of taxes imposed on the trust for such year attributable to such gains, as defined in § 1.665(d)–1A, and

(iii) In the case of a trust that does not use the alternative method for computing taxes on capital gains of the taxable year, the excess of deductions (other than deductions allowed under section 642(b) relating to personal exemption or section 642(c) relating to charitable contributions) over distributable net income for such year to the extent such excess deductions are properly allowable in determining taxable income for such year.

For purposes of computing the amount of capital gain under this paragraph, no deduction under section 1202, relating to deduction for excess of capital gains over capital losses, shall be taken into account. The application of this subparagraph may be illustrated by the following example:

Example. Under the terms of the trust, the trustee must distribute all income currently and has discretion to distribute capital gain to A or to allocate it to corpus. During the taxable year 1971 the trust recognized capital gain in the amount of $15,000, and capital losses of $5,000, and had interest income (after expenses) of $6,000. The trustee distributed $8,000 to A, consisting of $6,000 of interest and $2,000 of capital gain. The $2,000 of gain distributed to A is included in the computation of distributable net income under § 1.643(a)–3. The balance of the capital gain is not included in distributable net income since it is allocated to corpus and not paid, credited, or required to be distributed to any beneficiary. The trust paid taxes of $671, all of which are attributable under § 1.665(d)–1A to the undistributed capital gain. The amount of undistributed capital gain of the trust for 1971 is therefore $7,329, computed as follows:

Total capital gains	$15,000
Less: Capital losses	5,000
Gains in excess of losses	10,000
Less:	
Amount of capital gain included in distributable net income	2,000
Taxes imposed on the trust attributable to the undistributed capital gain (see § 1.665(d)–1A)	671
	2,671
Undistributed capital gain	7,329

(2) For purposes of subparagraph (1) of this paragraph, the term "losses for that year" includes losses of the trusts from the sale or exchange of capital assets in preceding taxable years not included in the computation of distributable net income of any year, reduced by such losses taken into account in a subsequent preceding taxable year in computing undistributed capital gain but not reduced by such losses taken into account in determining the deduction under section 1211. See section 1212(b)(2) and the regulations thereunder. For example, assume that a trust had a net long-term capital loss in 1970 of $5,000. During the years 1971 through 1975, the trust had no capital gains or capital losses. In 1976, it has a long-term capital gain of $8,000, which it allocates to corpus and does not distribute to a beneficiary, but has no taxes attributable to such gain. The undistributed capital gain for 1976 is $8,000–$5,000, or $3,000, even though all or a part of the $5,000 loss was claimed under section 1211 as a deduction in years 1970 through 1975.

(b) Foreign trusts. Distributable net income for a taxable year of a foreign trust created by a U.S. person includes capital gains in excess of capital losses for such year (see § 1.643(a)–6(a)(3)). Thus, a foreign trust created by a U.S. person can never have any undistributed capital gain.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

§ 1.665(g)–1A Capital gain distribution.

For any taxable year of a trust, the term "capital gain distribution" means, to the extent of the undistributed capital gain of the trust, that portion of an accumulation distribution that exceeds the amount of such accumulation distribution deemed under section 666(a) to be undistributed net income of the trust for all preceding taxable years. See § 1.665(b)–1A for the definition of "accumulation distribution". For any such taxable year the undistributed capital gain includes the total undistributed capital gain for all years of the trust beginning with the first taxable year beginning after December 31, 1968, in which income (as determined under section 643(b)) is accumulated, and ending before such taxable year. See § 1.665(g)–2A for application of the separate share rule. The application of this section may be illustrated by the following example:

Example. A trust on the calendar year basis made the following accumulations. For purposes of this example, the undistributed net income is the same as income under applicable local law. No income was accumulated prior to 1970.

Year	Undistributed net income	Undistributed capital gain
1969	None	$10,000
1970	$1,000	3,000
1971	None	4,000

The trust has distributable net income in 1972 of $2,000 and recognizes capital gains of $4,500 that are allocable to corpus. On December 31, 1972, the trustee makes a distribution of $20,000 to the beneficiary. There is an accumulation distribution of $18,000 ($20,000 distribution less $2,000 d.n.i.) that consists of undistributed net income of $1,000 (see § 1.666(a)–1A) and a capital gain distribution of $7,000. The capital gain distribution is computed as follows:

Accumulation distribution	$18,000
Less: Undistributed net income	1,000
Balance	17,000
Capital gain distribution (undistributed capital gain of the trust for 1972 ($3,000 from 1970 and $4,000 from 1971))	7,000
Balance (corpus)	10,000

No undistributed capital gain is deemed distributed from 1969 because 1969 is a year prior to the first year in which income is accumulated (1970). The accumulation distribution is not deemed to consist of any part of the capital gains recognized in 1972.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

§ 1.665(g)–2A Application of separate share rule.

(a) In general. If the separate share rule of section 663(c) is applicable for any taxable year of a trust, Subpart D is applied as if each share were a separate trust except as provided in paragraph (c) of this section and in § 1.668(a)–1A(c). Thus, the amounts of an "accumulation distribution", "undistributed net income", "undistributed capital gain", and "capital gain distribution" are computed separately for each share.

(b) Allocation of taxes—Undistributed net income. The "taxes imposed on the trust attributable to the undistributed net income" are allocated as follows:

(1) There is first allocated to each separate share that portion of the "taxes imposed on the trust attributable to the undistributed net income" (as defined in § 1.665(d)–1A(b)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(i) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a)(5), (6), and (7); and

(ii) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the "taxes imposed on the trust" that bears the same relation to the total of such credits that the items of distributable net income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust.

(c) Allocation of taxes—Undistributed capital gain. The "taxes imposed on the trust attributable to undistributed capital gain" are allocated as follows:

(1) There is first allocated to each separate share that portion of the "taxes imposed on the trust attributable to undistributed capital gain" (as defined in § 1.665(d)–1A(c)), computed before the allowance of any credits under section 642(a), that bears the same relation to the total of such taxes that the undistributed capital gain (prior to the

deduction of taxes under section 665(c)(2)) of the separate share bears to the total such undistributed capital gain of the trust.

(2) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the "taxes imposed on the trust" that bears the same relation to the total of such credits that the capital gain allocable to the separate share with respect to which the credit is allowed bear to the total of such capital gain of the trust.

(d) Termination of a separate share. **(1)** If upon termination of a separate share, an amount is properly paid, credited, or required to be distributed by the trust under section 661(a)(2) to a beneficiary from such share, an accumulation distribution will be deemed to have been made to the extent of such amount. In determining the distributable net income of such share, only those items of income and deduction for the taxable year of the trust in which such share terminates, properly allocable to such share, shall be taken into consideration.

(2) No accumulation distribution will be deemed to have been made upon the termination of a separate share to the extent that the property constituting such share, or a portion thereof, continues to be held as a part of the same trust. The undistributed net income, undistributed capital gain, and the taxes imposed on the trust attributable to such items, if any, for all preceding taxable years (reduced by any amounts deemed distributed under sections 666(a) and 669(a) by reason of any accumulation distribution of undistributed net income or undistributed capital gain in prior years or the current taxable year), which were allocable to the terminating share, shall be treated as being applicable to the trust itself. However, no adjustment will be made to the amounts deemed distributed under sections 666 and 669 by reason of an accumulation distribution of undistributed net income or undistributed capital gain from the surviving share or shares made in years prior to the year in which the terminating share was added to such surviving share or shares.

(3) The provisions of this paragraph may be illustrated by the following example:

Example. A trust was established under the will of X for the benefit of his wife and upon her death the property was to continue in the same trust for his two sons, Y and Z. The separate share rule is applicable to this trust. The trustee had discretion to pay or accumulate the income to the wife, and after her death was to pay each son's share to him after he attained the age of 25. When the wife died, Y was 23 and Z was 28.

(1) Upon the death of X's widow, there is no accumulation distribution. The entire trust is split into two equal shares, and therefore the undistributed net income and the undistributed capital gain of the trust are split into two shares.

(2) The distribution to Z of his share after his mother's death is an accumulation distribution of his separate share of one-half of the undistributed net income and undistributed capital gain.

[T.D. 7204, 37 FR 17142, Aug. 25, 1972]

Treatment Of Excess Distributions By Trusts

§ 1.665(a)–0 Excess distributions by trusts; scope of subpart D.

Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Internal Revenue Code, in the case of trusts other than foreign trusts created by U.S. persons, is designed generally to prevent a shift of tax burden to a trust from a beneficiary or beneficiaries. In the case of a foreign trust created by a U.S. person, Subpart D is designed to prevent certain other tax avoidance possibilities. To accomplish these ends, Subpart D provides special rules for treatment of amounts paid, credited, or required to be distributed by a complex trust (subject to Subpart C (section 661 and following) of such Part I) in any year in excess of distributable net income for that year. Such an excess distribution is defined as an accumulation distribution, subject to the limitations in section 665(b) or (c). An accumulation distribution, in the case of a trust other than a foreign trust created by a U.S. person, is "thrown back" to each of the 5 preceding years in inverse order. In the case of a foreign trust created by a U.S. person such an accumulation distribution is "thrown back," in inverse order, to each of the preceding years to which the Internal Revenue Code of 1954 applies. That is, an accumulation distribution will be taxed to the beneficiaries of the trust in the year the distribution is made or required, but, in general, only to the extent of the distributable net income of those years which was not in fact distributed. However, with respect to a distribution by a trust other than a foreign trust created by a U.S. person, the resulting tax will not be greater than the aggregate of the taxes that would have been attributable to the amount thrown back to previous years had they been included in gross income of the beneficiaries in those years. In the case of a foreign trust created by a U.S. person,

the resulting tax is computed under the provisions of section 669. To prevent double taxation, both in the case of a foreign trust created by a U.S. person, and a trust other than a foreign trust created by a U.S. person, the beneficiaries receive a credit for any taxes previously paid by the trust which are attributable to the excess thrown back and which are creditable under the provisions of Chapter 1 of the Internal Revenue Code. Subpart D does not apply to any estate.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 733, Jan. 17, 1969]

§ 1.665(a)–1 Undistributed net income.

(a) The term "undistributed net income" means for any taxable year the distributable net income of the trust for that year as determined under section 643(a), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on the trust, as defined in § 1.665(d)–1.

The application of the rule in this paragraph to the first year of a trust in which income is accumulated may be illustrated by the following example:

Example. Assume that under the terms of the trust, $10,000 of income is required to be distributed currently to A and the trustee has discretion to make additional distributions to A. During the taxable year 1954 the trust had distributable net income of $30,100 derived from royalties and the trustee made distributions of $20,000 to A. The taxable income of the trust is $10,000 on which a tax of $2,640 is paid. The undistributed net income of the trust as of the close of the taxable year 1954 is $7,460 computed as follows:

Distributable net income		$30,100
Less:		
Income currently distributable to A	$10,000	
Other amounts distributed to A	10,000	
Taxes imposed on the trust (see § 1.665(d)–1)	2,640	
		22,640
Undistributed net income		7,460

See also paragraphs (e)(1) and (f)(1) of § 1.668(b)–2 for additional illustrations of the application of the rule in this paragraph to the first year of a trust in which income is accumulated.

(b) The undistributed net income of a foreign trust created by a U.S. person for any taxable year is the distributable net income of such trust (see § 1.643(a)–6 and the examples set forth in paragraph (b) thereof), less:

(1) The amount of income required to be distributed currently and any other amounts properly paid or credited or required to be distributed to beneficiaries in the taxable year as specified in paragraphs (1) and (2) of section 661(a), and

(2) The amount of taxes imposed on such trust by Chapter 1 of the Internal Revenue Code, which are attributable to items of income which are required to be included in such distributable net income. For purposes of subparagraph (2) of this paragraph, the amount of taxes imposed on the trust (for any taxable year), by Chapter 1 of the Internal Revenue Code is the amount of taxes imposed pursuant to the provisions of section 871 which is properly allocable to the undistributed portion of the distributable net income. See § 1.665(d)–1. The amount of taxes imposed pursuant to the provisions of section 871 is the difference between the total tax imposed pursuant to the provisions of that section on the foreign trust created by a U.S. person for the year and the amount which would have been imposed on such trust had all the distributable net income, as determined under section 643(a), been distributed. The application of the rule in this paragraph may be illustrated by the following examples:

Example (1). A trust was created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money or property by a U.S. person. The entire trust constitutes a foreign trust created by a U.S. person. The governing instrument of the trust provides that $7,000 of income is required to be distributed currently to a U.S. beneficiary and gives the trustee discretion to make additional distributions to the beneficiary. During the taxable year 1963 the trust had income of $10,000 from dividends of a U.S. corporation (on which Federal income taxes of $3,000 were imposed pursuant to the provisions of section 871 and withheld under section 1441 resulting in the receipt by the trust of cash in the amount of $7,000), $20,000 in capital gains from the sale of stock of a Country Y corporation, and $30,000 from dividends of a Country X corporation, none of the gross income of which was derived from sources within the United States. The trustee did not file a U.S. income tax return for the taxable year 1963. The distributable net income of the trust before distributions to the beneficiary for 1963 is $60,000 ($57,000 of which is cash). During 1963 the trustee made distributions to the U.S. beneficiary equaling one-half of the trust's distributable net income or $30,000. Thus, the U.S. beneficiary is treated as having had distributed to him $5,000 (composed of $3,500 as a cash distribution and $1,500 as the tax imposed pursuant to the provisions of section 871 and withheld under section 1441), representing one-half of the income from U.S. sources; $10,000 in cash, representing one-half of the capital gains from the sale of stock of the Country Y corporation; and $15,000 in cash, representing one-half of the income from Country X sources for a total of $30,000. The undistributed net income of the trust at the close of taxable year 1963 is $28,500 computed as follows:

Distributable net income		$60,000
Less:		

(1) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary	$7,000	
Other amounts distributed to the beneficiary	21,500	
Taxes under sec. 871 deemed distributed to the beneficiary	1,500	
Total amounts distributed to the beneficiary	30,000	
(2) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1)	1,500	
Total		31,500
Undistributed net income		28,500

Example (2). The facts are the same as in example (1) except that property has been transferred to the trust by a person other than a U.S. person, and during 1963 the foreign trust created by a U.S. person was 60 percent of the entire foreign trust. The trustee paid no income taxes to Country X in 1963.

(1) The undistributed net income of the foreign trust created by a U.S. person for 1963 is $17,100, computed as follows:

Distributable net income (60% of each item of gross income of entire trust):		
60% of $10,000 U.S. dividends		$6,000
60% of $20,000 Country X capital gains		12,000
60% of $30,000 Country X dividends		18,000
Total		36,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (60% of $7,000)	$4,200	
Other amounts distributed to the beneficiary (60% of $21,500)	12,900	
Taxes under sec. 871 deemed distributed to the beneficiary (60% of $1,500)	900	
Total amounts distributed to the beneficiary	18,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1) (60% of $1,500)	$900	
Total		$18,900
Undistributed net income		17,100

(2) The undistributed net income of the portion of the entire trust which is not a foreign trust created by a U.S. person for 1963 is $11,400, computed as follows:

Distributed net income (40% of each item of gross income of entire trust)		
40% of $10,000 U.S. dividends		$4,000
40% of $20,000 Country X capital gains		8,000
40% of Country X dividends		12,000
Total		24,000
Less:		
(i) Amounts distributed to the beneficiary—		
Income currently distributed to the beneficiary (40% of $7,000)	$2,800	
Other amounts distributed to the beneficiary (40% of $21,500)	8,600	
Taxes under sec. 871 deemed distributed to the beneficiary (40% of $1,500)	600	
Total amounts distributed to the beneficiary	12,000	
(ii) Amount of taxes imposed on the trust under chapter 1 of the Code (See § 1.665(d)–1) (40% of $1,500)	$600	
Total		$12,600
Undistributed net income		11,400

(c) However, the undistributed net income for any year to which an accumulation distribution for a later year may be thrown back may be reduced by accumulation distributions in intervening years and also by any taxes imposed on the trust which are deemed to be distributed under section 666 by reason of the accumulation distributions. On the other hand, undistributed net income for any year will not be reduced by any distributions in an intervening year which are excluded from the definition of an accumulation distribution under section 665(b), or which are excluded under section 663(a)(1), relating to gifts, bequests, etc. See paragraph (f)(5) of § 1.668(b)–2 for an illustration of the reduction of undistributed net income for any year by a subsequent accumulation distribution. [T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 733, 741, Jan. 17, 1969]

§ 1.665(b)–1 Accumulation distributions of trusts other than certain foreign trusts; in general.

(a) Subject to the limitations set forth in § 1.665(b)–2, in the case of a trust other than a foreign trust created by a U.S. person, the term "accumulation distribution" for any taxable year means an amount (if in excess of $2,000), by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under the circumstances specified in section 677(b) or section 678(c) out of corpus or out of other than income for the taxable year and amounts used to

discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.) If the distribution as so computed is $2,000 or less, it is not an accumulation distribution within the meaning of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code. If the distribution exceeds $2,000, then the full amount is an accumulation distribution for the purposes of Subpart D.

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, in the case of a trust other than a foreign trust created by a U.S. person, the provisions of Subpart D will not apply unless there is undistributed net income in at least one of the five preceding taxable years. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples (it is assumed in each case that the exclusions provided in § 1.665(b)–2 do not apply):

Example (1). A trustee properly makes a distribution to a beneficiary of $20,000 during the taxable year 1956, of which $10,000 is income required to be distributed currently to the beneficiary. The distributable net income of the trust is $15,000. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently (section 661(a)(1))		10,000
Other amounts distributed (section 661(a)(2))		10,000
Distributable net income	$15,000	
Less: Income required to be distributed currently	10,000	
Balance of distributable net income		5,000
Accumulation distribution		5,000

Example (2). Under the terms of the trust instrument, an annuity of $15,000 is required to be paid to A out of income each year and the trustee may in his discretion make distributions out of income or corpus to B. During the taxable year the trust had income of $18,000, as defined in section 643(b), and expenses allocable to corpus of $5,000. Distributable net income amounted to $13,000. The trustee distributed $15,000 of income to A and in the exercise of his discretion, paid $5,000 to B. There is an accumulation distribution of $5,000 computed as follows:

Total distribution		$20,000
Less: Income required to be distributed currently to A (section 661(a)(1))		15,000
Other amounts distributed (section 661(a)(2))		5,000
Distributable net income	$13,000	
Less: Income required to be distributed currently to A	15,000	
Balance of distributable net income		0
Accumulation distribution to B		5,000

Example (3). Under the terms of a trust instrument, the trustee may either accumulate the trust income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. During the taxable year, the trust had income as defined in section 643(b) of $22,000 and expenses of $5,000 allocable to corpus. Distributable net income amounts to $17,000. The trustee distributed $10,000 each to A and B during the taxable year. There is an accumulation distribution of $3,000 computed as follows:

Total distribution	$20,000
Less: income required to be distributed currently	0
Other amounts distributed (section 661(a)(2))	20,000
Distributable net income	17,000
Accumulation distribution	3,000

(d) There are not taken into account, in computing the accumulation distribution for any taxable year, any amounts deemed distributed in that year because of an accumulation distribution in a later year.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 734, Jan. 17, 1969]

§ 1.665(b)–2 Exclusions from accumulation distributions in the case of trusts (other than a foreign trust created by a U.S. person).

(a) In the case of a trust other than a foreign trust created by a U.S. person, certain amounts paid, credited, or required to be distributed to a beneficiary are excluded under section 665(b) in determining whether there is an accumulation distribution for the purposes of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code. These exclusions are solely for the purpose of determining the amount allocable to preceding years under section 666 and in no way affect the determination under Subpart C (section 661 and following) of such Part I of the beneficiary's tax liability for the year of distribution. Further, amounts excluded from accumulation distributions do not reduce the amount of undistributed net income for the 5 years preceding the year of distribution.

(b) The amounts excluded from the computation of an accumulation distribution are discussed in the following subparagraphs:

(1) Distributions from accumulations while a beneficiary is under 21. (i) The first exception to the definition of an accumulation distribution is for amounts paid, credited, or required to be distributed to a beneficiary who was under 21 years of age or unborn when it was accumulated. A distribution is to be considered as so paid, credited, or required to be distributed to the extent, and only to the extent, that there is no undistributed net income for taxable years preceding the year of distribution other than undistributed net income accumulated while the beneficiary was under 21. If a distribution can be made from income accumulated either before or after a beneficiary reaches 21, it will be considered as made from the most recently accumulated income, and it will be so considered even though the governing instrument directs that distributions be charged first against the earliest accumulations.

(ii) As was indicated in paragraph (a) of this section, a distribution of an amount excepted from the definition of an accumulation distribution will not reduce undistributed net income for the purpose of determining the effect of a future accumulation distribution. Thus, a distribution to a beneficiary of income accumulated before he reached 21 would not reduce the undistributed net income includible in a future accumulation distribution to another beneficiary. However, all future distributions to the same beneficiary, or to another beneficiary to whom a distribution would be excepted under the provisions of this subparagraph, would be excepted from the definition of an accumulation distribution to the extent that they could not be paid, credited, or required to be distributed from other accumulated income.

(iii) The following examples illustrate the application of the foregoing rules of this subparagraph (in each of these examples it is assumed that the exceptions in section 665(b)(2), (3), and (4) do not apply):

(a) Income is to be accumulated until A reaches 21 when the corpus and accumulated income are to be distributed to him. The distribution is not an accumulation distribution.

(b) Income is to be accumulated until A is 21, when it is to be distributed to him but the corpus is to remain in trust. A distribution of the accumulated income to A when he reaches 21 is not an accumulation distribution.

(c) Income is to be accumulated and added to corpus until A reaches 21, when he is to receive one-third of the corpus (including accumulations). Thereafter all the income is to be paid to A until he is 23 when the remaining corpus (including accumulations) is to be paid to him. If A dies under that age any undistributed portion is to be paid to B. Distributions to A at 21 and 23 out of accumulations are not accumulation distributions even though they include accumulated income. However, if A died at the age of 22, when B was 23, a distribution to B would be an accumulation distribution to the extent of income accumulations since B reached 21, and the amount of undistributed net income includible in the distribution will not be reduced by the previous distribution to A.

(d) Income is to be accumulated and added to corpus until A is 21. After he is 21, he is entitled to all the income and, in addition, to distributions of corpus in the discretion of the trustee. When he reaches 25 he is entitled to the corpus. Distributions to A are not accumulation distributions, whether they are discretionary or upon termination of the trust.

(e) The facts are the same as in the preceding example, except that income is to be accumulated until A is 23. Distributions to A are accumulation distributions to the extent of income accumulated after A reached 21.

(f) Income may be distributed among a testator's children or accumulated and added to corpus until the youngest child is 21, when the corpus is to be distributed to the testator's then living descendants. Upon termination of the trust, the corpus is distributed to A, age 21; B, age 23; and C, the child of a deceased child, age 3. The distributions to A and C are not accumulation distributions. The distribution to B is an accumulation distribution to the extent of income accumulated after he reaches 21. (If the terms of the trust were such that it was subject to the separate share treatment under section 663(c), the distribution to B would be an accumulation distribution only to the extent of income accumulated for B's separate share since he reached 21.)

(g) Income may be distributed to A or accumulated and added to corpus during A's life. Upon the death of A the corpus is to be distributed to B. B is 23 at A's death. The distribution is an accumulation distribution to the extent of income accumulated since B reached 21.

(2) Emergency distributions. The second exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary to meet his emergency needs. Whether or not a distribution falls within this exclusion depends upon the facts and circumstanc-

es causing the distribution. A distribution based upon an unforeseen or unforeseeable combination of circumstances requiring immediate help to the beneficiary would qualify for the exclusion. However, the beneficiary must be in actual need of the distribution and the fact that he had other sufficient resources would tend to negate the conclusion that a distribution was to meet his emergency needs. Ordinary distributions for the support, maintenance, or education of the beneficiary would not qualify for the exclusion.

(3) **Certain distributions at specified ages.** The third exclusion from the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary upon the beneficiary's attaining a specified age or ages; provided, (i) the total number of such distributions with respect to that beneficiary cannot exceed 4; (ii) the period between each such distribution is 4 years or more; and (iii) on January 1, 1954, such distributions were required by the specific terms of the governing instrument. Any discretionary invasion of corpus at other times is not excluded under this subparagraph, but does not affect the status of distributions that would otherwise be excluded. If more than four distributions are required to be made to a particular beneficiary at specified ages if he survives to receive them, none of the distributions will be excluded, even though the beneficiary dies before he receives more than four. On the other hand, a direction to make additional distributions to a remainderman will not affect the status of distributions required to be made to the primary beneficiary. For example, a trust agreement provided on January 1, 1954, that when A reached age 25 he would receive one-eighth of the corpus and accumulated income, as then constituted, and similar distributions at ages 30, 35, and 40. It also provided for similar distributions to B after A's death, and for additional discretionary distributions to both A and B. Required distributions to both A and B are excluded, regardless of whether discretionary distributions are made, but discretionary distributions are not excluded. On the other hand, if an additional distribution to A was directed when he reached 45, no distributions to him would be excluded, regardless of when he died.

(4) **Certain final distributions.** (i) The last exception to the definition of an accumulation distribution is for amounts properly paid or credited to a beneficiary as a final distribution of a trust if the final distribution is made more than 9 years after the date of the last transfer to such trust.

(ii) The term "last transfer to such trust" includes only transfers, whether by the original grantor or by a third person, made with a donative intent. A transfer arising out of a property right held by the trust is excluded, such as a transfer by a debtor in satisfaction of his indebtedness, or a distribution in liquidation or reorganization of a corporation. If the terms of two or more trusts include cross-remainders on the deaths of life beneficiaries, the donative transfers occurred at the time the trusts were created. The addition of the corpus of one trust to that of another when a remainder falls in is therefore not a new transfer within the meaning of section 665(b)(4).

(iii) For example, under the terms of a trust created July 1, 1950, with an original corpus of $100,000, by H for the benefit of his wife, W, the income of the trust is to be accumulated and added to corpus. Upon the expiration of a 10-year period, the trust is to terminate and its assets, including all accumulated income, are to be distributed to W. No transfers were made by H or other persons to the trust after it was created. Both the trust and W file returns on the calendar year basis. In accordance with its terms, the trust terminated on June 30, 1960, and on August 1, 1960, the trustee made a final distribution of the assets of the trust to W, consisting of investments derived from $100,000 of donated principal, accumulated income of $30,000 attributable to the period July 1, 1950, through December 31, 1959, and income of $3,000 attributable to the period the trust was in existence during 1960. Subpart D is inapplicable to the $3,000 of income of the trust for 1960 since that amount would be deductible by the trust and includible in W's gross income for that year to the extent provided in subpart C. However, the balance of the distribution will qualify as an exclusion from the provisions of subpart D.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(b)–3 Exclusions under section 663(a)(1).

Subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, has no application to an amount which qualifies as an exclusion under section 663(a)(1), relating to gifts, bequests, etc.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.665(c)–1 Accumulation distributions of certain foreign trusts; in general.

(a) In the case of a foreign trust created by a U.S. person, the term "accumulation distribution"

for any taxable year means an amount by which the amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2) for that year exceed the distributable net income (determined under section 643(a)) of the trust, reduced (but not below zero) by the amount of income required to be distributed currently. (In computing the amount of an accumulation distribution pursuant to the preceding sentence, there is taken into account amounts applied or distributed for the support of a dependent under circumstances specified in section 677(b) and section 678(c) out of corpus or out of other than income for the taxable year and amounts used to discharge or satisfy any person's legal obligation as that term is used in § 1.662(a)–4.)

(b) Although amounts properly paid, credited, or required to be distributed under section 661(a)(2) do not exceed the income of the trust during the taxable year, an accumulation distribution may result if such amounts exceed distributable net income reduced (but not below zero) by the amount required to be distributed currently. This may result from the fact that expenses allocable to corpus are taken into account in determining taxable income and hence distributable net income. However, the provisions of Subpart D will not apply unless there is undistributed net income in at least one of the preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. See section 666 and the regulations thereunder.

(c) The provisions of paragraphs (a) and (b) of this section may be illustrated by the examples provided in paragraph (c) of § 1.665(b)–1.

[T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(c)–2 Indirect payments to the beneficiary.

(a) **In general.** Except as provided in paragraph (b) of this section, for purposes of section 665 any amount paid to a U.S. person which is from a payor who is not a U.S. person and which is derived directly or indirectly from a foreign trust created by a U.S. person shall be deemed in the year of payment to the U.S. person to have been directly paid to the U.S. person by the trust. For example, if a nonresident alien receives a distribution from a foreign trust created by a U.S. person and then pays the amount of the distribution over to a U.S. person, the payment of such amount to the U.S. person represents an accumulation distribution to the U.S. person from the trust to the extent that the amount received would have been an accumulation distribution had the trust paid the amount directly to the U.S. person in the year in which the payment was received by the U.S. person. This section also applies in a case where a nonresident alien receives indirectly an accumulation distribution from a foreign trust created by a U.S. person and then pays it over to a U.S. person. An example of such a transaction is one where the foreign trust created by a U.S. person makes the distribution to an intervening foreign trust created by either a U.S. person or a person other than a U.S. person and the intervening trust distributes the amount received to a nonresident alien who in turn pays it over to a U.S. person. Under these circumstances, it is deemed that the payment received by the U.S. person was received directly from a foreign trust created by a U.S. person.

(b) **Limitation.** In the case of a distribution to a beneficiary who is a U.S. person, paragraph (a) of this section does not apply if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 (76 Stat. 985) was enacted.

[T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(d)–1A Taxes imposed on the trust.

(a) For the purpose of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, the term "taxes imposed on the trust" means (for any taxable year) the amount of Federal income taxes which are properly allocable to the undistributed portion of the distributable net income. This amount is the difference between the total taxes of the trust for the year and the amount which would have been paid by the trust had all of the distributable net income, as determined under section 643(a), been distributed. Thus, in determining the amount of taxes imposed on the trust for the purposes of subpart D, there is excluded the portion of the taxes paid by the trust which is attributable to items of gross income which are not includible in distributable net income, such as capital gains allocable to corpus. The rule stated in this paragraph may be illustrated by the following example:

Example. (1) Under the terms of a trust which reports on the calendar year basis the income may be accumulated or distributed to A in the discretion of the trustee and capital gains are allocable to corpus. During the taxable year 1954, the trust had income of $20,000 from royalties, long-term capital gains of $10,000, and expenses of $2,000. The trustee in his discretion made a distribution of $10,000 to A. The

taxes imposed on the trust for the purposes of this subpart are $2,713, determined as shown below.

(2) The distributable net income of the trust computed under section 643(a) is $18,000 (royalties of $20,000 less expenses of $2,000). The total taxes paid by the trust are $3,787, computed as follows:

Royalties		$20,000
Capital gains		10,000
Gross income		30,000
Deductions:		
Expenses	$2,000	
Distributions to A	10,000	
Capital gain deduction	5,000	
Personal exemption	100	
		17,100
Taxable income		12,900
Total income taxes		3,787

(3) The amount of taxes which would have been paid by the trust, had all of the distributable net income ($18,000) of the trust been distributed to A, is $1,074, computed as follows:

Taxable income of the trust	$12,900
Less: Undistributed portion of distributable net income ($18,000–$10,000)	8,000
Balance of taxable income	4,900
Income taxes on $4,900	1,074

(4) The amount of taxes imposed on the trust as defined in this paragraph is $2,713, computed as follows:

Total taxes	$3,787
Taxes which would have been paid by the trust had all of the distributable net income been distributed	1,074
Taxes imposed on the trust as defined in this paragraph	2,713

(b) If in any subsequent year an accumulation distribution is made by the trust which results in a throwback to the taxable year, the taxes of the taxable year allocable to the undistributed portion of distributable net income (the taxes imposed on the trust), after the close of the subsequent year, are the taxes prescribed in paragraph (a) of this section reduced by the taxes of the taxable year allowed as credits to beneficiaries on account of amounts deemed distributed on the last day of the taxable year under section 666. See paragraph (f)(4) of § 1.668(b)–2 for an illustration of the application of this paragraph.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960. Redesignated by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(e)–1 Preceding taxable year.

(a) Definition. For purposes of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code of 1954, the term "preceding taxable year" does not include any taxable year to which such part I does not apply. See section 683 and regulations thereunder. Accordingly, the provisions of such subpart D may not, in general, be applied to any taxable year which begins before 1954 or ends before August 17, 1954. For example, if a trust (reporting on the calendar year basis) makes a distribution during the calendar year 1955 of income accumulated during prior years and the distribution exceeds the distributable net income of 1955, the excess distribution may be allocated under such subpart D to 1954, but it may not be allocated to 1953 and preceding years, since the Internal Revenue Code of 1939 applies to those years.

(b) Simple trusts subject to Subpart D. An accumulation distribution may be properly allocated to a preceding taxable year in which the trust qualified as a simple trust (that is, qualified for treatment under Subpart B (section 651 and following) of such Part I). In such event, the trust is treated for such preceding taxable year in all respects as if it were a trust to which Subpart C (section 661 and following) of such Part I applies. An example of such a circumstance would be in the case of a trust (required under the trust instrument to distribute all of its income currently) which received in the preceding taxable year extraordinary dividends or taxable stock dividends which the trustee in good faith allocated to corpus, but which are subsequently determined to be currently distributable to the beneficiary. See section 643(a)(4) and § 1.643(a)–4. The trust would qualify for treatment under such Subpart C for the year of distribution of the extraordinary dividends or taxable stock dividends, because the distribution is not out of income of the current taxable year and would be treated as other amounts properly paid or credited or required to be distributed for such taxable year within the meaning of section 661(a)(2). Also, in the case of a trust other than a foreign trust created by a U.S. person, the distribution would qualify as an accumulation distribution for the purposes of such Subpart D if in excess of $2,000 and not excepted under section 665(b) and the regulations thereunder. In the case of a foreign trust created by a U.S. person, the distribution, regardless of the amount, would qualify as an accumulation distribution for the purposes of Subpart D. For the purposes only of such Subpart D, the trust would be treated as subject to the provisions of such Subpart C for the preceding taxable year in which the extraordinary or taxable stock dividends were received and in computing undistributed net income for such preceding year, the extraordinary or taxable stock dividends would be included in distributable net income under section 643(a). The rule stated in the preceding sentence

would also apply if the distribution in the later year were made out of corpus without regard to a determination that the extraordinary dividends or taxable stock dividends in question were currently distributable to the beneficiary.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 735, Jan. 17, 1969. Redesignated by T.D. 6989, 34 FR 735, Jan. 17, 1969]

§ 1.665(e)–2 Application of separate share rule.

In trusts to which the separate share rule of section 663(c) is applicable for any taxable year, subpart D (section 665 and following), part I, subchapter J, of the Code, is applied as if each share were a separate trust. Thus, "undistributed net income" and the amount of an "accumulation distribution" are computed separately for each share. The "taxes imposed on the trust" are allocated as follows:

(a) There is first allocated to each separate share that portion of the "taxes imposed on the trust", computed before the allowance of credits under section 642(a), which bears the same relation to the total that the distributable net income of the separate share bears to the distributable net income of the trust, adjusted for this purpose as follows:

(1) There is excluded from distributable net income of the trust and of each separate share any tax-exempt interest, foreign income of a foreign trust, and excluded dividends, to the extent such amounts are included in distributable net income pursuant to section 643(a)(5), (6), and (7); and

(2) The distributable net income of the trust is reduced by any deductions allowable under section 661 for amounts paid, credited, or required to be distributed during the taxable year, and the distributable net income of each separate share is reduced by any such deduction allocable to that share.

(b) The taxes so determined for each separate share are then reduced by that portion of the credits against tax allowable to the trust under section 642(a) in computing the "taxes imposed on the trust" which bear the same relation to the total that the items of income allocable to the separate share with respect to which the credit is allowed bear to the total of such items of the trust. The amount of taxes imposed on the trust allocable to a separate share as so determined is then reduced by the amount of the taxes allowed under sections 667 and 668 as a credit to a beneficiary of the separate share on account of any accumulation distribution determined for any taxable year intervening between the year for which the determination is made and the year of an accumulation distribution with respect to which the determination is made. See paragraph (b) of § 1.665(d)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969. Redesignated by T.D. 6989, 34 FR 736, Jan. 17, 1969]

§ 1.666(a)–1A Amount allocated.

(a) In general. In the case of a trust that is subject to subpart C of part I of subchapter J of chapter 1 of the Code (relating to estates and trusts that may accumulate income or that distribute corpus), section 666(a) prescribes rules for determining the taxable years from which an accumulation distribution will be deemed to have been made and the extent to which the accumulation distribution is considered to consist of undistributed net income. In general, an accumulation distribution made in taxable years beginning after December 31, 1969, is deemed to have been made first from the earliest preceding taxable year of the trust for which there is undistributed net income. An accumulation distribution made in a taxable year beginning before January 1, 1970, is deemed to have been made first from the most recent preceding taxable year of the trust for which there is undistributed net income. See § 1.665(e)–1A for the definition of "preceding taxable year."

(b) Distributions by domestic trusts—(1) Taxable years beginning after December 31, 1973. An accumulation distribution made by a trust (other than a foreign trust created by a U.S. person) in any taxable year beginning after December 31, 1973, is allocated to the preceding taxable years of the trust (defined in § 1.665(e)–1A(a)(1)(ii) as those beginning after December 31, 1968) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first to be allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See para-

graph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1977, a domestic trust reporting on the calendar year basis makes an accumulation distribution of $33,000. Therefore, years before 1969 are ignored. In 1969, the trust had $6,000 of undistributed net income; in 1970, $4,000; in 1971, none; in 1972, $7,000; in 1973, $5,000; in 1974, $8,000; in 1975, $6,000; and $4,000 in 1976. The accumulation distribution is deemed distributed $6,000 in 1969, $4,000 in 1970, none in 1971, $7,000 in 1972, $5,000 in 1973, $8,000 in 1974, and $3,000 in 1975.

(2) **Taxable years beginning after December 31, 1969, and before January 1, 1974.** If a trust (other than a foreign trust created by a U.S. person) makes an accumulation distribution in a taxable year beginning after December 31, 1969, and before January 1, 1974, the distribution will be deemed distributed in the same manner as accumulation distributions qualifying under subparagraph (1) of this paragraph, except that the first year to which the distribution may be thrown back cannot be earlier than the fifth taxable year of the trust preceding the year in which the accumulation distribution is made. Thus, for example, in the case of an accumulation distribution made in the taxable year of a domestic trust which begins on January 1, 1972, the taxable year of the trust beginning on January 1, 1967, would be the first year in which the distribution was deemed made, assuming that there was undistributed net income for 1967. See also § 1.665(e)–1A(a)(1). The provisions of this subparagraph may be illustrated by the following example:

Example. In 1973, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1968, the fifth year preceding 1973, the trust had $7,000 of undistributed net income; in 1969, none; in 1970, $12,000; in 1971, $4,000; in 1972, $4,000. The accumulation distribution is deemed distributed in the amounts of $7,000 in 1968, none in 1969, $12,000 in 1970, $4,000 in 1971, and $2,000 in 1972.

(3) **Taxable years beginning after December 31, 1968, and before January 1, 1970.** Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(c) **Distributions by foreign trusts—(1) Foreign trusts created solely by U.S. persons—(i) Taxable years beginning after December 31, 1969.** If a foreign trust created by a U.S. person makes an accumulation distribution in any taxable year beginning after December 31, 1969, the distribution is allocated to the trust's preceding taxable years (defined in § 1.665(e)–1A(a)(2) as those beginning after Dec. 31, 1953, and ending after Aug. 16, 1954) according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable years. See paragraph (d) of this section for adjustments to undistributed net income for prior distributions. The provisions of this subdivision may be illustrated by the following example:

Example. In 1971, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of $50,000. In 1961, the trust had $12,000 of undistributed net income; in 1962, none; in 1963, $10,000; in 1964, $8,000; in 1965, $5,000; in 1966, $14,000; in 1967, none; in 1968, $3,000; in 1969, $2,000; and in 1970, $1,000. The accumulation distribution is deemed distributed in the amounts of $12,000 in 1961, none in 1962, $10,000 in 1963, $8,000 in 1964, $5,000 in 1965, $14,000 in 1966, none in 1967, and $1,000 in 1968.

(ii) **Taxable years beginning after December 31, 1968, and before January 1, 1970.** Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(2) **Foreign trusts created partly by U.S. persons—(i) Taxable years beginning after December 31, 1969.** If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1969, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire foreign trust. Accordingly, an accumulation distribution of such a trust is composed

of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the earliest preceding taxable year, as defined in § 1.665(e)–1A(a), of the applicable foreign trusts, to the extent of the undistributed net income for the such trust for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the earliest accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year beginning after December 31, 1969, the distribution is included in the beneficiary's income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The provisions of this subdivision may be illustrated by the following example:

Example. A trust is created in 1962 under the laws of Country X by the transfer to a trustee in Country X of property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1974, the trust makes an accumulation distribution of $150,000 to the beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of § 1.643(d)–1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of § 1.665(a)–1A. For taxable years 1962 through 1973, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income-portion of the trust created by a U.S. person	Undistributed net income-portion of the trust created by a person other than a U.S. person
1962	$7,000	$4,000
1963	12,000	7,000
1964	None	None
1965	11,000	5,000
1966	8,000	3,000
1967	None	None
1968	4,000	2,000
1969	17,000	8,000
1970	16,000	9,000
1971	None	None
1972	25,000	12,000
1973	20,000	10,000
Totals	120,000	60,000

The accumulation distribution in the amount of $150,000 is deemed to have been distributed in the amount of $100,000 (120,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a U.S. person and in the amount of $39,000, which is less than $50,000 (60,000/180,000×$150,000), from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1962	$7,000	None
1963	12,000	None
1964	None	None
1965	11,000	None
1966	8,000	None
1967	None	None
1968	4,000	None
1969	17,000	$8,000
1970	16,000	9,000
1971	None	None
1972	25,000	$12,000
1973	None	10,000
Totals	100,000	39,000

Pursuant to this paragraph, the accumulation distribution in the amount of $100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's income for 1974, as the amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's income for 1974 to the extent of the undistributed net income of the trust for the preceding years beginning after December 31, 1968. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person, only the undistributed net income for the years 1969 through 1973, which totals $39,000, is includible in the beneficiary's income for 1974. Thus, of the $150,000 distribution made in 1974, the beneficiary is required to include a total of $139,000 in his income for 1974. The balance of $11,000 is deemed to represent a distribution of corpus.

(ii) Taxable years beginning after December 31, 1968, and before January 1, 1970. Accumulation distributions made in taxable years of the trust beginning after December 31, 1968, and before January 1, 1970, are allocated to prior years according to § 1.666(a)–1.

(3) **Foreign trusts created by non-U.S. persons.** To the extent that a foreign trust is a foreign trust created by a person other than a U.S. person, an accumulation distribution is included in the beneficiary's income for the year paid, credited, or required to be distributed to the extent provided under paragraph (b) of this section.

(d) **Reduction of undistributed net income for prior accumulation distributions.** For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is reduced by the amount from such year deemed distributed in any accumulation distribution of undistributed net income made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust has undistributed net income for 1974 and makes accumulation distributions during the taxable years 1978 and 1979, in determining that part of the 1979 accumulation distribution that is thrown back to 1974 the undistributed net income for 1974 is first reduced by the amount of the undistributed net income for 1974 deemed distributed in the 1978 accumulation distribution.

(e) **Rule when no undistributed net income.** If, before the application of the provisions of subpart D to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is undistributed net income deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed net income for 1970, then no portion of the 1975 accumulation distribution is undistributed net income deemed distributed on the last day of 1970.

[T.D. 7204, 37 FR 17143, Aug. 25, 1972]

§ 1.666(b)–1A Total taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the "taxes imposed on the trust attributable to the undistributed net income" (as defined in § 1.665(d)–1A(b)) for such preceding taxable year is also deemed distributed under section 661(a)(2). For example, a trust has undistributed net income of $8,000 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed net income are $3,032. During the taxable year 1977, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under § 1.666(a)–1A to have been distributed on the last day of 1974. The 1977 accumulation distribution is not less than the 1974 undistributed net income. Accordingly, the taxes of $3,032 imposed on the trust attributable to the undistributed net income for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of § 1.666(a)–1A.

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§ 1.666(c)–1A Pro rata portion of taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is also deemed distributed under section 661(a)(2). The additional amount is equal to the "taxes imposed on the trust attributable to the undistributed net income" (as defined in § 1.665(a)–1A(b)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the accumulation distribution allocated to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year. See paragraph (b) of example (1) and paragraphs (c) and (f) of example (2) in § 1.666(c)–2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed net income are computed after taking into account any accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (d) of § 1.666(a)–1A and paragraph

(c) of example (1) and paragraphs (e) and (h) of example (2) in § 1.666(c)–2A.

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§ 1.666(c)–2A Illustration of the provisions of section 666(a), (b), and (c).

The application of the provisions of §§ 1.666(a)–1A, 1.666(b)–1A, and 1.666(c)–1A may be illustrated by the following examples:

Example (1). (a) A trust created on January 1, 1974, makes accumulation distributions as follows:

1979	$7,000
1980	26,000

For 1974 through 1978, the undistributed portion of distributable net income, taxes imposed on the trust attributable to the undistributed net income, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust attributable to the undistributed net income	Undistributed net income
1974	$12,100	$3,400	$8,700
1975	16,100	5,200	10,900
1976	6,100	1,360	4,740
1977	None	None	None
1978	10,100	2,640	7,460

The trust has no undistributed capital gain.

(b) Since the entire amount of the accumulation distribution for 1979 ($7,000) is less than the undistributed net income for 1974 ($8,700), an additional amount of $2,736 (7,000/8,700 × $3,400) is deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1980, the amount of undistributed net income for 1974 will reflect the accumulation distribution for 1979. The undistributed net income for 1974 will then be $1,700 and the taxes imposed on the trust for 1974 will be $664, determined as follows:

Undistributed net income as of the close of 1974	$8,700
Less: Accumulation distribution (1979)	7,000
Balance (undistributed net income as of the close of 1979)	1,700
Taxes imposed on the trust attributable to the undistributed net income as of the close of 1979 (1,700/8,700 × $3,400)	664

(d) The accumulation distribution of $26,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of $24,800, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $9,864, the total taxes imposed on the trust attributable to the undistributed net income for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1974	$1,700	$664
1975	10,900	5,200
1976	4,740	1,360
1977	None	None
1978	7,460	2,640
1979	None	None

Example (2). (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1974 was accumulated. The distributable net income of the trust for the taxable year 1974 is $20,100 and the income taxes paid by the trust for 1974 attributable to the undistributed net income are $7,260. All of the income for 1975 and 1976 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of $5,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1974, is $12,840, computed as follows:

Distributable net income	$20,100
Less: Taxes imposed on the trust attributable to the undistributed net income	7,260
Undistributed net income as of the close of 1974	12,840

(c) The accumulation distribution of $5,420 made during the taxable year 1975 is deemed under section 666(a) to have been made on December 31, 1974. Since this accumulation distribution is less than the 1974 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1974 is also deemed under section 666(c) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974 is $8,484, computed as follows:

Accumulation distribution	$5,420
Taxes deemed distributed (5,420/12,840 × $7,260)	3,064
Total	8,484

(d) After the application of the provisions of subpart D to the accumulation distribution of 1975, the undistributed net income of the trust for 1974 is $7,420, computed as follows:

Undistributed net income as of the close of 1974	$12,840
Less: 1975 accumulation distribution deemed distributed on December 31, 1974 (paragraph (c) of this example)	5,420
Undistributed net income for 1974 as of the close of 1975	7,420

(e) The taxes imposed on the trust attributable to the undistributed net income for the taxable year 1974, as adjusted to give effect to the 1975 accumulation distribution, amount to $4,196, computed as follows:

Taxes imposed on the trust attributable to undistributed net income as of the close of 1974	$7,260
Less: Taxes deemed distributed in 1974	3,064
Taxes attributable to the undistributed net income determined as of the close of 1975	4,196

(f) The accumulation distribution of $5,420 made during the taxable year 1976 is, under section 666(a), deemed a distribution to X on December 31, 1974, within the meaning of section 661(a)(2). Since the accumulation distribution is less than the 1974 adjusted undistributed net income of $7,420, the trust is deemed under section 666(c) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the accumulation distribution made in 1976, is $8,484, computed as follows:

Accumulation distribution	$5,420
Taxes deemed distributed (5,420/7,420 × $4,196)	3,064
Total	8,484

(g) After the application of the provisions of subpart D to the accumulation distribution of 1976, the undistributed net income of the trust for 1974 is $2,000, computed as follows:

Undistributed net income for 1974 as of the close of 1975	$7,420
Less: 1976 accumulation distribution deemed distributed on December 31, 1974 (paragraph (f) of this example)	5,420
Undistributed net income for 1974 as of the close of 1976	2,000

(h) The taxes imposed on the trust attributable to the undistributed net income of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to $1,132 ($4,196 less $3,064).

[T.D. 7204, 37 FR 17145, Aug. 25, 1972]

§ 1.666(d)–1A Information required from trusts.

(a) Adequate records required. For all taxable years of a trust, the trustee must retain copies of the trust's income tax return as well as information pertaining to any adjustments in the tax shown as due on the return. The trustee shall also keep the records of the trust required to be retained by section 6001 and the regulations thereunder for each taxable year as to which the period of limitations on assessment of tax under section 6501 has not expired. If the trustee fails to produce such copies and records, and such failure is due to circumstances beyond the reasonable control of the trustee or any predecessor trustee, the trustee may reconstruct the amount of corpus, accumulated income, etc., from competent sources (including, to the extent permissible, Internal Revenue Service records). To the extent that an accurate reconstruction can be made for a taxable year, the requirements of this paragraph shall be deemed satisfied for such year.

(b) Rule when information is not available—(1) Accumulation distributions. If adequate records (as required by paragraph (a) of this section) are not available to determine the proper application of subpart D to an accumulation distribution made in a taxable year by a trust, such accumulation distribution shall be deemed to consist of undistributed net income earned during the earliest preceding taxable year (as defined in § 1.665(e)–1A) of the trust in which it can be established that the trust was in existence. If adequate records are available for some years, but not for others, the accumulation distribution shall be allocated first to the earliest preceding taxable year of the trust for which there are adequate records and then to each subsequent preceding taxable year for which there are adequate records. To the extent that the distribution is not allocated in such manner to years for which adequate records are available, it will be deemed distributed on the last day of the earliest preceding taxable year of the trust in which it is established that the trust was in existence and for which the trust has no records. The provisions of this subparagraph may be illustrated by the following example:

Example. A trust makes a distribution in 1975 of $100,000. The trustee has adequate records for 1973, 1974, and 1975. The records show that the trust is on the calendar year basis, had distributable net income in 1975 of $20,000, and undistributed net income in 1974 of $15,000, and in 1973 of $16,000. The trustee has no other records of the trust except for a copy of the trust instrument showing that the trust was established on January 1, 1965. He establishes that the loss of the records was due to circumstances beyond his control. Since the distribution is made in 1975, the earliest "preceding taxable year", as defined in § 1.665(e)–1A, is 1969. Since $80,000 of the distribution is an accumulation distribution, and $31,000 thereof is allocated to 1974 and 1973, $49,000 is deemed to have been distributed on the last day of 1969.

(2) Taxes. (i) If an amount is deemed under this paragraph to be undistributed net income allocated to a preceding taxable year for which adequate records are not available, there shall be deemed to be "taxes imposed on the trust" for such preceding taxable year an amount equal to the taxes that the trust would have paid if the deemed undistributed net income were the amount remaining when the taxes were subtracted from taxable income of the trust for such year. For example, assume that an accumulation distribution in 1975 of $100,000 is deemed to be undistributed net income from 1971, and that the taxable income required to produce $100,000 after taxes in 1971 would be $284,966. Therefore the amount deemed to be "taxes imposed on the trust" for such preceding taxable year is $184,966.

(ii) The credit allowed by section 667(b) shall not be allowed for any amount deemed under this subparagraph to be "taxes imposed on the trust."

[T.D. 7204, 37 FR 17146, Aug. 25, 1972]

§ 1.666(a)–1 Amount allocated.

(a)(1) If a trust other than a foreign trust created by a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years. It is therefore necessary to determine the extent to which there is undistributed net income for the preceding 5 years. For this purpose, an accumulation distribution made in any taxable year is allocated to each of the 5 preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(2) If a foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. It is therefore necessary to determine the extent to which there is undistributed net income for such preceding taxable years. For this purpose, an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income of each of those years. Thus, an accumulation distribution is deemed to have been made from the most recently accumulated income of the trust.

(3) If a trust that is in part a foreign trust created by a U.S. person and in part a foreign trust created by a person other than a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is deemed made from the undistributed net income of the foreign trust created by a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by the U.S. person bears to the total undistributed net income for all years of the entire foreign trust. In addition, such distribution is deemed made from the undistributed net income of the foreign trust created by a person other than a U.S. person in the proportion that the total undistributed net income for all preceding years of the foreign trust created by a person other than a U.S. person bears to the total undistributed net income for all years of the entire foreign trust. Accordingly, an accumulation distribution of such a trust is composed of two portions with one portion relating to the undistributed net income of the foreign trust created by the U.S. person and the other portion relating to the undistributed net income of the foreign trust created by the person other than a U.S. person. For these purposes, each portion of an accumulation distribution made in any taxable year is first allocated to each of such preceding taxable years in turn, beginning with the most recent year, to the extent of the undistributed net income for the applicable foreign trust for each of those years. Thus, each portion of an accumulation distribution is deemed to have been made from the most recently accumulated income of the applicable trust. If the foreign trust created by a U.S. person makes an accumulation distribution in any year after December 31, 1962, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. If the foreign trust created by a person other than a U.S. person makes an accumulation distribution in any taxable year, the distribution is included in the beneficiary's gross income for that year to the extent of the undistributed net income of the trust for the preceding 5 years.

(b) If, before the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to an accumulation distribution for the taxable year, there is no undistributed net income for a preceding taxable year, then no portion of the accumulation distribution is deemed distributed on the last day of such preceding taxable year. Thus, if an accumulation distribution is made during the taxable year 1960 and the trust had no undistributed net income for the taxable year 1959, then no portion of the 1960 accumulation distribution is deemed distributed on the last day of 1959. For purposes of subpart D, the term "5 preceding taxable years" includes only the 5 taxable years immediately preceding the taxable year in which the accumulation distribution is made and which are subject to part I (section 641 and following) of such subchapter J even though the trust has no undistributed net income during one or more of those years.

(c) Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). In 1964, a domestic trust, reporting on the calendar year basis, makes an accumulation distribution of $25,000. In 1963, the trust had $7,000 of undistributed net income; in 1962, none; in 1961, $12,000; in 1960, $4,000; in 1959, $4,000. The accumulation distribution is deemed distrib-

uted $7,000 in 1963, none in 1962, $12,000 in 1961, $4,000 in 1960, and $2,000 in 1959.

Example (2). In 1964, a foreign trust created by a U.S. person, reporting on the calendar year basis, makes an accumulation distribution of $50,000. In 1963, the trust had $12,000 of undistributed net income; in 1962, none; in 1961, $10,000; in 1960, $8,000; in 1959, $5,000; in 1958, $14,000; in 1957, none; in 1956, $3,000; in 1955, $2,000; and in 1954, $1,000. The accumulation distribution is deemed distributed $12,000 in 1963, none in 1962, $10,000 in 1961, $8,000 in 1960, $5,000 in 1959, $14,000 in 1958, none in 1957, $1,000 in 1956.

Example (3). A trust is created in 1952 under the laws of Country X by the transfer to a trustee in Country X of money and property by both a U.S. person and a person other than a U.S. person. Both the trust and the only beneficiary of the trust (who is a U.S. person) report their taxable income on a calendar year basis. On March 31, 1964, the trust makes an accumulation distribution of $150,000 to the U.S. beneficiary. The distributable net income of both the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person for each year is computed in accordance with the provisions of paragraph (b)(3) of § 1.643(d)–1 and the undistributed net income for each portion of the trust for each year is computed as described in paragraph (b) of § 1.665(a)–1. For the taxable years 1952 through 1963, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1963	$20,000	$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	11,000	5,000
1954	None	None
1953	12,000	7,000
1952	7,000	4,000
Totals	120,000	60,000

The accumulation distribution in the amount of $150,000 is deemed to have been distributed in the amount of $100,000 (120,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a U.S. person, and in the amount of $50,000 (60,000/180,000×$150,000) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by a U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1963	$20,000	$10,000
1962	25,000	12,000
1961	None	None
1960	16,000	9,000
1959	17,000	8,000
1958	4,000	2,000
1957	None	None
1956	8,000	3,000
1955	10,000	5,000
1954	None	None
1953	None	1,000
1952	None	None
Totals	100,000	50,000

Pursuant to paragraph (a)(3) of this section, the accumulation distribution in the amount of $100,000 from the portion of the trust which is a foreign trust created by a U.S. person is included in the beneficiary's gross income for 1964, as this amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $50,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1964 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, with respect to the portion of the trust which is a foreign trust created by a person other than a U.S. person only the undistributed net income for the years 1959 through 1963 which totals $39,000 is includible in the beneficiary's gross income for 1964. Thus, of the $150,000 distribution made in 1964, the beneficiary is required to include a total of $139,000 in his gross income for 1964.

Example (4). Assume the same facts as in example (3) and, in addition, that by December 31, 1964, the undistributed net income for 1964 is determined to be $20,000, and that in accordance with the provisions of paragraph (b)(3) of § 1.643(d)–1 and paragraph (b) of § 1.665(a)–1, $10,000 is allocated to the portion of the trust which is a foreign trust created by a U.S. person and $10,000 is allocated to the portion of the trust which is a foreign trust created by a person other than a U.S. person. On March 31, 1965, the trust makes an accumulation distribution of $25,000 to the U.S. beneficiary. For the taxable years 1952 through 1964, the portion of the trust which is a foreign trust created by a U.S. person and the portion of the trust which is a foreign trust created by a person other than a U.S. person had the following amounts of undistributed net income:

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1964	$10,000	$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None

Year	Undistributed net income—portion of the trust created by a U.S. person	Undistributed net income—portion of the trust created by a person other than a U.S. person
1954	None	None
1953	12,000	6,000
1952	7,000	4,000
Totals	30,000	20,000

The accumulation distribution is deemed to have been distributed in the amount of $15,000 (30,000/50,000×$25,000), from the portion of the trust which is a foreign trust created by a U.S. person, and in the amount of $10,000 (20,000/50,000 × $25,000) from the portion of the trust which is a foreign trust created by a person other than a U.S. person computed as follows:

Year	Throwback to preceding years of foreign trust created by U.S. person	Throwback to preceding years of portion of the entire foreign trust which is not a foreign trust created by a U.S. person
1964	$10,000	$10,000
1963	None	None
1962	None	None
1961	None	None
1960	None	None
1959	None	None
1958	None	None
1957	None	None
1956	None	None
1955	1,000	None
1954	None	None
1953	4,000	None
1952	None	None
Totals	15,000	10,000

Pursuant to paragraph (a)(3) of this section, only $11,000 of the accumulation distribution in the amount of $15,000 from the portion of the trust which is a foreign trust created by a U.S. person is includible in the beneficiary's gross income for 1965 as the $11,000 amount represents undistributed net income of the trust for the trust's preceding taxable years which began after December 31, 1953, and ended after August 16, 1954. The accumulation distribution in the amount of $10,000 from the portion of the trust which is a foreign trust created by a person other than a U.S. person is included in the beneficiary's gross income for 1965 to the extent of the undistributed net income of the trust for the preceding 5 years. Accordingly, the entire $10,000 (representing the undistributed net income for the year 1964) is includible in the beneficiary's gross income for 1965. Thus, of the $25,000 distribution made in 1965, the beneficiary is required to include a total of $21,000 in his gross income for 1965.

(d) For the purposes of allocating to any preceding taxable year an accumulation distribution of the taxable year, the undistributed net income of such preceding taxable year is computed without regard to the accumulation distribution of the taxable year or of taxable years following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. Accordingly, if a trust has undistributed net income for the taxable year 1954 and makes an accumulation distribution during the taxable year 1955, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1955 or any subsequent year. If the trust makes a further accumulation distribution for 1956, the undistributed net income for 1954 is computed without regard to the accumulation distribution for 1956 or subsequent years; but in determining the undistributed net income for 1954 for purposes of the 1956 accumulation distribution the accumulation distribution for 1955 will be taken into account.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 736, Jan. 17, 1969]

§ 1.666(b)-1 Total taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)-1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal to the "taxes imposed on the trust" (as defined in § 1.665(d)-1) for such preceding taxable year is likewise deemed distributed under section 661(a)(2). For example, a trust has taxable income of $11,032 (not including any capital gains) and undistributed net income of $8,000 for the taxable year 1954. The taxes imposed on the trust are $3,032. During the taxable year 1955, an accumulation distribution of $8,000 is made to the beneficiary, which is deemed under § 1.666(a)-1 to have been distributed on the last day of 1954. The taxes imposed on the trust for 1954 of $3,032 are also deemed to have been distributed on the last day of 1954 since the 1955 accumulation distribution is not less than the 1954 undistributed net income. Thus, a total of $11,032 will be deemed to have been distributed on the last day of 1954 because of the accumulation distribution of $8,000 made in 1955.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following such taxable year. However, any accumulation distribution of taxable years intervening between such preceding taxable year and the taxable year are taken into account.

See paragraph (d) of § 1.666(a)–1 and paragraphs (f)(5) and (g)(1) of § 1.668(b)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.666(c)–1 Pro rata portion of taxes deemed distributed.

(a) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust, as defined in § 1.665(d)–1, for such preceding taxable year, multiplied by the fraction of which the numerator is the amount of the accumulation distribution and the denominator is the undistributed net income for such preceding taxable year. See paragraph (b) of example (1) and paragraphs (c) and (f) of example (2) in § 1.666(c)–2, and paragraph (f)(2) of § 1.668(b)–2 for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed net income of any preceding taxable year is computed without regard to the accumulation distribution of the taxable year or any taxable year following the taxable year. However, accumulation distributions of any taxable years intervening between such preceding taxable year and the taxable year are taken into account. See paragraph (d) of § 1.666(a)–1, paragraph (c) of example (1) and paragraphs (e) and (h) of example (2) in § 1.666(c)–2 and paragraph (f)(5)(iii) of § 1.668(b)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.666(c)–2 Illustration of the provisions of section 666.

The application of the provisions of §§ 1.666(a)–1, 1.666(b)–1, and 1.666(c)–1 may be illustrated by the following examples:

Example (1). (a) A trust makes accumulation distributions as follows:

1959	$7,000
1960	25,000

For 1954 through 1958, the undistributed portion of distributable net income taxes imposed on the trust, and undistributed net income are as follows:

Year	Undistributed portion of distributable net income	Taxes imposed on the trust	Undistributed net income
1958	$12,100	$3,400	$8,700
1957	16,100	5,200	10,900
1956	6,100	1,360	4,740
1955	None	None	None
1954	10,100	2,640	7,460

(b) Since the entire amount of the accumulation distribution for 1959 ($7,000), determined without regard to the accumulation distribution for 1960, is less than the undistributed net income for 1958 ($8,700), an additional amount of $2,736 (7,000/8,700×$3,400) is likewise deemed distributed under section 666(c).

(c) In allocating the accumulation distribution for 1960, the undistributed net income for 1958 will take into account the accumulation distribution for 1959, and the additional amount of taxes imposed on the trust for 1958 deemed distributed. The undistributed net income for 1958 will then be $1,906; and the taxes imposed on the trust for 1958 will then be $458, determined as follows:

Undistributed portion of distributable net income as of the close of 1958		$12,100
Less:		
Accumulation distribution (1959)	$7,000	
Taxes deemed distributed under section 666(c) (7,000/8,700 × $3,400)	2,736	
		9,736
Balance (undistributed portion of distributable net income as of the close of 1959)		2,364
Less: Personal exemption		100
Balance		2,264
Taxes imposed on the trust (income taxes on $2,264)		458
Undistributed portion of distributable net income as of the close of 1959		2,364
Less: Income taxes attributable thereto		458
Undistributed net income for 1958 as of the close of 1959		1,906

(d) The accumulation distribution of $25,000 for 1960 is deemed to have been made on the last day of the 5 preceding taxable years of the trust to the extent of $17,546, the total of the undistributed net income for such years, as shown in the tabulation below. In addition, $7,018, the total taxes imposed on the trust for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed net income	Taxes imposed on the trust
1959	None	None
1958	$1,906	$458
1957	10,900	5,200
1956	4,740	1,360
1955	None	None

(e) No portion of the 1960 accumulation distribution is deemed made on the last day of 1954 because, as to 1960, 1954 is the sixth preceding taxable year.

Example (2). (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The entire income of the trust is from royalties. Both X and the trust report on the calendar year basis. All of the income for 1954 was accumulated. The distributable net income of the trust for the taxable year 1954 is $20,100 and the income taxes paid by the trust for 1954 with respect to its distributable net income are $7,260. All of the income for 1955 and 1956 was distributed and in addition the trustee made accumulation distributions within the meaning of section 665(b) of $6,420 for each year.

(b) The undistributed net income of the trust determined under section 665(a) as of the close of 1954, is $12,840, computed as follows:

Distributable net income	$20,100
Less: Taxes imposed on the trust	7,260
Undistributed net income as of the close of 1954	12,840

(c) The accumulation distribution of $6,420 made during the taxable year 1955 is deemed under section 666(a) to have been made on December 31, 1954. Since this accumulation distribution is less than the 1954 undistributed net income of $12,840, a portion of the taxes imposed on the trust for 1954 is also deemed under section 666(c) to have been distributed on December 31, 1954. The total amount deemed to have been distributed to X on December 31, 1954, is $10,050, computed as follows:

Accumulation distribution	$6,420
Taxes deemed distributed (6,420/12,840 × $7,260)	3,630
Total	10,050

(d) After the application of the provisions of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, to the accumulation distribution of 1955, the undistributed portion of the distributable net income of the trust for 1954, is $10,050, and the taxes imposed with respect thereto are $2,623, computed as follows:

Distributable net income as of the close of 1954	$20,100
Less: 1955 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (c) of this example)	10,050
Undistributed portion of the 1954 distributable net income adjusted as of the close of 1955	10,050
Less: Personal exemption	100
Balance	9,950
Income taxes on $9,950	2,623

(e) The undistributed net income of the trust for the taxable year 1954, as adjusted to give effect to the 1955 accumulation distribution, is $7,427, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10,050
Less: Income taxes applicable thereto	2,623
Undistributed net income determined as of the close of 1955	7,427

(f) Inasmuch as all of the income of the trust for the taxable year 1955 was distributed to X, the trust had no undistributed net income for that year. Accordingly, the accumulation distribution of $6,420 made during the taxable year 1956 is, under section 666(a), deemed a distribution to X on December 31, 1954, within the meaning of section 661(a)(2). Since this accumulation distribution is less than the 1954 adjusted undistributed net income of $7,427, the trust is deemed under section 666(c) also to have distributed on December 31, 1954, a portion of the taxes imposed on the trust for 1954. The total amount deemed to be distributed on December 31, 1954, with respect to the accumulation distribution made in 1956, is $8,687, computed as follows:

Accumulation distribution	$6,420
Taxes deemed distributed (6,420/7,427 × $2,623)	2,267
Total	8,687

(g) After the application of the provisions of subpart D to the accumulation distribution of 1956, the undistributed portion of the distributable net income of the trust for 1954, is $1,363, and the taxes imposed on the trust with respect thereto are $253, computed as follows:

Undistributed portion of distributable net income as of the close of 1955	$10,050
Less: 1956 accumulation distribution and taxes deemed distributed on December 31, 1954 (paragraph (f) of this example)	8,687
Undistributed portion of distributable net income as of the close of 1956	1,363
Less: Personal exemption	100
Balance	1,263
Income taxes on $1,263	253

(h) The undistributed net income of the trust for the taxable year 1954, determined as of the close of the taxable year 1956, is $1,110 ($1,363 less $253).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.667–1 Denial of refund to trusts.

(a) If an amount is deemed under section 666 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of "taxes imposed on the trust", as defined in § 1.665(d)–1, which would not have been payable for the preceding taxable year had the trust in fact made such distribution on the last day of such year. However, such taxes are allowed as a credit under section 668(b) against the tax of the beneficiaries who are treated as having received the distributions in the preceding taxable year. The amount of taxes which may not be refunded or credited to the trust under this paragraph and which are allowed as a credit under section 668(b) against the tax of the beneficiaries, is an amount equal to the excess of:

(1) The taxes imposed on the trust (as defined in section 665(d) and § 1.655(d)–1) for any preceding taxable year (computed without regard to the accumulation distribution for the taxable year) over

(2) The amount of taxes for such preceding taxable year which would be imposed on the undistributed portion of distributable net income of the trust for such preceding taxable year after the application of subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, on account of the accumulation distribution determined for the taxable year.

It should be noted that the credit under section 667 is computed by the use of a different ratio from that used for computing the amount of taxes deemed distributed under section 666(c).

(b) Paragraph (a) of this section may be illustrated by the following examples:

Example (1). In 1954, a trust of which A is the sole beneficiary has taxable income of $20,000 (including capital gains of $5,100 allocable to corpus less a personal exemption of $100), on which a tax of $7,260 is paid.

The undistributed portion of distributable net income is $15,000, to which $6,160 of the tax is allocable under section 665. The undistributed net income is therefore $8,840 ($15,000 minus $6,160). In 1955, the trust makes an accumulation distribution of $8,840. Under section 666(b), the total taxes for 1954 attributable to the undistributed net income are deemed distributed, so $15,000 is deemed distributed. The amount of the tax which may not be refunded to the trust under section 667 and the credit to which A is entitled under section 668(b) is the excess of $6,160 over zero, since after the distribution and the application of subpart D there is no remaining undistributed portion of distributable net income for 1954.

Example (2). The same trust as in example (1) of this paragraph distributes $5,000 in 1955, rather than $8,840. The amount of the tax which may not be refunded to the trust but which is available to A as a credit is $4,044, computed as follows:

Accumulation distribution in 1955		$5,000
Taxes deemed distributed under section 666(c) (5,000/8,840 × $6,160)		3,484
Total amount deemed distributed out of the undistributed portion of distributable net income		8,484
Tax attributable to the undistributed portion of distributable net income ($15,000) before 1955 distribution (see example (1) of this paragraph)		6,160
Tax on $11,516 (taxable income of $20,000 minus $8,484, amount deemed distributed)	$3,216	
Tax on $5,000 (capital gains of $5,100, less personal exemption of $100, allocable to corpus)	1,100	
Tax attributable to undistributed portion of distributable net income after 1955 distribution		2,116
Refund disallowed to the trust and credit available to A in 1955		4,044

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 741, Jan. 17, 1969]

§ 1.667(a)–1A Denial of refund to trusts.

If an amount is deemed under section 666 or 669 to be an amount paid, credited, or required to be distributed on the last day of a preceding taxable year, the trust is not allowed a refund or credit of the amount of "taxes imposed on the trust", as defined in § 1.665(d)–1A. However, such taxes imposed on the trust are allowed as a credit under section 667(b) against the tax of certain beneficiaries who are treated as having received the distributions in the preceding taxable year.

[T.D. 7204, 37 FR 17147, Aug. 25, 1972]

§ 1.667(b)–1A Authorization of credit to beneficiary for taxes imposed on the trust.

(a) Determination of credit—(1) In general. Section 667(b) allows under certain circumstances a credit (without interest) against the tax imposed by subtitle A of the Code on the beneficiary for the taxable year in which the accumulation distribution is required to be included in income under section 668(a). In the case of an accumulation distribution consisting only of undistributed net income, the amount of such credit is the total of the taxes deemed distributed to such beneficiary under section 666(b) and (c) as a result of such accumulation distribution for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.668(b)–1A. In the case of an accumulation distribution consisting only of undistributed capital gain, the amount of such credit is the total of the taxes deemed distributed as a result of the accumulation distribution to such beneficiary under section 669(d) and (e) for preceding taxable years of the trust on the last day of which such beneficiary was in being, less the amount of such taxes for such preceding taxable years taken into account in reducing the amount of partial tax determined under § 1.669(b)–1A. In the case of an accumulation distribution consisting of both undistributed net income and undistributed capital gain, a credit will not be available unless the total taxes deemed distributed to the beneficiary for all preceding taxable years as a result of the accumulation distribution exceeds the beneficiary's partial tax determined under §§ 1.668(b)–1A and 1.669(b)–1A without reference to the taxes deemed distributed. A credit is not allowed for any taxes deemed distributed as a

result of an accumulation distribution to a beneficiary by reason of sections 666(b) and (c) or sections 669(d) and (e) for a preceding taxable year of the trust before the beneficiary was born or created. However, if as a result of an accumulation distribution the total taxes deemed distributed under sections 668(a)(2) and 668(a)(3) in preceding taxable years before the beneficiary was born or created exceed the partial taxes attributable to amounts deemed distributed in such years, such excess may be used to offset any liability for partial taxes attributable to amounts deemed distributed as a result of the same accumulation distribution in preceding taxable years after the beneficiary was born or created.

(2) **Exact method.** In the case of the tax computed under the exact method provided in §§ 1.668(b)-1A(b) and 1.669(b)-1A(b), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed under §§ 1.666(b)-1A and 1.666(c)-1A or §§ 1.669(d)-1A and 1.669(e)-1A, whichever are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(ii) Compute the total of the amounts of tax determined under § 1.668(b)-1A(b)(1) or § 1.669(b)-1A(b)(1), whichever is appropriate, for the prior taxable years of the beneficiary in which he was in being.

If the amount determined under subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable. If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph, the credit allowable is the lesser of the amount of such excess or the amount of taxes deemed distributed to the beneficiary for all preceding taxable years to the extent that such taxes are not used in § 1.668(b)-1A(b)(2) or § 1.669(b)-1A(b)(2) in determining the beneficiary's partial tax under section 668(a)(2) or 668(a)(3). The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution made in 1975 is deemed distribution in 1973 and 1974, years in which the beneficiary was in being. The taxes deemed distributed in such years are $4,000 and $2,000, respectively, totaling $6,000. The amounts of tax computed under § 1.668(b)-1A(b)(1) attributable to the amounts thrown back are $3,000 and $2,000, respectively, totaling $5,000. The credit allowable under this subparagraph is therefore $1,000 ($6,000 less $5,000).

(3) **Short-cut method.** In the case of the tax computed under the short-cut method provided in § 1.668(b)-1A(c) or 1.669(b)-1A(c), the credit allowed by this section is computed as follows:

(i) Compute the total taxes deemed distributed in all preceding taxable years of the trust under §§ 1.666(b)-1A and 1.666(c)-1A or §§ 1.669(d)-1A and 1.669(e)-1A, whichever are appropriate.

(ii) Compute the beneficiary's partial tax determined under either § 1.668(b)-1A(c)(1)(v) or § 1.669(b)-1A(c)(1)(v), whichever is appropriate.

If the amount determined under subdivision (i) of this subparagraph does not exceed the amount determined under subdivision (ii) of this subparagraph, no credit is allowable. If the amount determined under subdivision (i) of this subparagraph exceeds the amount determined under subdivision (ii) of this subparagraph,

(iii) Compute the total taxes deemed distributed under §§ 1.666(b)-1A and 1.666(c)-1A or §§ 1.669(d)-1A and 1.669(e)-1A, which are appropriate, for the preceding taxable years of the trust on the last day of which the beneficiary was in being.

(iv) Multiply the amount by which subdivision (i) of this subparagraph exceeds subdivision (ii) of this subparagraph by a fraction, the numerator of which is the amount determined under subdivision (iii) of this subparagraph and the denominator of which is the amount determined under subdivision (i) of this subparagraph. The result is the allowable credit. The application of this subparagraph may be illustrated by the following example:

Example. An accumulation distribution that consists only of undistributed net income is made in 1975. The taxes deemed distributed in the preceding years under §§ 1.666(b)-1A and 1.666(c)-1A are $15,000. The amount determined under § 1.668(b)-1A(c)(1)(v) is $12,000. The beneficiary was in being on the last day of all but one preceding taxable year in which the accumulation distribution was deemed made, and the taxes deemed distributed in those years was $10,000. Therefore, the excess of the subdivision (i) amount over the subdivision (ii) amount is $3,000, and is multiplied by 10,000/15,000, resulting in an answer of $2,000, which is the credit allowable when computed under the short-cut method.

* * * * *

(b) **Year of credit.** The credit to which a beneficiary is entitled under this section is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the income of the beneficiary under section 668(a). Any excess over the total tax liability of the beneficiary for such year is treated

as an overpayment of tax by the beneficiary. See section 6401(b) and the regulations thereunder. [T.D. 7204, 37 FR 17147, Aug. 25, 1972]

§ 1.668(a)–1A Amounts treated as received in prior taxable years; inclusion in gross income.

(a) Section 668(a) provides that the total of the amounts treated under sections 666 and 669 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the income of the beneficiary or beneficiaries receiving them. The total of such amounts is includable in the income of each beneficiary to the extent the amounts would have been included under section 662(a)(2) and (b) as if the total had actually been an amount properly paid by the trust under section 661(a)(2) on the last day of such preceding taxable year. The total is included in the income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder.

(b) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

(c) For purposes of applying section 668(a)(3), a trust shall be considered to be other than a "trust which is not required to distribute all of its income currently" for each taxable year prior to the first taxable year beginning after December 31, 1968, and ending after November 30, 1969, in which income is accumulated. Income will not be deemed to have been accumulated for purposes of applying section 668(a)(3) in a year if the trustee makes a determination, as evidenced by a statement on the return, to distribute all of the trust's income for such year and also makes a good faith determination as to the amount of such income and actually distributed for such year the entire amount so determined. The term "income," as used in the preceding two sentences, is defined in §§ 1.643(b)–1 and 1.643(b)–2. Since, under such definitions, certain items may be included in distributable net income but are not, under applicable local law, "income" (as, for example, certain extraordinary dividends), a trust that has undistributed net income from such sources might still qualify as a trust that has not accumulated income. Also, for example, if a trust establishes a reserve for depreciation or depletion and applicable local law permits the deduction for such reserve in the computation of "income," amounts so added to the reserve do not constitute an accumulation of income. If a trust has separate shares, and any share accumulates income, all shares of the trust will be considered to have accumulated income for purposes of section 668(a)(3). Amounts retained by a trust or a portion of a trust that is subject to subpart E (sections 671–678) shall not be considered accumulated income.

(d) See section 1302(a)(2)(B) to the effect that amounts included in the income of a beneficiary of a trust under section 668(a) are not eligible for income averaging.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§ 1.668(a)–2A Allocation among beneficiaries; in general.

The portion of the total amount includible in income under § 1.668(a)–1A which is includible in the income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year). This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for taxable year 1975 is $10,000. The trust had undistributed net income for taxable year 1973, the first year of the trust, of $5,000, to which a tax of $1,100 was allocable. On May 1, 1975, the trustee distributes $10,000 to A, and on November 29, 1975, he distributes $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B receives one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1975, the trust is deemed to have made the following distributions:

Amount distributed out of 1975 income (distributable net income)	$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1973 under section 666(a)	5,000
Taxes imposed on the trust attributable to the undistributed net income deemed distributed under section 666(b)	1,100

(c) A will include in his income for 1975 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income $6,666.67 (10,000/15,000×$10,000) of

the 1975 distributable net income of the trust as provided in section 662(a)(2) (which is not an amount includable in his income under § 1.668(a)–1A(a)). He will include in his income $3,333.33 (10,000/15,000×$5,000) of the accumulation distribution and $733.33 (10,000/15,000×$1,100) of the taxes imposed on the trust, as provided in section 668(a).

(d) B will include in his income for 1975 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

(e) To the extent the total accumulation distribution consists of undistributed net income and undistributed capital gain, A and B shall be treated as receiving a pro rata share of each for the preceding taxable year 1973.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§ 1.668(a)–3A Determination of tax.

In a taxable year in which an amount is included in a beneficiary's income under § 1.668(a)–1A(a), the tax on the beneficiary for such taxable year is determined only as provided in section 668 and consists of the sum of—

(a) A partial tax computed on (1) the beneficiary's taxable income reduced by (2) an amount equal to the total amounts includible in his income under § 1.668(a)–1A(a), at the rate and in the manner as if section 668 had not been enacted,

(b) A partial tax determined as provided in § 1.668(b)–1A, and

(c) In the case of a beneficiary of a trust which is not required to distribute all of its income currently, a partial tax determined as provided in § 1.669(b)–1A.

[T.D. 7204, 37 FR 17148, Aug. 25, 1972]

§ 1.668(b)–1A Tax on distribution.

(a) In general. The partial tax imposed on the beneficiary by section 668(a)(2) shall be the lesser of—

(1) The tax computed under paragraph (b) of this section (the "exact" method), or

(2) The tax computed under paragraph (c) of this section (the "short-cut" method),

except as provided in § 1.668(b)–4A (relating to failure to furnish proper information) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary's choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(3).

(b) Computation of partial tax by the exact method. The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years. For purposes of this paragraph, the "section 666 amounts" for a preceding taxable year are the amounts deemed distributed under section 666(a) on the last day of the preceding taxable year, plus the amount of taxes deemed distributed on such day under section 666(b) or (c). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 666 amounts in the beneficiary's gross income and the tax for such year computed without including them in such gross income. Tax computations for each such year shall reflect a taxpayer's marital, dependency, exemption, and filing status for such year. To the extent the undistributed net income of a trust deemed distributed in an accumulation distribution includes amounts received as an accumulation distribution from another trust, for purposes of this paragraph they shall be considered as amounts deemed distributed by the trust under section 666(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income and taxes of trust Y for the taxable years 1972, 1973, and 1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income and taxes, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)–1A and 1.666(c)–1A as does not exceed such sum. The resulting amount, if any, is the partial tax, computed under the exact method, for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to the beneficiary.

(3) The provisions of this paragraph may be illustrated by the following example:

Example. (i) Assume that in 1979 a trust makes an accumulation distribution of $15,000 to A. The accumulation distribution is allocated under section 666(a) in the amounts of $5,000 to 1971, $4,000 to 1972, and $6,000 to 1973. Under section 666(b) and (c), taxes in the amounts of $935, $715, and $1,155 (totaling $2,805) are deemed distributed in 1971, 1972, and 1973, respectively.

(ii) A, the beneficiary, had taxable income and paid income tax in 1971–73 as follows:

Year	Taxable income	Tax
1971	$10,000	$2,190
1972	12,000	2,830
1973	14,000	3,550

(iii) Taxes attributable to the section 666 amounts (paragraph (i) of this example) are $6,979, computed as follows:

1971		
Taxable income including section 666 amounts ($10,000 + $5,000 + $935)	$15,935	
Tax on $15,935		$4,305
Less: Tax paid by A in 1971		2,190
Tax attributable to 1971 section 666 amounts		2,115
1972		
Taxable income including section 666 amounts ($12,000 + $4,000 + $715)	$16,715	
Tax on $16,715		$4,620
Less: Tax paid by A in 1972		2,830
Tax attributable to 1972 section 666 amounts		1,790
1973		
Taxable income including section 666 amounts ($14,000 + $6,000 + $1,155)	$21,155	
Tax on $21,155		$6,624
Less: Tax paid by A in 1973		3,550
Tax attributable to 1973 section 666 amounts		3,074
Total tax attributable to section 666 amounts:		
1971	$2,115	
1972	1,790	
1973	3,074	
Total	6,979	

(iv) The partial tax computed under the exact method is $4,174, computed by subtracting the taxes deemed distributed ($2,805) from the tax attributable to the section 666 amounts ($6,979).

(c) Computation of tax by the short-cut method. (1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received an accumulation distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such accumulation distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 an accumulation distribution from trust Y, a calendar year trust, that included undistributed net income of trust Y for the taxable years 1972, 1973, and 1974. To the extent an accumulation distribution made by trust Z in its taxable year 1976 includes such undistributed net income, it shall be considered an accumulation distribution by trust Z in the taxable year 1976 and under section 666(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed net income deemed distributed is less than 25 percent of (a) the total amounts deemed under section 666(a) to be undistributed net income from preceding taxable years divided by (b) the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed without application of this sentence. For example, assume that an accumulation distribution of $90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of $29,000 in each of the years 1972, 1973, and 1974, and $3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is four. However, the distribution deemed made in 1975 ($3,000) is less than $5,625, which is 25 percent of (a) the total undistributed net income deemed distributed under section 666(a) ($90,000) divided by (b) the number of such preceding taxable years (4), or $22,500. Therefore, for purposes of this subparagraph the accumulation distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the accumulation distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subdivision (i) of this subparagraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of each class of income as the total of each class of income deemed distributed in the accumulation distribution bears to the total undistributed net income from such preceding taxable years deemed distributed in the accumulation distribution. For example, assume that an amount of

$50,000 is deemed distributed under section 666(a) from undistributed net income of 5 preceding taxable years of the trust, and consists of $25,000 of interest, $15,000 of dividends, and $10,000 of net rental income. Taxes attributable to such amounts in the amount of $10,000 are also deemed distributed. The amount determined under this subdivision, $12,000 ($50,000 income plus $10,000 tax divided by 5 years), is deemed to consist of $6,000 in interest, $3,600 in dividends, and $2,400 in net rental income.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.

The difference between the amount of tax computed under (a) of this subdivision for each year and the amount computed under (b) of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph. For example, assume that a distribution of $12,000, is includible in the income of each of the beneficiary's 3 preceding taxable years when his income (without the inclusion of the accumulation distribution) was $20,000, $30,000, and $40,000. The inclusion of $12,000 in income would produce taxable income of $32,000, $42,-000, and $52,000, and the tax attributable to such increases would be $4,000, $5,000, and $6,000, respectively.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3. For example, if these additional taxes are $4,000, $5,000, and $6,000 for the 3 preceding taxable years, this amount would be $5,000 ($4,000+$5,-000+$6,000 divided by 3).

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subdivision (i) of this subparagraph). For example, if an amount is deemed distributed for 5 preceding taxable years, the resulting amount would be five times the $5,000 amount.

(vi) Sixth, the resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.666(b)–1A and 1.666(c)–1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 668(b)(1)(B).

(2) The computation of the tax by the short-cut method may be illustrated by the following example:

Example: In 1971, X creates a trust which is to accumulate its income and pay the income to Y when Y reaches 30. Y is 19. Over the 11 years of the trust, the trust earns $1,200 of interest income annually and has expenses each year of $100 allocable to the production of income. The trust pays a total tax of $1,450 on the accumulated income. In 1981, when Y reaches 30, the $9,550 of accumulated undistributed net income and the $1,100 of current net income are distributed to Y. Y is treated as having received a total distribution of $11,000 (the $9,550 accumulation distribution plus the taxes paid by the trust which are deemed to have been distributed to Y). The income of the current year (1981) is taxed directly to Y. The computation is as follows: $11,000 (accumulation distribution plus taxes) divided by 10 (number of years out of which distribution was made) equals $1,100. The $1,100 added to the income of the beneficiary's preceding 3 years produces increases in tax as follows:

1980	$350
1979	300
1978	250
Total	900

$900 (total additional tax) divided by 3 equals $300 (average annual increase in tax). $300 (average annual increase in tax) times 10 equals $3,000, from which is deducted the amount of taxes ($1,450) paid by the trust attributable to the undistributed net income deemed distributed. The amount of tax to be paid currently under the short-cut method is therefore $1,550.

(d) Disallowance of short-cut method. If, in any prior taxable year of the beneficiary in which any part of the accumulation distribution of undistributed net income is deemed to have been distributed under section 666(a) to such beneficiary, any part of prior accumulation distributions of undistributed net income by each of two or more other trusts is deemed under section 666(a) to have been distributed to such beneficiary, then the short-cut method under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(2) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes an accumulation distribution of undistributed net income to A, who is on the calendar year basis, and part of the accumulation distribution is deemed under section 666(a) to have been distributed on March 31, 1974. In 1977, A had received an accumulation distribution of undistributed net income from both trust Y and trust Z. Part of the accumulation distribution from trust Y was

deemed under section 666(a) to have been distributed to A on June 30, 1974, and part of the accumulation distribution from trust Z was deemed under section 666(a) to have been distributed to A on December 31, 1974. Because there were portions of accumulation distributions of undistributed net income from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 accumulation distribution from trust X may not be computed under the short-cut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 666(a)(2).

[T.D. 7204, 37 FR 17149, Aug. 25, 1972]

§ 1.668(b)–2A Special rules applicable to section 668.

(a) Rule when beneficiary not in existence on the last day of a taxable year. If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 666(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of § 1.668(b)–1A, that the beneficiary—

(1) Was in existence on such last day,

(2) Was a calendar year taxpayer,

(3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,

(4) If an individual, was unmarried and had no dependents,

(5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and

(6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of an accumulation distribution made in 1980 is deemed under section 666(a) to have been distributed to the beneficiary, A, in 1973; $10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of § 1.668(b)–1A that A was alive in 1973, was on the calendar year basis, had no income other than (i) the $10,000 from the earlier accumulation distribution deemed distributed in 1973, and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. It should be noted that the standard deduction for 1973 will be available to A with respect to the distribution only to the extent it qualifies as "earned income" in the hands of the trust. See section 141(e) and the regulations thereunder and § 1.652(b)–1. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A's first actual taxable year.

(b) Effect of other distributions. The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under § 1.668(b)–1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a "prior accumulation distribution" is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term "prior accumulation distribution" also includes accumulation distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (c) of this section to treat as having been distributed before the accumulation distribution for which tax is being computed under § 1.668(b)–1A. Any capital gain distribution from the same trust paid, credited, or required to be distributed in the same taxable year of the beneficiary shall not be considered under this paragraph to be a "prior capital gain distribution."

(c) Multiple distributions in the same taxable year. For purposes of paragraph (b) of this section, accumulation distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several accumulation distributions. The beneficiary shall indicate the order he has determined to deem the accumulation distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to

make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(d) Examples. The provisions of paragraphs (b) and (c) of this section may be illustrated by the following examples:

Example (1). In 1978, trust X made an accumulation distribution of undistributed net income to A, a calendar year taxpayer, of which $3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another accumulation distribution of undistributed net income to A, $10,000 of which is deemed under section 666 to have been distributed in 1974. Also in 1980, trust Y makes an accumulation distribution of undistributed net income to A, of which $5,000 is deemed under section 666 to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A's gross income for 1974 includes (i) the $3,000 deemed distributed from the 1978 distribution, and (ii) the $5,000 deemed distributed in 1974 from the 1980 trust Y accumulation distribution. To compute A's tax under the exact method for 1974 on the $10,000 from the 1980 trust X accumulation distribution deemed distributed in 1974, A's gross income for 1974 includes (i) the $10,000, (ii) the $3,000 previously deemed distributed in 1974 from the 1978 trust X accumulation distribution, and (iii) the $5,000 deemed distribution in 1974 from the 1980 trust Y accumulation distribution.

Example (2). In 1978, trust T makes an accumulation distribution of undistributed net income to B, a calendar year taxpayer. Determination of the tax on the accumulation distribution under the short-cut method requires the use of B's gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution of undistributed net income from trust U, of which $2,000 was deemed to have been distributed in 1975, and $3,000 in 1976. B's gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T accumulation distribution, will be deemed to include the $2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the $3,000 deemed distributed by trust U in 1976.

[T.D. 7204, 37 FR 17151, Aug. 25, 1972]

§ 1.668(b)–3A Computation of the beneficiary's income and tax for a prior taxable year.

(a) Basis for computation. (1) The beneficiary's income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under § 1.668(b)–4A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for computation purposes. The term "as finally determined" has reference to the final status of the gross income, deductions, credits, and taxes of the taxable year after the expiration of the period of limitations or after completion of any court action regarding the tax for the taxable year.

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 666 amount in the beneficiary's gross income and the tax for such year computed without including such amounts in such gross income shall be based upon the return after the correction of such mathematical errors, and the beneficiary shall be credited for the correct amount of tax that should have been properly paid.

(b) Effect of allocation of undistributed net income on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover. (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed net income allocated to such year. For example, if $1,000 of undistributed net income is allocated to 1970, adjusted gross income for 1970 is increased from $5,000 to $6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed net income deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed net income on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by

such amounts so allocated. The provisions of this subparagraph may be illustrated by the following example:

Example. In 1978, a trust makes an accumulation distribution of undistributed net income to X of $50,000 that is deemed under section 666(a) to have been distributed in 1972. X had income in 1972, 1973, and 1974, and had a net operating loss in 1975 that offset his taxable income (computed as provided in § 1.172–5) for those years, as follows:

Year	Actual income (or loss)	Income after net operating loss carryback (n.o.l.c.b.)
1972	$10,000	$0
1973	50,000	0
1974	50,000	10,000
1975	(100,000)	0

As a result of the allocation of the 1973 accumulation distribution to 1972, X's income for 1972, 1973, 1974, and 1975, after taking into account the 1975 n.o.l.c.b., is deemed to be as follows:

Year	Income deemed to have been earned after consideration of n.o.l.c.b. and accumulation distribution
1972	0 ($10,000 + $50,000 – $60,000 n.o.l.c.b.).
1973	$10,000 ($50,000 – $40,000 balance of n.o.l.c.b.).
1974	$50,000.
1975	0.

Therefore, the tax on the 1978 accumulation distribution to X is the tax X would have paid in 1973 and 1974 had he had the above income in such years.

(c) Averaging. A beneficiary who uses the exact method may recompute his tax for a prior taxable year by using income averaging for all of his actual income for that year, plus the amount deemed distributed in that year under section 666, even though he may not have actually used section 1301 to determine his income tax for such taxable year. For purposes of such recomputation, the beneficiary's income for all other taxable years involved must include any amounts deemed distributed in such years from the current and all prior accumulation distributions. See § 1.668(b)–4A(c)(3) for additional information requirements. The beneficiary may not apply the provisions of this paragraph to a taxable year in which an amount is deemed to be income by reason of § 1.666(d)–1A(b). The accumulation distribution itself is not eligible for income averaging in the years in which it is paid, credited, or required to be distributed. See section 1302(a)(2)(B) and the regulations thereunder.

[T.D. 7204, 37 FR 17151, Aug. 25, 1972]

§ 1.668(b)–4A Information requirements with respect to beneficiary.

(a) Information to be supplied by beneficiary—(1) In general. The beneficiary must supply the information required by subparagraph (3) of this paragraph for any prior taxable year for which a recomputation is required under either the exact method or the short-cut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(2) is imposed.

(2) Failure to furnish. If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and the tax computed under paragraph (c) of § 1.668(b)–1A (the short-cut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(2). See, however, paragraph (b) of this section for an exception to this rule where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(3) Information required. The beneficiary shall file the following items with his income tax return for the taxable year in which the accumulation distribution is included in income:

(i) A statement showing the gross income, adjustments, deductions, credits, taxes paid, and computations for each of his taxable years for which a computation is required under the method by which he computes his partial tax imposed by section 668(a)(2). Such statement shall include such amounts for the taxable year as adjusted by any events subsequent to such year, such as any adjustment resulting from the determination of a deficiency or an overpayment, or from a court action regarding the tax.

(ii) A copy of the statement required by this subparagraph to be furnished by the beneficiary for any prior taxable year in which an accumulation distribution was received by him which was also deemed distributed in whole or in part in the prior taxable year for which the statement under subdivision (i) of this subparagraph is required.

(iii) A copy of any statements furnished the beneficiary by the trustee (such as schedules E and J of Form 1041, etc.) with regard to the current taxable year or any prior taxable year for which a statement is furnished under subdivision (i) of this subparagraph.

(b) Exception. If by reason of § 1.668(b)–1A(e) the beneficiary may not compute the partial tax on the accumulation distribution under § 1.668(b)–1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by subparagraph (3) of paragraph (a) of this section for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

(c) Records to be supplied by the beneficiary—(1) Year when return was filed. If the beneficiary filed an income tax return for a taxable year for which a recomputation is necessary, and the period of limitations on assessment under section 6501 for such year has expired as of the filing of the return for the year in which the accumulation distribution was made, then a copy of such return, plus proof of any changes of liability for such year due to the determination of a deficiency or an overpayment, court action, etc., shall, to the extent they verify the statements required under paragraph (a) of this section, serve as proof of such statements. If the period of limitations on assessment under section 6501 for a prior taxable year has not expired as of the filing of the beneficiary's return for the year in which the accumulation distribution was received, then the records required by section 6001 to be retained by the beneficiary for such prior taxable year shall serve as the basis of proof of the statements required to be filed under paragraph (a) of this section.

(2) Year for which no return was filed. If the beneficiary did not file a return for a taxable year for which a recomputation is necessary, he shall be deemed to have had in such year, in the absence of proof to the contrary, gross income in the amount equal to the maximum amount of gross income that he could have received without having had to file a return under section 6012 for such year.

(3) Distributions deemed averaged. In order for a beneficiary to use income averaging with respect to a prior taxable year (see § 1.668(b)–3A(c)), he must furnish all the information that would support the computation under section 1301 as if the distribution were actually received and averaged in such prior taxable year, even if a portion of the information relates to years in which no amount was deemed distributed to the beneficiary.

[T.D. 7204, 37 FR 17152, Aug. 25, 1972]

§ 1.668(a)–1 Amounts treated as received in prior taxable years; inclusion in gross income.

(a) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust shall be included in the gross income of the beneficiary or beneficiaries receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amounts would have been included under section 662(a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and the regulations thereunder). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules set forth in section 662(b) and the regulations thereunder. See paragraphs (h)(1)(ii) and (j)(1)(ii) of § 1.668(b)–2.

(b) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in paragraph (a) of this section in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(c) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.668(a)–2 Allocation among beneficiaries; in general.

The portion of the total amount includible in gross income under § 1.668(a)–1 which is includible in the gross income of a particular beneficiary is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year (and not for the preceding taxable year).

This section may be illustrated by the following example:

Example. (a) Under the terms of a trust instrument, the trustee may accumulate the income or make distributions to A and B. The trustee may also invade corpus for the benefit of A and B. The distributable net income of the trust for the taxable year 1955 is $10,000. The trust had undistributed net income for the taxable year 1954 of $5,000, to which a tax of $1,100 was allocable. During the taxable year 1955, the trustee distributes $10,000 to A and $5,000 to B. Thus, of the total distribution of $15,000, A received two-thirds and B received one-third.

(b) For the purposes of determining the amounts includible in the beneficiaries' gross income for 1955, the trust is deemed to have made the following distributions:

Amount distributed out of 1955 income (distributable net income)	$10,000
Accumulation distribution deemed distributed by the trust on the last day of 1954 under section 666(a)	5,000
Taxes imposed on the trust deemed distributed under section 666(b)	1,100

(c) A will include in his gross income for 1955 two-thirds of each item shown in paragraph (b) of this example. Thus, he will include in gross income $6,666.67 (10,000/15,000 × $10,000) of the 1955 distributable net income of the trust as provided in section 662(a)(2), and $3,333.33 (10,000/$15,000 × $5,000) of the accumulation distribution and $733.33 (10,000/15,000 × $1,100) of the taxes imposed on the trust as provided in section 668(a).

(d) B will include in his gross income for 1955 one-third of each item shown in paragraph (b) of this example, computed in the manner shown in paragraph (c) of this example.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.668(a)–3 Excluded amounts.

When a trust pays, credits, or is required to distribute to a beneficiary amounts which are excluded under section 665(b)(1), (2), (3), or (4) from the computation of an accumulation distribution, the amount includible under subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code, in the gross income of the beneficiaries pursuant to § 1.668(a)–1 is first allocated to the beneficiaries as provided in § 1.668(a)–2 and, second, the amount allocable to the beneficiary receiving amounts which are excluded under section 665(b)(1), (2), (3), or (4) is reduced by the excluded amounts. This section may be illustrated by the following examples, in which it is assumed the trusts and beneficiaries report on the calendar year basis and the income of the trusts was derived entirely from taxable interest:

Example (1). (a) A trust in 1957 has income as defined in section 643(b) of $35,000 and expenses allocable to corpus of $5,000. Its distributable net income is, therefore, $30,000 ($35,000–$5,000). The undistributed net income of the trust and the taxes imposed on the trust were $12,840 and $7,260, respectively, for each of the years 1956, 1955, and 1954. The terms of the trust instrument provide for the accumulation of income during the minority of beneficiaries A and B. However, the trustee may make discretionary distributions to either beneficiary after he becomes 21 years of age. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on January 1, 1957, and, as of that date, A was 25 years old. The trustee distributed $50,000 each to A and B during 1957.

(b) Since each beneficiary received one-half of the total amount distributed by the trust, each must include in gross income under section 662(a)(2) one-half ($15,000) of the distributable net income ($30,000) of the trust for 1957.

(c) The excess distribution of $35,000 ($50,000–$15,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in B's gross income under section 668(a). Nor is such amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income under section 668(a).

(d) The accumulation distribution of the trust is $35,000, computed as follows:

Total distribution by the trust		$100,000
Less:		
Distributable net income for 1957	$30,000	
Excess distribution to B	35,000	
		65,000
Accumulation distribution to A		35,000

(e) The accumulation distribution of $35,000 will be allocated to the preceding taxable years 1956, 1955, and 1954, and the trust will be deemed to have made the following distributions to A on the last day of those years:

	1956	1955	1954	Total
Undistributed net income	$12,840	$12,840	$9,320	$35,000
Taxes imposed on the trust	7,260	7,260	5,270	19,790
Total	20,100	20,100	14,590	54,790

Thus, A will include $54,790 in his gross income for 1957 under section 668(a). A will, however, receive credit against his tax under section 668(b).

Example (2). (a) Under the terms of a trust the trustee may make discretionary distributions out of income to A during her life. The balance of the income is to be accumulated during the minority of her son, B, and is to be distributed to him when he becomes 21 years of age. Thereafter the trustee may also make discretionary payments of income to B. Also, the trustee may invade corpus for the benefit of A and B. B became 21 years of age on December 31, 1955. The distributable net income of the trust for 1955 is $30,000. It had undistributed net income of $12,840 for the preceding taxable year 1954 and the taxes imposed on the trust for such year were $7,260. The trustee distributed $15,000 to A during 1955 and on December 31, 1955, he distributed $60,000 to B, which represented income accumulated during his minority.

(b) Since B received four-fifths of the total amount ($75,000) distributed by the trust during 1955, he must include in his gross income under section 662(a)(2) four-fifths ($24,000) of the distributable net income ($30,000) of the trust for 1955. A will include in her gross income under section 662(a)(2) one-fifth ($6,000) of the distributable net income ($30,000) of the trust for 1955.

(c) The excess distribution of $36,000 ($60,000–$24,000) received by B is excluded from the determination of an accumulation distribution under section 665(b)(1) and accordingly is not includible in his gross income under section 668(a).

(d) The amount treated as an accumulation distribution for the purpose of determining the amount includible in A's gross income for 1955 under section 668(a) is $9,000, computed as follows:

Total distribution by the trust		$75,000
Less:		
Distributable net income for 1955	$30,000	
Excess distribution to B	36,000	
		66,000
Amount treated as an accumulation distribution		9,000

(e) Inasmuch as the amount of $9,000 is less than the total undistributed net income of the trust ($12,840) for the preceding taxable year 1954, a pro rata portion of the taxes imposed on the trust for that year are also deemed distributed by the trust. Thus, A will include $14,089 in her gross income for 1955 under section 668(a) computed as follows:

1954	
Accumulation distribution	$9,000
Taxes imposed on the trust (9,000/12,840 × $7,260)	5,089
Total	14,089

A will, however, receive credit against her tax under section 668(b).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.668(a)–4 Tax attributable to throwback.

(a) The tax attributable to amounts deemed distributed under section 666 is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made unless the taxable year of the beneficiary is different from that of the trust (see section 662(c) and the regulations thereunder). In the case of a trust (other than a foreign trust created by a U.S. person), the tax cannot be greater than the aggregate of the taxes attributable to those amounts had they been included, in accordance with the provisions of section 662(a)(2) and (b), in the gross income of the beneficiary for the preceding taxable year or years in which they were deemed distributed. In the case of a foreign trust created by a U.S. person, the tax on the beneficiary shall be computed in accordance with the provisions of section 669 and the regulations thereunder. The tax liability of the beneficiary of a trust (other than a foreign trust created by a U.S. person), including the portion of an entire foreign trust which does not constitute a foreign trust created by a U.S. person (see § 1.643(d)–1), for the taxable year is computed in the following manner:

(1) First, compute the amount of tax for the taxable year attributable to the section 666 amounts which are included in the gross income of the beneficiary for the year. The tax attributable to those amounts is the difference between the tax for the taxable year computed with the inclusion of the section 666 amounts in gross income and the tax computed without including them in gross income.

(2) Next, compute the tax attributable to the section 666 amounts for each of the preceding taxable years as if they had been included in gross income for those years. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding year computed with the inclusion of the section 666 amounts in gross income and the tax for such year computed without including them in gross income. The tax computation for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(3) The total tax for the taxable year is the tax for that year computed without including the section 666 amounts, *plus*—

(i) The amount of the tax for the taxable year attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph),

or

(ii) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (2) of this paragraph),

whichever is the smaller.

(b) The provisions of paragraph (a) of this section may be illustrated by the following example:

Example. (1) During the taxable year 1956, $10,000 is deemed distributed under section 666 to a beneficiary, of which $6,000 is deemed distributed by the trust on the last day of 1955 and $4,000 on the last day of 1954. The beneficiary had taxable income (after deductions) from other sources of $5,000 for 1956, $10,000 for 1955, and $10,000 for 1954. The beneficiary's tax liability for 1956 is $4,730 determined as follows:

Year 1956	
Tax on $15,000 (taxable income including section 666 amounts)	$4,730
Tax on $5,000 (taxable income excluding section 666 amounts)	1,100
Tax attributable to section 666 amounts	3,630

Year 1955	
Tax on $16,000 (taxable income including section 666 amounts)	$5,200

Tax on $10,000 (taxable income excluding section 666 amounts)	$2,640
Tax attributable to section 666 amounts	2,560

Year 1954

Tax on $14,000 (taxable income including section 666 amounts)	$4,260
Tax on $10,000 (taxable income excluding section 666 amounts)	2,640
Tax attributable to section 666 amounts	1,620

(2) Inasmuch as the tax of $3,630 attributable to the section 666 amounts as computed at 1956 rates is less than the aggregate of the taxes of $4,180 ($2,560 plus $1,620) determined for the preceding taxable years the amount of $3,630 is added to the tax ($1,100) computed for 1956 without including the section 666 amounts.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 737, Jan. 17, 1969]

§ 1.668(b)-1 Credit for taxes paid by the trust.

(a) The taxes imposed on a complex trust for a taxable year which would not have been payable by the trust if amounts deemed under section 666 to have been distributed in the year had in fact been distributed in the year are not allowable as a refund to the trust but are allowable as a credit against the tax of the beneficiaries to whom the amounts described in section 666(a) are distributed.

(b) The credit to which a beneficiary is entitled under section 668(b) is allowed for the taxable year in which the accumulation distribution (to which the credit relates) is required to be included in the gross income of the beneficiary. Any excess over the total tax liability of the beneficiary is treated as an overpayment of tax by the beneficiary.

(c) The beneficiary is entitled to a portion of the credit described in paragraph (a) of this section in the ratio which the amount of the accumulation distribution to him bears to the accumulation distributions to all the beneficiaries.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.668(b)-2 Illustration of the provisions of Subpart D.

The provisions of Subpart D (section 665 and following), Part I, Subchapter J, Chapter 1 of the Code, other than provisions relating to a foreign trust created by a U.S. person, may be illustrated by the following example:

Example. **(a) Facts.** (1) Under the terms of a trust instrument, one-half of the trust income is required to be distributed currently to beneficiary A. The trustee may in his discretion accumulate the balance of the income of the trust or he may make distributions to B out of income or corpus. The trust is to terminate upon the death of A and the corpus is to be distributed to B. Capital gains are allocable to corpus. All of the expenses of the trust are charges against income. The trust instrument provides for a reserve for depreciation, so that depreciation is deductible in computing distributable net income. The trust and both beneficiaries report on the calendar year basis. The trust had long-term capital gains of $20,000 for 1954, and $10,000 for 1955, which were allocated to corpus. The distributable net income of the trust as determined under section 643(a) for 1954, 1955, 1956, and 1957 is deemed to consist of the following items of income:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1954 ...	$15,000	$20,000	$10,000	$5,000	$50,000
1955 ...	10,000	15,000	10,000	5,000	40,000
1956 ...	10,000	20,000	15,000	5,000	50,000
1957 ...	10,000	15,000	15,000	5,000	45,000

(2) One-half ($7,500) of the dividends for 1954 was received by the trust on or before July 31, 1954, and the balance was received after that date.

(3) The following distributions were made by the trustee to A and B during the taxable years 1954 through 1957:

	A	B
1954	$25,000	None
1955	20,000	None
1956	25,000	$45,000
1957	22,500	29,550

(b) Distributions to A. A is deemed to have received one-half of each item of income entering into the computation of distributable net income as shown in paragraph (a)(1) of this example. See § 1.662(a)-2 for rules for the treatment of currently distributable income in the hands of the beneficiary.

(c) Tax liability of the trust—(1) 1954. (i) The tax liability of the trust for the taxable year 1954 is $13,451, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$50,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		44,950
Add: Capital gains (long-term)		20,000
Total		64,950
Deductions:		
Distributions to A	$22,475	
Capital gain deduction	$10,000	
Personal exemption	100	
		32,575
Taxable income		32,375
Alternative tax		13,601
Dividend received credit		150
Tax liability		13,451

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half of the dividends of the trust is deemed to be distributed to A, $25 of such distribution is deemed to be made from the dividend exclusion of $50, and

the balance from dividends included in the gross income of the trust (that is, since the year 1954 is involved, $3,725 from dividends received on or before July 31, 1954, and $3,750 from dividends received after July 31, 1954). The trust is entitled to a dividend received credit attributable to the dividends of $3,750 received after July 31, 1954, which were not distributed to any beneficiary during the taxable year.

(2) 1955. (i) The tax liability of the trust for the taxable year 1955 is $8,189, computed as follows:

Distributable net income under section 643(a) (paragraph (a)(1) of this example)		$40,000
Less amounts not includible in gross income:		
Tax-exempt interest	$5,000	
Dividend exclusion	50	
		5,050
Distributable net income as adjusted		34,950
Add: Capital gains (long-term)		10,000
Total		44,950
Deductions:		
Distributions to A	$17,475	
Capital gain deduction	5,000	
Personal exemption	100	
		22,575
Taxable income		22,375
Alternative tax		8,388
Dividend received credit		199
Tax liability		8,189

(ii) See paragraph (b) of this example for character of income deemed distributed to A and section 661 for rules for computing the amount deductible by a trust for distributions to beneficiaries. Inasmuch as one-half ($4,975) of the dividends of $9,950 ($10,000 less dividend exclusion of $50) included in the gross income of the trust is deemed distributed to A, the trust is entitled to a dividend received credit with respect to the dividends of $4,975 which were not distributed to any beneficiary during the taxable year.

(3) 1956 and 1957. The trust had no tax liability for the taxable years 1956 and 1957 since all of its income was distributed during such years.

(d) Accumulation distributions. (1) Accumulation distributions of $20,000 and $7,050, as defined in section 665(b), were made to B during the years 1956 and 1957, respectively, computed as shown below:

	1956	1957
Distributable net income of the trust as computed under section 643(a)	$50,000	$45,000
Less. Income currently distributable to A	25,000	22,500
Balance of income	25,000	22,500
Other amounts distributed to B	45,000	29,550
Accumulation distributions to B	20,000	7,050

(2) B is deemed to have received one-half of each item of income entering into the computation of distributable net income (shown in paragraph (a)(1) of this example) for the years 1956 and 1957.

(3) The accumulation distribution for 1956 must first be allocated to the preceding taxable years as provided in section 666. After the application of the provisions of subpart D to the 1956 accumulation distribution and to the undistributed net incomes of the preceding taxable years, a similar allocation must be made of the 1957 accumulation distribution.

(e) Throwback of 1956 accumulation distribution to 1955. The accumulation distribution of $20,000 for 1956 must be allocated to the first preceding taxable year 1955, before allocation is made to the second preceding taxable year 1954.

(1) 1955 Undistributed net income. (i) The undistributed net income of the trust for 1955, determined as of the close of 1955, is $12,885, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)		$40,00
Less:		
Distributions to A	$20,000	
Taxes imposed on the trust	7,115	
		27,115
Undistributed net income as of the close of 1955		12,885

(ii) The taxes imposed on the trust of $7,115 are that portion of the taxes paid by the trust for 1955 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the "balance" in the computation below) and is determined as follows:

Taxable income (paragraph (c)(2)(i) of this example)			$22,375
Capital gains allocable to corpus		$10,000	
Less:			
Capital gain deduction	$5,000		
Personal exemption	100		
		5,100	
Portion of taxable income allocable to corpus			4,900
Balance			17,475
Total taxes paid by the trust			8,189
Taxes on income ($4,900) allocable to corpus			1,074
Taxes imposed on the trust (section 665(c))			7,115

(iii) The amount of $1,074 is the taxes which the trust would have paid for 1955 had all of the distributable net income been distributed during the year.

(2) Allocation of 1956 accumulation distribution to the preceding taxable year 1955. The portion of the 1956 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1955 (the first preceding taxable year) is $12,885, an amount equal to the undistributed net income for 1955. An additional amount equal to the taxes imposed on the trust ($7,115) is, under section 666(b), also deemed to be distributed to B on the last day of 1955. Thus, a total of $20,000 ($12,885 plus $7,115) is deemed to be distributed to B on December 31, 1955, by reason of the allocation of the 1956 accumulation distribution to the first preceding taxable year. See paragraph (h) of this example for the treatment of the amount of $20,000 in the hands of B.

(3) Character of amounts deemed distributed. Inasmuch as one-half of the 1955 distributable net income of the trust as determined under section 643(a) was currently distributable to A and the balance of such income is deemed under section 666 to be distributed to B on December 31, 1955, the distribution to B is deemed to consist of one-half of each item of income entering into the computation of the 1955 distributable net income; that is, dividends of $5,000, rents of $7,500, taxable interest of $5,000, and tax-exempt interest of $2,500.

(4) **Credit for taxes paid by the trust.** The amount of the taxes for the year 1955 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b) is $7,115. See also paragraph (h)(3) of this example.

(5) **Effect of application of provisions of subpart D to the year 1955.** After the allocation of the 1956 accumulation distribution to the preceding taxable year 1955, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1955 are zero. The portion of the 1956 accumulation distribution which is unabsorbed by the 1955 undistributed net income is $7,115, determined as follows:

1956 accumulation distribution (paragraph (d)(1) of this example)	$20,000
Less: Amount allocable to 1955	12,885
Balance allocable to second preceding taxable year 1954	7,115

(f) **Throwback of 1956 accumulation distribution to 1954.** The unabsorbed portion of the 1956 accumulation distribution of $7,115 is allocable to the second preceding taxable year 1954 and is treated under section 666 as a distribution to B on the last day of such year.

(1) **1954 undistributed net income.** (i) The undistributed net income of the trust for 1954, determined as of the close of 1954, is $14,155, computed as follows:

Distributable net income as computed under section 643(a) (paragraph (a)(1) of this example)		$50,000
Less:		
Distributions to A	$25,000	
Taxes imposed on the trust	10,845	
		35,845
Undistributed net income as of the close of 1954		14,155

(ii) The taxes imposed on the trust of $10,845 are that portion of the taxes paid by the trust for 1954 which is attributable to the undistributed portion of distributable net income included in the taxable income of the trust (the "balance" in the computation below in this subdivision) and is determined as follows:

Taxable income (paragraph (c)(1)(i) of this example)			$32,375
Capital gains allocable to corpus		$20,000	
Less:			
Capital gain deduction	$10,000		
Personal exemption	100		
		10,100	
Portion of taxable income allocable to corpus			$9,900
Balance			22,475
Total taxes paid by the trust			13,451
Taxes on income ($9,900) allocable to corpus			2,606
Taxes imposed on the trust (section 665(c))			10,845

(iii) The amount of $2,606 is the taxes which the trust would have paid for 1954 had all of the distributable net income been distributed during that year.

(2) **Allocation of 1956 accumulation distribution to the second preceding taxable year 1954.** Since the unabsorbed portion of the 1956 accumulation distribution of $7,115 is less than the 1954 undistributed net income of $14,155, the trust is deemed under section 666(c) to have also distributed an additional amount ($5,451) equal to a pro rata portion (7,115/14,155×$10,845) of the taxes imposed on the trust for 1954. Thus, a total of $12,566 ($7,115 plus $5,451) is deemed to be distributed to B on December 31, 1954, by reason of the throwback of the 1956 accumulation distribution. See paragraph (h) of this example for the treatment of the amount of $12,566 in the hands of B.

(3) **Character of amounts deemed distributed to B.** The amount of $12,566 which, under section 666, is deemed to be distributed to B on December 31, 1954, is deemed to be composed of the following items of income of the trust: Dividends, $3,770 (15,000/50,000×$12,566); rents, $5,026 (20,000/50,000×$12,566); taxable interest, $2,513 (10,000/50,000×$12,566); and tax-exempt interest, $1,257 (5,000/50,000×$12,566). One-half of the dividends of $3,770 is considered as distributed from the dividends received by the trust on or before July 31, 1954, of which $13 (3,770/15,000×$50) is deemed distributed from the dividends excluded under section 116, and the other half as distributed from the dividends received after July 31, 1954. Thus, of the total of $12,566 deemed distributed to B, $11,296 is considered as made from income included in the gross income of the trust and $1,270 from non-taxable income of the trust.

(4) **Credit for taxes paid by the trust.** The amount of the taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B for 1956 under section 668(b), because of the allocation of the 1956 accumulation distribution to 1954, is $5,401, computed as follows:

Taxable income of the trust as of the close of 1954 (paragraph (c)(1) of this example)	$32,375
Less: Amount deemed distributed to B under section 666 from the taxable income of the trust	11,296
Taxable income adjusted as of the close of 1956	21,079
(Taxes on $21,079 (alternative tax)	$8,050
Taxes on income allocable to corpus (subparagraph (1)(ii) of this paragraph)	$2,606
Taxes imposed on the trust determined as of the close of 1956	5,444
Taxes imposed on the trust determined as of the close of 1954	$10,845
Taxes imposed on the trust determined as of the close of 1956	5,444
Amount of taxes allowed as a credit to B under section 668(b)	5,401

(5) **Effect of application of provisions of subpart D to the year 1954.** (i) The undistributed portion of the distributable net income of the trust for the year 1954, determined as of the close of 1956, is $12,434, computed as follows:

Distributable net income (section 643(a))		$50,000
Less:		
Amount currently distributable to A	$25,000	
Amount deemed distributed to B under section 666	12,566	
		37,566
Undistributed portion of distributable net income as of the close of 1956		12,434

(ii) The amount of $12,434 is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243, determined as follows:

	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
Trust income	$15,000	$20,000	$10,000	$5,000	[1] $50,000
Distributions:					
To A	7,500	10,000	5,000	2,500	[2] 25,000
To B	3,770	5,026	2,513	1,257	[3] 12,566
Total	11,270	15,026	7,513	3,757	37,566
Balance	3,730	4,974	2,487	1,243	12,434

[1] See paragraph (a)(1) of this example.
[2] See paragraph (b) of this example.
[3] See paragraph (f)(3) of this example.

(iii) The undistributed net income of the trust for 1954, determined as of the close of 1956, is $6,990, computed as follows:

Undistributed portion of distributable net income as of the close of 1956	$12,434
Less: Taxes imposed on the trust determined as of the close of 1956 (subparagraph (4) of this paragraph)	5,444
Undistributed net income as of the close of 1956	6,990

(g) Throwback of 1957 accumulation distribution. Inasmuch as all of the income of the trust for the first preceding taxable year 1956 was distributed during such year and the trust had no undistributed net income for the second preceding taxable year 1955 after the application of subpart D to the accumulation distribution made during 1956, the 1957 accumulation distribution of $7,050 is allocable to the third preceding taxable year 1954. See paragraph (d)(1) of this example for computation of the accumulation distribution.

(1) Allocation of 1957 accumulation distribution to the preceding taxable year 1954. The portion of the 1957 accumulation distribution which is deemed under section 666(a) to be distributed to B on the last day of 1954 is $6,990, an amount equal to the undistributed net income of the trust for 1954, determined as of the close of 1956. An additional amount equal to the taxes imposed on the trust ($5,444), determined as of the close of 1956, is under section 666(b) also deemed to be distributed to B on the last day of 1954. See paragraph (f)(4) and (5) of this example. Thus, a total of $12,434 ($6,990 plus $5,444) is deemed to be distributed to B on December 31, 1954, by reason of the allocation of the 1957 accumulation distribution to the taxable year 1954. See paragraph (j) of this example for the treatment of the amount of $12,434 in the hands of B.

(2) Character of amounts deemed distributed. Inasmuch as the balance of the 1954 distributable net income of the trust is deemed under section 666 to be distributed to B on December 31, 1954, the distribution is deemed to consist of dividends of $3,730, rents of $4,974, taxable interest of $2,487, and tax-exempt interest of $1,243. See paragraph (f)(5)(ii) of this example.

(3) Credit for taxes paid by the trust. The amount of taxes for the year 1954 which may not be refunded or credited to the trust under section 667 and which is allowed as a credit against the tax of B under section 668(b) is $5,444, the amount of taxes imposed on the trust determined as of the close of 1956. See paragraph (f)(4) of this example.

(4) Effect of application of provisions of subpart D to the year 1954. After the allocation of the 1957 accumulation distribution to the preceding taxable year 1954, the undistributed portion of the distributable net income, the undistributed net income, and the taxes imposed on the trust for 1954 are zero. The balance of $60 ($7,050 less $6,990) of the 1957 accumulation distribution remaining after the allocation of the accumulation distribution to the year 1954, may not be allocated to the year 1953 since that year is not subject to the provisions of the Internal Revenue Code of 1954.

(h) Determination of B's tax liability; taxable year 1956—(1) Amount of trust income includible in gross income. (i) Of the amount of $45,000 distributed by the trust to B during the taxable year 1956, $25,000 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and $20,000 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $12,885 plus taxes of $7,115 is deemed distributed to B on December 31, 1955, and $7,115 plus taxes of $5,451 on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1956, and these amounts are includible in B's gross income for 1956 to the extent that they would have been includible in his gross income under section 662(a)(2) and (b) for 1955 and 1954, respectively, had they been distributed on the last day of those years.

(ii) The amounts distributed to B out of trust income for the year 1956, and the amounts deemed distributed out of income for the preceding taxable years 1955 and 1954 have the following character for the purpose of determining the amount includible in B's gross income for 1956:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1956	$5,000	$10,000	$7,500	$2,500	[1] $25,000
1955	5,000	7,500	5,000	2,500	[2] 20,000
1954	3,770	5,026	2,513	1,257	[3] 12,566
Total	13,770	22,526	15,013	6,257	57,566

[1] See paragraph (d)(2) of this example.
[2] See paragraph (e)(3) of this example.
[3] See paragraph (f)(3) of this example.

Thus, B will include in gross income for 1956 dividends of $13,770 (subject to the dividend exclusion), rents of $22,526, and taxable interest of $15,013, and will exclude the tax-exempt interest of $6,257.

(2) Computation of tax. (i) For the purpose of computing B's tax liability, it is assumed that he was single during the taxable years 1954, 1955, and 1956, and that his taxable income

(derived from salary) for each of the years 1954 and 1955 amounted to $13,400 on which a tax of $4,002 was paid for each year. It is also assumed that his income (other than distributions from the trust) for 1956 was $15,000 derived from salary, and he had allowable deductions of $10,600, which included the deduction for personal exemption.

(ii) The computation of the tax for the taxable year 1956 attributable to the section 666 amounts which are included in B's gross income for such year, as provided in paragraph (a)(1) of § 1.668(a)–4, is as follows:

	(1) Section 666 amounts excluded	(2) Section 666 amounts included
Salary	$15,000	$15,000
Income from trust:		
Dividends ($50 excluded)	4,950	13,720
Rents	10,000	22,526
Taxable interest	7,500	15,013
Total	37,450	66,259
Less: Allowable deductions	10,600	10,600
Taxable income	26,850	55,659
Total tax	11,267	31,064
Less: Dividend received credit	198	475
Tax liability	$11,069	30,589
Tax on income from which section 666 amounts are excluded	....	11,069
1956 tax attributable to section 666 amounts	....	19,520

Only that portion of the dividends received by the trust after July 31, 1954, and deemed distributed to B under section 666, on the last day of such year is included in computing the dividend received credit shown in column (2). See paragraph (f)(3) of this example.

(iii) The computation of the taxes for the preceding taxable years attributable to the section 666 amounts which are deemed distributed by the trust on the last day of these years, as provided in paragraph (a)(2) of § 1.668(a)–4, is as follows:

	Preceding taxable years	
	First 1955	Second 1954
Taxable income previously reported	$13,400	$13,400
Section 666 amounts:		
Dividends ($50 excluded)	4,950	3,720
Rents	7,500	5,026
Taxable interest	5,000	2,513
Taxable income as adjusted	30,850	24,659
Total tax	13,747	9,949
Less: Dividend received credit	198	75
Balance of tax	13,549	9,874
Tax liability	4,002	4,002
Tax attributable to section 666 amounts	9,547	5,872

Only that portion ($1,885) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $75 for the year 1954. See paragraph (f)(3) of this example.

(iv) Inasmuch as the aggregate of the taxes of $15,419 ($9,547 plus $5,872) attributable to the section 666 amounts as determined for the preceding taxable years is less than the tax of $19,520 determined for the taxable year 1956, the amount of $15,419 shall be added to the tax computed for 1956 without including the section 666 amounts. Thus, B's tax liability for 1956 is $26,488 ($11,069 plus $15,419).

(3) **Credits against the tax.** B is allowed under section 668(b) a credit of $12,516 ($5,401 for 1954 and $7,115 for 1955) against his 1956 tax liability for the taxes paid by the trust for the preceding taxable years and which may not be refunded or credited to the trust under section 667. See paragraphs (e)(4) and (f)(4) of this example.

(i) **[Reserved]**

(j) **Taxable year 1957—(1) Amount of trust income includible in gross income.** (i) Of the amount of $29,550 distributed by the trust to B during the taxable year 1957, $22,500 is treated as a distribution out of trust income for that year within the meaning of section 662(a)(2), and $7,050 as an accumulation distribution within the meaning of section 665(b) (see paragraph (d) of this example). However, $6,990 plus taxes of $5,444 is deemed distributed to B on December 31, 1954, under section 666 by reason of the accumulation distribution made during 1957, and that amount is includible in B's gross income for 1957, to the extent that it would have been includible in his gross income under section 662(a)(2) and (b) for 1954, had it been distributed on the last day of that year.

(ii) The amounts deemed distributed to B out of trust income for the year 1957 and the preceding taxable year 1954 are deemed to have the following character for the purpose of determining the amount includible in B's gross income for 1957:

Year	Dividends	Rents	Interest (taxable)	Interest (exempt)	Total
1957	$5,000	$7,500	$7,500	$2,500	[1]$22,500
1954	3,730	4,974	2,487	1,243	[2]12,434
Total	8,730	12,474	9,987	3,743	34,934

[1] See paragraph (d)(2) of this example.
[2] See paragraph (g)(2) of this example.

Thus, B will include in gross income for the year 1957 dividends of $8,730 (subject to the dividend exclusion), rents of $12,474, and taxable interest of $9,987 and will exclude the tax-exempt interest of $3,743.

(2) **Computation of tax.** (i) For the purpose of computing B's tax liability for 1957, it is assumed that he was single for the entire year and had income (other than distributions from the trust) of $15,000 from salary. Also, he had allowable deductions of $8,100, which included the deductions for personal exemption.

(ii) The computation of the tax for the taxable year 1957 attributable to the section 666 amounts which are included in B's gross income for that year, as provided in paragraph (a)(1) of § 1.668(a)–4, is as follows:

	Section 666 amounts excluded	Section 666 amounts included
Salary	$15,000	$15,000
Trust income:		
Dividends ($50 excluded)	4,950	8,680
Rents	7,500	12,474
Taxable interest	7,500	9,987
Total	34,950	46,141

	Section 666 amounts excluded	Section 666 amounts included
Less: Allowable deductions	$8,100	$8,100
Taxable income	26,850	38,041
Total tax	11,267	18,388
Less: Dividends received credit	198	275
Tax liability	11,069	18,113
Tax on income from which section 666 amounts are excluded	....	11,069
1957 tax attributable to section 666 amounts	....	7,044

See explanation following computation in paragraph (h)(2)(ii) of this example with respect to the computation of the dividend received credit on dividends received by the trust in 1954.

(iii) The amount of tax, computed at 1954 rates, attributable to the section 666 amounts which are deemed to have been distributed by the trust on the last day of 1954, is $6,939, computed as follows:

1954 taxable income as adjusted (paragraph (h)(2)(iii) of this example)		$24,659
Section 666 amounts:		
Dividends		3,730
Rents		4,974
Taxable interest		2,487
Taxable income as adjusted		35,850
Total tax		16,963
Less: Dividends received credit		150
Balance of tax		16,813
Tax liability for 1954	$4,002	
Tax attributable to 1956 accumulation distribution (this example)	5,872	
		9,874
Tax attributable to the section 666 amounts distributed in 1957		6,939

Only that portion ($3,750) of the dividends received by the trust after July 31, 1954, and deemed distributed under section 666 on the last day of that year, is included in computing the dividend received credit of $150. See paragraphs (f)(3) and (g)(2) of this example.

(iv) Inasmuch as the tax of $6,939 attributable to the section 666 amounts as determined for the preceding taxable year 1954 is less than the tax of $7,044 attributable to these amounts for the year 1957, the amount of $6,939 shall be added to the tax computed for 1957 without including in gross income the section 666 amounts. Thus, B's tax liability for 1957 is $18,008 ($11,069 plus $6,939).

(3) **Credit against the tax.** B is allowed under section 668(b) a credit of $5,444 against his 1957 tax liability for the balance of the taxes paid by the trust for 1954 and which may not be refunded or credited to the trust under section 667. See paragraph (g)(3) of this example.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 738, Jan. 17. 1969]

§ 1.669(a)–1A Amount allocated.

(a) **In general.** After a trust has distributed all of its undistributed net income, the rules concerning the treatment of capital gain distributions (prescribed under section 669) may become applicable to an accumulation distribution. This section prescribes rules to determine from which years capital gain distributions are considered to be made. For the definition of "capital gain distribution," see § 1.665(g)–1A. Section 669 does not apply to a trust that has distributed all of its income currently since its inception. See § 1.668(a)–1A(c). Capital gain retains its character in the hands of the beneficiary. See § 1.669(f)–1A. A capital gain distribution to more than one beneficiary will be allocated among them. See § 16.668(a)–2A.

(b) **First-in, first-out rule.** A capital gain distribution is allocated to the preceding taxable years of the trust (as defined in § 1.665(e)–1A(a)(1)(iii)), according to the undistributed capital gain of the trust for such years. For this purpose, a capital gain distribution is first allocated to the earliest such preceding taxable year in which there is undistributed capital gain and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the capital gain distribution allocated to the earliest preceding taxable year is the amount of undistributed capital gain for that preceding taxable year. The portion of the capital gain distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the capital gain distribution over the aggregate of the undistributed capital gain for all earlier preceding taxable years. See paragraph (c) of this section for adjustments to undistributed capital gain for prior distributions.

(c) **Reduction of undistributed capital gain for prior capital gain distributions.** For the purposes of allocating to any preceding taxable year a capital gain distribution of the taxable year, the undistributed capital gain of such preceding taxable year is reduced by the amount from such year deemed distributed in any capital gain distribution made in any taxable year intervening between such preceding taxable year and the taxable year. Accordingly, for example, if a trust subject to the capital gain throwback has no undistributed net income but has undistributed capital gain for 1974, and makes capital gain distributions during the taxable years 1978 and 1979, then in determining that part of the 1979 capital gain distribution that is thrown back to 1974, the undistributed capital gain for 1974 is reduced by the amount of such undistributed capital gain for 1974 deemed distributed in the 1978 capital gain distribution.

(d) **Rule when no undistributed capital gain.** If, before the application of the provisions of subpart D to a capital gain distribution for the taxable

year, there is no undistributed capital gain for a preceding taxable year, then no portion of the capital gain distribution is deemed distributed on the last day of such preceding taxable year. Thus, for example, if a capital gain distribution is made during the taxable year 1975 from a trust whose earliest preceding taxable year is taxable year 1970, and the trust had no undistributed capital gain for 1970, then no portion of the 1975 capital gain distribution is deemed distributed on the last day of 1970.

(e) **Example.** The provisions of this section may be illustrated by the following example:

Example. In 1977, a trust reporting on the calendar year basis makes a capital gain distribution of $33,000. In 1969, the trust had $6,000 of undistributed capital gain; in 1970, $4,000; in 1971, none; in 1972, $7,000; in 1973, $5,000; in 1974, $8,000; in 1975, $6,000; in 1976, $4,000; and $6,000 in 1977. The capital gain distribution is deemed distributed $6,000 in 1969, $4,000 in 1970, none in 1971, $7,000 in 1972, $5,000 in 1973, $8,000 in 1974, and $3,000 in 1975.

[T.D. 7204, 37 FR 17153, Aug. 25, 1972]

§ 1.669(b)–1A Tax on distribution.

(a) **In general.** The partial tax imposed on the beneficiary by section 668(a)(3) shall be the lesser of—

(1) The tax computed under paragraph (b) of this section (the "exact" method), or

(2) The tax computed under paragraph (c) of this section (the "short-cut" method),

except as provided in § 1.669(c)–3A (relating to failure to furnish proper information) and paragraph (d) of this section (relating to disallowance of short-cut method). For purposes of this paragraph, the method used in the return shall be accepted as the method that produces the lesser tax. The beneficiary's choice of the two methods is not dependent upon the method that he uses to compute his partial tax imposed by section 668(a)(2).

(b) **Computation of partial tax by the exact method.** The partial tax referred to in paragraph (a)(1) of this section is computed as follows:

(1) First, compute the tax attributable to the section 669 amounts for each of the preceding taxable years. For purposes of this paragraph, the "section 669 amounts" for a preceding taxable year are the amounts deemed distributed under section 669(a) on the last day of such preceding taxable year, plus the amount of taxes deemed distributed on such day under section 669 (d) or (e). The tax attributable to such amounts in each prior taxable year of the beneficiary is the difference between the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary's gross income and the tax for such year computed with the inclusion of them in such gross income. Tax computations for each such year shall reflect a taxpayer's marital, dependency, exemption, and filing status for such year. To the extent the undistributed capital gain of a trust deemed distributed in a capital gain distribution includes amounts received as a capital gain distribution from another trust, for purposes of this paragraph they shall be considered as amounts deemed distributed by the trust under section 669(a) on the last day of each of the preceding taxable years in which such amounts were accumulated by such other trust. For example, assume trust Z, a calendar year trust received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust, that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974.

(2) From the sum of the taxes for the prior taxable years attributable to the section 669(a) amounts (computed in accordance with subparagraph (1) of this paragraph), subtract so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.669(d)–1A and 1.669(e)–1A as does not exceed such sum. The resulting amount, if any, is the partial tax on the beneficiary, computed under the exact method, for the taxable year in which the capital gain distribution is paid, credited, or required to be distributed to the beneficiary.

(c) **Computation of tax by the short-cut method.** (1) The tax referred to in paragraph (a)(2) of this section is computed as follows:

(i) First, determine the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed. For purposes of the preceding sentence, the preceding taxable years of a trust that has received a capital gain distribution from another trust shall include the taxable years of such other trust in which an amount was deemed distributed in such capital gain distribution. For example, assume trust Z, a calendar year trust, received in its taxable year 1975 a capital gain distribution from trust Y, a calendar year trust,

that included undistributed capital gain of trust Y for the taxable years 1972, 1973, and 1974. To the extent a capital gain distribution made by trust Z in its taxable year 1976 includes such undistributed capital gain, it shall be considered a capital gain distribution by trust Z in the taxable year 1976 and under section 669(a) will be deemed distributed on the last day of the preceding taxable years 1972, 1973, and 1974. For purposes of this subparagraph, such number of preceding taxable years of the trust shall not include any preceding taxable year of the trust in which the undistributed capital gain deemed distributed is less than 25 percent of (a) the total amounts deemed under section 669(a) to be undistributed capital gain from preceding taxable years, divided by (b) the number of such preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed without application of this sentence. For example, assume that a capital gain distribution of $90,000 made to a beneficiary in 1979 is deemed distributed in the amounts of $29,000 in each of the years 1972, 1973, and 1974, and $3,000 in 1975. The number of preceding taxable years on the last day of which an amount was deemed distributed without reference to the second sentence of this subparagraph is 4. However, the distribution deemed made in 1975 ($3,000) is less than $5,625, which is 25 percent of (a) the total undistributed capital gain deemed distributed under section 669(a) ($90,000) divided by (b) the number of such preceding taxable years (4), or $22,500. Therefore, for purposes of this subparagraph, the capital gain distribution is deemed distributed in only 3 preceding taxable years (1972, 1973, and 1974).

(ii) Second, divide the amount (representing the capital gain distribution and taxes deemed distributed) required under section 668(a) to be included in the income of the beneficiary for the taxable year by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (determined as provided in subdivision (i) of this paragraph). The amount determined under this subdivision, including taxes deemed distributed, consists of the same proportion of long-term and short-term capital gain as the total of each type of capital gain deemed distributed in the capital gain distribution bears to the total undistributed capital gain from such preceding taxable years deemed distributed in the capital gain distribution. For example, assume that an amount of $50,000 is deemed distributed under section 669(a) from undistributed capital gain of 5 preceding taxable years of the trust, and consists of $30,000 of long-term capital gain and $20,000 of short-term capital gain. Taxes attributable to such amounts in the amount of $10,000 are also deemed distributed. The amount determined under this subdivision, $12,000 ($50,000 income plus $10,000 tax, divided by 5 years), is deemed to consist of $7,200 of long-term capital gain and $4,800 in short-term capital gain.

(iii) Third, compute the tax of the beneficiary for each of the 3 taxable years immediately preceding the year in which the capital gain distribution is paid, credited, or required to be distributed to him,

(a) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subdivision (ii) of this subparagraph, and

(b) Without such inclusion.

The difference between the amount of tax computed under (a) of this subdivision for each year and the amount computed under (b) of this subdivision for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subdivision (ii) of this subparagraph.

(iv) Fourth, add the additional taxes resulting from the application of subdivision (iii) of this subparagraph and then divide this amount by 3.

(v) Fifth, the resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 669(a) to have been distributed (previously determined under subdivision (i) of this subparagraph).

(vi) The resulting amount, less so much of the amount of taxes deemed distributed to the beneficiary under §§ 1.669(d)–1A and 1.669(e)–1A as does not exceed such resulting amount, is the tax under the short-cut method provided in section 669(b)(1)(B).

(2) See § 1.668(b)–1A(c) for examples of the short-cut method in the context of an accumulation distribution.

(d) **Disallowance of short-cut method.** If, in any prior taxable year of the beneficiary in which any part of the capital gain distribution is deemed to have been distributed under section 669(a) to such beneficiary, any part of prior capital gain distributions by each of two or more other trusts is deemed under section 669(a) to have been distributed to such beneficiary, then the short-cut meth-

od under paragraph (c) of this section may not be used and the partial tax imposed by section 668(a)(3) shall be computed only under the exact method under paragraph (b) of this section. For example, assume that, in 1978, trust X makes a capital gain distribution to A, who is on the calendar year basis, and part of the distribution is deemed under section 669(a) to have been distributed on March 31, 1974. In 1977, A had received a capital gain distribution from both trust Y and trust Z. Part of the capital gain distribution from trust Y was deemed under section 669(a) to have been distributed to A on June 30, 1974, and part of the capital gain distribution from trust Z was deemed under section 669(a) to have been distributed to A on December 31, 1974. Because there were portions of capital gain distributions from two other trusts deemed distributed within the same prior taxable year of A (1974), the 1978 capital gain distribution from trust X may not be computed under the short-cut method provided in paragraph (c) of this section. Therefore the exact method under paragraph (b) of this section must be used to compute the tax imposed by section 668(a)(3).

[T.D. 7204, 37 FR 17153, Aug. 25, 1972]

§ 1.669(c)–1A Special rules applicable to section 669.

(a) Effect of other distributions. The income of the beneficiary, for any of his prior taxable years for which a tax is being recomputed under § 1.669(b)–1A, shall include any amounts of prior accumulation distributions (including prior capital gain distributions) deemed distributed under sections 666 and 669 in such prior taxable year. For purposes of the preceding sentence, a "prior accumulation distribution" is a distribution from the same or another trust which was paid, credited, or required to be distributed in a prior taxable year of the beneficiary. The term "prior accumulation distribution" also includes accumulation distributions of the same or other trusts which were distributed to the beneficiary in the same taxable year. The term "prior capital gain distribution" also includes capital gain distributions of other trusts which were paid, credited, or required to be distributed to the beneficiary in the same taxable year and which the beneficiary has determined under paragraph (b) of this section to treat as having been distributed before the capital gain distribution for which tax is being computed under § 1.669(b)–1A.

(b) Multiple distributions in the same taxable year. For purposes of paragraph (a) of this section, capital gain distributions made from more than one trust in the same taxable year of the beneficiary, regardless of when in the taxable year they were actually made, shall be treated as having been made consecutively, in whichever order the beneficiary may determine. However, the beneficiary must treat them as having been made in the same order for the purpose of computing the partial tax on the several capital gain distributions. The beneficiary shall indicate the order he has determined to deem the capital gain distributions to have been received by him on his return for the taxable year. A failure by him so to indicate, however, shall not affect his right to make such determination. The purpose of this rule is to assure that the tax resulting from the later (as so deemed under this paragraph) distribution is computed with the inclusion of the earlier distribution in the taxable base and that the tax resulting from the earlier (as so deemed under this paragraph) distribution is computed with the later distribution excluded from the taxable base.

(c) Rule when beneficiary not in existence on the last day of a taxable year. If a beneficiary was not in existence on the last day of a preceding taxable year of the trust with respect to which a distribution is deemed made under section 669(a), it shall be assumed, for purposes of the computations under paragraphs (b) and (c) of § 1.669(b)–1A, that the beneficiary—

(1) Was in existence on such last day,

(2) Was a calendar year taxpayer,

(3) Had no gross income other than the amounts deemed distributed to him from such trust in his calendar year in which such last day occurred and from all other trusts from which amounts are deemed to have been distributed to him in such calendar year,

(4) If an individual, was unmarried and had no dependents,

(5) Had no deductions other than the standard deduction, if applicable, under section 141 for such calendar year, and

(6) Was entitled to the personal exemption under section 151 or 642(b).

For example, assume that part of a capital gain distribution made in 1980 is deemed under section 669(a) to have been distributed to the beneficiary, A, in 1973. $10,000 of a prior accumulation distribution was deemed distributed in 1973. A was born on October 9, 1975. It will be assumed for purposes of § 1.669(b)–1A that A was alive in

1973, was on the calendar year basis, had no income other than (i) the $10,000 from the accumulation distribution deemed distributed in 1973 and (ii) the part of the 1980 distribution deemed distributed in 1973, and had no deductions other than the personal exemption provided in section 151. If A were a trust or estate created after 1973, the same assumptions would apply, except that the trust or estate would not be entitled to the standard deduction and would receive the personal exemption provided under section 642(b) in the same manner as allowed under such section for A's first actual taxable year.

(d) Examples. The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). In 1978, trust X made a capital gain distribution to A, a calendar year taxpayer, of which $3,000 was deemed to have been distributed in 1974. In 1980, trust X makes another capital gain distribution to A, $10,000 of which is deemed under section 669(a) to have been distributed in 1974. Also in 1980, trust Y makes a capital gain distribution to A, of which $5,000 is deemed under section 669(a) to have been distributed in 1974. A determines to treat the 1980 distribution from trust Y as having been made prior to the 1980 distribution from trust X. In computing the tax on the 1980 trust Y distribution, A's gross income for 1974 includes (i) the $3,000 deemed distributed from the 1978 distribution, and (ii) the $5,000 deemed distributed in 1974 from the 1980 Trust Y capital gain distribution. To compute A's tax under the exact method for 1974 on the $10,000 from the 1980 trust X capital gain distribution deemed distributed in 1974. A's gross income for 1974 includes (i) the $10,000, (ii) the $3,000 previously deemed distributed in 1974 from the 1978 trust X capital gain distribution, and (iii) the $5,000 deemed distributed in 1974 from the 1980 trust Y capital gain distribution.

Example (2). In 1978, trust T makes a capital gain distribution to B, a calendar year taxpayer. Determination of the tax on the distribution under the short-cut method requires the use of B's gross income for 1975, 1976, and 1977. In 1977, B received an accumulation distribution from trust U, of which $2,000 was deemed to have been distributed in 1975, and $3,000 in 1976. B's gross income for 1975, for purposes of using the short-cut method to determine the tax from the trust T capital gain distribution, will be deemed to include the $2,000 deemed distributed in 1975 by trust U, and his gross income for 1976 will be deemed to include the $3,000 deemed distributed by trust U in 1976.

[T.D. 7204, 37 FR 17155, Aug. 25, 1972]

§ 1.669(c)–2A Computation of the beneficiary's income and tax for a prior taxable year.

(a) Basis for computation. (1) The beneficiary's income and tax paid for any prior taxable year for which a recomputation is involved under either the exact method or the short-cut method shall be determined by reference to the information required to be furnished by him under § 1.669(c)–3A(a). The gross income, related deductions, and taxes paid for a prior taxable year of the beneficiary as finally determined shall be used for recomputation purposes. The term "as finally determined" shall have the same meaning for purposes of this section as in § 1.668(b)–3A(a).

(2) If any computations rely on the beneficiary's return for a prior taxable year for which the applicable period of limitations on assessment under section 6501 has expired, and such return shows a mathematical error on its face which resulted in the wrong amount of tax being paid for such year, the determination of both the tax for such year computed with the inclusion of the section 669 amounts in the beneficiary's gross income, and the tax for such year computed without including such amounts in such gross income, shall be based upon the return after the correction of such mathematical errors.

(b) Effect of allocation of undistributed capital gain on items based on amount of income and with respect to a net operating loss, a charitable contributions carryover, or a capital loss carryover. (1) In computing the tax for any taxable year under either the exact method or the short-cut method, any item which depends upon the amount of gross income, adjusted gross income, or taxable income shall be recomputed to take into consideration the amount of undistributed capital gain allocated to such year. For example, if $2,000 of undistributed long-term capital gain is allocated to 1970, adjusted gross income for 1970 is increased from $5,000 to $6,000. The allowable 50 percent charitable deduction under section 170(b)(1)(A) is then increased and the amount of the nondeductible medical expenses under section 213 (3 percent of adjusted gross income) is also increased.

(2) In computing the tax attributable to the undistributed capital gain deemed distributed to the beneficiary in any of his prior taxable years under either the exact method or the short-cut method, the effect of amounts of undistributed capital gain on a net operating loss carryback or carryover, a charitable contributions carryover, or a capital loss carryback or carryover, shall be taken into account. In determining the amount of tax attributable to such deemed distribution, a computation shall also be made for any taxable year which is affected by a net operating loss carryback or carryover, by a charitable contributions carryover, or by a capital loss carryback or carryover determined by reference to the taxable year to which amounts are allocated under either method and which carryback or carryover is reduced or increased by such amounts so allocated.

[T.D. 7204, 37 FR 17155, Aug. 25, 1972]

§ 1.669(c)–3A Information requirements with respect to beneficiary.

(a) **Information to be supplied by beneficiary—(1) Use of exact method.** The beneficiary must supply the information required by subparagraph (3) of § 1.668(b)–4A(a) for any prior taxable year for which a recomputation is required under either the exact method or the short-cut method. Such information shall be filed with the beneficiary's return for the year in which the tax under section 668(a)(3) is imposed.

(2) **Failure to furnish.** If the beneficiary fails to furnish the information required by this paragraph for any prior year involved in the exact method, he may not use such method and the tax computed under paragraph (c) of § 1.669(b)–1A (the short-cut method) shall be deemed to be the amount of partial tax imposed by section 668(a)(3). See, however, paragraph (b) of this section for an exception to this rule where the short-cut method is not permitted. If he cannot furnish the information required for a prior year involved in the short-cut method, such year will be recomputed on the basis of the best information available.

(b) **Exception.** If, by reason of § 1.669(b)–1A(e), the beneficiary may not compute the partial tax on the capital gain distribution under § 1.669(b)–1A(c) (the short-cut method), the provisions of subparagraph (2) of paragraph (a) of this section shall not apply. In such case, if the beneficiary fails to provide the information required by § 1.668(b)–4A(a)(3) for any prior taxable year, the district director shall, by utilizing whatever information is available to him (including information supplied by the beneficiary), determine the beneficiary's income and related expenses for such prior taxable year.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(d)–1A Total taxes deemed distributed.

(a) If a capital gain distribution is deemed under § 1.669(a)–1A to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed capital gain for such preceding taxable year, then an additional amount equal to the "taxes imposed on the trust attributable to the undistributed capital gain" (as defined in § 1.665(d)–1A(c)) for such preceding taxable year is also deemed to have been properly distributed. For example, assume a trust has no distributable net income and has undistributed capital gain of $18,010 for the taxable year 1974. The taxes imposed on the trust attributable to the undistributed capital gain are $2,190. During the taxable year 1977, a capital gain distribution of $18,010 is made to the beneficiary which is deemed under § 1.669(a)–1A to have been distributed on the last day of 1974. The 1977 capital gain distribution is not less than the 1974 undistributed capital gain. Accordingly, taxes of $2,190 imposed on the trust attributable to the undistributed capital gain for 1974 are also deemed to have been distributed on the last day of 1974. Thus, a total of $20,200 will be deemed to have been distributed on the last day of 1974.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)–1A.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(e)–1A Pro rata portion of taxes deemed distributed.

(a) If a capital gain distribution is deemed under § 1.669(a)–1A to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed capital gain for such preceding taxable year, then an additional amount is also deemed to have been properly distributed. The additional amount is equal to the "taxes imposed on the trust attributable to the undistributed capital gain" (as defined in § 1.665(d)–1A(c)) for such preceding taxable year, multiplied by a fraction, the numerator of which is the amount of the capital gain distribution allocated to such preceding taxable year and the denominator of which is the undistributed capital gain for such preceding taxable year. See paragraph (b) of example (1) and paragraphs (c) and (f) of example (2) in § 1.669(e)–2A for illustrations of this paragraph.

(b) For the purpose of paragraph (a) of this section, the undistributed capital gain of any preceding taxable year and the taxes imposed on the trust for such preceding taxable year attributable to such undistributed capital gain are computed after taking into account any capital gain distributions of any taxable years intervening between such preceding taxable year and the taxable year. See paragraph (c) of § 1.669(a)–1A, paragraph (c) of example (1) and paragraphs (e) and (h) of example (2) in § 1.669(e)–2A.

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(e)–2A Illustration of the provisions of section 669.

The application of the provisions of §§ 1.669(a)–1A, 1.669(d)–1A, and 1.669(e)–1A may be illustrated by the following examples:

Example (1). (a) A trust created on January 1, 1974, makes capital gain distributions as follows:

1979	$14,000
1980	60,000

The trust had accumulated income in 1974.

For 1974 through 1978, the undistributed portion of capital gain, taxes imposed on the trust attributable to the undistributed capital gain, and undistributed capital gain are as follows:

Year	Undistributed portion of capital gain	Taxes imposed on the trust attributable to the undistributed capital gain	Undistributed capital gain
1974	$24,200	$2,830	$21,370
1975	32,200	4,330	27,870
1976	12,200	1,130	11,070
1977	None	None	None
1978	10,200	910	9,290

(b) Since the entire amount of the capital gain distribution for 1979 ($14,000), determined without regard to the capital gain distribution for 1980, is less than the undistributed capital gain for 1974 ($21,370), an additional amount of $1,854 (14,000/21,370×$2,830) is deemed distributed under section 669(e).

(c) In allocating the capital gain distribution for 1980, the amount of undistributed capital gain for 1974 will reflect the capital gain distribution for 1979. The undistributed capital gain for 1974 will then be $7,370 and the taxes imposed on the trust for 1974 will be $976, determined as follows:

Undistributed capital gain as of the close of 1974	$21,370
Less: Capital gain distribution (1979)	14,000
Balance (undistributed capital gain as of the close of 1979)	7,370
Taxes imposed on the trust attributable to the undistributed capital gain as of the close of 1979 (7,370/21,370×2,830)	976

(d) The capital gain distribution of $60,000 for 1980 is deemed to have been made on the last day of the preceding taxable years of the trust to the extent of $55,600, the total of the undistributed capital gain for such years, as shown in the tabulation below. In addition, $7,346, the total taxes imposed on the trust attributable to the undistributed capital gain for such years is also deemed to have been distributed on the last day of such years, as shown below:

Year	Undistributed capital gain	Taxes imposed on the trust attributable to the undistributed capital gain
1974	$7,370	$976
1975	27,870	4,330
1976	11,070	1,130
1977	None	None
1978	$9,290	$910
1979	None	None
Total	55,600	7,346

Example (2). (a) Under the terms of a trust instrument, the trustee has discretion to accumulate or distribute the income to X and to invade corpus for the benefit of X. The trust is subject to capital gain throwback. Both X and the trust report on the calendar year basis. All of the income for 1974 was distributed and the capital gain was accumulated. The capital gain of the trust for the taxable year 1974 is $40,200 and the income taxes paid by the trust for 1974 attributable to the undistributed capital gain are $6,070. All of the income and capital gains for 1975 and 1976 were distributed and in addition the trustee made capital gain distributions within the meaning of section 665(g) of $8,000 for each year.

(b) The undistributed capital gain of the trust determined under section 665(f) as of the close of 1974 is $34,130, computed as follows:

Capital gain	$40,200
Less: Taxes imposed on the trust attributable to the undistributed capital gain	6,070
Undistributed capital gain as of the close of 1974	34,130

(c) The capital gain distribution of $8,000 made during the taxable year 1975 is deemed under section 669(a) to have been made on December 31, 1974. Since this capital gain distribution is less than the 1974 undistributed capital gain of $34,130, a portion of the taxes imposed on the trust for 1974 is also deemed under section 669(e) to have been distributed on December 31, 1974. The total amount deemed to have been distributed to X on December 31, 1974, is $9,486, computed as follows:

Capital gain distribution	$8,000
Taxes deemed distributed (8,000/34,130× $6,070)	1,423
Total	9,423

(d) After the application of the provisions of subpart D to the capital gain distribution of 1975, the undistributed capital gain of the trust for 1974 is $26,130, computed as follows:

Undistributed capital gain as of the close of 1974	$34,130
Less: 1975 capital gain distribution deemed distributed on December 31, 1974 (paragraph (c) of this example)	8,000
Undistributed capital gain for 1974 as of the close of 1975	26,130

(e) The taxes imposed on the trust attributable to the undistributed capital gain for the taxable year 1974, as adjusted to give effective to the 1975 capital gain distribution, amount to $4,647, computed as follows:

Taxes imposed on the trust attributable to undistributed capital gain as of the close of 1974	$6,070
Less: Taxes deemed distributed in 1974	1,423
Taxes attributable to the undistributed capital gain determined as of the close of 1975	4,647

(f) The capital gain distribution of $8,000 made during the taxable year 1976 is, under section 669(a), deemed an amount

properly distributed to X on December 31, 1974. Since the capital gain distribution is less than the 1974 adjusted undistributed capital gain of $26,130, the trust is deemed under section 669(e) also to have distributed on December 31, 1974, a portion of the taxes imposed on the trust for 1974. The total amount deemed to be distributed on December 31, 1974, with respect to the capital gain distribution made in 1976, is $9,423, computed as follows:

Capital gain distribution	$8,000
Taxes deemed distributed (8,000/26,130× $4,647)	1,423
Total	9,423

(g) After the application of the provisions of subpart D to the capital gain distribution of 1976, the undistributed capital gain of the trust for 1974 is $18,130, computed as follows:

Undistributed capital gain for 1974 as of the close of 1975	$26,130
Less:	
1976 capital gain distribution deemed distributed on December 31, 1974 (paragraph (f) of this example)	8,000
Undistributed capital gain for 1974 as of the close of 1976	18,130

(h) The taxes imposed on the trust attributable to the undistributed capital gain of the trust for the taxable year 1974, determined as of the close of the taxable year 1976, amount to $3,224 ($4,647 less $1,423).

[T.D. 7204, 37 FR 17156, Aug. 25, 1972]

§ 1.669(f)–1A Character of capital gain.

Amounts distributed as a capital gain distribution and the taxes attributable thereto (determined under § 1.665(d)–1A(c)) retain the character that the gain had with respect to the trust. Thus, a capital gain that was taxed to the trust as a "long-term" capital gain and the pro rata amount of taxes attributable to such long-term gain shall be treated to the beneficiary as a "long-term" capital gain when they are deemed distributed as part of a capital gain distribution. If a trust has different types of capital gain for the same taxable year, and all of the capital gains are not deemed distributed for such year under section 669(a), the amount deemed distributed from such year (including taxes deemed distributed) shall be treated as consisting of the different types of gains in the ratio that the total of each such type of gains of the trust bears to the total of all such gains for the taxable year. For example, assume that in 1975 a trust had net long-term capital gains of $4,000 and net short-term capital gains of $2,000. Taxes attributable to such undistributed capital gain were $700. Therefore, undistributed capital gain for 1975 is $5,300. In 1980, the trust distributes $2,650 that is deemed to be undistributed capital gain from 1975. Such distribution is deemed to consist of long-term gain of $1,766.67 and short-term gain of $883.33. The taxes deemed distributed of $350 consist of long-term gain of $233.33 and short-term gain of $116.67.

[T.D. 7204, 37 FR 17157, Aug. 25, 1972]

§ 1.669(f)–2A Exception for capital gain distributions from certain trusts.

(a) General rule. If a capital gain distribution is paid, credited, or required to be distributed before January 1, 1973, from a trust that was in existence on December 31, 1969, section 669 shall not apply and no tax shall be imposed on such capital gain distribution under section 668(a)(3). If capital gain distributions from more than one such trust are paid, credited, or required to be distributed to a beneficiary before January 1, 1973, the exception under the preceding sentence shall apply only to the capital gain distributions from one of the trusts. The beneficiary shall indicate on his income tax return for the taxable year in which the distribution would otherwise be included in income under section 668(a) the trust to which the exception provided by this section shall apply.

(b) Special rule for section 2056(b)(5) trust. A capital gain distribution paid, credited, or required to be distributed by a trust that qualifies under section 2056(b)(5) of the Code (commonly known as a "marital deduction trust") to a surviving spouse shall, in general, not be taxed under section 668(a)(3) since such a trust is required to distribute all of its income annually or more often. See section 2056(b)(5) and the regulations thereunder.

(c) Effect of exception. If this section applies to a capital gain distribution from a trust, such distribution shall reduce the undistributed capital gain of the trust. Since section 669 does not apply to such capital gain distribution, no amount of taxes paid by the trust attributable to such capital gain distribution are deemed distributed under sections 669(d) and (e).

[T.D. 7204, 37 FR 17157, Aug. 25, 1972]

§ 1.669(a)–1 Limitation on tax.

(a) In general. Section 669 provides that, at the election of a beneficiary who is a U.S. person (as defined in section 7701(a)(30)) and who satisfies the requirements of section 669(b) (that certain information with respect to the operation and accounts of the trust be supplied), the tax attributable to the amounts treated under section 668(a) as having been received by him, from a foreign trust created by a U.S. person, on the last day of a preceding taxable year of the trust shall not be greater than the tax computed under section

669(a)(1)(A) (the computation under this provision will hereinafter be referred to as the "exact throwback" method) or under section 669(a)(1)(B) (the computation under this provision will hereinafter be referred to as the "short-cut throwback" method). This election of the beneficiary with respect to the taxable year of the beneficiary in which the distribution is made shall be made with the district director before the expiration of the period of limitations for assessment provided in section 6501 for such taxable year.

(b) Where no election is made. If the beneficiary does not make the election provided in section 669(a) in the manner required in section 669(b) and § 1.669(b)–2, or furnish the information with respect to the operation and accounts of the foreign trust created by a U.S. person required by section 669(b) and § 1.669(b)–1, the tax on an accumulation distribution treated under section 668(a) as having been received by him from such foreign trust on the last day of a preceding taxable year of the trust shall be computed without reference to section 668 or 669. In such case, the entire accumulation distribution will be included in the gross income of the beneficiary in the year in which it is paid, credited, or required to be distributed, and tax for such year will be computed on the basis of the beneficiary's total taxable income for the year after taking into account such inclusion in gross income.

(c) Year for which tax is payable. The tax, regardless of the manner in which computed, of the beneficiary which is attributable to an accumulation distribution is imposed on the beneficiary for the taxable year of the beneficiary in which the accumulation distribution is made to him unless the taxable year of the beneficiary is different from that of the trust. See section 662(c) and § 1.662(c)–1.

[T.D. 6989, 34 FR 738, Jan. 17, 1969]

§ 1.669(a)–2 Rules applicable to section 669 computations.

(a) In general. (1) Section 668(a) provides that the total of the amounts treated under section 666 as having been distributed by the foreign trust created by a U.S. person on the last day of a preceding taxable year of such trust shall be included in the gross income of the beneficiary or the beneficiaries who are U.S. persons receiving them. The total of such amounts is includible in the gross income of each beneficiary to the extent the amount would have been included in his gross income under section 662(a)(2) and (b) if the total had actually been paid by the trust on the last day of such preceding taxable year. The total is included in the gross income of the beneficiary for the taxable year of the beneficiary in which such amounts are in fact paid, credited, or required to be distributed unless the taxable year of the beneficiary differs from the taxable year of the trust (see section 662(c) and § 1.662(c)–1). The character of the amounts treated as received by a beneficiary in prior taxable years, including taxes deemed distributed, in the hands of the beneficiary is determined by the rules contained in section 662(b) and §§ 1.662(b)–1 and 1.662(b)–2.

(2) The total of the amounts treated under section 666 as having been distributed by the trust on the last day of a preceding taxable year of the trust are included as prescribed in subparagraph (1) of this paragraph in the gross income of the beneficiary even though as of that day the beneficiary would not have been entitled to receive them had they actually been distributed on that day.

(3) Any deduction allowed to the trust in computing distributable net income for a preceding taxable year (such as depreciation, depletion, etc.) is not deemed allocable to a beneficiary because of the amounts included in a beneficiary's gross income under this section since the deduction has already been utilized in reducing the amount included in the beneficiary's income.

(b) Allocation among beneficiaries of a foreign trust. Where there is more than one beneficiary the portion of the total amount includible in gross income under paragraph (a) of this section which is includible in the gross income of a beneficiary who is a U.S. person is based upon the ratio determined under the second sentence of section 662(a)(2) for the taxable year in which distributed (and not for the preceding taxable year). This paragraph may be illustrated by the example in § 1.668(a)–2.

(c) Treatment of income taxes paid by the trust—(1) Current distributions. The income taxes imposed by the provisions of section 871 on the income of a foreign trust created by a U.S. person shall be included in the gross income of the beneficiary, who is a U.S. person, for the taxable year in which such income is paid, credited, or required to be distributed to the beneficiary.

(2) Accumulation distribution. (i) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is not less than the undistributed net income for such preceding taxable year, then an additional amount equal

to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year is likewise deemed distributed under section 661(a)(2).

(ii) If an accumulation distribution is deemed under § 1.666(a)–1 to be distributed on the last day of a preceding taxable year and the amount is less than the undistributed net income for such preceding taxable year, then an additional amount (representing taxes) is likewise deemed distributed under section 661(a)(2). The additional amount is equal to the taxes imposed on the trust pursuant to the provisions of section 871 for such preceding taxable year, multiplied by the fraction the numerator of which is the amount of the accumulation distribution attributable to such preceding taxable year and the denominator of which is the undistributed net income for such preceding taxable year.

(3) **Credits under sections 32 and 668(b).** Credit under section 32 is allowable to the beneficiary for income taxes withheld at source under subchapters A and B of chapter 3 and which are deemed distributed to him. Credit under section 668(b) is allowable to the beneficiary for income taxes imposed upon the foreign trust by section 871(b). These credits shall be allowed against the tax of the beneficiary for the taxable year of the beneficiary in which the income is paid, credited, or required to be distributed to him, or in which the accumulation distribution to which such taxes relate is made to him.

(d) **Credit for foreign income taxes paid by the trust.** To the extent provided in section 901, credit under section 33 is allowable to the beneficiary for the foreign taxes paid or accrued by the trust to a foreign country.

[T.D. 6989, 34 FR 738, Jan. 17, 1969]

§ 1.669(a)–3 Tax computed by the exact throwback method.

(a) **Tax attributable to amounts treated as received in preceding taxable years.** If a taxpayer elects to compute the tax, on amounts deemed distributed under section 666, by the exact throwback method provided in section 669(a)(1)(A), the tax liability of the beneficiary for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed is computed as provided in paragraph (b) of this section. The beneficiary may not elect to use the exact throwback method of computing his tax on an accumulation distribution as provided in section 669(a)(1)(A) if he were not alive on the last day of each preceding taxable year of the foreign trust created by a U.S. person with respect to which a distribution is deemed made under section 666(a). Thus, if a portion of an amount received as an accumulation distribution was accumulated by the trust during years before the beneficiary was born, the beneficiary is not permitted to elect the exact throwback method provided in section 669(a)(1)(A). See § 1.669(a)–4 for the computation of the tax on an accumulation distribution by the short-cut throwback method provided in section 669(a)(1)(B) under these circumstances.

(b) **Computation of tax.** The tax referred to in paragraph (a) of this section is computed as follows:

(1) First, compute the tax attributable to the section 666 amounts for each of the preceding taxable years. To determine the section 666 amounts attributable to each of the preceding taxable years, see § 1.666(a)–1. The tax attributable to such amounts in each such preceding taxable year is the difference between the tax for such preceding taxable year computed with the inclusion of the section 666 amounts in gross income, and the tax for such year computed without including them in gross income. Tax computations for each preceding year shall reflect the taxpayer's marital and dependency status for that year.

(2) Second, add

(i) The sum of the taxes for the preceding taxable years attributable to the section 666 amounts (computed in accordance with subparagraph (1) of this paragraph), and

(ii) The tax for the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him, computed without including the section 666 amounts in gross income.

The total of these amounts is the beneficiary's tax, computed under section 669(a)(1)(A) for the taxable year in which the accumulation distribution is paid, credited, or required to be distributed to him.

(c) **Effect of prior election.** In computing the tax attributable to an accumulation distribution for the taxable year in which such accumulation distribution is paid, credited, or required to be distributed to him, the beneficiary in computing the tax attributable to section 666 amounts for each of the preceding taxable years, must include in his gross income for each such year the section 666 amounts deemed distributed to him in such year resulting from prior accumulation distributions made to him in taxable years prior to the current

taxable year. These section 666 amounts resulting from such prior accumulation distributions must be included in the gross income for such preceding taxable year even though the tax on the accumulation distribution of such prior taxable year was computed by the short-cut throwback method provided in section 669(a)(1)(B) and § 1.669(a)–4. [T.D. 6989, 34 FR 739, Jan. 17, 1969]

§ 1.669(a)–4 Tax attributable to short-cut throwback method.

(a) Manner of computing tax. If a beneficiary has elected under section 669(a) to compute the tax on the amounts deemed distributed under section 666 by the short-cut throwback method provided in section 669(a)(1)(B), the tax liability of the beneficiary for the taxable year is computed in the following manner:

(1) First, determine the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed. In any case where there has been a prior accumulation distribution with respect to which the beneficiary has elected to compute his tax either by the exact throwback method or by the short-cut throwback method, or to which the next to the last sentence of section 668(a) has applied, for purposes of an election to use the short-cut throwback method with respect to a subsequent accumulation distribution, in determining the number of preceding taxable years of the trust with respect to which an amount of the subsequent accumulation distribution is deemed distributed to a beneficiary under section 666(a), there shall be excluded any preceding taxable year during which any part of the prior accumulation distribution was deemed distributed to the beneficiary. For example, assume that an accumulation distribution of $90,000 made to a beneficiary in 1963 is deemed distributed in the amounts of $25,000 in each of the years 1962, 1961, and 1960, and in the amount of $15,000 in 1959, and a subsequent accumulation distribution of $85,000 made to the same beneficiary in 1964 is deemed distributed in the amount of $10,000 during 1959, and $25,000 during each of the years 1958, 1957, and 1956. The accumulation distribution made in 1963 is deemed distributed in 4 preceding taxable years of the trust (1962, 1961, 1960, and 1959). Inasmuch as the year 1959 was a year during which part of the 1963 accumulation distribution was deemed distributed, for purposes of determining the number of preceding taxable years in which the accumulation distribution of $85,000 made in 1964 is deemed distributed, the year 1959 is excluded and the $85,000 accumulation distribution is deemed distributed in three preceding taxable years (1958, 1957, and 1956),

(2) Second, divide the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed (determined as provided in subparagraph (1) of this paragraph) into the amount (representing an accumulation distribution made by a foreign trust created by a U.S. person) required to be included under section 669(a) in the gross income of the beneficiary for the taxable year,

(3) Third, compute the tax of the beneficiary for the current taxable year (the year in which the accumulation distribution is paid, credited, or required to be distributed to him) and for each of the 2 taxable years immediately preceding such year,

(i) With the inclusion in gross income of the beneficiary for each of such 3 years of the amount determined under subparagraph (2) of this paragraph, and

(ii) Without such inclusion.

The difference between the amount of tax computed under subdivision (i) of this subparagraph for each year and the amount computed under subdivision (ii) of this subparagraph for that year is the additional tax resulting from the inclusion in gross income for that year of the amount determined under subparagraph (2) of this paragraph. If the number of preceding taxable years of the trust, on the last day of which an amount is deemed under section 666(a) to have been distributed, is less than three, the taxable years of the beneficiary for which this recomputation is made shall equal the number of years in which an amount is deemed under section 666(a) to have been distributed, commencing with the taxable year of the beneficiary in which the accumulation distribution is paid, credited, or required to be distributed to him. If the beneficiary was not alive during one of the two taxable years immediately preceding the taxable year, the tax resulting from the inclusion of the amount determined in subparagraph (2) of this paragraph in the gross income of the beneficiary will be computed only for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him and the preceding year during which the beneficiary was alive. In the event the beneficiary was not alive during either of the 2 years immediately preceding the taxable year in which the accumulation distribution was paid, credited, or required to

be distributed, the tax shall be computed on the basis of the beneficiary's taxable year without regard to the inclusion in income required by section 668(a) of any amount other than pursuant to section 669(a)(1)(B). For example, assume that a foreign trust created by a U.S. person accumulates $3,000 of income in 1964 and $7,000 in 1963 and then distributes the accumulated income on January 1, 1965, to a beneficiary who is a U.S. person. The limitation on tax is determined by recomputing the beneficiary's gross income for 1964 and 1965 by adding $5,000 to his gross income for each year. If the same distribution were made to an infant who was born in 1965, the limitation on tax would be computed by adding $5,000 to his gross income for such year. In the case of the infant, the resulting increase in tax would be multiplied by two to arrive at the limitation on the increase in his tax for 1965 attributable to such distribution.

(4) Fourth, add the additional taxes resulting from the application of subparagraph (3) of this paragraph for the taxable year and the 2 taxable years (or the 1 taxable year, where applicable) immediately preceding the year in which the accumulation distribution is paid, credited, or required to be distributed and then divide this amount by three (or two, where applicable). The resulting amount is then multiplied by the number of preceding taxable years of the trust on the last day of which an amount is deemed under section 666(a) to have been distributed (previously determined under subparagraph (1) of this paragraph). The resulting amount is the tax, under the short-cut throwback method provided in section 669(a)(1)(B), which is attributable to the amounts treated under section 668(a) as having been received by the beneficiary from a foreign trust created by a U.S. person on the last day of the preceding taxable year.

(5) Fifth, add the amount determined under subparagraph (4) of this paragraph to the beneficiary's tax for the taxable year in which the accumulation distribution was paid, credited, or required to be distributed to him, computed without inclusion of the accumulation distribution in gross income for that year. The total is the beneficiary's income tax for such year.

(b) Credit for tax paid by trust. The income taxes deemed distributed to a beneficiary in the manner described in paragraphs (c) and (d) of § 1.669(a)–2 are included in the beneficiary's gross income for purposes of the computations required by this section. To the extent provided in § 1.669(a)–2, credits for such taxes are allowable to the beneficiary. In the computations under the short-cut throwback method provided in section 669(a)(1)(B), the rules set forth in section 662(b) and § 1.662(b)–1 shall be applied in determining the character, in the hands of the beneficiary, of the amounts, including taxes includible in the distribution or deemed distributed, treated as received by a beneficiary in prior taxable years. For example, if one-fifth of such amounts represents tax-free income, then one-fifth of the amount determined under paragraph (a)(2) of this section shall be treated as tax-free income.

[T.D. 6989, 34 FR 739, Jan. 17, 1969]

§ 1.669(b)–1 Information requirements.

The election of a beneficiary who is a U.S. person to apply the limitations on tax provided in section 669(a) shall not be effective unless the beneficiary, at or before the time the election is made, supplies, in a letter addressed to the district director for the internal revenue district in which the taxpayer files his return (or the Director of International Operations where appropriate), or in a statement attached to his return, the following information with respect to the operation and accounts of the foreign trust created by a U.S. person for each of the preceding taxable years, on the last day of which an amount is deemed distributed under section 666(a):

(a) The gross income of the trust: The gross income should be separated to show the amount of each type of income received by the trust and to identify its source. For example, the beneficiary should list separately, by type (dividends, rents, capital gains, taxable interest, exempt interest, etc.) and source (name and country of payor), each item of income included in the gross income of the trust. For this purpose, the gross income of the trust includes gross income from U.S. sources which is exempt from taxation under section 894.

(b) The amount of tax withheld under section 1441 by the United States on income from sources within the United States.

(c) The amount of the tax paid to each foreign country by the trust.

(d) The expenses of the trust attributable to each type of income disclosed in paragraph (b) of this section, and the general expenses of the trust.

(e) The distributions, if any, made by the trust to the beneficiaries (including those who are not U.S. persons). These distributions should be separated into amounts of income required to be distributed currently within the meaning of section

661(a)(1), and any other amounts properly paid, credited, or required to be distributed within the meaning of section 661(a)(2).

(f) Any other information which is necessary for the computation of tax on the accumulation distribution as provided in section 669(a).

(g) If the foreign trust created by a U.S. person is less than the entire foreign trust, the information listed in paragraphs (a) through (f) of this section shall also be furnished with respect to that portion of the entire foreign trust which is not a foreign trust created by a U.S. person.

[T.D. 6989, 34 FR 740, Jan. 17, 1969]

§ 1.669(b)–2 Manner of exercising election.

(a) By whom election is to be made. Except as otherwise provided in this paragraph, a taxpayer whose tax liability is affected by the election shall make the election provided in section 669(a). In the case of a partnership, or a corporation electing under the provisions of Subchapter S, Chapter 1 of the Code, the election shall be exercised by the partnership or such corporation.

(b) Time and manner of making election. The election under section 669(a) may be made, or revoked, at any time before the expiration of the period provided in section 6501 for assessment of the tax. If an election is revoked, a new election may be made at any time before the expiration of such period. The election (or a revocation of an election) may be made in a letter addressed to the district director of internal revenue for the district in which the taxpayer files his tax return (or the Director of International Operations where appropriate) or may be made in a statement attached to the return. In any case where all the information described in § 1.669(b)–1 is not furnished at or before the time the beneficiary signifies his intention of making an election and by reason thereof an election has not been made, and subsequent thereto, but before the expiration of the period provided in section 6501 for the assessment of the tax, there is furnished the required information not previously furnished, the election will be considered as made at the time such additional information is furnished.

[T.D. 6989, 34 FR 740, Jan. 17, 1969]

Grantors and Others Treated as Substantial Owners

§ 1.671–1 Grantors and others treated as substantial owners; scope.

(a) Subpart E (section 671 and following), part I, subchapter J, Chapter 1 of the Code, contains provisions taxing income of a trust to the grantor or another person under certain circumstances even though he is not treated as a beneficiary under Subparts A through D (section 641 and following) of such Part I. Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675).

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (section 677).

Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in such Subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on that income even though the assignment is to a trust over which the assignor has retained none of

the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an uncontrolled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See § 1.662(a)–4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) The provisions of subpart E are not applicable with respect to a pooled income fund as defined in paragraph (5) of section 642(c) and the regulations thereunder, a charitable remainder annuity trust as defined in paragraph (1) of section 664(d) and the regulations thereunder, or a charitable remainder unitrust as defined in paragraph (2) of section 664(d) and the regulations thereunder.

(e) For the effective date of subpart E see section 683 and the regulations thereunder.

(f) For rules relating to the treatment of liabilities resulting on the sale or other disposition of encumbered trust property due to a renunciation of powers by the grantor or other owner, see § 1.1001-2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7148, 36 FR 20749, Oct. 29, 1971; T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§ 1.671-2 Applicable principles.

(a) Under section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in § 1.671-3.

(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in § 1.643(b)–1 is meant, the phrase "ordinary income" is used.

(c) An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country.

(d) Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under subpart E are subject to the provisions of subparts A through D (section 641 and following), of such part I.

(e) The term "grantor" as used in the regulations under subpart E includes a corporation.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.671-3 Attribution or inclusion of income, deductions, and credits against tax.

(a) When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of in-

come, deduction, and credit against tax attributable to or included in that portion. For example:

(1) If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D. See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example—

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674–678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676(a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person in-

cludes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deductions, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For examples of computations under this paragraph, see paragraph (g) of § 1.677(a)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6989, 34 FR 742, Jan. 17, 1969]

§ 1.671–4 Method of reporting.

(a) **Portion of trust income taxed to grantor.** Except as provided in paragraphs (b)(1) and (2) of this section, items of income, deduction, and credit attributable to any portion of a trust which, under the provisions of subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, are treated as owned by the grantor or another person should not be reported by the trust on Form 1041, but should be shown on a separate statement to be attached to that form.

(b) **Trust income taxed entirely to grantor.** (1) In the case of a trust when

(i) The same individual is both grantor and trustee (or co-trustee), and

(ii) That individual is treated as owner for the taxable year of all of the assets of the trust by the application of section 676,

A Form 1041 should not be filed. Instead, all items of income, deduction, and credit from the trust should be reported on the individual's Form 1040 in accordance with its instructions. For provisions dealing with taxpayer identifying numbers, see § 301.6109–1 (Regulations on Procedure and Administration).

(2) In the case of a trust when

(i) A husband and wife are the sole grantors, and

(ii) One spouse is trustee or co-trustee with a third party or both spouses are trustees or co-trustees with a third party, and

(iii) One or both spouses are treated as owners of all of the assets of the trust for the taxable year by the application of section 676, and

(iv) The husband and wife for the taxable year make a single return jointly of income taxes under section 6013,

A Form 1041 should not be filed. Instead, all items of income, deduction, and credit from the trust should be reported on the spouses' Form 1040 in accordance with its instructions.

(3) The grantor of a trust described in § 1.671–(b)(1) or (2) who filed a Form 1041 on or before November 24, 1981 may continue to report income, deductions, and credits of the trust pursuant to § 1.671–4(a). Alternatively, the grantor of such a trust may file a final Form 1041 for the trust's current taxable year pursuant to § 1.671–4(a). In such a case, the grantor must write across the front of the Form 1041 a statement in substance saying "Pursuant to § 1.671–4(b), this is the final Form 1041 for this grantor trust." For the next taxable year, the grantor must furnish payers of income with his or her social security number, pursuant to § 301.6109–1(a)(2), and must follow the rule of § 1.671–4(b)(1) or (2), as the case may be.

(4) This paragraph (b) of this section shall not apply to a trust if the situs of the trust or any of the assets of the trust are not in the United States.

(c) **Effective date.** Paragraphs (b)(1) and (2) of this section apply to trusts created in tax years beginning on or after January 1, 1981. Paragraph (b)(3) of this section is effective immediately.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; T.D. 7796, 46 FR 57481, Nov. 24, 1981]

§ 1.672(a)–1 Definition of adverse party.

(a) Under section 672(a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. A trustee is not an adverse party merely because of his interest as trustee. A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

(b) Ordinarily, a beneficiary will be an adverse party, but if his right to share in the income or corpus of a trust is limited to only a part, he may be an adverse party only as to that part. Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

(c) The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under section 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

(d) The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder. For example, if the grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living, a power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.672(b)–1 Nonadverse party.

A "nonadverse party" is any person who is not an adverse party.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.672(c)–1 Related or subordinate party.

Section 672(c) defines the term "related or subordinate party". The term, as used in sections 674(c) and 675(3), means any nonadverse party who is the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. For purposes of sections 674(c) and 675(3), these persons are presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on them unless shown not to be subservient by a preponderance of the evidence.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.672(d)–1 Power subject to condition precedent.

Section 672(d) provides that a person is considered to have a power described in subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, even though the exercise of the power is subject to a precedent giving of notice or takes effect only after the expiration of a certain period of time. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. See sections 674(b)(2), 676(b), and the last sentence of section 677(a). Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the

expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.673(a)–1 Reversionary interests; income payable to beneficiaries other than certain charitable organizations; general rule.

(a) Under section 673(a), a grantor, in general, is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or income if, as of the inception of that portion of the trust, the grantor's interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of transfer of that portion of the trust. However, the following types of reversionary interests are excepted from the general rule of the preceding sentence:

(1) A reversionary interest after the death of the income beneficiary of a trust (see paragraph (b) of this section); and

(2) Except in the case of transfers in trust made after April 22, 1969, a reversionary interest in a charitable trust meeting the requirements of section 673(b) (see § 1.673(b)–1).

Even though the duration of the trust may be such that the grantor is not treated as its owner under section 673, and therefore is not taxed on the ordinary income, he may nevertheless be treated as an owner under section 677(a)(2) if he has a reversionary interest in the corpus. In the latter case, items of income, deduction, and credit allocable to corpus, such as capital gains and losses, will be included in the portion he owns. See § 1.671–3 and the regulations under section 677. See § 1.673(d)–1 with respect to a postponement of the date specified for reacquisition of a reversionary interest.

(b) Section 673(c) provides that a grantor is not treated as the owner of any portion of a trust by reason of section 673 if his reversionary interest in the portion is not to take effect in possession or enjoyment until the death of the person or persons to whom the income of the portion is regardless of the life expectancies of the income beneficiaries. If his reversionary interest is to take effect on or after the death of an income beneficiary or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner if the specific term of years is less than 10 years (but not if the term is 10 years or longer).

(c) Where the grantor's reversionary interest in a portion of a trust is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years or the death of the income beneficiary, the grantor is treated as the owner of the portion if the event may reasonably be expected to occur within 10 years from the date of transfer of that portion, but he is not treated as the owner under section 673 if the event may not reasonably be expected to occur within 10 years from that date. For example, if the reversionary interest in any portion of a trust is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) the grantor is treated under section 673 as the owner of the portion if the life expectancy of the grantor (or other person) is less than 10 years on the date of transfer of the portion, but not if the life expectancy is 10 years or longer. If the reversionary interest in any portion is to take effect on or after the death of the grantor (or any person other than the person to whom the income is payable) or upon the expiration of a specific term of years, whichever is earlier, the grantor is treated as the owner of the portion if on the date of transfer of the portion either the life expectancy of the grantor (or other person) or the specific term is less than 10 years; however, if both the life expectancy and the specific term are 10 years or longer the grantor is not treated as the owner of the portion under section 673. Similarly, if the grantor has a reversionary interest in any portion which will take effect at the death of the income beneficiary or the grantor, whichever is earlier, the grantor is not treated as an owner of the portion unless his life expectancy is less than 10 years.

(d) It is immaterial that a reversionary interest in corpus or income is subject to a contingency if the reversionary interest may, taking the contingency into consideration, reasonably be expected to take effect in possession or enjoyment within 10 years. For example, the grantor is taxable where the trust income is to be paid to the grantor's son for 3 years, and the corpus is then to be returned

to the grantor if he survives that period, or to be paid to the grantor's son if he is already deceased.

(e) See section 671 and §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7357, 40 FR 23742, June 2, 1975]

§ 1.673(b)-1 Income payable to charitable beneficiaries (before amendment by Tax Reform Act of 1969).

(a) Pursuant to section 673(b) a grantor is not treated as an owner of any portion of a trust under section 673, even though he has a reversionary interest which will take effect within 10 years, to the extent that, under the terms of the trust, the income of the portion is irrevocably payable for a period of at least 2 years (commencing with the date of the transfer) to a designated beneficiary of the type described in section 170(b)(1)(A).

(b) Income must be irrevocably payable to a designated beneficiary for at least 2 years commencing with the date of the transfer before the benefit of section 673(b) will apply. Thus, section 673(b) will not apply if income of a trust is irrevocably payable to University A for 1 year and then to University B for the next year; or if income of a trust may be allocated among two or more charitable beneficiaries in the discretion of the trustee or any other person. On the other hand, section 673(b) will apply if half the income of a trust is irrevocably payable to University A and the other half is irrevocably payable to University B for two years.

(c) Section 673(b) applies to the period of 2 years or longer during which income is paid to a designated beneficiary of the type described in section 170(b)(1)(A)(i), (ii), or (iii), even though the trust term is to extend beyond that period. However, the other provisions of section 673 apply to the part of the trust term, if any, that extends beyond that period. This paragraph may be illustrated by the following example:

Example. G transfers property in trust with the ordinary income payable to University C (which qualifies under section 170(b)(1)(A)(ii)) for 3 years, and then to his son, B, for 5 years. At the expiration of the term the trust reverts to G. G is not taxed under section 673 of the trust income payable to University C for the first 3 years because of the application of section 673(b). However, he is taxed on income for the next 5 years because he has a reversionary interest which will take effect within 10 years commencing with the date of the transfer. On the other hand, if the income were payable to University C for 3 years and then to R for 7 years so that the trust corpus would not be returned to G within 10 years, G would not be taxable under section 673 on income payable to University C and to B during any part of the term.

(d) This section does not apply to transfers in trust made after April 22, 1969.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962; T.D. 7357, 40 FR 23743, June 2, 1975]

§ 1.673(c)-1 Reversionary interest after income beneficiary's death.

The subject matter of section 673(c) is covered in paragraph (b) of § 1.673(a)-1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.673(d)-1 Postponement of date specified for reacquisition.

Any postponement of the date specified for the reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. However, the grantor will not be treated as the owner of any portion of a trust for any taxable year by reason of the foregoing sentence if he would not be so treated in the absence of any postponement. The rules contained in this section may be illustrated by the following example:

Example. G places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to G or his estate. After the expiration of 9 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under section 673 for the first 3 years of the new term because he would not be so treated if the term of the trust had not been extended. G is treated as the owner of the trust, however, for the remaining 2 years.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.674(a)-1 Power to control beneficial enjoyment; scope of section 674.

(a) Under section 674, the grantor is treated as the owner of a portion of trust if the grantor or a nonadverse party has a power, beyond specified limits, to dispose of the beneficial enjoyment of the income or corpus, whether the power is a fiduciary power, a power of appointment, or any other power. Section 674(a) states in general terms that the grantor is treated as the owner in every case in which he or a nonadverse party can affect the beneficial enjoyment of a portion of a trust, the limitations being set forth as exceptions in subsections (b), (c), and (d) of section 674. These exceptions are discussed in detail in §§ 1.674(b)-1

through 1.674(d)–1. Certain limitations applicable to section 674(b), (c), and (d) are set forth in § 1.674(d)–2. Section 674(b) describes powers which are excepted regardless of who holds them. Section 674(c) describes additional powers of trustees which are excepted if at least half the trustees are independent, and if the grantor is not a trustee. Section 674(d) describes a further power which is excepted if it is held by trustees other than the grantor or his spouse (if living with the grantor).

(b) In general terms the grantor is treated as the owner of a portion of a trust if he or a nonadverse party or both has a power to dispose of the beneficial enjoyment of the corpus or income unless the power is one of the following:

(1) **Miscellaneous powers over either ordinary income or corpus.** (i) A power that can only affect the beneficial enjoyment of income (including capital gains) received after a period of time such that the grantor would not be treated as an owner under section 673 if the power were a reversionary interest (section 674(b)(2));

(ii) A testamentary power held by anyone (other than a testamentary power held by the grantor over accumulated income) (section 674(b)(3));

(iii) A power to choose between charitable beneficiaries or to affect the manner of their enjoyment of a beneficial interest (section 674(b)(4));

(iv) A power to allocate receipts and disbursements between income and corpus (section 674(b)(8)).

(2) **Powers of distribution primarily affecting only one beneficiary.** (i) A power to distribute corpus to or for a current income beneficiary, if the distribution must be charged against the share of corpus from which the beneficiary may receive income (section 674(b)(5)(B));

(ii) A power to distribute income to or for a current income beneficiary or to accumulate it either (a) if accumulated income must either be payable to the beneficiary from whom it was withheld or as described in paragraph (b)(6) of § 1.674(b)–1 (section 674(b)(6)); (b) if the power is to apply income to the support of a dependent of the grantor, and the income is not so applied (section 674(b)(1)); or (c) if the beneficiary is under 21 or under a legal disability and accumulated income is added to corpus (section 674(b)(7)).

(3) **Powers of distribution affecting more than one beneficiary.** A power to distribute corpus or income to or among one or more beneficiaries or to accumulate income, either (i) if the power is held by a trustee or trustees other than the grantor, at least half of whom are independent (section 674(c)), or (ii) if the power is limited by a reasonably definite standard in the trust instrument, and in the case of a power over income, if in addition the power is held by a trustee or trustees other than the grantor and the grantor's spouse living with the grantor (section 674(b)(5)(A) and (d)). (These powers include both powers to "sprinkle" income or corpus among current beneficiaries, and powers to shift income or corpus between current beneficiaries and remaindermen; however, certain of the powers described under subparagraph (2) of this paragraph can have the latter effect incidentally.)

(c) See section 671 and §§ 1.671–2 and 1.671–3 for rules for the treatment of income, deductions, and credits when a person is treated as the owner of all or only a portion of a trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.674(b)–1 Excepted powers exercisable by any person.

(a) Paragraph (b)(1) through (8) of this section sets forth a number of powers which may be exercisable by any person without causing the grantor to be treated as an owner of a trust under section 674(a). Further, with the exception of powers described in paragraph (b)(1) of this section, it is immaterial whether these powers are held in the capacity of trustee. It makes no difference under section 674(b) that the person holding the power is the grantor, or a related or subordinate party (with the qualifications noted in paragraph (b)(1) and (3) of this section).

(b) The exceptions referred to in paragraph (a) of this section are as follows (see, however, the limitations set forth in § 1.674(d)–2):

(1) **Powers to apply income to support of a dependent.** Section 674(b)(1) provides, in effect, that regardless of the general rule of section 674(a), the income of a trust will not be considered as taxable to the grantor merely because in the discretion of any person (other than a grantor who is not acting as a trustee or cotrustee) it may be used for the support of a beneficiary whom the grantor is legally obligated to support, except to the extent that it is in fact used for that purpose. See section 677(b) and the regulations thereunder.

(2) **Powers affecting beneficial enjoyment only after a period.** Section 674(b)(2) provides an exception to section 674(a) if the exercise of a power can only affect the beneficial enjoyment of the

income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. For example, if a trust created on January 1, 1955, provides for the payment of income to the grantor's son, and the grantor reserves the power to substitute other beneficiaries of income or corpus in lieu of his son on or after January 1, 1965, the grantor is not treated under section 674 as the owner of the trust with respect to ordinary income received before January 1, 1965. But the grantor will be treated as an owner on and after that date unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673(d)–1 are applicable in order to determine whether the grantor should be treated as an owner during the period following the postponement.

(3) Testamentary powers. Under paragraph (3) of section 674(b) a power in any person to control beneficial enjoyment exercisable only by will does not cause a grantor to be treated as an owner under section 674(a). However, this exception does not apply to income accumulated for testamentary disposition by the grantor or to income which may be accumulated for such distribution in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. For example, if a trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is treated as the owner of the trust. Moreover, if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. (See § 1.671–3.)

(4) Powers to determine beneficial enjoyment of charitable beneficiaries. Under paragraph (4) of section 674(b) a power in any person to determine the beneficial enjoyment of corpus or income which is irrevocably payable (currently or in the future) for purposes specified in section 170(c) (relating to definition of charitable contributions) will not cause the grantor to be treated as an owner under section 674(a). For example, if a grantor creates a trust, the income of which is irrevocably payable solely to educational or other organizations that qualify under section 170(c), he is not treated as an owner under section 674 although he retains the power to allocate the income among such organizations.

(5) Powers to distribute corpus. Paragraph (5) of section 674(b) provides an exception to section 674(a) for powers to distribute corpus, subject to certain limitations, as follows:

(i) If the power is limited by a reasonably definite standard which is set forth in the trust instrument, it may extend to corpus distributions to any beneficiary or beneficiaries or class of beneficiaries (whether income beneficiaries or remaindermen) without causing the grantor to be treated as an owner under section 674. See section 674(b)(5)(A). It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

(ii) If the power is not limited by a reasonably definite standard set forth in the trust instrument, the exception applies only if distributions of corpus may be made solely in favor of current income beneficiaries, and any corpus distribution to the current income beneficiary must be chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust (whether or not physically segregated). See section 674(b)(5)(B).

(iii) This subparagraph may be illustrated by the following examples:

Example (1). A trust instrument provides for payment of the income to the grantor's two brothers for life, and for payment of the corpus to the grantor's nephews in equal shares.

The grantor reserves the power to distribute corpus to pay medical expenses that may be incurred by his brothers or nephews. The grantor is not treated as an owner by reason of this power because section 674(b)(5)(A) excepts a power, exercisable by any person, to invade corpus for any beneficiary, including a remainderman, if the power is limited by a reasonably definite standard which is set forth in the trust instrument. However, if the power were also exercisable in favor of a person (for example, a sister) who was not otherwise a beneficiary of the trust, section 674(b)(5)(A) would not be applicable.

Example (2). The facts are the same as in example (1) except that the grantor reserves the power to distribute any part of the corpus to his brothers or to his nephews for their happiness. The grantor is treated as the owner of the trust. Paragraph (5)(A) of section 674(b) is inapplicable because the power is not limited by a reasonably definite standard. Paragraph (5)(B) is inapplicable because the power to distribute corpus permits a distribution of corpus to persons other than current income beneficiaries.

Example (3). A trust instrument provides for payment of the income to the grantor's two adult sons in equal shares for 10 years, after which the corpus is to be distributed to his grandchildren in equal shares. The grantor reserves the power to pay over to each son up to one-half of the corpus during the 10-year period, but any such payment shall proportionately reduce subsequent income and corpus payments made to the son receiving the corpus. Thus, if one-half of the corpus is paid to one son, all the income from the remaining half is thereafter payable to the other son. The grantor is not treated as an owner under section 674(a) by reason of this power because it qualifies under the exception of section 674(b)(5)(B).

(6) Powers to withhold income temporarily. (i) Section 674(b)(6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either:

(a) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674(b)(6)(A));

(b) To the beneficiary from whom it was withheld, or if he does not survive a date of distribution which could reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor of the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(A) and the flush material following); or

(c) On termination of the trust, or in conjunction with a distribution of corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument (section 674(b)(6)(B) and the flush material following).

(In the application of (a) of this subdivision, if the accumulated income of a trust is ultimately payable to the estate of the current income beneficiary or is ultimately payable to his appointees or takers in default of appointment, under a power of the type described in (a) of this subdivision, it need not be payable to the beneficiary from whom it was withheld under any circumstances. Furthermore, if a trust otherwise qualifies for the exception in (a) of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in (a) of this subdivision.) In general, the exception in section 674(b)(6) is not applicable if the power is in substance one to shift ordinary income from one beneficiary to another. Thus, a power will not qualify for this exception if ordinary income may be distributed to beneficiary A, or may be added to corpus which is ultimately payable to beneficiary B, a remainderman who is not a current income beneficiary. However, section 674(b)(6)(B), and (c) of this subdivision, permit a limited power to shift ordinary income among current income beneficiaries, as illustrated in example (1) of this subparagraph.

(ii) The application of section 674(b)(6) may be illustrated by the following examples:

Example (1). A trust instrument provides that the income shall be paid in equal shares to the grantor's two adult daughters but the grantor reserves the power to withhold from either beneficiary any part of that beneficiary's share of income and to add it to the corpus of the trust until the younger daughter reaches the age of 30 years. When the younger daughter reaches the age of 30, the trust is to terminate and the corpus is to be divided equally between the two daughters or their estates. Although exercise of this power may permit the shifting of accumulated income from one beneficiary to the other (since the corpus with the accumulations is to be divided

equally) the power is excepted under section 674(b)(6)(B) and subdivision (i)(c) of this subparagraph.

Example (2). The facts are the same as in example (1), except that the grantor of the trust reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. The combined powers are not excepted by section 674(b)(6)(B) since income accumulated pursuant to the first power is neither required to be payable only in conjunction with a corpus distribution nor required to be payable in shares specified in the trust instrument. See, however, section 674(c) and § 1.674(c)–1 for the effect of such a power if it is exercisable only by independent trustees.

Example (3). A trust provides for payment of income to the grantor's adult son with the grantor retaining the power to accumulate the income until the grantor's death, when all accumulations are to be paid to the son. If the son predeceases the grantor, all accumulations are, at the death of the grantor, to be paid to his daughter, or if she is not living, to alternate takers (which do not include the grantor's estate) in specified shares. The power is excepted under section 674(b)(6)(A) since the date of distribution (the date of the grantor's death) may, in the usual case, reasonably be expected to occur during the beneficiary's (the son's) lifetime. It is not necessary that the accumulations be payable to the son's estate or his appointees if he should predecease the grantor for this exception to apply.

(7) Power to withhold income during disability. Section 674(b)(7) provides an exception for a power which, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he is under 21. Specifically, there is excepted a power, exercisable only during the existence of a legal disability of any current income beneficiary or the period during which any income beneficiary is under the age of 21 years, to distribute or apply ordinary income to or for that beneficiary or to accumulate the income and add it to corpus. To qualify under this exception it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, his estate, or his appointees; that is, the accumulated income may be added to corpus and ultimately distributed to others. For example, the grantor is not treated as an owner under section 674 if the income of a trust is payable to his son for life, remainder to his grandchildren, although he reserves the power to accumulate income and add it to corpus while his son is under 21.

(8) Powers to allocate between corpus and income. Paragraph (8) of section 674(b) provides that a power to allocate receipts and disbursements between corpus and income, even though expressed in broad language, will not cause the grantor to be treated as an owner under the general rule of section 674(a).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.674(c)–1 Excepted powers exercisable only by independent trustees.

Section 674(c) provides an exception to the general rule of section 674(a) for certain powers that are exercisable by independent trustees. This exception is in addition to those provided for under section 674(b) which may be held by any person including an independent trustee. The powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. (See section 672(c) for definitions of these terms.) An example of the application of section 674(c) is a trust whose income is payable to the grantor's three adult sons with power in an independent trustee to allocate without restriction the amounts of income to be paid to each son each year. Such a power does not cause the grantor to be treated as the owner of the trust. See however, the limitations set forth in § 1.674(d)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.674(d)–1 Excepted powers exercisable by any trustee other than grantor or spouse.

Section 674(d) provides an additional exception to the general rule of section 674(a) for a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, whether or not the conditions of section 674(b)(6) or (7) are satisfied, if the power is solely exercisable (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor or spouse living with the grantor, and if the power is limited by a reasonably definite external standard set forth in the trust instrument (see paragraph (b)(5) of § 1.674(b)–1 with respect to what constitutes a reasonably definite standard). See, however, the limitations set forth in § 1.674(d)–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.674(d)–2 Limitations on exceptions in section 674(b), (c), and (d).

(a) Power to remove trustee. A power in the grantor to remove, substitute, or add trustees (oth-

er than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674(c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674(c) or (d). On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674(c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c).

(b) Power to add beneficiaries. The exceptions described in section 674(b)(5), (6), and (7), (c), and (d), are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.675–1 Administrative powers.

(a) General rule. Section 675 provides in effect that the grantor is treated as the owner of any portion of a trust if under the terms of the trust instrument or circumstances attendant on its operation administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. If a grantor retains a power to amend the administrative provisions of a trust instrument which is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under section 675, he will be treated as the owner of the portion from its inception. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

(b) Prohibited controls. The circumstances which cause administrative controls to be considered exercisable primarily for the benefit of the grantor are specifically described in paragraphs (1) through (4) of section 675 as follows:

(1) The existence of a power, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, which enables the grantor or any other person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income of the trust for less than adequate consideration in money or money's worth. Whether the existence of the power itself will constitute the holder an adverse party will depend on the particular circumstances.

(2) The existence of a power exercisable by the grantor or a nonadverse party, or both, which enables the grantor to borrow the corpus or income of the trust, directly or indirectly, without adequate interest or adequate security. However, this paragraph does not apply where a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security. A general lending power in the grantor, acting alone as trustee, under which he has power to determine interest rates and the adequacy of security is not in itself an indication that the grantor has power to borrow the corpus or income without adequate interest or security.

(3) The circumstance that the grantor has directly or indirectly borrowed the corpus or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence does not apply to a loan which provides for adequate interest and adequate security, if it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. See section 672(c) for definition of "a related or subordinate party".

(4) The existence of certain powers of administration exercisable in a nonfiduciary capacity by any nonadverse party without the approval or consent of any person in a fiduciary capacity. The term "powers of administration" means one or more of the following powers:

(i) A power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

(ii) A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(iii) A power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

(c) Authority of trustee. The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.676(a)-1 Power to revest title to portion of trust property in grantor; general rule.

If a power to revest in the grantor title to any portion of a trust is exercisable by the grantor or a nonadverse party, or both, without the approval or consent of an adverse party, the grantor is treated as the owner of that portion, except as provided in section 676(b) (relating to powers affecting beneficial enjoyment of income only after the expiration of certain periods of time). If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor or a nonadverse party, or both, the grantor is treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. See section 671 and §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or only a portion of a trust.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.676(b)-1 Powers exercisable only after a period of time.

Section 676(b) provides an exception to the general rule of section 676(a) when the exercise of a power can only affect the beneficial enjoyment of the income of a trust received after the expiration of a period of time which is such that a grantor would not be treated as the owner of that portion, except as power were a reversionary interest. See §§ 1.673(a)-1 and 1.673(b)-1. Thus, for example, a grantor is excepted from the general rule of section 676(a) with respect to ordinary income if exercise of a power to revest corpus in him cannot affect the beneficial enjoyment of the income received within 10 years after the date of transfer of that portion of the trust. It is immaterial for this purpose that the power is vested at the time of the transfer. However, the grantor is subject to the general rule of section 676(a) after the expiration of the period unless the power is relinquished. Thus, in the above example, the grantor may be treated as the owner and be taxed on all income in the eleventh and succeeding years if exercise of the power can affect beneficial enjoyment of income received in those years. If the beginning of the period during which the grantor may revest is postponed, the rules set forth in § 1.673(d)-1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.677(a)-1 Income for benefit of grantor; general rule.

(a)(1) Scope. Section 677 deals with the treatment of the grantor of a trust as the owner of a portion of the trust because he has retained an interest in the income from that portion. For convenience, "grantor" and "spouse" are generally referred to in the masculine and feminine genders, respectively, but if the grantor is a woman the reference to "grantor" is to her and the reference to "spouse" is to her husband. Section 677 also deals with the treatment of the grantor of a trust as the owner of a portion of the trust because the income from property transferred in trust after October 9, 1969, is, or may be, distributed to his spouse or applied to the payment of premiums on policies of insurance on the life of his spouse. However, section 677 does not apply when the income of a trust is taxable to a grantor's spouse

under section 71 (relating to alimony and separate maintenance payments) or section 682 (relating to income of an estate or trust in case of divorce, etc.). See section 671–1(b).

(2) Cross references. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit when a person is treated as the owner of all or a portion of a trust.

(b) Income for benefit of grantor or his spouse; general rule—(1) Property transferred in trust prior to October 10, 1969. With respect to property transferred in trust prior to October 10, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section 674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor or a nonadverse party, or both (without the approval or consent of any adverse party) may be:

(i) Distributed to the grantor;

(ii) Held or accumulated for future distribution to the grantor; or

(iii) Applied to the payment of premiums on policies of insurance on the life of the grantor, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

(2) Property transferred in trust after October 9, 1969. With respect to property transferred in trust after October 9, 1969, the grantor is treated, under section 677, in any taxable year as the owner (whether or not he is treated as an owner under section 674) of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section is, or in the discretion of the grantor, or his spouse, or a nonadverse party, or any combination thereof (without the approval or consent of any adverse party other than the grantor's spouse) may be:

(i) Distributed to the grantor or the grantor's spouse;

(ii) Held or accumulated for future distribution to the grantor or the grantor's spouse; or

(iii) Applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, except policies of insurance irrevocably payable for a charitable purpose specified in section 170(c).

With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distribution to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

(c) Constructive distribution; cessation of interest. Under section 677 the grantor is treated as the owner of a portion of a trust if he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from that portion distributed to him at some time either actually or constructively (subject to the exception described in paragraph (e) of this section). In the case of a transfer in trust after October 9, 1969, the grantor is also treated as the owner of a portion of a trust if he has granted or retained any interest which might, without the approval or consent of an adverse party (other than the grantor's spouse), enable his spouse to have the income from the portion at some time, whether or not within the grantor's lifetime, distributed to the spouse either actually or constructively. See paragraph (b)(2) of this section for additional rules relating to the income of a trust prior to the grantor's marriage to a beneficiary. Constructive distribution to the grantor or to his spouse includes payment on behalf of the grantor or his spouse to another in obedience to his or her direction and payment of premiums upon policies of insurance on the grantor's, or his spouse's, life (other than policies of insurance irrevocably payable for charitable purposes specified in section 170(c)). If the grantor (in the case of property transferred prior to Oct. 10, 1969) or the grantor and his spouse (in the case of property transferred after Oct. 9, 1969) are divested permanently and completely of every interest described in this paragraph, the grantor is not treated as an owner under section 677 after that divesting. The word "interest" as used in this paragraph does not include the possibility that the grantor or his spouse might receive back from a beneficiary an interest in a trust by inheritance. Further, with respect to transfers in trust prior to October 10, 1969, the word "interest" does not include the possibility that the grantor might receive back from a beneficiary an interest in a trust as a surviving spouse under a statutory right of election or a similar right.

(d) Discharge of legal obligation of grantor or his spouse. Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969). However, see § 1.677(b)–1 for special rules for trusts whose income may not be applied for the discharge of any legal obligation of the grantor or the grantor's spouse other than the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or grantor's spouse is legally obligated to support.

(e) Exception for certain discretionary rights affecting income. The last sentence of section 677(a) provides that a grantor shall not be treated as the owner when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time during which a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)–1 and 1.673(b)–1. For example, if the ordinary income of a trust is payable to B for 10 years and then in the grantor's discretion income or corpus may be paid to B or to the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969), the grantor is not treated as an owner with respect to the ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished. If the beginning of the period during which the grantor may substitute beneficiaries is postponed, the rules set forth in § 1.673(d)–1 are applicable in determining whether the grantor should be treated as an owner during the period following the postponement.

(f) Accumulation of income. If income is accumulated in any taxable year for future distribution to the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969), section 677(a)(2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor (or his spouse in the case of property transferred in trust by the grantor after Oct. 9, 1969) must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor, or his spouse in the case of property transferred in trust after October 9, 1969, or a nonadverse party, may be, distributed to the grantor (or his spouse in the case of property transferred in trust after Oct. 9, 1969), the grantor is treated as the owner of the trust from its inception. If income attributable to transfers after October 9, 1969 is accumulated in any taxable year during the grantor's lifetime for future distribution to his spouse, section 677(a)(2) treats the grantor as an owner for that taxable year even though his spouse may not receive or exercise discretion over such income prior to the grantor's death.

(g) Examples. The application of section 677(a) may be illustrated by the following examples:

Example (1). G creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust has the following items of gross income and deductions:

Dividends	$5,000
Capital gain	1,000
Expenses allocable to income	200
Expenses allocable to corpus	100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the $5,000 of dividends, $200 income expense, and $100 corpus expense in the computation of his taxable income for 1970. He should not include the $1,000 capital gain since that is not attributable to the portion of the trust that he owns. See § 1.671–3(b). The tax consequences of the capital gain are governed by the provisions of subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of such subparts.

Example (2). G creates a trust which provides that the ordinary income is payable to his adult son. Ten years and one day from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G. In addition, G retains a discretionary right to receive $5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retained no other right or power which would cause him to be treated as an owner under subpart E (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust had the following items of income and deductions:

Dividends	$10,000
Capital gain	2,000
Expenses allocable to income	400
Expenses allocable to corpus	200

Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. See § 1.671-3(b).

Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.) In addition, because of G's discretionary right (whether exercised or not) he is treated as the owner of a portion of the trust which will permit a distribution of income to him of $5,000. Accordingly, G includes dividends of $5,208.33 and income expenses of $208.33 in computing his taxable income, determined in the following manner:

Total dividends	$10,000.00
Less: Expenses allocable to income	400.00
Distributable income of the trust	9,600.00
Portion of dividends attributable to G (5,000 /9,600×$10,000)	5,208.33
Portion of income expenses attributable to G (5,000/9,600×$400)	208.33
Amount of income subject to discretionary right	5,000.00

In accordance with § 1.671-3(c), G also takes into account $104.17 (5,000/9,600×$200) of corpus expenses in computing his tax liability. The portion of the dividends and expenses of the trust not attributable to G are governed by the provisions of Subparts A through D.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7148, 36 FR 20749, Oct. 29, 1971]

§ 1.677(b)-1 Trusts for support.

(a) Section 677(b) provides that a grantor is not treated as the owner of a trust merely because its income may in the discretion of any person other than the grantor (except when he is acting as trustee or cotrustee) be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse in the case of income from property transferred in trust after October 9, 1969), such as the child of the grantor, whom the grantor or his spouse is legally obligated to support. If income of the current year of the trust is actually so applied or distributed the grantor may be treated as the owner of any portion of the trust under section 677 to that extent, even though it might have been applied or distributed for other purposes. In the case of property transferred to a trust before October 10, 1969, for the benefit of the grantor's spouse, the grantor may be treated as the owner to the extent income of the current year is actually applied for the support or maintenance of his spouse.

(b) If any amount applied or distributed for the support of a beneficiary, including the grantor's spouse in the case of property transferred in trust before October 10, 1969, whom the grantor is legally obligated to support is paid out of corpus or out of income other than income of the current year, the grantor is treated as a beneficiary of the trust, and the amount applied or distributed is considered to be an amount paid within the meaning of section 661(a)(2), taxable to the grantor under section 662. Thus, he is subject to the other relevant portions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Accordingly, the grantor may be taxed on an accumulation distribution or a capital gain distribution under subpart D (section 665 and following) of such part I. Those provisions are applied on the basis that the grantor is the beneficiary.

(c) For the purpose of determining the items of income, deduction, and credit of a trust to be included under this section in computing the grantor's tax liability, the income of the trust for the taxable year of distribution will be deemed to have been first distributed. For example, in the case of a trust reporting on the calendar year basis, a distribution made on January 1, 1956, will be deemed to have been made out of ordinary income of the trust for the calendar year 1956 to the extent of the income for that year even though the trust had received no income as of January 1, 1956. Thus, if a distribution of $10,000 is made on January 1, 1956, for the support of the grantor's dependent, the grantor will be treated as the owner of the trust for 1956 to that extent. If the trust received dividends of $5,000 and incurred expenses of $1,000 during that year but subsequent to January 1, he will take into account dividends of $5,000 and expenses of $1,000 in computing his tax liability for 1956. In addition, the grantor will be treated as a beneficiary of the trust with respect to the $6,000 ($10,000 less distributable income of $4,000 (dividends of $5,000 less expenses of $1,000)) paid out of corpus or out of other than income of the current year. See paragraph (b) of this section.

(d) The exception provided in section 677(b) relates solely to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary. Consequently, the general rule of section 677(a) is applicable when in the discretion of the grantor or nonadverse parties income of a trust may be applied in discharge of a grantor's obligations other than his obligation of support or maintenance falling within section 677(b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied in the payment of the grantor's debts, such as the payment of his rent or other household expenses, he is treated as an owner of the trust

regardless of whether the income is actually so applied.

(e) The general rule of section 677(a), and not section 677(b), is applicable if discretion to apply or distribute income of a trust rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as trustee or cotrustee.

(f) The general rule of section 677(a), and not section 677(b), is applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7148, 36 FR 20750, Oct. 29, 1971]

§ 1.678(a)–1 Person other than grantor treated as substantial owner; general rule.

(a) Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, except as provided in section 678(b) (involving taxation of the grantor) and section 678(c) (involving an obligation of support). The holder of such a power also is treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under sections 671 to 677, inclusive. See section 671 and §§ 1.671–2 and 1.671–3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.

(b) Section 678(a) treats a person as an owner of a trust if he has a power exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations, other than an obligation to support a dependent (see § 1.678(c)–1 subject to the limitation of section 678(b)). Section 678 does not apply if the power is not exercisable solely by himself. However, see § 1.662(a)–4 for principles applicable to income of a trust which, pursuant to the terms of the trust instrument, is used to satisfy the obligations of a person other than the grantor.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.678(b)–1 If grantor is treated as the owner.

Section 678(a) does not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust is treated as the owner under sections 671 to 677, inclusive.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.678(c)–1 Trusts for support.

(a) Section 678(a) does not apply to a power which enables the holder, in the capacity of trustee or cotrustee, to apply the income of the trust to the support or maintenance of a person whom the holder is obligated to support, except to the extent the income is so applied. See paragraphs (a), (b), and (c) of § 1.677(b)–1 for applicable principles where any amount is applied for the support or maintenance of a person whom the holder is obligated to support.

(b) The general rule in section 678(a) (and not the exception in section 678(c)) is applicable in any case in which the holder of a power exercisable solely by himself is able, in any capacity other than that of trustee or cotrustee, to apply the income in discharge of his obligation of support or maintenance.

(c) Section 678(c) is concerned with the taxability of income subject to a power described in section 678(a). It has no application to the taxability of income which is either required to be applied pursuant to the terms of the trust instrument or is applied pursuant to a power which is not described in section 678(a), the taxability of such income being governed by other provisions of the Code. See § 1.662(a)–4.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.678(d)–1 Renunciation of power.

Section 678(a) does not apply to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

Miscellaneous

§ 1.681(a)–1 Limitation on charitable contributions deductions of trusts; scope of section 681.

Under section 681, the unlimited charitable contributions deduction otherwise allowable to a trust under section 642(c) is, in general, subject to percentage limitations, corresponding to those applicable to contributions by an individual under section 170(b)(1)(A) and (B), under the following circumstances:

(a) To the extent that the deduction is allocable to "unrelated business income";

(b) For taxable years beginning before January 1, 1970, if the trust has engaged in a prohibited transaction;

(c) For taxable years beginning before January 1, 1970, if income is accumulated for a charitable purpose and the accumulation is (1) unreasonable, (2) substantially diverted to a noncharitable purpose, or (3) invested against the interests of the charitable beneficiaries.

Further, if the circumstance set forth in paragraph (a) or (c) of this section is applicable, the deduction is limited to income actually paid out for charitable purposes, and is not allowed for income only set aside or to be used for those purposes. If the circumstance set forth in paragraph (b) of this section is applicable, deductions for contributions to the trust may be disallowed. The provisions of section 681 are discussed in detail in §§ 1.681(a)–2 through 1.681(c)–1. For definition of the term "income", see section 643(b) and § 1.643(b)–1. [T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.681(a)–2 Limitation on charitable contributions deduction of trusts with trade or business income.

(a) In general. No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year. For the purpose of section 681(a) the term "unrelated business income" of a trust means an amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder, if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3). For the purpose of the computation under section 512, the term "unrelated trade or business" includes a trade or business carried on by a partnership of which a trust is a member, as well as one carried on by the trust itself. While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to "unrelated business income", a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section. This partial deduction is subject to the percentage limitations applicable to contributions by an individual under section 170(b)(1)(A) and (B), and is not allowed for amounts set aside or to be used for charitable purposes but not actually paid out during the taxable year. Charitable contributions deductions otherwise allowable under section 170, 545(b)(2), or 642(c) for contributions to a trust are not disallowed solely because the trust has unrelated business income.

(b) Determination of amounts allocable to unrelated business income. In determining the amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) which are allocable to unrelated business income, and therefore not allowable as a deduction, the following steps are taken:

(1) There is first determined the amount which would be computed as the trust's unrelated business taxable income under section 512 and the regulations thereunder if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3), but without taking the charitable contributions deduction allowed under section 512(b)(11).

(2) The amount for which a charitable contributions deduction would otherwise be allowable under section 642(c) is then allocated between the amount determined in subparagraph (1) of this paragraph and any other income of the trust. Unless the facts clearly indicate to the contrary, the allocation to the amount determined in subparagraph (1) of this paragraph is made on the basis of the ratio (but not in excess of 100 percent) of the amount determined in subparagraph (1) of this paragraph to the taxable income of the trust, determined without the deduction for personal exemption under section 642(b), the charitable contributions deduction under section 642(c), or the deduction for distributions to beneficiaries under section 661(a).

(3) The amount for which a charitable contributions deduction would otherwise be allowable under

der section 642(c) which is allocable to unrelated business income as determined in subparagraph (2) of this paragraph, and therefore not allowable as a deduction, is the amount determined in subparagraph (2) of this paragraph reduced by the charitable contributions deduction which would be allowed under section 512(b)(11) if the trust were an organization exempt from tax under section 501(a) by reason of section 501(c)(3).

(c) Examples. (1) The application of this section may be illustrated by the following examples, in which it is assumed that the Y charity is not a charitable organization qualifying under section 170(b)(1)(A) (see subparagraph (2) of this paragraph):

Example (1). The X trust has income of $50,000. There is included in this amount a net profit of $31,000 from the operation of a trade or business. The trustee is required to pay half of the trust income to A, an individual, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). The trustee pays each beneficiary $25,000. Under these facts, the unrelated business income of the trust (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512(b)(12)). The deduction otherwise allowable under section 642(c) is $25,000, the amount paid to the Y charity. The portion allocable to the unrelated business income (computed as prescribed in paragraph (b)(2) of this section) is $15,000, that is, an amount which bears the same ratio to $25,000 as $30,000 bears to $50,000. The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (20 percent of $30,000, the charitable contributions deduction which would be allowable under section 512(b)(11)), or $9,000.

Example (2). Assume the same facts as in example (1), except that the trustee has discretion as to the portion of the trust income to be paid to each beneficiary, and the trustee pays $40,000 to A and $10,000 to the Y charity. The deduction otherwise allowable under section 642(c) is $10,000. The portion allocable to the unrelated business income computed as prescribed in paragraph (b)(2) of this section is $6,000, that is, an amount which bears the same ratio to $10,000 as $30,000 bears to $50,000. Since this amount does not exceed the charitable contributions deduction which would be allowable under section 512(b)(11) ($6,000, determined as in example (1)), no portion of it is disallowed as a deduction.

Example (3). Assume the same facts as in example (1), except that the terms of the trust instrument require the trustee to pay to the Y charity the trust income, if any, derived from the trade or business, and to pay to A all the trust income derived from other sources. The trustee pays $31,000 to the Y charity and $19,000 to A. The deduction otherwise allowable under section 642(c) is $31,000. Since the entire income from the trade or business is paid to Y charity, the amount allocable to the unrelated business income computed before the charitable contributions deduction under section 512(b)(11) is $30,000 ($31,000 less the deduction of $1,000 allowed by section 512(b)(12)). The amount allocable to the unrelated business income and therefore disallowed as a deduction is $24,000 ($30,000 less $6,000).

Example (4). (i) Under the terms of the trust, the trustee is required to pay half of the trust income to A, an individual, for his life, and the balance of the trust income to the Y charity, an organization described in section 170(c)(2). Capital gains are allocable to corpus and upon A's death the trust is to terminate and the corpus is to be distributed to the Y charity. The trust has taxable income of $50,000 computed without any deduction for personal exemption, charitable contributions, or distributions. The amount of $50,000 includes $10,000 capital gains, $30,000 ($31,000 less the $1,000 deduction allowed under section 512(b)(12)) unrelated business income (computed before the charitable contributions deduction which would be allowed under section 512(b)(11)) and other income of $9,000. The trustee pays each beneficiary $20,000.

(ii) The deduction otherwise allowable under section 642(c) is $30,000 ($20,000 paid to Y charity and $10,000 capital gains allocated to corpus and permanently set aside for charitable purposes). The portion allocable to the unrelated business income is $15,000, that is, an amount which bears the same ratio to $20,000 (the amount paid to Y charity) as $30,000 bears to $40,000 ($50,000 less $10,000 capital gains allocable to corpus). The portion allocable to the unrelated business income, and therefore disallowed as a deduction, is $15,000 reduced by $6,000 (the charitable contributions deduction which would be allowable under section 512(b)(11)), or $9,000.

(2) If, in the examples in subparagraph (1) of this paragraph, the Y charity were a charitable organization qualifying under section 170(b)(1)(A), then the deduction allowable under section 512(b)(11) would be computed at a rate of 30 percent.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962]

§ 1.681(b)–1 Cross reference.

For disallowance of certain charitable, etc., deductions otherwise allowable under section 642(c), see sections 508(d) and 4948(c)(4). See also 26 CFR §§ 1.681(b)–1 and 1.681(c)–1 (rev. as of Apr. 1, 1974) for provisions applying before January 1, 1970.

[T.D. 7428, 41 FR 34627, Aug. 16, 1976]

§ 1.682(a)–1 Income of trust in case of divorce, etc.

(a) In general. (1) Section 682(a) provides rules in certain cases for determining the taxability of income of trusts as between spouses who are divorced, or who are separated under a decree of separate maintenance or a written separation agreement. In such cases, the spouse actually entitled to receive payments from the trust is considered the beneficiary rather than the spouse in discharge of whose obligations the payments are made, except to the extent that the payments are specified to be for the support of the obligor spouse's minor children in the divorce or separate maintenance decree, the separation agreement or the governing trust instrument. For convenience, the beneficiary spouse will hereafter in this section and in § 1.682(b)–1 be referred to as the "wife"

and the obligor spouse from whom she is divorced or legally separated as the "husband". (See section 7701(a)(17).) Thus, under section 682(a) income of a trust—

(i) Which is paid, credited, or required to be distributed to the wife in a taxable year of the wife, and

(ii) Which, except for the provisions of section 682, would be includible in the gross income of her husband,

is includible in her gross income and is not includible in his gross income.

(2) Section 682(a) does not apply in any case to which section 71 applies. Although section 682(a) and section 71 seemingly cover some of the same situations, there are important differences between them. Thus, section 682(a) applies, for example, to a trust created before the divorce or separation and not in contemplation of it, while section 71 applies only if the creation of the trust or payments by a previously created trust are in discharge of an obligation imposed upon or assumed by the husband (or made specific) under the court order or decree divorcing or legally separating the husband and wife, or a written instrument incident to the divorce status or legal separation status, or a written separation agreement. If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while, if section 71 does not apply, section 682(a) requires amounts paid, credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

(3) Section 682(a) is designed to produce uniformity as between cases in which, without section 682(a), the income of a so-called alimony trust would be taxable to the husband because of his continuing obligation to support his wife or former wife, and other cases in which the income of a so-called alimony trust is taxable to the wife or former wife because of the termination of the husband's obligation. Furthermore, section 682(a) taxes trust income to the wife in all cases in which the husband would otherwise be taxed not only because of the discharge of his alimony obligation but also because of his retention of control over the trust income or corpus. Section 682(a) applies whether the wife is the beneficiary under the terms of the trust instrument or is an assignee of a beneficiary.

(4) The application of section 682(a) may be illustrated by the following examples, in which it is assumed that both the husband and wife make their income tax returns on a calendar year basis:

Example (1). Upon the marriage of H and W, H irrevocably transfers property in trust to pay the income to W for her life for support, maintenance, and all other expenses. Some years later, W obtains a legal separation from H under an order of court. W, relying upon the income from the trust payable to her, does not ask for any provision for her support and the decree recites that since W is adequately provided for by the trust, no further provision is being made for her. Under these facts, section 682(a), rather than section 71, is applicable. Under the provisions of section 682(a), the income of the trust which becomes payable to W after the order of separation is includible in her income and is deductible by the trust. No part of the income is includible in H's income or deductible by him.

Example (2). H transfers property in trust for the benefit of W, retaining the power to revoke the trust at any time. H, however, promises that if he revokes the trust he will transfer to W property in the value of $100,000. The transfer in trust and the agreement were not incident to divorce, but some years later W divorces H. The court decree is silent as to alimony and the trust. After the divorce, income of the trust which becomes payable to W is taxable to her, and is not taxable to H or deductible by him. If H later terminates the trust and transfers $100,000 of property to W, the $100,000 is not income to W nor deductible by H.

(b) Alimony trust income designated for support of minor children. Section 682(a) does not require the inclusion in the wife's income of trust income which the terms of the divorce or separate maintenance decree, separation agreement, or trust instrument fix in terms of an amount of money or a portion of the income as a sum which is payable for the support of minor children of the husband. The portion of the income which is payable for the support of the minor children is includible in the husband's income. If in such a case trust income fixed in terms of an amount of money is to be paid but a lesser amount becomes payable, the trust income is considered to be payable for the support of the husband's minor children to the extent of the sum which would be payable for their support out of the originally specified amount of trust income. This rule is similar to that provided in the case of periodic payments under section 71. See § 1.71–1.

§ 1.682(b)–1 Application of trust rules to alimony payments.

(a) For the purpose of the application of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code, the wife described in section 682 or section 71 who is entitled to receive payments attributable to property in trust is considered a beneficiary of the trust, whether or not the payments are made for the

benefit of the husband in discharge of his obligations. A wife treated as a beneficiary of a trust under this section is also treated as the beneficiary of such trust for purposes of the tax imposed by section 56 (relating to the minimum tax for tax preferences). For rules relating to the treatment of items of tax preference with respect to a beneficiary of a trust, see § 1.58–3.

(b) A periodic payment includible in the wife's gross income under section 71 attributable to property in trust is included in full in her gross income in her taxable year in which any part is required to be included under section 652 or 662. Assume, for example, in a case in which both the wife and the trust file income tax returns on the calendar year basis, that an annuity of $5,000 is to be paid to the wife by the trustee every December 31 (out of trust income if possible and, if not, out of corpus) pursuant to the terms of a divorce decree. Of the $5,000 distributable on December 31, 1954, $4,000 is payable out of income and $1,000 out of corpus. The actual distribution is made in 1955. Although the periodic payment is received by the wife in 1955, since under section 662 the $4,000 income distributable on December 31, 1954, is to be included in the wife's income for 1954, the $1,000 payment out of corpus is also to be included in her income for 1954.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7564, 43 FR 40495, Sept. 12, 1978]

§ 1.682(c)–1 Definitions.

For definitions of the terms "husband" and "wife" as used in section 682, see section 7701(a)(17) and the regulations thereunder.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.683–1 Applicability of provisions; general rule.

Part I (section 641 and following), subchapter J, chapter 1 of the Code, applies to estates and trusts and to beneficiaries only with respect to taxable years which begin after December 31, 1953, and end after August 16, 1954 the date of enactment of the Internal Revenue Code of 1954. In the case of an estate or trust, the date on which a trust is created or amended or on which an estate commences, and the taxable years of beneficiaries, grantors, or decedents concerned are immaterial. This provision applies equally to taxable years of normal and of abbreviated length.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.683–2 Exceptions.

(a) In the case of any beneficiary of an estate or trust, sections 641 through 682 do not apply to any amount paid, credited, or to be distributed by an estate or trust in any taxable year of the estate or trust which begins before January 1, 1954, or which ends before August 17, 1954. Whether an amount so paid, credited, or to be distributed is to be included in the gross income of a beneficiary is determined with reference to the Internal Revenue Code of 1939. Thus, if a trust in its fiscal year ending June 30, 1954, distributed its current income to a beneficiary on June 30, 1954, the extent to which the distribution is includible in the beneficiary's gross income for his taxable year (the calendar year 1954) and the character of such income will be determined under the Internal Revenue Code of 1939. The Internal Revenue Code of 1954, however, determines the beneficiary's tax liability for a taxable year of the beneficiary to which such Code applies, with respect even to gross income of the beneficiary determined under the Internal Revenue Code of 1939 in accordance with this paragraph. Accordingly, the beneficiary is allowed credits and deductions pursuant to the Internal Revenue Code of 1954 for a taxable year governed by the Internal Revenue Code of 1954. See subparagraph (ii) of example (1) in paragraph (c) of this section.

(b) For purposes of determining the time of receipt of dividends under sections 34 (for purposes of the credit for dividends received on or before December 31, 1964) and 116, the dividends paid, credited, or to be distributed to a beneficiary are deemed to have been received by the beneficiary ratably on the same dates that the dividends were received by the estate or trust.

(c) The application of this section may be illustrated by the following examples:

Example (1). (i) A trust, reporting on the fiscal year basis, receives in its taxable year ending November 30, 1954, dividends on December 3, 1953, and April 3, July 5, and October 4, 1954. It distributes the dividends to A, its sole beneficiary (who reports on the calendar year basis) on November 30, 1954. Since the trust has received dividends in a taxable year ending after July 31, 1954, it will receive a dividend credit under section 34 with respect to dividends received which otherwise qualify under that section, in this case dividends received on October 4, 1954 (i. e., received after July 31, 1954). See section 7851(a)(1)(C). This credit, however, is reduced to the extent the dividends are allocable to the beneficiary as a result of income being paid, credited, or required to be distributed to him. The trust will also be permitted the dividend exclusion under section 116, since it received its dividends in a taxable year ending after July 31, 1954.

(ii) A is entitled to the section 34 credit with respect to the portion of the October 4, 1954, dividends which is distributed to him even though the determination of whether the amount

distributed to him is includible in his gross income is made under the Internal Revenue Code of 1939. The credit allowable to the trust is reduced proportionately to the extent A is deemed to have received the October 4 dividends. A is not entitled to a credit with respect to the dividends received by the trust on December 3, 1953, and April 3, and July 5, 1954, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust on dates prior to July 31, 1954. In determining the exclusion under section 116 to which he is entitled, all the dividends received by the trust in 1954 and distributed to him are aggregated with any other dividends received by him in 1954, since he is deemed to have received such dividends in 1954 and therefore within a taxable year ending after July 31, 1954. He is not, however, entitled to the exclusion for the dividends received by the trust in December 1953.

Example (2). (i) A simple trust reports on the basis of a fiscal year ending July 31. It receives dividends on October 3, 1953, and January 4, April 3, and July 5, 1954. It distributes the dividends to A, its sole beneficiary, on September 1, 1954. The trust, receiving dividends in a taxable year ending prior to August 17, 1954, is entitled neither to the dividend received credit under section 34 nor the dividend exclusion under section 116.

(ii) A (reporting on the calendar year basis) is not entitled to the section 34 credit, because, although he receives after July 31, 1954, the distribution resulting from the trust's receipt of dividends, he is deemed to have received the dividends ratably with the trust, that is, on October 3, 1953, and January 4, April 3, and July 5, 1954. He is, however, entitled to the section 116 exclusion with respect to the dividends received by the trust in 1954 (along with other dividends received by him in 1954) and distributed to him, since he is deemed to have received such dividends on January 4, April 3, and July 5, 1954, each a date in this taxable year ending after July 31, 1954. He is entitled to no exclusion for the dividends received by the trust on October 3, 1953, since he is deemed to receive the resulting distribution on the same date, which falls within a taxable year of his which ends before August 1, 1954, although he is required to include the October 1953 dividends in his 1954 income. See section 164 of the Internal Revenue Code of 1939.

Example (3). A simple trust on a fiscal year ending July 31, 1954, receives dividends August 5 and November 4, 1953. It distributes the dividends to A, its sole beneficiary (who is on a calendar year basis), on September 1, 1954. Neither the trust nor A is entitled to a credit under section 34 or an exclusion under section 116.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964]

§ 1.683-3 Application of the 65-day rule of the Internal Revenue Code of 1939.

If an amount is paid, credited, or to be distributed in the first 65 days of the first taxable year of an estate or trust (heretofore subject to the provisions of the Internal Revenue Code of 1939) to which the Internal Revenue Code of 1954 applies and the amount would be treated, if the Internal Revenue Code of 1939 were applicable, as if paid, credited, or to be distributed on the last day of the preceding taxable year, sections 641 through 682 do not apply to the amount. The amount so paid, credited, or to be distributed is taken into account as provided in the Internal Revenue Code of 1939. See 26 CFR (1939) 39.162-2(c) and (d) (Regulations 118).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

Income In Respect Of Decedents

§ 1.691(a)-1 Income in respect of a decedent.

(a) Scope of section 691. In general, the regulations under section 691 cover: (1) The provisions requiring that amounts which are not includible in gross income for the decedent's last taxable year or for a prior taxable year be included in the gross income of the estate or persons receiving such income to the extent that such amounts constitute "income in respect of a decedent"; (2) the taxable effect of a transfer of the right to such income; (3) the treatment of certain deductions and credit in respect of a decedent which are not allowable to the decedent for the taxable period ending with his death or for a prior taxable year; (4) the allowance to a recipient of income in respect of a decedent of a deduction for estate taxes attributable to the inclusion of the value of the right to such income in the decedent's estate; (5) special provisions with respect to installment obligations acquired from a decedent and with respect to the allowance of a deduction for estate taxes to a surviving annuitant under a joint and survivor annuity contract; and (6) special provisions relating to installment obligations transmitted at death when prior law applied to the transmission.

(b) General definition. In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes—

(1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;

(2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and

(3) Income to which the decedent had a contingent claim at the time of his death.

See sections 736 and 753 and the regulations thereunder for "income in respect of a decedent" in the case of a deceased partner.

(c) Prior decedent. The term "income in respect of a decedent" also includes the amount of all items of gross income in respect of a prior decedent, if (1) the right to receive such amount was acquired by the decedent by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent and if (2) the amount of gross income in respect of the prior decedent was not properly includible in computing the decedent's taxable income for the taxable year ending with the date of his death or for a previous taxable year. See example (2) of paragraph (b) of § 1.691(a)–2.

(d) Items excluded from gross income. Section 691 applies only to the amount of items of gross income in respect of a decedent, and items which are excluded from gross income under subtitle A of the Code are not within the provisions of section 691.

(e) Cross reference. For items deemed to be income in respect of a decedent for purposes of the deduction for estate taxes provided by section 691(c), see paragraph (c) of § 1.691(c)–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6808, 30 FR 3435, March 16, 1965]

§ 1.691(a)–2 Inclusion in gross income by recipients.

(a) Under section 691(a)(1), income in respect of a decedent shall be included in the gross income, for the taxable year when received, of—

(1) The estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent;

(2) The person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or

(3) The person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

These amounts are included in the income of the estate or of such persons when received by them whether or not they report income by use of the cash receipts and disbursements methods.

(b) The application of paragraph (a) of this section may be illustrated by the following examples, in each of which it is assumed that the decedent kept his books by use of the cash receipts and disbursements method.

Example (1). The decedent was entitled at the date of his death to a large salary payment to be made in equal annual installments over five years. His estate, after collecting two installments, distributed the right to the remaining installment payments to the residuary legatee of the estate. The estate must include in its gross income the two installments received by it, and the legatee must include in his gross income each of the three installments received by him.

Example (2). A widow acquired, by bequest from her husband, the right to receive renewal commissions on life insurance sold by him in his lifetime, which commissions were payable over a period of years. The widow died before having received all of such commissions, and her son inherited the right to receive the rest of the commissions. The commissions received by the widow were includible in her gross income. The commissions received by the son were not includible in the widow's gross income but must be included in the gross income of the son.

Example (3). The decedent owned a Series E United States savings bond, with his wife as co-owner or beneficiary, but died before the payment of such bond. The entire amount of interest accruing on the bond and not includible in income by the decedent, not just the amount accruing after the death of the decedent, would be treated as income to his wife when the bond is paid.

Example (4). A, prior to his death, acquired 10,000 shares of the capital stock of the X Corporation at a cost of $100 per share. During his lifetime, A had entered into an agreement with X Corporation whereby X Corporation agreed to purchase and the decedent agreed that his executor would sell the 10,000 shares of X Corporation stock owned by him at the book value of the stock at the date of A's death. Upon A's death, the shares are sold by A's executor for $500 a share pursuant to the agreement. Since the sale of stock is consummated after A's death, there is no income in respect of a decedent with respect to the appreciation in value of A's stock to the date of his death. If, in this example, A had in fact sold the stock during his lifetime but payment had not been received before his death, any gain on the sale would constitute income in respect of a decedent when the proceeds were received.

Example (5). (1) A owned and operated an apple orchard. During his lifetime, A sold and delivered 1,000 bushels of apples to X, a canning factory, but did not receive payment before his death. A also entered into negotiations to sell 3,000 bushels of apples to Y, a canning factory, but did not complete the sale before his death. After A's death, the executor received payment from X. He also completed the sale to Y and transferred to Y 1,200 bushels of apples on hand at A's death and harvested and transferred an additional 1,800 bushels. The gain from the sale of apples by A to X constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to Y does not.

(2) Assume that, instead of the transaction entered into with Y, A had disposed of the 1,200 bushels of harvested apples by delivering them to Z, a cooperative association, for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him. After the fruit is processed and the products

are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After A's death, the association made distributions to the executor with respect to A's share of the proceeds from the pool in which A had an interest. Under such circumstances, the proceeds from the disposition of the 1,200 bushels of apples constitute income in respect of a decedent.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.691(a)–3 Character of gross income.

(a) The right to receive an amount of income in respect of a decedent shall be treated in the hands of the estate, or by the person entitled to receive such amount by bequest, devise, or inheritance from the decedent or by reason of his death, as if it had been acquired in the transaction by which the decedent (or a prior decedent) acquired such right, and shall be considered as having the same character it would have had if the decedent (or a prior decedent) had lived and received such amount. The provisions of section 1014(a), relating to the basis of property acquired from a decedent, do not apply to these amounts in the hands of the estate and such persons. See section 1014(c).

(b) The application of paragraph (a) of this section may be illustrated by the following:

(1) If the income would have been capital gain to the decedent, if he had lived and had received it, from the sale of property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), the income, when received, shall be treated in the hands of the estate or of such person as capital gain from the sale of the property, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), in the same manner as if such person had held the property for the period the decedent held it, and had made the sale.

(2) If the income is interest on United States obligations which were owned by the decedent, such income shall be treated as interest on United States obligations in the hands of the person receiving it, for the purpose of determining the credit provided by section 35, as if such person had owned the obligations with respect to which such interest is paid.

(3) If the amounts received would be subject to special treatment under part I (section 1301 and following), subchapter Q, chapter 1 of the Code, relating to income attributable to several taxable years, as in effect for taxable years beginning before January 1, 1964, if the decedent had lived and included such amounts in his gross income, such sections apply with respect to the recipient of the income.

(4) The provisions of sections 632 and 1347, relating to the tax attributable to the sale of certain oil or gas property and to certain claims against the United States, apply to any amount included in gross income, the right to which was obtained by the decedent by a sale or claim within the provisions of those sections.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.691(a)–4 Transfer of right to income in respect of a decedent.

(a) Section 691(a)(2) provides the rules governing the treatment of income in respect of a decedent (or a prior decedent) in the event a right to receive such income is transferred by the estate or person entitled thereto by bequest, devise, or inheritance, or by reason of the death of the decedent. In general, the transferor must include in his gross income for the taxable period in which the transfer occurs the amount of the consideration, if any, received for the right or the fair market value of the right at the time of the transfer, whichever is greater. Thus, upon a sale of such right by the estate or person entitled to receive it, the fair market value of the right or the amount received upon the sale, whichever is greater, is included in the gross income of the vendor. Similarly, if such right is disposed of by gift, the fair market value of the right at the time of the gift must be included in the gross income of the donor. In the case of a satisfaction of an installment obligation at other than face value, which is likewise considered a transfer under section 691(a)(2), see § 1.691(a)–5.

(b) If the estate of a decedent or any person transmits the right to income in respect of a decedent to another who would be required by section 691(a)(1) to include such income when received in his gross income, only the transferee will include such income when received in his gross income. In this situation, a transfer within the meaning of section 691(a)(2) has not occurred. This paragraph may be illustrated by the following:

(1) If a person entitled to income in respect of a decedent dies before receiving such income, only his estate or other person entitled to such income by bequest, devise, or inheritance from the latter decedent, or by reason of the death of the latter decedent, must include such amount in gross income when received.

(2) If a right to income in respect of a decedent is transferred by an estate to a specific or residuary legatee, only the specific or residuary legatee must include such income in gross income when received.

(3) If a trust to which is bequeathed a right of a decedent to certain payments of income terminates and transfers the right to a beneficiary, only the beneficiary must include such income in gross income when received.

If the transferee described in subparagraphs (1), (2), and (3) of this paragraph transfers his right to receive the amounts in the manner described in paragraph (a) of this section, the principles contained in paragraph (a) are applied to such transfer. On the other hand, if the transferee transmits his right in the manner described in this paragraph, the principles of this paragraph are again applied to such transfer.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.691(a)–5 Installment obligations acquired from decedent.

(a) Section 691(a)(4) has reference to an installment obligation which remains uncollected by a decedent (or a prior decedent) and which was originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453. Under the provisions of section 691(a)(4), an amount equal to the excess of the face value of the obligation over its basis in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) shall be considered an amount of income in respect of a decedent and shall be treated as such. The decedent's estate (or the person entitled to receive such income by bequest or inheritance from the decedent or by reason of the decedent's death) shall include in its gross income when received the same proportion of any payment in satisfaction of such obligations as would be returnable as income by the decedent if he had lived and received such payment. No gain on account of the transmission of such obligations by the decedent's death is required to be reported as income in the return of the decedent for the year of his death. See § 1.691(e)–1 for special provisions relating to the filing of an election to have the provisions of section 691(a)(4) apply in the case of installment obligations in respect of which section 44(d) of the Internal Revenue Code of 1939 (or corresponding provisions of prior law) would have applied but for the filing of a bond referred to therein.

(b) If an installment obligation described in paragraph (a) of this section is transferred within the meaning of section 691(a)(2) and paragraph (a) of § 1.691(a)–4, the entire installment obligation transferred shall be considered a right to income in respect of a decedent but the amount includible in the gross income of the transferor shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453(d)(2) and the regulations thereunder) adjusted, however, to take into account the receipt of any installment payments after the decedent's death and before such transfer. Thus, the amount includible in the gross income of the transferor shall be the fair market value of such obligation at the time of the transfer or the consideration received for the transfer of the installment obligation, whichever is greater, reduced by the basis of the obligation as described in the preceding sentence. For purposes of this paragraph, the term "transfer" in section 691(a)(2) and paragraph (a) of § 1.691(a)–4 includes the satisfaction of an installment obligation at other than face value.

(c) The application of this section may be illustrated by the following example:

Example. An heir of a decedent is entitled to collect an installment obligation with a face value of $100, a fair market value of $80, and a basis in the hands of the decedent of $60. If the heir collects the obligation at face value, the excess of the amount collected over the basis is considered income in respect of a decedent and includible in the gross income of the heir under section 691(a)(1). In this case, the amount includible would be $40 ($100 less $60). If the heir collects the obligation at $90, an amount other than face value, the entire obligation is considered a right to receive income in respect of a decedent but the amount ordinarily required to be included in the heir's gross income under section 691(a)(2) (namely, the consideration received in satisfaction of the installment obligation or its fair market value, whichever is greater) shall be reduced by the amount of the basis of the obligation in the hands of the decedent. In this case, the amount includible would be $30 ($90 less $60).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6808, 30 FR 3435, March 16, 1965]

§ 1.691(b)–1 Allowance of deductions and credit in respect to decedents.

(a) Under section 691(b) the expenses, interest, and taxes described in sections 162, 163, 164, and 212 for which the decedent (or a prior decedent) was liable, which were not properly allowable as a deduction in his last taxable year or any prior taxable year, are allowed when paid—

(1) As a deduction by the estate; or

(2) If the estate was not liable to pay such obligation, as a deduction by the person who by bequest, devise, or inheritance from the decedent or by reason of the death of the decedent acquires,

subject to such obligation, an interest in property of the decedent (or the prior decedent).

Similar treatment is given to the foreign tax credit provided by section 33. For the purposes of subparagraph (2) of this paragraph, the right to receive an amount of gross income in respect of a decedent is considered property of the decedent; on the other hand, it is not necessary for a person, otherwise within the provisions of subparagraph (2) of this paragraph, to receive the right to any income in respect of a decedent. Thus, an heir who receives a right to income in respect of a decedent (by reason of the death of the decedent) subject to any income tax imposed by a foreign country during the decedent's life, which tax must be satisfied out of such income, is entitled to the credit provided by section 33 when he pays the tax. If a decedent who reported income by use of the cash receipts and disbursements method owned real property on which accrued taxes had become a lien, and if such property passed directly to the heir of the decedent in a jurisdiction in which real property does not become a part of a decedent's estate, the heir, upon paying such taxes, may take the same deduction under section 164 that would be allowed to the decedent if, while alive, he had made such payment.

(b) The deduction for percentage depletion is allowable only to the person (described in section 691(a)(1)) who receives the income in respect of the decedent to which the deduction relates, whether or not such person receives the property from which such income is derived. Thus, an heir who (by reason of the decedent's death) receives income derived from sales of units of mineral by the decedent (who reported income by use of the cash receipts and disbursements method) shall be allowed the deduction for percentage depletion, computed on the gross income from such number of units as if the heir had the same economic interest in the property as the decedent. Such heir need not also receive any interest in the mineral property other than such income. If the decedent did not compute his deduction for depletion on the basis of percentage depletion, any deduction for depletion to which the decedent was entitled at the date of his death would be allowable in computing his taxable income for his last taxable year, and there can be no deduction in respect of the decedent by any other person for such depletion.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.691(c)-1 Deduction for estate tax attributable to income in respect of a decedent.

(a) In general. A person who is required to include in gross income for any taxable year an amount of income in respect of a decedent may deduct for the same taxable year that portion of the estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount. The deduction is determined as follows:

(1) Ascertain the net value in the decedent's estate of the items which are included under section 691 in computing gross income. This is the excess of the value included in the gross estate on account of the items of gross income in respect of the decedent (see § 1.691(a)-1 and paragraph (c) of this section) over the deductions from the gross estate for claims which represent the deductions and credit in respect of the decedent (see § 1.691(b)-1). But see section 691(d) and paragraph (b) of § 1.691(d)-1 for computation of the special value of a survivor's annuity to be used in computing the net value for estate tax purposes in cases involving joint and survivor annuities.

(2) Ascertain the portion of the estate tax attributable to the inclusion in the gross estate of such net value. This is the excess of the estate tax over the estate tax computed without including such net value in the gross estate. In computing the estate tax without including such net value in the gross estate, any estate tax deduction (such as the marital deduction) which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of such net value from the gross estate. See example (2), paragraph (e) of § 1.691(d)-1.

For purposes of this section, the term "estate tax" means the tax imposed under section 2001 or 2101 (or the corresponding provisions of the Internal Revenue Code of 1939), reduced by the credits against such tax. Each person including in gross income an amount of income in respect of a decedent may deduct as his share of the portion of the estate tax (computed under subparagraph (2) of this paragraph) an amount which bears the same ratio to such portion as the value in the gross estate of the right to the income included by such person in gross income (or the amount included in gross income if lower) bears to the value in the gross estate of all the items of gross income in respect of the decedent.

(b) Prior decedent. If a person is required to include in gross income an amount of income in respect of a prior decedent, such person may deduct for the same taxable year that portion of the estate tax imposed upon the prior decedent's

estate which is attributable to the inclusion in the prior decedent's estate of the value of the right to receive such amount. This deduction is computed in the same manner as provided in paragraph (a) of this section and is in addition to the deduction for estate tax imposed upon the decedent's estate which is attributable to the inclusion in the decedent's estate of the right to receive such amount.

(c) Amounts deemed to be income in respect of a decedent. For purposes of allowing the deduction under section 691(c), the following items are also considered to be income in respect of a decedent under section 691(a):

(1) The value for estate tax purposes of stock options in respect of which amounts are includible in gross income under section 421(b) (prior to amendment by section 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, or under section 422(c)(1), 423(c), or 424(c)(1), whichever is applicable, in the case of taxable years ending after December 31, 1963. See section 421(d)(6) (prior to amendment by sec. 221(a) of the Revenue Act of 1964), in the case of taxable years ending before January 1, 1964, and section 421(c)(2), in the case of taxable years ending after December 31, 1963.

(2) Amounts received by a surviving annuitant during his life expectancy period as an annuity under a joint and survivor annuity contract to the extent included in gross income under section 72. See section 691(d).

(d) Examples. Paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). X, an attorney who kept his books by use of the cash receipts and disbursements method, was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued in his estate at $1,000, and to accrued bond interest, which was valued in his estate at $500. In all, $1,500 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate $150 for business expenses for which his estate was liable and $50 for taxes accrued on certain property which he owned. In all, $200 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $185,000 and, considering deductions of $15,000 and an exemption of $60,000, his taxable estate amounted to $110,000. The estate tax on this amount is $23,700 from which is subtracted a $75 credit for State death taxes leaving an estate tax liability of $23,625. In the year following the closing of X's estate, the fee in the amount of $1,200 was collected by X's son, who was the sole beneficiary of the estate. This amount was included under section 691(a)(1)(C) in the son's gross income. The son may deduct, in computing his taxable income for such year, $260 on account of the estate tax attributable to such income, computed as follows:

(1) (i) Value of income described in section 691(a)(1) included in computing gross estate	$1,500
(ii) Deductions in computing gross estate for claims representing deductions described in section 691(b)	200
(iii) Net value of items described in section 691(a)(1)	1,300
(2) (i) Estate tax	23,625
(ii) Less: Estate tax computed without including $1,300 (item (1)(iii)) in gross estate	23,235
(iii) Portion of estate tax attributable to net value of items described in section 691(a)(1)	390
(3) (i) Value in gross estate of items described in section 691(a)(1) received in taxable year (fee)	1,000
(ii) Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	1,500
(iii) Part of estate tax deductible on account of receipt of $1,200 fee (1,000/1,500 of $390)	260

Although $1,200 was later collected as the fee, only the $1,000 actually included in the gross estate is used in the above computations. However, to avoid distortion, section 691(c) provides that if the value included in the gross estate is greater than the amount finally collected, only the amount collected shall be used in the above computations. Thus, if the amount collected as the fee were only $500, the estate tax deductible on the receipt of such amount would be 500/1,500 of $390, or $130. With respect to taxable years ending before January 1, 1964, see paragraph (d)(3) of § 1.421–5 for a similar example involving a restricted stock option. With respect to taxable years ending after December 31, 1963, see paragraph (c)(3) of § 1.421–8 for a similar example involving a stock option subject to the provisions of part II of subchapter D.

Example (2). Assume that in example (1) the fee valued at $1,000 had been earned by prior decedent Y and had been inherited by X who died before collecting it. With regard to the son, the fee would be considered income in respect of a prior decedent. Assume further that the fee was valued at $1,000 in Y's estate, that the net value in Y's estate of items described in section 691(a)(1) was $5,000 and that the estate tax imposed on Y's estate attributable to such net value was $550. In such case, the portion of such estate tax attributable to the fee would be 1,000/5,000 of $550, or $110. When the son collects the $1,200 fee, he will receive for the same taxable year a deduction of $110 with respect to the estate tax imposed on the estate of prior decedent Y as well as the deduction of $260 (as computed in example (1)) with respect to the estate tax imposed on the estate of decedent X.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6887, 31 FR 8812, June 24, 1966]

§ 1.691(c)–2 Estates and trusts.

(a) In the case of an estate or trust, the deduction prescribed in section 691(c) is determined in the same manner as described in § 1.691(c)–1, with the following exceptions:

(1) If any amount properly paid, credited, or required to be distributed by an estate or trust to a beneficiary consists of income in respect of a decedent received by the estate or trust during the taxable year—

(i) Such income shall be excluded in determining the income in respect of the decedent with respect to which the estate or trust is entitled to a deduction under section 691(c), and

(ii) Such income shall be considered income in respect of a decedent to such beneficiary for purposes of allowing the deduction under section 691(c) to such beneficiary.

(2) For determination of the amount of income in respect of a decedent received by the beneficiary, see sections 652 and 662, and §§ 1.652(b)–2 and 1.662(b)–2. However, for this purpose, distributable net income as defined in section 643(a) and the regulations thereunder shall be computed without taking into account the estate tax deduction provided in section 691(c) and this section. Distributable net income as modified under the preceding sentence shall be applied for other relevant purposes of subchapter J, chapter 1 of the Code, such as the deduction provided by section 651 or 661, or subpart D, part I of subchapter J, relating to excess distributions by trusts.

(3) The rule stated in subparagraph (1) of this paragraph does not apply to income in respect of a decedent which is properly allocable to corpus by the fiduciary during the taxable year but which is distributed to a beneficiary in a subsequent year. The deduction provided by section 691(c) in such a case is allowable only to the estate or trust. If any amount properly paid, credited, or required to be distributed by a trust qualifies as a distribution under section 666, the fact that a portion thereof constitutes income in respect of a decedent shall be disregarded for the purposes of determining the deduction of the trust and of the beneficiaries under section 691(c) since the deduction for estate taxes was taken into consideration in computing the undistributed net income of the trust for the preceding taxable year.

(b) This section shall apply only to amounts properly paid, credited, or required to be distributed in taxable years of an estate or trust beginning after December 31, 1953, and ending after August 16, 1954, except as otherwise provided in paragraph (c) of this section.

(c) In the case of an estate or trust heretofore taxable under the provisions of the Internal Revenue Code of 1939, amounts paid, credited, or to be distributed during its first taxable year subject to the Internal Revenue Code of 1954 which would have been treated as paid, credited, or to be distributed on the last day of the preceding taxable year if the Internal Revenue Code of 1939 were still applicable shall not be subject to the provisions of section 691(c)(1)(B) or this section. See section 683 and the regulations thereunder.

(d) The provisions of this section may be illustrated by the following example, in which it is assumed that the estate and the beneficiary make their returns on the calendar year basis:

Example. (1) The fiduciary of an estate receives taxable interest of $5,500 and income in respect of a decedent of $4,500 during the taxable year. Neither the will of the decedent nor local law requires the allocation to corpus of income in respect of a decedent. The estate tax attributable to the income in respect of a decedent is $1,500. In his discretion, the fiduciary distributes $2,000 (falling within sections 661(a) and 662(a)) to a beneficiary during that year. On these facts the fiduciary and beneficiary are respectively entitled to estate tax deductions of $1,200 and $300, computed as follows:

(2) Distributable net income computed under section 643(a) without regard to the estate tax deduction under section 691(c) is $10,000, computed as follows:

Taxable interest	$5,500
Income in respect of a decedent	4,500
Total	10,000

(3) Inasmuch as the distributable net income of $10,000 exceeds the amount of $2,000 distributed to the beneficiary, the deduction allowable to the estate under section 661(a) and the amount taxable to the beneficiary under section 662(a) is $2,000.

(4) The character of the amounts distributed to the beneficiary under section 662(b) is shown in the following table:

	Taxable interest	Income in respect of a decedent	Total
Distributable net income	$5,500	$4,500	$10,000
Amount deemed distributed under section 662(b)	1,100	900	2,000

(5) Accordingly, the beneficiary will be entitled to an estate tax deduction of $300 (900/4,500×$1,500) and the estate will be entitled to an estate tax deduction of $1,200 (3,600/4,500×$1,500).

(6) The taxable income of the estate is $6,200, computed as follows:

Gross income		$10,000
Less:		
Distributions to the beneficiary	$2,000	
Estate tax deduction under section 691(c)	1,200	
Personal exemption	600	
		3,800
Taxable income		6,200

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.691(d)–1 Amounts received by surviving annuitant under joint and survivor annuity contract.

(a) In general. Under section 691(d), annuity payments received by a surviving annuitant under

a joint and survivor annuity contract (to the extent indicated in paragraph (b) of this section) are treated as income in respect of a decedent under section 691(a) for the purpose of allowing the deduction for estate tax provided for in section 691(c)(1)(A). This section applies only if the deceased annuitant died after December 31, 1953, and after the annuity starting date as defined in section 72(c)(4).

(b) Special value for surviving annuitant's payments. Section 691(d) provides a special value for the surviving annuitant's payments to determine the amount of the estate tax deduction provided for in section 691(c)(1)(A). This special value is determined by multiplying—

(1) The excess of the value of the annuity at the date of death of the deceased annuitant over the total amount excludable from the gross income of the surviving annuitant under section 72 during his life expectancy period (see paragraph (d)(1)(i) of this section)

by

(2) A fraction consisting of the value of the annuity for estate tax purposes over the value of the annuity at the date of death of the deceased annuitant.

This special value is used for the purpose of determining the net value for estate tax purposes (see section 691(c)(2)(B) and paragraph (a)(1) of § 1.691(c)–1) and for the purpose of determining the portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)–1).

(c) Amount of deduction. The portion of estate tax attributable to the survivor's annuity (see paragraph (a) of § 1.691(c)–1) is allowable as a deduction to the surviving annuitant over his life expectancy period. If the surviving annuitant continues to receive annuity payments beyond this period, there is no further deduction under section 691(d). If the surviving annuitant dies before expiration of such period, there is no compensating adjustment for the unused deduction.

(d) Definitions. **(1)** For purposes of section 691(d) and this section—

(i) The term "life expectancy period" means the period beginning with the first day of the first period for which an amount is received by the surviving annuitant under the contract and ending with the close of the taxable year with or in which falls the termination of the life expectancy of the surviving annuitant.

(ii) The life expectancy of the surviving annuitant shall be determined as of the date of death of the deceased annuitant, with reference to actuarial Table I set forth in § 1.72–9 (but without making any adjustment under paragraph (a)(2) of § 1.72–5).

(iii) The value of the annuity at the date of death of the deceased annuitant shall be the entire value of the survivor's annuity determined by reference to the principles set forth in section 2031 and the regulations thereunder, relating to the valuation of annuities for estate tax purposes.

(iv) The value of the annuity for estate tax purposes shall be that portion of the value determined under subdivision (iii) of this subparagraph which was includible in the deceased annuitant's gross estate.

(2) The determination of the "life expectancy period" of the survivor for purposes of section 691(d) may be illustrated by the following example:

Example. H and W file their income tax returns on the calendar year basis. H dies on July 15, 1955, on which date W is 70 years of age. On August 1, 1955, W receives a monthly payment under a joint and survivor annuity contract. W's life expectancy determined as of the date of H's death is 15 years as determined from Table I in § 1.72–9; thus her life expectancy ends on July 14, 1970. Under the provisions of section 691(d), her life expectancy period begins as of July 1, 1955, and ends as of December 31, 1970, thus giving her a life expectancy period of 15½ years.

(e) Examples. The application of section 691(d) and this section may be illustrated by the following examples:

Example (1). (1) H and W, husband and wife, purchased a joint and survivor annuity contract for $203,800 providing for monthly payments of $1,000 starting January 28, 1954, and continuing for their joint lives and for the remaining life of the survivor. H contributed $152,850 and W contributed $50,950 to the cost of the annuity. As of the annuity starting date, January 1, 1954, H's age at his nearest birthday was 70 and W's age at her nearest birthday was 67. H dies on January 1, 1957, and beginning on January 28, 1957, W receives her monthly payments of $1,000. The value of the annuity at the date of H's death is $159,000 (see paragraph (d)(1)(iii) of this section), and the value of the annuity for estate tax purposes (see paragraph (d)(1)(iv) of this section) is $119,250 (152,850/203,800 of $159,000). As of the date of H's death, W's age is 70 and her life expectancy period is 15 years (see paragraph (d) of this section for method of computation). Both H and W reported income by use of the cash receipts and disbursements method and filed income tax returns on the calendar year basis.

(2) The following computations illustrate the application of section 72 in determining the excludable portions of the annuity payments to W during her life expectancy period:

Amount of annuity payments per year (12×$1,000)	$12,000

Life expectancy of H and W as of the annuity starting date (see section 72(c)(3)(A) and Table II of § 1.72–9 (male, age 70; female, age 67))	19.7
Expected return as of the annuity starting date, January 1, 1954 ($12,000 × 19.7 as determined under section 72(c)(3)(A) and paragraph (b) of § 1.72–5)	$236,400
Investment in the contract as of the annuity starting date, Jan. 1, 1954 (see section 72(c)(1) and paragraph (a) of § 1.72–6)	$203,800
Exclusion ratio (203,800/236,400 as determined under section 72(b) and § 1.72–4) (percent)	86.2
Exclusion per year under section 72 ($12,000 × 86.2 percent)	$10,344
Excludable during W's life expectancy period ($10,344 × 15)	$155,160

(3) For the purpose of computing the deduction for estate tax under section 691(c), the value for estate tax purposes of the amounts includible in W's gross income and considered income in respect of a decedent by virtue of section 691(d)(1) is $2,880. This amount is arrived at in accordance with the formula contained in section 691(d)(2), as follows:

Value of annuity at the date of H's death	$159,000
Total amount excludable from W's gross income under section 72 during W's life expectancy period (see subparagraph (2) of this example)	$155,160
Excess	$3,840
Ratio which value of annuity for estate tax purposes bears to value of annuity at date of H's death (119,250/159,000) (percent)	75
Value for estate tax purposes (75 percent of $3,840)	$2,880

This amount ($2,880) is included in the items of income under section 691(a)(1) for the purpose of determining the estate tax attributable to each item under section 691(c)(1)(A). The estate tax determined to be attributable to the item of $2,880 is then allowed as a deduction to W over her 15-year life expectancy period (see example (2) of this paragraph).

Example (2). Assume, in addition to the facts contained in example (1) of this paragraph, that H was an attorney and was entitled at the date of his death to a fee for services rendered in a case not completed at the time of his death, which fee was valued at $1,000, and to accrued bond interest, which was valued at $500. Taking into consideration the annuity payments of example (1), valued at $2,880, a total of $4,380 was included in his gross estate in respect of income described in section 691(a)(1). There were deducted as claims against his estate $280 for business expenses for which his estate was liable and $100 for taxes accrued on certain property which he owned. In all, $380 was deducted for claims which represent amounts described in section 691(b) which are allowable as deductions to his estate or to the beneficiaries of his estate. His gross estate was $404,250 and considering deductions of $15,000, a marital deduction of $119,250 (assuming the annuity to be the only qualifying gift) and an exemption of $60,000, his taxable estate amounted to $210,000. The estate tax on this amount is $53,700 from which is subtracted a $175 credit for State death taxes, leaving an estate tax liability of $53,525. W may deduct, in computing her taxable income during each year of her 15-year life expectancy period, $14.73 on account of the estate tax attributable to the value for estate tax purposes of that portion of the annuity payments considered income in respect of a decedent, computed as follows:

(1) (i) Value of income described in section 691(a)(1) included in computing gross estate	$4,380.00
(ii) Deductions in computing gross estate for claims representing deductions described in section 691(b)	380.00
(iii) Net value of items described in section 691(a)(1)	4,000.00
(2) (i) Estate tax	53,525.00
(ii) Less: estate tax computed without including $4,000 (item (1)(iii)) in gross estate and by reducing marital deduction by $2,880 (portion of item (1)(iii) allowed as a marital deduction)	53,189.00
(iii) Portion of estate tax attributable to net value of income items	336.00
(3) (i) Value in gross estate of income attributable to annuity payments	$2,880.00
(ii) Value in gross estate of all income items described in section 691(a)(1) (item (1)(i))	4,380.00
(iii) Part of estate tax attributable to annuity income (2,880/4,380 of $336)	220.93
(iv) Deduction each year on account of estate tax attributable to annuity income ($220.93 ÷ 15 (life expectancy period))	14.73

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.691(e)–1 Installment obligations transmitted at death when prior law applied.

(a) In general—(1) Application of prior law. Under section 44(d) of the Internal Revenue Code of 1939 and corresponding provisions of prior law, gains and losses on account of the transmission of installment obligations at the death of a holder of such obligations were required to be reported in the return of the decedent for the year of his death. However, an exception to this rule was provided if there was filed with the Commissioner a bond assuring the return as income of any payment in satisfaction of these obligations in the same proportion as would have been returnable as income by the decedent had he lived and received such payments. Obligations in respect of which such bond was filed are referred to in this section as "obligations assured by bond".

(2) Application of present law. Section 691(a)(4) of the Internal Revenue Code of 1954 (effective for taxable years beginning after December 31, 1953, and ending after August 16, 1954) in effect makes the exception which under prior law applied to obligations assured by bond the general rule for obligations transmitted at death, but contains no requirement for a bond. Section 691(e)(1) provides that if the holder of the installment obligation makes a proper election, the provisions of section 691(a)(4) shall apply in the case of obligations assured by bond. Section 691(e)(1) further provides that the estate tax deduction provided by section 691(c)(1) is not allowable for any

amount included in gross income by reason of filing such an election.

(b) Manner and scope of election—(1) In general. The election to have obligations assured by bond treated as obligations to which section 691(a)(4) applies shall be made by the filing of a statement with respect to each bond to be released, containing the following information:

(i) The name and address of the decedent from whom the obligations assured by bond were transmitted, the date of his death, and the internal revenue district in which the last income tax return of the decedent was filed.

(ii) A schedule of all obligations assured by the bond on which is listed—

(a) The name and address of the obligors, face amount, date of maturity, and manner of payment of each obligation,

(b) The name, identifying number (provided under section 6109 and the regulations thereunder), and address of each person holding the obligations, and

(c) The name, identifying number, and address, of each person who at the time of the election possesses an interest in each obligation, and a description of such interest.

(iii) The total amount of income in respect of the obligations which would have been reportable as income by the decedent if he had lived and received such payment.

(iv) The amount of income referred to in subdivision (iii) of this subparagraph which has previously been included in gross income.

(v) An unqualified statement, signed by all persons holding the obligations, that they elect to have the provisions of section 691(a)(4) apply to such obligations and that such election shall be binding upon them, all current beneficiaries, and any person to whom the obligations may be transmitted by gift, bequest, or inheritance.

(vi) A declaration that the election is made under the penalties of perjury.

(2) Filing of statement. The statement with respect to each bond to be released shall be filed in duplicate with the district director of internal revenue for the district in which the bond is maintained. The statement shall be filed not later than the time prescribed for filing the return for the first taxable year (including any extension of time for such filing) to which the election applies.

(3) Effect of election. The election referred to in subparagraph (1) of this paragraph shall be irrevocable. Once an election is made with respect to an obligation assured by bond, it shall apply to all payments made in satisfaction of such obligation which were received during the first taxable year to which the election applies and to all such payments received during each taxable year thereafter, whether the recipient is the person who made the election, a current beneficiary, or a person to whom the obligation may be transmitted by gift, bequest, or inheritance. Therefore, all payments received to which the election applies shall be treated as payments made on installment obligations to which section 691(a)(4) applies. However, the estate tax deduction provided by section 691(c) is not allowable for any such payment. The application of this subparagraph may be illustrated by the following example:

Example. A, the holder of an installment obligation, died in 1952. The installment obligation was transmitted at A's death to B who filed a bond on Form 1132 pursuant to paragraph (c) of § 39.44–5 of Regulations 118 (26 CFR Part 39, 1939 ed.) for the necessary amount. On January 1, 1965, B, a calendar year taxpayer, filed an election under section 691(e) to treat the obligation assured by bond as an obligation to which section 691(a)(4) applies, and B's bond was released for 1964 and subsequent taxable years. B died on June 1, 1965, and the obligation was bequeathed to C. On January 1, 1966, C received an installment payment on the obligation which had been assured by the bond. Because B filed an election with respect to the obligation assured by bond, C is required to treat the proper proportion of the January 1, 1966, payment and all subsequent payments made in satisfaction of this obligation as income in respect of a decedent. However, no estate tax deduction is allowable to C under section 691(c)(1) for any estate tax attributable to the inclusion of the value of such obligation in the estate of either A or B.

(c) Release of bond. If an election according to the provisions of paragraph (b) of this section is filed, the liability under any bond filed under section 44(d) of the 1939 Code (or the corresponding provisions of prior law) shall be released with respect to each taxable year to which such election applies. However, the liability under any such bond for an earlier taxable year to which the election does not apply shall not be released until the district director of internal revenue for the district in which the bond is maintained is assured that the proper portion of each installment payment received in such taxable year has been reported and the tax thereon paid.

[T.D. 6808, 30 FR 3436, March 16, 1965]

§ 1.691(f)–1 Cross reference.

See section 753 and the regulations thereunder for application of section 691 to income in respect of a deceased partner.

[T.D. 6808, 30 FR 3436, March 16, 1965]

§ 1.692–1 Abatement of income taxes of certain members of the Armed Forces of the United States upon death.

(a)(1) This section applies if—

(i) An individual dies while in active service as a member of the Armed Forces of the United States, and

(ii) His death occurs while he is serving in a combat zone (as determined under section 112), or at any place as a result of wounds, disease, or injury incurred while he was serving in a combat zone.

(2) If an individual dies as described in paragraph (a)(1), the following liabilities for tax, under Subtitle A of the Internal Revenue Code of 1954 or under Chapter 1 of the Internal Revenue Code of 1939, are canceled:

(i) The liability of the deceased individual, for the last taxable year, ending on the date of his death, and for any prior taxable year ending on or after the first day he served in a combat zone in active service as a member of the U.S. Armed Forces after June 24, 1950, and

(ii) The liability of any other person to the extent the liability is attributable to an amount received after the individual's death (including income in respect of a decedent under section 691) which would have been includible in the individual's gross income for his taxable year in which the date of his death falls (determined as if he had survived).

If the tax (including interest, additions to the tax, and additional amounts) is assessed, the assessment will be abated. If the amount of the tax is collected regardless of the date of collection), the amount so collected will be credited or refunded as an overpayment.

(3) If an individual dies as described in paragraph (a)(1), there will not be assessed any amount of tax of the individual for taxable years preceding the years specified in paragraph (a)(2), under Subtitle A of the Internal Revenue Code of 1954, Chapter 1 of the Internal Revenue Code of 1939, or corresponding provisions of prior revenue laws, remaining unpaid as of the date of death. If any such unpaid tax (including interest, additions to the tax, and additional amounts) has been assessed, the assessments will be abated. If the amount of any such unpaid tax is collected after the date of death, the amount so collected will be credited or refunded as an overpayment.

(4) As to what constitutes active service as a member of the Armed Forces, service in a combat zone, and wounds, disease, or injury incurred while serving in a combat zone, see section 112. As to who are members of the Armed Forces, see section 7701(a)(15). As to the period of time within which any claim for refund must be filed, see sections 6511(a) and 7508(a)(1)(E).

(b) If such an individual and his spouse have for any such year filed a joint return, the tax abated, credited, or refunded pursuant to the provisions of section 692 for such year shall be an amount equal to that portion of the joint tax liability which is the same percentage of such joint tax liability as a tax computed upon the separate income of such individual is of the sum of the taxes computed upon the separate income of such individual and his spouse, but with respect to taxable years ending before June 24, 1950, and with respect to taxable years ending before the first day such individual served in a combat zone, as determined under section 112, the amount so abated, credited, or refunded shall not exceed the amount unpaid at the date of death. For such purpose, the separate tax of each spouse—

(1) For taxable years beginning after December 31, 1953, and ending after August 16, 1954, shall be the tax computed under Subtitle A of the Internal Revenue Code of 1954 before the application of sections 31, 32, 6401(b), and 6402, but after the application of section 33, as if such spouse were required to make a separate income tax return; and

(2) For taxable years beginning before January 1, 1954, and for taxable years beginning after December 31, 1953, and ending before August 17, 1954, shall be the tax computed under Chapter 1 of the Internal Revenue Code of 1939 before the application of sections 32, 35, and 322(a), but after the application of section 31, as if such spouse were required to make a separate income tax return.

(c) If such an individual and his spouse filed a joint declaration of estimated tax for the taxable year ending with the date of his death, the estimated tax paid pursuant to such declaration may be treated as the estimated tax of either such individual or his spouse, or may be divided between them, in such manner as his legal representative and such spouse may agree. Should they agree to treat such estimated tax, or any portion thereof, as the estimated tax of such individual, the estimated tax so paid shall be credited or refunded as an

overpayment for the taxable year ending with the date of his death.

(d) For the purpose of determining the tax which is unpaid at the date of death, amounts deducted and withheld under Chapter 24, Subtitle C of the Internal Revenue Code of 1954, or under Subchapter D, Chapter 9 of the Internal Revenue Code of 1939 (relating to income tax withheld at source on wages), constitute payment of tax imposed under Subtitle A of the Internal Revenue Code of 1954 or under Chapter 1 of the Internal Revenue Code of 1939, as the case may be.

(e) This section shall have no application whatsoever with respect to the liability of an individual as a transferee of property of a taxpayer where such liability relates to the tax imposed upon the taxpayer by Subtitle A of the Internal Revenue Code of 1954 or by Chapter 1 of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7543, 43 FR 19392, May 5, 1978]

PARTNERS AND PARTNERSHIPS

Determination Of Tax Liability

§ 1.701–1 Partners, not partnership, subject to tax.

Partners are liable for income tax only in their separate capacities. Partnerships as such are not subject to the income tax imposed by Subtitle A but are required to make returns of income under the provisions of section 6031 and the regulations thereunder. For definition of the terms "partner" and "partnership", see sections 761 and 7701(a)(2), and the regulations thereunder. For provisions relating to the election of certain partnerships to be taxed as domestic corporations, see section 1361 and the regulations thereunder.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.702–1 Income and credits of partner.

(a) General rule. Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph. (For the taxable year in which a partner includes his distributive share of partnership taxable income, see section 706(a) and § 1.706–1(a). Such distributive share shall be determined as provided in section 704 and § 1.704–1.) Accordingly, in determining his income tax:

(1) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(2) Each partner shall take into account, as part of his gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), his distributive share of the combined net amount of such gains and losses of the partnership.

(3) Each partner shall take into account, as part of his gains and losses from sales or exchanges of property described in section 1231 (relating to property used in the trade or business and involuntary conversions), his distributive share of the combined net amount of such gains and losses of the partnership. The partnership shall not combine such items with items set forth in subparagraph (1) or (2) of this paragraph.

(4) Each partner shall take into account, as part of the charitable contributions paid by him, his distributive share of each class of charitable contributions paid by the partnership within the partnership's taxable year. Section 170 determines the extent to which such amount may be allowed as a deduction to the partner. For the definition of the term "charitable contribution", see section 170(c).

(5) Each partner shall take into account, as part of the dividends received by him from domestic corporations, his distributive share of dividends received by the partnership, with respect to which the partner is entitled to a credit under section 34 (for dividends received on or before December 31, 1964), an exclusion under section 116, or a deduction under part VIII, Subchapter B, Chapter 1 of the Code.

(6) Each partner shall take into account, as part of his taxes described in section 901 which have been paid or accrued to foreign countries or to possessions of the United States, his distributive share of such taxes which have been paid or accrued by the partnership, according to its meth-

od of treating such taxes. A partner may elect to treat his total amount of such taxes, including his distributive share of such taxes of the partnership, as a deduction under section 164 or as a credit under section 901, subject to the provisions of sections 901 through 905.

(7) Each partner shall take into account, as part of the partially tax-exempt interest received by him on obligations of the United States or on obligations of instrumentalities of the United States, as described in section 35 or section 242, his distributive share of such partially tax-exempt interest received by the partnership. However, if the partnership elects to amortize premiums on bonds as provided in section 171, the amount received on such obligations by the partnership shall be reduced by the amortizable bond premium applicable to such obligations as provided in section 171(a)(3).

(8)(i) Each partner shall take into account separately, as part of any class of income, gain, loss, deduction, or credit, his distributive share of the following items: Recoveries of bad debts, prior taxes, and delinquency amounts (section 111); gains and losses from wagering transactions (section 165(d)); soil and water conservation expenditures (section 175); nonbusiness expenses as described in section 212; medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); amounts representing taxes and interest paid to cooperative housing corporations (section 216); intangible drilling and developments costs (section 263(c)); pre-1970 exploration expenditures (section 615); certain mining exploration expenditures (section 617); income, gain, or loss to the partnership under section 751(b); and any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement which differs from the allocation of partnership taxable income or loss generally.

(ii) Each partner must also take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. Thus, if any partner would qualify for the retirement income credit under section 37 if the partnership pensions and annuities, interest, rents, dividends, and earned income were separately stated, such items must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from his gross income the part of his distributive share which qualifies as earned income as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 270 (relating to "hobby losses") and the recomputation of tax thereunder for any partner.

(iii) Each partner shall aggregate the amount of his separate deductions or exclusions and his distributive share of partnership deductions or exclusions separately stated in determining the amount allowable to him of any deduction or exclusion under Subtitle A of the Code as to which a limitation is imposed. For example, partner A has individual domestic exploration expenditures of $300,000. He is also a member of the AB partnership which in 1971 in its first year of operation has foreign exploration expenditures of $400,000. A's distributable share of this item is $200,000. However, the total amount of his distributable share that A can deduct as exploration expenditures under section 617(a) is limited to $100,000 in view of the limitation provided in section 617(h). Therefore, the excess of $100,000 ($200,000 minus $100,000) is not deductible by A.

(9) Each partner shall also take into account separately his distributive share of the taxable income or loss of the partnership, exclusive of items requiring separate computations under subparagraphs (1) through (8) of this paragraph. For limitation on allowance of a partner's distributive share of partnership losses, see section 704(d) and paragraph (d) of § 1.704–1.

(b) **Character of items constituting distributive share.** The character in the hands of a partner of any item of income, gain, loss, deduction, or credit described in section 702(a)(1) through (8) shall be determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. For example, a partner's distributive share of gain from the sale of depreciable property used in the trade or business of the partnership shall be considered as gain from the sale of such depreciable property in the hands of the partner. Similarly, a partner's distributive share of partnership "hobby losses" (section 270) or his distributive share of partnership charitable contributions to organizations qualifying under section 170(b)(1)(A) retains such character in the hands of the partner.

(c) Gross income of a partner. (1) Where it is necessary to determine the amount or character of the gross income of a partner, his gross income shall include the partner's distributive share of the gross income of the partnership, that is, the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in section 702(a)(1) through (8)). For example, a partner is required to include his distributive share of partnership gross income:

(i) In computing his gross income for the purpose of determining the necessity of filing a return (section 6012 (a));

(ii) In determining the application of the provisions permitting the spreading of income for services rendered over a 36-month period (section 1301, as in effect for taxable years beginning before January 1, 1964);

(iii) In computing the amount of gross income received from sources within possessions of the United States (section 931); and

(iv) In determining a partner's "gross income from farming" (sections 175 and 6073).

(2) In determining the applicability of the 6-year period of limitation on assessment and collection provided in section 6501(e) (relating to omission of more than 25 percent of gross income), a partner's gross income includes his distributive share of partnership gross income (as described in section 6501(e)(1)(A)(i)). In this respect, the amount of partnership gross income from which was derived the partner's distributive share of any item of partnership income, gain, loss, deduction, or credit (as included or disclosed in the partner's return) is considered as an amount of gross income stated in the partner's return for the purposes of section 6501(e). For example, A, who is entitled to one-fourth of the profits of the ABCD partnership, which has $10,000 gross income and $2,000 taxable income, reports only $300 as his distributive share of partnership profits. A should have shown $500 as his distributive share of profits, which amount was derived from $2,500 of partnership gross income. However, since A included only $300 on his return without explaining in the return the difference of $200, he is regarded as having stated in his return only $1,500 ($300/$500 of $2,500) as gross income from the partnership.

(d) Partners in community property States. If separate returns are made by a husband and wife domiciled in a community property State, and only one spouse is a member of the partnership, the part of his or her distributive share of any item or items listed in paragraph (a)(1) through (9) of this section which is community property, or which is derived from community property, should be reported by the husband and wife in equal proportions.

(e) Cross reference. For special rules in accordance with the principles of section 702 applicable solely for the purpose of the tax imposed by section 56 (relating to the minimum tax for tax preferences) see § 1.58–2(a).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8097, Aug. 15, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6885, 31 FR 7803, June 2, 1966; T.D. 7192, 37 FR 12949, June 30, 1972; T.D. 7564, 43 FR 40496, Sept. 12, 1978; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.702–1T Temporary regulations on requirement to separately state meal, travel, and entertainment expenses (temporary).

Each partner shall take into account separately his or her distributive share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1987, and ending with or within partners' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274(*l*)(2), each partner shall take into account separately his or her distributive share of rents paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1989, and ending with or within partners' taxable years beginning on or after January 1, 1987.

[T.D. 8182, 53 FR 6603, March 2, 1988]

§ 1.702–2 Net operating loss deduction of partner.

For the purpose of determining a net operating loss deduction under section 172, a partner shall take into account his distributive share of items of income, gain, loss, deduction, or credit of the partnership. The character of any such item shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. See section 702(b) and paragraph (b) of § 1.702–1. To the extent necessary to determine the allowance under section 172(d)(4) of the nonbusiness deductions of a partner (arising from both partnership and nonpartnership sources), the partner shall separately take into

account his distributive share of the deductions of the partnership which are not attributable to a trade or business and combine such amount with his nonbusiness deductions from nonpartnership sources. Such partner shall also separately take into account his distributive share of the gross income of the partnership not derived from a trade or business and combine such amount with his nonbusiness income from nonpartnership sources. See section 172 and the regulations thereunder. [T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.702-3T 4-year spread (temporary).

(a) Applicability. This section applies to a partner in a partnership if—

(1) The partnership is required by section 806 of the Tax Reform Act of 1986 (the 1986 Act), Pub.L. 99-514, 100 Stat. 2362, to change its taxable year for the first taxable year beginning after December 31, 1986 (partnership's year of change); and

(2) As a result of such change in taxable year, items from more than one taxable year of the partnership would, but for the provisions of this section, be included in the taxable year of the partner with or within which the partnership's year of change ends.

(b) Partner's treatment of items from the partnership's year of change—(1) In general. Except as provided in paragraph (c) of this section, if a partner's share of "income items" exceeds the partner's share of "expense items," the partner's share of each and every income and expense item shall be taken into account ratably (and retain its character) over the partner's first 4 taxable years beginning with the partner's taxable year with or within which the partnership's year of change ends.

(2) Definitions—(i) Income items. For purposes of this section, the term "income items" means the sum of—

(A) The partner's distributive share of taxable income (exclusive of separately stated items) from the partnership's year of change.

(B) The partner's distributive share of all separately stated income or gain items from the partnership's year of change, and

(C) Any amount includible in the partner's income under section 707(c) on account of payments during the partnership's year of change.

(ii) Expense items. For purposes of this section, the term "expense items" means the sum of—

(A) The partner's distributive share of taxable loss (exclusive of separately stated items) from the partnership's year of change, and

(B) The partner's distributive share of all separately stated items of loss or deduction from the partnership's year of change.

(c) Electing out of 4-year spread. A partner may elect out of the rules of paragraph (b) of this section by meeting the requirements of § 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(d) Special rules for a partner that is a partnership or S corporation—(1) In general. Except as provided in paragraph (d)(2) of this section, a partner that is a partnership or S corporation may, if otherwise eligible, use the 4-year spread (with respect to partnership interests owned by the partner) described in this section.

(2) Certain partners prohibited from using 4-year spread—(i) In general. Except as provided in paragraph (d)(2)(ii) of this section, a partner that is a partnership or S corporation may not use the 4-year spread (with respect to partnership interests owned by the partner) if such partner is also changing its taxable year pursuant to section 806 of the 1986 Act.

(ii) Exception. If a partner's year of change does not include any income or expense items with respect to the partnership's year of change, such partner may, if otherwise eligible, use the 4-year spread (with respect to such partnership interest) described in this section even though the partner is a partnership or S corporation. See examples (13) and (14) in paragraph (h) of this section.

(e) Basis of partner's interest. The basis of a partner's interest in a partnership shall be determined as if the partner elected not to spread the partnership items over 4 years, regardless of whether such election was in fact made. Thus, for example, if a partner is eligible for the 4-year spread and does not elect out of the 4-year spread pursuant to paragraph (c) of this section, the partner's basis in the partnership interest will be increased in the first year of the 4-year spread period by an amount equal to the excess of the income items over the expense items. However, the partner's basis will not be increased again, with respect to the unamortized income and expense items, as they are amortized over the 4-year spread period.

(f) Effect on other provisions of the Code. Except as provided in paragraph (e) of this section, determinations with respect to a partner, for purposes of other provisions of the Code, must be made with regard to the manner in which partnership items are taken into account under the rules of this section. Thus, for example, a partner who does not elect out of the 4–year spread must take into account, for purposes of determining net earnings from self-employment under section 1402(a) for a taxable year, only the ratable portion of partnership items for that taxable year.

(g) Treatment of dispositions—(1) In general. If a partnership interest is disposed of before the last taxable year in the 4–year spread period, unamortized income and expense items that are attributable to the interest disposed of and that would be taken into account by the partner for subsequent taxable years in the 4–year spread period shall be taken into account by the partner as determined under paragraph (g)(2) of this section. For purposes of this section, the term "disposed of" means any transfer, including (but not limited to) transfers by sale, exchange, gift, and by reason of death.

(2) Year unamortized items taken into account—(i) In general. If, at the end of a partner's taxable year, the fraction determined under paragraph (g)(2)(ii) of this section is—

(A) Greater than ⅔, the partner must continue to take the unamortized income and expense items into account ratably over the 4–year spread period;

(B) Greater than ⅓ but less than or equal to ⅔, the partner must, in addition to its ratable amortization, taken into account in such year 50 percent of the income and expense items that would otherwise be unamortized at the end of such year (however, this paragraph (g)(2)(i)(B) is only applied once with respect to a partner's interest in a particular partnership); or

(C) Less than or equal to ⅓, the partner must take into account the entire balance of unamortized income and expense items in such year.

(ii) Determination of fraction. For purposes of paragraph (g)(2)(i) of this section, the numerator of the fraction is the partner's proportionate interest in the partnership at the end of the partner's taxable year and the denominator is the partner's proportionate interest in the partnership as of the last day of the partnership's year of change.

(h) Examples. The provisions of this section may be illustrated by the following examples.

Example (1). Assume that P1, a partnership with a taxable year ending September 30, is required by the 1986 Act to change its taxable year to a calendar year. All of the partners of P1 are individual taxpayers reporting on a calendar year. P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for the short taxable year ending December 31, 1987. Based on the above facts, the partners of P1 are required to include the items from more than one taxable year of P1 in income for their 1987 taxable year. Thus, under paragraph (b) of this section, if a partner's share of income items exceeds the partner's share of expense items, the partner's share of each and every income and expense item shall be taken into account ratably by such partner in each of the partner's first four taxable years beginning with the partner's 1987 taxable year, unless such partner elects under paragraph (c) of this section to include all such amounts in his 1987 taxable year.

Example (2). Assume the same facts as in example (1), except P1 is a personal service corporation with all of its employee-owners reporting on a calendar year. Although P1 is required to change to a calendar year for its taxable year beginning October 1, 1987, neither P1 nor its employee-owners obtain the benefits of a 4–year spread. Pursuant to section 806(e)(2)(C) of the 1986 Act, the 4–year spread provision is only applicable to short taxable years of partnerships and S corporations required to change their taxable year under the 1986 Act.

Example (3). Assume the same facts as example (1) and that I is one of the individual partners of P1. Further assume that I's distributive share of P1's taxable income for the short taxable year ended December 31, 1987 (*i.e.*, P1's year of change), is $10,000. In addition, I has $8,000 of separately stated expense from P1's year of change. Since I's income items (*i.e.*, $10,000 of taxable income) exceed I's expense items (*i.e.*, $8,000 of separately stated expense) attributable to P1's year of change, I is eligible for the 4–year spread provided by this section. If I does not elect out of the 4–year spread, I will recognize $2,500 of taxable income and $2,000 of separately stated expense in his 1987 calendar year return. Assuming I does not dispose of his partnership interest in P1 by December 31, 1989, the remaining $7,500 of taxable income and $6,000 of separately stated expense will be amortized (and retain its character) over I's next three taxable years (*i.e.*, 1988, 1989 and 1990).

Example (4). Assume the same facts as example (3), except that I disposes of his entire interest in P1 during 1988. Pursuant to paragraph (g) of this section, I would recognize $7,500 of taxable income and $6,000 of separately stated expense in his 1988 calendar year return.

Example (5). Assume the same facts as in example (3), except that I disposes of 50 percent of his interest in P1 during 1989. Pursuant to paragraph (g) of this section, I would recognize $3,750 of taxable income in his 1989 calendar year return ($2,500 ratable portion for 1989 plus 50 percent of the $2,500 of income items that would otherwise be unamortized at the end of 1989). I would also recognize $3,000 of separately stated expense items in 1989 ($2,000 ratable portion for 1989 plus 50 percent of the $2,000 of separately stated expense items that would otherwise be unamortized at the end of 1989).

Example (6). Assume the same facts as in example (1), except that X, a personal service corporation as defined in section 441(i), is a partner of P1. X is a calendar year taxpayer, and thus is not required to change its taxable year under the 1986 Act. The same result occurs as in example 1 (*i.e.*, unless X elects to the contrary, X is required to include one fourth of its share of income and expense items from P1's

year of change in the first four taxable years of X beginning with the 1987 taxable year).

Example (7). Assume the same facts as in example (6), except that X is a fiscal year personal service corporation with a taxable year ending September 30. X is required under the 1986 Act to change to a calendar year for its taxable year beginning October 1, 1987, and to file a return for its short year ending December 31, 1987. Based on the above facts, X is not required to include the items from more than one taxable year of P1 in any one taxable year of X. Thus, the provisions of this section do not apply to X, and X is required to include the full amount of income and expense items from P1's year of change in X's taxable income for X's short year ending December 31. Under section 443 of the Code, X is required to annualize the taxable income for its short year ending December 31, 1987.

Example (8). Assume that P2 is a partnership with a taxable year ending September 30. Under the 1986 Act, P2 would have been required to change its taxable year to a calendar year, effective for the taxable year beginning October 1, 1987. However, P2 properly changed its taxable year to a calendar year for the year beginning October 1, 1986, and filed a return for the short period ending December 31, 1986. The provisions of the 1986 Act do not apply to P2 because the short year ending December 31, 1986, was not required by the amendments made by section 806 of the 1986 Act. Thus, the partners of P2 are required to take all items of income and expense for the short taxable year ending December 31, 1986, into account for the taxable year with or within which such short year ends.

Example (9). Assume that P3 is a partnership with a taxable year ending March 31 and I, a calendar year individual, is a partner in P3. Under the 1986 Act, P3 would have been required to change its taxable year to a calendar year. However, under Rev.Proc. 87–32, P3 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987. Thus, P3 is required to change its taxable year under section 806 of the 1986 Act, and I is required to include items from more than one taxable year of P3 in one of her taxable years. Furthermore, I's share of P3's income items exceeds her share of P3's expense items for the short period April 1, 1987 through June 30, 1987. Accordingly, under this section, unless I elects to the contrary, I is required to take one fourth of her share of items of income and expense from P3's short taxable year ending June 30, 1987 into account for her taxable year ending December 31, 1987.

Example (10). Assume that P4 is a partnership with a taxable year ending March 31. Y, a C corporation, owns a 51 percent interest in the profits and capital of P4. Y reports its income on the basis of a taxable year ending March 31. P4 establishes and changes to a natural business year beginning with the taxable year ending June 30, 1987, under Rev.Proc. 87–32. Under the above facts, P4 is not required to change its taxable year because its March 31 taxable year was the taxable year of Y, the partner owning a majority of the partnership's profits and capital. Therefore, the remaining partners of P4 owning 49 percent of the profits and capital are not permitted the 4–year spread of the items of income and expense with respect to the short year, even though they may be required to include their distributive share of P4's items from more than one taxable year in one of their years.

Example (11). Assume that X and Y are C corporations with taxable years ending June 30. Each owns a 50–percent interest in the profits and capital of partnership P5. P5 has a taxable year ending March 31. Assume that P5 cannot establish a business purpose in order to retain a taxable year ending March 31, and thus P5 must change to a June 30 taxable year, the taxable year of its partners. Furthermore, assume that X's share of P5's income items exceeds its share of P5's expense items for P5's short taxable year ending June 30, 1987. Unless X elects out of the 4–year spread, the taxable year ending June 30, 1987, is the first of the four taxable years in which X must take into account its share of the items of income and expense resulting from P5's short taxable year ending June 30, 1987.

Example (12). Assume that I, an individual who reports income on the basis of the calendar year, is a partner in two partnerships, P6 and P7. Both partnerships have a taxable year ending September 30. Neither partnership can establish a business purpose for retaining its taxable year. Consequently, each partnership will change its taxable year to December 31, for the taxable year beginning October 1, 1987. The election to avoid a 4–year spread is made at the partner level; in addition, a partner may make such elections on a partnership-by-partnership basis. Thus, assuming I is eligible to obtain the 4–year spread with respect to income and expense items from partnerships P6 and P7, I may use the 4–year spread with respect to items from P6, while not using the 4–year spread with respect to items from P7.

Example (13). I, an individual taxpayer using a calendar year, owns an interest in P8, a partnership using a taxable year ending June 30. Furthermore, P8 owns an interest in P9, a partnership with a taxable year ending March 31. Under section 806 of the 1986 Act, P8 will be required to change to a taxable year ending December 31, while P9 will be required to change to a taxable year ending June 30. As a result, P8's year of change will be July 1 through December 31, 1987, while P9's year of change will be from April 1 through June 30, 1987. Since P9's year of change does not end with or within P8's year of change, paragraph (d)(2) of this section does not prevent P8 from obtaining a 4–year spread with respect to its interest in P9.

Example (14). The facts are the same as in example (13), except that P9 has a taxable year ending September 30, and under the 1986 Act P9 is required to change to a taxable year ending December 31. Therefore, P9's year of change will be from October 1, 1987 through December 31, 1987. Although P8's year of change from July 1, 1987 through December 31, 1987 includes two taxable years of P9 (*i.e.*, October 1, 1986 through September 30, 1987 and October 1, 1987 through December 31, 1987), paragraph (d)(2) of this section prohibits P8 from using the 4–year spread with respect to its interest in P9, because P9's year of change ends with or within P8's year of change.

[T.D. 8167, 52 FR 48530, Dec. 23, 1987]

§ 1.703–1 Partnership computations.

(a) Income and deductions. **(1)** The taxable income of a partnership shall be computed in the same manner as the taxable income of an individual, except as otherwise provided in this section. A partnership is required to state separately in its return the items described in section 702(a)(1) through (7) and, in addition, to attach to its return a statement setting forth separately those items described in section 702(a)(8) which the partner is required to take into account separately in determining his income tax. See paragraph (a)(8) of § 1.702–1. The partnership is further required to compute and to state separately in its return:

(i) As taxable income under section 702(a)(9), the total of all other items of gross income (not separately stated) over the total of all other allowable deductions (not separately stated), or

(ii) As loss under section 702(a)(9), the total of all other allowable deductions (not separately stated) over the total of all other items of gross income (not separately stated).

The taxable income or loss so computed shall be accounted for by the partners in accordance with their partnership agreement.

(2) The partnership is not allowed the following deductions:

(i) The standard deduction provided in section 141.

(ii) The deduction for personal exemptions provided in section 151.

(iii) The deduction provided in section 164(a) for taxes, described in section 901, paid or accrued to foreign countries or possessions of the United States. Each partner's distributive share of such taxes shall be accounted for separately by him as provided in section 702(a)(6).

(iv) The deduction for charitable contributions provided in section 170. Each partner is considered as having paid within his taxable year his distributive share of any contribution or gift, payment of which was actually made by the partnership within its taxable year ending within or with the partner's taxable year. This item shall be accounted for separately by the partners as provided in section 702(a)(4). See also paragraph (b) of § 1.702-1.

(v) The net operating loss deduction provided in section 172. See § 1.702-2.

(vi) The additional itemized deductions for individuals provided in Part VII, Subchapter B, Chapter 1 of the Code, as follows: Expenses for production of income (section 212); medical, dental, etc., expenses (section 213); expenses for care of certain dependents (section 214); alimony, etc., payments (section 215); and amounts representing taxes and interest paid to cooperative housing corporation (section 216). However, see paragraph (a)(8) of § 1.702-1.

(vii) The deduction for capital gains provided by section 1202 and the deduction for capital loss carryover provided by section 1212.

(b) Elections of the partnership—(1) General rule. Any elections (other than those described in subparagraph (2) of this paragraph) affecting the computation of income derived from a partnership shall be made by the partnership. For example, elections of methods of accounting, of computing depreciation, of treating soil and water conservation expenditures, and the option to deduct as expenses intangible drilling and development costs, shall be made by the partnership and not by the partners separately. All partnership elections are applicable to all partners equally, but any election made by a partnership shall not apply to any partner's nonpartnership interests.

(2) Exceptions. (i) Each partner shall add his distributive share of taxes described in section 901 paid or accrued by the partnership to foreign countries or possessions of the United States (according to its method of treating such taxes) to any such taxes paid or accrued by him (according to his method of treating such taxes), and may elect to use the total amount either as a credit against tax or as a deduction from income.

(ii) Each partner shall add his distributive share of expenses described in section 615 or section 617 paid or accrued by the partnership to any such expenses paid or accrued by him and shall treat the total amount according to his method of treating such expenses, notwithstanding the treatment of the expenses by the partnership.

(iii) Each partner who is a nonresident alien individual or a foreign corporation shall add his distributive share of income derived by the partnership from real property located in the United States, as described in section 871(d)(1) or 882(d)(1), to any such income derived by him and may elect under § 1.871-10 to treat all such income as income which is effectively connected for the taxable year with the conduct of a trade or business in the United States.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7192, 37 FR 12949, June 30, 1972; T.D. 7332, 39 FR 44232, Dec. 23, 1974]

§ 1.704-1 Partner's distributive share.

(a) Effect of partnership agreement. A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) Determination of partner's distributive share—(0) Cross-references.

(1) In general—(i) Basic principles. Under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph (b)(2) of this section. Second, taking into account all facts and circumstances, the allo-

cation can be in accordance with the partner's interest in the partnership. See paragraph (b)(3) of this section. Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules contained in paragraph (b)(4) of this section. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership (determined under paragraph (b)(3) of this section).

(ii) Effective dates. The provisions of this paragraph are effective for partnership taxable years beginning after December 31, 1975. However, for partnership taxable years beginning after December 31, 1975, but before May 1, 1986, (January 1, 1987, in the case of allocations of nonrecourse deductions as defined in paragraph (b)(4)(iv)(a) of this section) an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that is not respected under this paragraph nevertheless will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of this paragraph in effect for partnership taxable years beginning before May 1, 1986.

(iii) Effect of other sections. The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, *e.g., Goldstein v. Commissioner,* 364 F.2d 734 (2d Cir.1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of § 1.751-1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in § 1.743-1 (see paragraph (b)(2)(iv)(m)(2) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

(iv) Other possible tax consequences. Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of § 1.46-3, § 1.47-6, paragraph (b)(1) of § 1.721-1 (and related principles), and paragraph (e) of § 1.752-1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

(v) Purported allocations. Section 704(b) and this paragraph do not apply to a purported allocation if it is made to a person who is not a partner of the partnership (see section 7701(a)(2) and paragraph (d) of § 301.7701-3) or to a person who is not receiving the purported allocation in his capacity as a partner (see section 707(a) and paragraph (a) of § 1.707-1).

(vi) Section 704(c) determinations. Under section 704(c) if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to such property are determined so as to take account of the variation between the adjusted tax basis and fair market value of such property. Although section 704(b) does not directly determine the partners' distributive shares of tax items governed by section 704(c), the partners' distributive shares of tax items are determined under section 704(c) with reference to the partners' distributive shares of the corresponding book items, as determined under section 704(b) and this paragraph. (See paragraphs (b)(2)(iv)(d) and (b)(4)(i) of this section.) Section 704(c), as cited in this paragraph, refers to such section as in effect for property contributed to a partnership

after March 31, 1984. See example (13)(i) of paragraph (b)(5) of this section.

(vii) Bottom line allocations. Section 704(b) and this paragraph are applicable to allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain, loss, deduction, and credit, and allocations of partnership net or "bottom line" taxable income and loss. An allocation to a partner of a share of partnership net or "bottom line" taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or "bottom line" taxable income or loss. See example (15)(i) of paragraph (b)(5) of this section.

(2) Substantial economic effect—(i) Two-part analysis. The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section). Second, the economic effect of the allocation must be substantial (within the meaning of paragraph (b)(2)(iii) of this section).

(ii) Economic effect—(a) Fundamental principles. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.

(b) Three requirements. Based on the principles contained in paragraph (b)(2)(ii)(a) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides—

(1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section.

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)).

For purposes of the preceding sentence, a partnership taxable year shall be determined without regard to section 706(c)(2)(A). Requirements (2) and (3) of this paragraph (b)(2)(ii)(b) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section. In addition, requirement (2) of this paragraph (b)(2)(ii)(b) is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in that requirement (2) in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances. See

examples (1)(i) and (ii), (4)(i), (8)(i), and (16)(i) of paragraph (b)(5) of this section.

(c) Obligation to restore deficit. If a partner is not expressly obligated to restore the deficit balance in his capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent of—

(1) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(2) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by State or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker),

provided that such note or obligation is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation). If a promissory note referred to in the previous sentence is negotiable, a partner will be considered required to satisfy such note within the time period specified in such sentence if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(d)(2) of this section. See examples (1)(ix) and (x) of paragraph (b)(5) of this section. A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent such partner's obligation is not legally enforceable, or the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation. See paragraphs (b)(2)(ii)(f), (b)(2)(ii)(h), and (b)(4)(vi) of this section for other rules regarding such obligation.

(d) Alternate test for economic effect. If—

(1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(3) The partnership agreement contains a "qualified income offset,"

such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for—

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of § 751–1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section).

For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to

be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. See examples (1)(iii), (iv), (v), (vi), (viii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

(e) Partial economic effect. If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated shall consist of a proportionate share of all items that made up the allocation to such partner for such year. See examples (15)(ii) and (iii) of paragraph (b)(5) of this section.

(f) Reduction of obligation to restore. If requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, a partner's obligation to restore the deficit balance in his capital account (or any limited dollar amount thereof) to the partnership may be eliminated or reduced as of the end of a partnership taxable year without affecting the validity of prior allocations (see paragraph (b)(4)(vi) of this section) to the extent the deficit balance (if any) in such partner's capital account, after reduction for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section, will not exceed the partner's remaining obligation (if any) to restore the deficit balance in his capital account. See example (1)(viii) of paragraph (b)(5) of this section.

(g) Liquidation defined. For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of § 1.761–1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner's obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section.

(h) Partnership agreement defined. For purposes of this paragraph, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases to be made in accordance with the partners' positive capital account balances (requirement (2) of paragraph (b)(2)(ii)(b) of this section), and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account (requirement (3) of paragraph (b)(2)(ii)(b) of this section), all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options, and other buy-sell agreements, and any other "stop-loss" arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending upon the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.) In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement (see the last sentence of paragraph (c) of § 1.761–1). For purposes of this paragraph (b)(2)(ii)(h), an agreement with a partner or a partnership shall include an agreement with a person related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to such partner or partnership.

(i) Economic effect equivalence. Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic

performance of the partnership. See examples (4)(ii) and (iii) of paragraph (b)(5) of this section.

(iii) Substantiality—(a) General rules. Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. See examples (5) and (9) of paragraph (b)(5) of this section. The economic effect of an allocation is not substantial in the two situations described in paragraphs (b)(2)(iii)(b) and (c) of this section. However, even if an allocation is not described therein, its economic effect may be insubstantial under the general rules stated in this paragraph (b)(2)(iii)(a). References in this paragraph (b)(2)(iii) to allocations include capital account adjustments made pursuant to paragraph (b)(2)(iv)(k) of this section.

(b) Shifting tax consequences. The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that—

(1) The net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).

If, at the end of a partnership taxable year to which an allocation (or allocations) relates, the net increases and decreases that are recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the allocation (or allocations) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had the allocation (or allocations) not been contained in the partnership agreement, it will be presumed that, at the time the allocation (or allocations) became part of such partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (6), (7)(ii) and (iii), and (10)(ii) of paragraph (b)(5) of this section.

(c) Transitory allocations. If a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by one or more other allocations (the "offsetting allocation(s)"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that—

(1) The net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)

the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial. If, at the end of a partnership taxable year to

which an offsetting allocation(s) relates, the net increases and decreases recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the original allocation(s) and the offsetting allocation(s) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had such allocations not been contained in the partnership agreement, it will be presumed that, at the time the allocations became part of the partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (1)(xi), (2), (3), (7), (8)(ii), and (17) of paragraph (b)(5) of this section. Notwithstanding the foregoing, the original allocation(s) and the offsetting allocation(s) will not be insubstantial (under this paragraph (b)(2)(iii)(c)) and, for purposes of paragraph (b)(2)(iii)(a), it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis). See example (2) of paragraph (b)(5) of this section. For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. See examples (1)(vi) and (xi) of paragraph (b)(5) of this section.

(iv) Maintenance of capital accounts—(a) In general. The economic effect test described in paragraph (b)(2)(ii) of this section requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement. Except as otherwise provided in paragraph (b)(2)(ii)(i) of this section, an allocation of income, gain, loss, or deduction will not have economic effect under paragraph (b)(2)(ii) of this section, and will not be deemed to be in accordance with a partner's interest in the partnership under paragraph (b)(4) of this section, unless the capital accounts of the partners are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of this paragraph (b)(2)(iv).

(b) Basic rules. Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752), and (3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and is decreased by (4) the amount of money distributed to him by the partnership, (5) the fair market value of property distributed to him by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under section 752), (6) allocations to him of expenditures of the partnership described in section 705(a)(2)(B), and (7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g) of this section, but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv). For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired.

(c) Treatment of liabilities. For purposes of this paragraph (b)(2)(iv), (1) money contributed by a partner to a partnership includes the amount of any partnership liabilities that are assumed by such partner (other than liabilities described in paragraph (b)(2)(iv)(b)(5) of this section that are

assumed by a distributee partner) but does not include increases in such partner's share of partnership liabilities (see section 752(a)), and (2) money distributed to a partner by a partnership includes the amount of such partner's individual liabilities that are assumed by the partnership (other than liabilities described in paragraph (b)(2)(iv)(b)(2) of this section that are assumed by the partnership) but does not include decreases in such partner's share of partnership liabilities (see section 752(b)). For purposes of this paragraph (b)(2)(iv)(c), liabilities are considered assumed only to the extent the assuming party is thereby subjected to personal liability with respect to such obligation, the obligee is aware of the assumption and can directly enforce the assuming party's obligation, and, as between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable.

(d) Contributed property—(1) In general. The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be increased by the fair market value of property contributed to the partnership by such partner on the date of contribution. See examples (13)(i) and (v) of paragraph (b)(5) of this section. Consistent with section 752(c), section 7701(g) does not apply in determining such fair market value.

(2) Contribution of promissory notes. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(2) of this section, except as provided in this paragraph (b)(2)(iv)(d)(2), if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner's capital account will be increased with respect to such note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note. See example (1)(ix) of paragraph (b)(5) of this section. The first sentence of this paragraph (b)(2)(iv)(d)(2) shall not apply if the note referred to therein is readily tradable on an established securities market. See also paragraph (b)(2)(ii)(c) of this section. Furthermore, a partner whose interest is liquidated will be considered as satisfying his obligation to restore the deficit balance in his capital account to the extent of (i) the fair market value, at the time of contribution, of any negotiable promissory note (of which such partner is the maker) that such partner contributes to the partnership on or after the date his interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(3) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partner is the maker) that such partner previously contributed to the partnership. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at the time of valuation.

(3) Section 704(c) considerations. Section 704(c) governs the determination of the partner's distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to property contributed to a partnership (see paragraph (b)(1)(vi) of this section). In cases where section 704(c) applies to partnership property, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of this section for allocation to them of depreciation, depletion, amortization, and gain and loss, as computed for book purposes, with respect to such property. See example (13)(i) of paragraph (b)(5) of this section.

(e) Distributed property—(1) In general. The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be decreased by the fair market value of property distributed by the partnership (without regard to section 7701(g)) to such partner (whether in connection with a liquidation or otherwise). To satisfy this requirement, the capital accounts of the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property (taking section 7701(g) into account) on the date of distribution. See example (14)(v) of paragraph (b)(5) of this section.

(2) Distribution of promissory notes. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(5), except as provided in this paragraph (b)(2)(iv)(e)(2), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence

shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (i) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at time of valuation.

(f) Revaluations of property. A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(1) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, and

(2) The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date, and

(3) The partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of this section for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property, and

(4) The partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and

(5) The adjustments are made principally for a substantial non-tax business purpose—

(i) In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or

(ii) In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or

(iii) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

See example (14) and (18) of paragraph (b)(5) of this section. If the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquished to the partnership, paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied to determine the partners' distributive shares of depreciation, depletion, amortization, and gain or loss as computed for tax purposes, with respect to such property.

(g) Adjustments to reflect book value—(1) In general. Under paragraphs (b)(2)(iv)(d) and (b)(2)(iv)(f) of this section, property may be properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property. In these circumstances, paragraphs (b)(2)(iv)(d)(3) and (b)(2)(iv)(f)(3) of this section provide that the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires the partners' capital accounts to be adjusted in accordance with this paragraph (b)(2)(iv)(g) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property. In determining whether the economic effect of an allocation of book items is substantial, consideration will be given to the effect of such

allocation on the determination of the partners' distributive shares of corresponding tax items under section 704(c) and paragraph (b)(4)(i) of this section. See example (17) of paragraph (b)(5) of this section. If an allocation of book items under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such items will be reallocated in accordance with the partners' interests in the partnership, and such reallocation will be the basis upon which the partners' distributive shares of the corresponding tax items are determined under section 704(c) and paragraph (b)(4)(i) of this section. See examples (13), (14), and (18) of paragraph (b)(5) of this section.

(2) Payables and receivables. References in this paragraph (b)(2)(iv) and paragraph (b)(4)(i) of this section to book and tax depreciation, depletion, amortization, and gain or loss with respect to property that has an adjusted tax basis that differs from book value include, under analogous rules and principles, the unrealized income or deduction with respect to accounts receivable, accounts payable, and other accrued but unpaid items.

(3) Determining amount of book items. The partners' capital accounts will not be considered adjusted in accordance with this paragraph (b)(2)(iv)(g) unless the amount of book depreciation, depletion, or amortization for a period with respect to an item of partnership property is the amount that bears the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to such property for such period bears to the adjusted tax basis of such property. If such property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership.

(h) Determinations of fair market value. For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.

(i) Section 705(a)(2)(B) expenditures—(1) In general. The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be decreased by allocations made to such partner of expenditures described in section 705(a)(2)(B). See example (11) of paragraph (b)(5) of this section. If an allocation of these expenditures under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such expenditures will be reallocated in accordance with the partners' interest in the partnership.

(2) Expenses described in section 709. Except for amounts with respect to which an election is properly made under section 709(b), amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such a partnership shall, solely for purposes of this paragraph, be treated as section 705(a)(2)(B) expenditures, and upon liquidation of the partnership no further capital account adjustments will be made in respect thereof.

(3) Disallowed losses. If a deduction for a loss incurred in connection with the sale or exchange of partnership property is disallowed to the partnership under section 267(a)(1) or section 707(b), that deduction shall, solely for purposes of this paragraph, be treated as a section 705(a)(2)(B) expenditure.

(j) Basis adjustments to section 38 property. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted by the partners' shares of any upward or downward basis adjustments allocated to them under this paragraph (b)(2)(iv)(j). When there is a reduction in the adjusted tax basis of partnership section 38 property under section 48(q)(1) or section 48(q)(3), section 48(q)(6) provides for an equivalent downward adjustment to the aggregate basis of partnership interests (and no additional adjustment is made under section 705(a)(2)(B)). These downward basis adjustments shall be shared

among the partners in the same proportion as the adjusted tax basis or cost of (or the qualified investment in) such section 38 property is allocated among the partners under paragraph (f) of § 1.46–3 (or paragraph (a)(4)(iv) of § 1.48–8). Conversely, when there is an increase in the adjusted tax basis of partnership section 38 property under section 48(q)(2), section 48(q)(6) provides for an equivalent upward adjustment to the aggregate basis of partnership interests. These upward adjustments shall be allocated among the partners in the same proportion as the investment tax credit from such property is recaptured by the partners under § 1.47–6.

(k) Depletion of oil and gas properties—(1) In general. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted for depletion and gain or loss with respect to the oil or gas properties of the partnership in accordance with this paragraph (b)(2)(iv)(k).

(2) Simulated depletion. Except as provided in paragraph (b)(2)(iv)(k)(3) of this section, a partnership shall, solely for purposes of maintaining capital accounts under this paragraph, compute simulated depletion allowances with respect to its oil and gas properties at the partnership level. These allowances shall be computed on each depletable oil or gas property of the partnership by using either the cost depletion method or the percentage depletion method (computed in accordance with section 613 at the rates specified in section 613A(c)(5) without regard to the limitations of section 613A, which theoretically could apply to any partner) for each partnership taxable year that the property is owned by the partnership and subject to depletion. The choice between the simulated cost depletion method and the simulated percentage depletion method shall be made on a property-by-property basis in the first partnership taxable year beginning after April 30, 1986, for which it is relevant for the property, and shall be binding for all partnership taxable years during which the oil or gas property is held by the partnership. The partnership shall make downward adjustments to the capital accounts of the partners for the simulated depletion allowance with respect to each oil or gas property of the partnership, in the same proportion as such partners (or their predecessors in interest) were properly allocated the adjusted tax basis of each such property. The aggregate capital account adjustments for simulated percentage depletion allowances with respect to an oil or gas property of the partnership shall not exceed the aggregate adjusted tax basis allocated to the partners with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, such partnership's simulated gain or loss shall be determined by subtracting its simulated adjusted basis in such property from the amount realized upon such disposition. (The partnership's simulated adjusted basis in an oil or gas property is determined in the same manner as adjusted tax basis except that simulated depletion allowances are taken into account instead of actual depletion allowances.) The capital accounts of the partners shall be adjusted upward by the amount of any simulated gain in proportion to such partners' allocable shares of the portion of the total amount realized from the disposition of such property that exceeds the partnership's simulated adjusted basis in such property. The capital accounts of such partners shall be adjusted downward by the amount of any simulated loss in proportion to such partners' allocable shares of the total amount realized from the disposition of such property that represents recovery of the partnership's simulated adjusted basis in such property. See section 613A(c)(7)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section. See example (19)(iv) of paragraph (b)(5) of this section.

(3) Actual depletion. Pursuant to section 613A(c)(7)(D) and the regulations thereunder, the depletion allowance under section 611 with respect to the oil and gas properties of a partnership is computed separately by the partners. Accordingly, in lieu of adjusting the partner's capital accounts as provided in paragraph (b)(2)(iv)(k)(2) of this section, the partnership may make downward adjustments to the capital account of each partner equal to such partner's depletion allowance with respect to each oil or gas property of the partnership (for the partner's taxable year that ends with or within the partnership's taxable year). The aggregate adjustments to the capital account of a partner for depletion allowances with respect to an oil or gas property of the partnership shall not exceed the adjusted tax basis allocated to such partner with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, the capital account of each partner shall be adjusted upward by the amount of any excess of such partner's allocable share of the total amount realized from the disposition of such property over such partner's remaining adjusted tax basis in such property. If there is no such excess, the capital account of such partner shall be adjusted downward by the amount of any excess of such partner's remaining adjusted tax basis in such

property over such partner's allocable share of the total amount realized from the disposition thereof. See section 613A(c)(7)(4)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section.

(4) Effect of book values. If an oil or gas property of the partnership is, under paragraphs (b)(2)(iv)(d) or (b)(2)(iv)(f) of this section, properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, the rules contained in this paragraph (b)(2)(iv)(k) and paragraph (b)(4)(v) of this section shall be applied with reference to such book value. A revaluation of a partnership oil or gas property under paragraph (b)(2)(iv)(f) of this section may give rise to a reallocation of the adjusted tax basis of such property, or a change in the partners' relative shares of simulated depletion from such property, only to the extent permitted by section 613A(c)(7)(D) and the regulations thereunder.

(*l*) Transfers of partnership interests. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See paragraph (b)(2)(iv)(m) of this section for rules concerning the effect of a section 754 election on the capital accounts of the partners.) However, if the transfer of an interest in a partnership causes a termination of the partnership under section 708(b)(1)(B), the capital account that carriers over to the transferee partner will be adjusted in accordance with paragraph (b)(2)(iv)(e) of this section in connection with the constructive liquidation of the partnership under paragraph (b)(1)(iv) of § 1.708–1. Moreover, the constructive reformation of such partnership will, for purposes of this paragraph, be treated as the formation of a new partnership, and the capital accounts of the partners of such new partnership will be determined and maintained accordingly. See example (13) of paragraph (b)(5) of this section.

(m) Section 754 elections—(1) In general. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon adjustment to the adjusted tax basis of partnership property under section 732, 734, or 743, the capital accounts of the partners are adjusted as provided in this paragraph (b)(2)(iv)(m).

(2) Section 743 adjustments. In the case of a transfer of all or a part of an interest in a partnership that has a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions (see paragraph (b)(2)(iv)(e)(1) of this section) and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment. The preceding sentence shall not apply to the extent such basis adjustment is allocated to the common basis of partnership property under paragraph (b)(1) of § 1.734–2; in these cases, such basis adjustment shall, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, give rise to adjustments to the capital accounts of the partners in accordance with their interests in the partnership under paragraph (b)(3) of this section. See examples (13)(iii) and (iv) of paragraph (b)(5) of this section.

(3) Section 732 adjustments. In the case of a transfer of all or a part of an interest in a partnership that does not have a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 732(d) will be treated in the capital accounts of the partners in the same manner as section 743 basis adjustments are treated under paragraph (b)(2)(iv)(m)(2) of this section.

(4) Section 734 adjustments. Except as provided in paragraph (b)(2)(iv)(m)(5) of this section, in the case of a distribution of property in liquidation of a partner's interest in the partnership by a partnership that has a section 754 election in effect for the partnership taxable year in which the distribution occurs, the partner who receives the distribution that gives rise to the adjustment to the adjusted tax basis of partnership property under section 734 shall have a corresponding adjustment made to his capital account. If such distribution is made other than in liquidation of a partner's interest in the partnership, however, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, the capital accounts of the partners shall be adjusted by the amount of the adjustment to the adjusted tax basis of partnership property under section 734, and such capital account adjustment shall be shared among the partners in the manner in which the unrealized income and gain that is displaced by such adjustment would have been shared if the property whose basis is adjusted were sold immedi-

ately prior to such adjustment for its recomputed adjusted tax basis.

(5) Limitations on adjustments. Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

(n) Partnership level characterization. Except as otherwise provided in paragraph (b)(2)(iv)(k) of this section, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless adjustments to such capital accounts in respect of partnership income, gain, loss, deduction, and section 705(a)(2)(B) expenditures (or item thereof) are made with reference to the Federal tax treatment of such items (and in the case of book items, with reference to the Federal tax treatment of the corresponding tax items) at the partnership level, without regard to any requisite or elective tax treatment of such items at the partner level (for example, under section 58(i)). However, a partnership that incurs mining exploration expenditures will determine the Federal tax treatment of income, gain, loss, and deduction with respect to the property to which such expenditures relate at the partnership level only after first taking into account the elections made by its partners under section 617 and section 703(b)(4).

(*o*) Guaranteed payments. Guaranteed payments to a partner under section 707(c) cause the capital account of the recipient partner to be adjusted only to the extent of such partner's distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.

(p) Minor discrepancies. Discrepancies between the balances in the respective capital accounts of the partners and the balances that would be in such respective capital accounts if they had been determined and maintained in accordance with this paragraph (b)(2)(iv) will not adversely affect the validity of an allocation, provided that such discrepancies are minor and are attributable to good faith error by the partnership.

(q) Adjustments where guidance is lacking. If the rules of this paragraph (b)(2)(iv) fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership, such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that (1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (2) is consistent with the underlying economic arrangement of the partners, and (3) is based, wherever practicable, on Federal tax accounting principles.

(r) Restatement of capital accounts. With respect to partnerships that began operating in a taxable year beginning before May 1, 1986, the capital accounts of the partners of which have not been determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) since inception, such capital accounts shall not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) for taxable years beginning after April 30, 1986, unless either—

(1) Such capital accounts are adjusted, effective for the first partnership taxable year beginning after April 30, 1986, to reflect the fair market value of partnership property as of the first day of such taxable year, and in connection with such adjustment, the rules contained in paragraph (b)(2)(iv)(f) (2), (3), and (4) of this section are satisfied, or

(2) the differences between the balance in each partner's capital account and the balance that would be in such partner's capital account if capital accounts had been determined and maintained in accordance with this paragraph (b)(2)(iv) throughout the full term of the partnership are not significant (for example, such differences are solely attributable to a failure to provide for treatment of section 709 expenses in accordance with the rules of paragraph (b)(2)(iv)(i)(2) of this section or to a failure to follow the rules in paragraph (b)(2)(iv)(m) of this section), and capital accounts are adjusted to bring them into conformity with the rules of this paragraph (b)(2)(iv) no later than

the end of the first partnership taxable year beginning after April 30, 1986.

However, compliance with the previous sentence will have no bearing on the validity of allocations that relate to partnership taxable years beginning before May 1, 1986.

(3) Partner's interest in the partnership—(i) In general. References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partner's interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. All partners' interests in the partnership are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the Internal Revenue Service by establishing facts and circumstances that show that the partners' interests in the partnership are otherwise.

(ii) Factors considered. In determining a partner's interest in the partnership, the following factors are among those that will be considered:

(a) The partners' relative contributions to the partnership,

(b) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

(c) The interests of the partners in cash flow and other non-liquidating distributions, and

(d) The rights of the partners to distributions of capital upon liquidation.

The provisions of this subparagraph (b)(3) are illustrated by examples (1)(i) and (ii), (4)(i), (5)(i) and (ii), (6), (7), (8), (10)(ii), (16)(i), and (19)(iii) of paragraph (b)(5) of this section. See paragraph (b)(4)(i) of this section concerning rules for determining the partners' interests in the partnership with respect to certain tax items.

(iii) Certain determinations. If—

(a) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(b) All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership taxable year does not have economic effect under paragraph (b)(2)(ii) of this section.

the partners' interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of this section. See examples (1)(iv), (v), and (vi), and (15)(ii) and (iii) of paragraph (b)(5) of this section.

(4) Special rules—(i) Allocations to reflect revaluations. If partnership property is, under paragraphs (b)(2)(iv)(d) or (b)(2)(iv)(f) of this section, properly reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from the adjusted tax basis of such property, then depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property will be greater or less than the depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property. In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to such partners (see paragraph (b)(2)(iv)(g) of this section), and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts. Thus, separate al-

locations of these tax items cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the partners' distributive shares of such tax items must (unless governed by section 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under section 704(c). See examples (14) and (18) of paragraph (b)(5) of this section.

(ii) **Credits.** Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits and tax credit recapture give rise to capital account adjustments under paragraph (b)(2)(iv)(j) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. With respect to the investment tax credit provided by section 38, allocations of cost or qualified investment made in accordance with paragraph (f) of § 1.46–3 and paragraph (a)(4)(iv) of § 1.48–8 shall be deemed to be made in accordance with the partners' interests in the partnership. With respect to other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments). See example (11) of paragraph (b)(5) of this section. Identical principles shall apply in determining the partners' interests in the partnership with respect to tax credits that arise from receipts of the partnership (whether or not taxable).

(iii) **Excess percentage depletion.** To the extent the percentage depletion in respect of an item of depletable property of the partnership exceeds the adjusted tax basis of such property, allocations of such excess percentage depletion are not reflected by adjustments to the partners' capital accounts. Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and such excess percentage depletion must be allocated in accordance with the partners' interests in the partnership. The partners' interests in the partnership for a partnership taxable year with respect to such excess percentage depletion shall be in the same proportion as such partners' respective distributive shares of gross income from the depletable property (as determined under section 613(c)) for such year. See example (12) of paragraph (b)(5) of this section. See paragraphs (b)(2)(iv)(k) and (b)(4)(v) of this section for special rules concerning oil and gas properties of the partnership.

(iv) **Nonrecourse deductions**—(a) Allocation of nonrecourse deductions. An allocation of loss, deduction, or section 705(a)(2)(B) expenditure (or item thereof) attributable to nonrecourse liabilities of the partnership ("nonrecourse deductions") cannot have economic effect because, in the event there is an economic burden that corresponds to such an allocation, the creditor alone bears that burden. Thus, nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership. Paragraph (b)(4)(iv)(d) of this section, however, provides a test under which certain allocations of nonrecourse deductions will be deemed to be in accordance with the partners' interests in the partnership. If that test is not satisfied, the partners' distributive shares of nonrecourse deductions will be determined, under paragraph (b)(3) of this section, according to the partners' overall economic interests in the partnership.

(b) Determination of nonrecourse deductions. The amount of nonrecourse deductions for a partnership taxable year equals the net increase, if any, in the amount of partnership minimum gain during that taxable year. See Examples (20)(i), (21), and (22) of paragraph (b)(5) of this section. In determining such net increase for any partnership taxable year in which the capital accounts of the partners are increased pursuant to paragraph (b)(2)(iv)(f) of this section to reflect a revaluation of partnership property subject to one or more nonrecourse liabilities of the partnership, any decrease in partnership minimum gain attributable to each such revaluation shall be added back to the net decrease or increase otherwise determined. See example (22)(iii) of paragraph (b)(5) of this section. The nonrecourse deductions for a partnership taxable year shall consist first of depreciation or cost recovery deductions with respect to items of partnership property subject to one or more nonrecourse liabilities of the partnership to

the extent of the increase in minimum gain attributable to the nonrecourse liabilities to which each such item of property is subject, with the remainder of such nonrecourse deductions, if any, made up of a pro rata portion of the partnership's other items of deduction, loss, and section 705(a)(2)(B) expenditure for that year. If, however, such depreciation or cost recovery deductions exceed the net increase in partnership minimum gain, a proportional share of each such deduction shall constitute a nonrecourse deduction. See example (23) of paragraph (b)(5) of this section. In addition, if the net increase in partnership minimum gain during a partnership taxable year exceeds the total amount of items of partnership loss, deduction, and section 705(a)(2)(B) expenditure for such year, then an amount of partnership loss, deduction, and section 705(a)(2)(B) expenditure for the partnership's next succeeding taxable year (or years) equal to such excess shall constitute nonrecourse deductions, as if there had been a net increase in partnership minimum gain during such succeeding year (or years) in the amount of such excess.

(c) Partnership minimum gain. The amount of partnership minimum gain is determined by computing, with respect to each nonrecourse liability of the partnership, the amount of gain (of whatever character), if any, that would be realized by the partnership if it disposed of (in a taxable transaction) the partnership property subject to such liability in full satisfaction thereof, and by then aggregating the amounts so computed. See examples (20) (i) and (iv), (21), and (22) of paragraph (b)(5) of this section. For the purpose of determining the amount of such gain, (1) the adjusted basis of partnership property subject to two or more liabilities of equal priority shall be allocated among such liabilities in proportion to the respective outstanding balances of such liabilities, and (2) the adjusted basis of partnership property subject to two or more liabilities of unequal priority shall be allocated to the liabilities of an inferior priority (in accordance with (1) above) only to the extent of the excess, if any, of the adjusted tax basis of such property over the aggregate outstanding balance of the liabilities of superior priority. Only the portion of the property's adjusted basis allocated to nonrecourse liabilities of the partnership shall be used in computing minimum gain. See example (20) (v) and (vi) of paragraph (b)(5) of this section. If partnership property subject to one or more nonrecourse liabilities of the partnership is, under paragraph (b)(2)(iv)(d) or (b)(2)(iv)(f) of this section, properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, the determinations under this paragraph (b)(4)(iv) shall be made with reference to such book value. See example (22) of paragraph (b)(5) of this section.

(d) Requirements to be satisfied. Allocations of nonrecourse deductions shall be deemed to be made in accordance with the partners' interests in the partnership if, and only if—

(1) Throughout the full term of the partnership, requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied,

(2) Beginning in the first taxable year in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions among the partners in a manner that is reasonably consistent with allocations, which have substantial economic effect, of some other significant partnership item attributable to the property securing nonrecourse liabilities of the partnership (other than minimum gain recognized by the partnership),

(3) Beginning in the first taxable year of the partnership in which the partnership has nonrecourse deductions and thereafter throughout the full term of the partnership, (i) requirement (3) of paragraph (b)(2)(ii)(b) of this section is satisfied, or (ii) the partnership agreement contains a "minimum gain chargeback" (as defined in paragraph (b)(4)(iv)(e) of this section), and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under this paragraph (b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under paragraph (b)(4)(v) of this section).

(e) Minimum gain chargeback. A partnership agreement contains a "minimum gain chargeback" if, and only if, it provides that, if there is a net decrease in partnership minimum gain during a partnership taxable year, all partners with a deficit capital account balance at the end of such year (excluding from each partner's deficit capital account balance any amount that such partner is obligated to restore under paragraph (b)(2)(ii)(c) of this section, as well as any addition thereto pursuant to the next to last sentence of paragraph (b)(4)(iv)(f) of this section computed with respect to the amount of partnership minimum gain after such net decrease) will be allocated, before any other allocation is made under section 704(b) of partnership items for such taxable year, items of

income and gain for such year (and, if necessary, subsequent years) in the amount and in the proportions needed to eliminate such deficits as quickly as possible. For purposes of the preceding sentence, partners' capital accounts shall be reduced for the items described in paragraphs (b)(2)(ii)(d) (4), (5), and (6) of this section. Allocations of items of income and gain made pursuant to a minimum gain chargeback shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. The minimum gain chargeback allocated in any taxable year shall consist first of gains recognized from the disposition of items of partnership property subject to one or more nonrecourse liabilities of the partnership to the extent of the decrease in minimum gain attributable to the disposition of such items of property, with the remainder of such minimum gain chargeback, if any, made up of a pro rata portion of the partnership's other items of income and gain for that year. If, however, such gains exceed the amount of the minimum gain chargeback, a proportional share of each such gain shall constitute a part of the minimum gain chargeback. For purposes of paragraph (b)(2)(ii)(d)(6) of this section, offsetting increases to a partner's capital account taken into account under that paragraph shall not include income and gain that is expected to be allocated to such partner pursuant to a minimum gain chargeback.

(f) Partner's share of partnership minimum gain. A partner's share of partnership minimum gain at the end of any partnership taxable year equals the aggregate nonrecourse deductions allocated to such partner (and such partner's predecessors in interest) up to that time, less such partner's (and such predecessors') aggregate share of the net decreases in partnership minimum gain up to that time. A partner's share of the net decrease in partnership minimum gain during a partnership taxable year equals an amount that bears the same relation to the net decrease in partnership minimum gain during such year as such partner's share of partnership minimum gain at the end of the prior taxable year of the partnership (or, if later, at the time immediately following the last time that the capital accounts of the partners are increased pursuant to paragraph (b)(2)(iv)(f) of this section to reflect a revaluation of partnership property subject to one or more nonrecourse liabilities of the partnership) bears to the amount of partnership minimum gain at the end of such prior taxable year (or such later date). See examples (20) (i) and (iv) and (21) of paragraph (b)(5) of this section. In addition, if there is a decrease in partnership minimum gain in a taxable year of the partnership (whether or not there is a net decrease in partnership minimum gain during such year) attributable to the revaluation of partnership property subject to one or more nonrecourse liabilities of the partnership, each partner's share of partnership minimum gain as of the time of such revaluation shall be reduced by the amount of the increase in such partner's capital account attributable to such revaluation to the extent of the reduction in minimum gain caused by such revaluation. See example (22)(ii) of paragraph (b)(5) of this section. For purposes of paragraph (b)(2)(ii)(d) of this section, the amount of a partner's share of minimum gain shall be added to the limited dollar amount, if any, of the deficit balance in such partner's capital account that such partner is obligated to restore. See examples (20)(i) and (22)(i) of paragraph (b)(5) of this section.

(g) Nonrecourse liabilities of the partnership where a partner has economic risk of loss. The rationale for the special rule contained in this paragraph (b)(4)(iv) is that, in the event there is an economic burden that corresponds to the nonrecourse deductions, none of the partners will bear that burden. Accordingly, for purposes of this paragraph, a nonrecourse liability of the partnership is a liability of the partnership (or portion thereof) with respect to which none of the partners has any economic risk of loss (other than through their interests as partners in the partnership assets subject to the liability). Therefore, to the extent a partner may bear the burden of an economic loss corresponding to a loss, deduction, or section 705(a)(2)(B) expenditure attributable to a partnership liability that would be considered nonrecourse for purposes of § 1.1001-2 (e.g., a purported nonrecourse loan made by such partner to the partnership or guaranteed by such partner), allocations of such loss, deduction, or section 705(a)(2)(B) expenditure are not governed by this paragraph (b)(4)(iv). Instead, allocations of such loss or deduction shall be made in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. This will require allocations of such loss or deduction to be made to the partner or partners who bear the burden of an economic loss corresponding to such loss or deduction. See examples (20) (vii) and (viii) of paragraph (b)(5) of this section.

(h) Nonrecourse liabilities of the partnership where a person related to a partner has economic risk of loss. [Reserved]

(v) Allocations under section 613A(c)(7)(D). Allocations of the adjusted tax basis of a partner-

ship oil or gas property are controlled by section 613A(c)(7)(D) and the regulations thereunder. However, if the partnership agreement provides for an allocation of the adjusted tax basis of an oil or gas property among the partners, and such allocation is not otherwise governed under section 704(c) (or related principles under paragraph (b)(4)(i) of this section), that allocation will be recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), provided (a) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(k) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(iii) of this section), and (b) all other material allocations and capital account adjustments under the partnership agreement are recognized under this paragraph (b). Otherwise, such adjusted tax basis must be allocated among the partners pursuant to section 613A(c)(7)(D) in accordance with the partners' actual interests in partnership capital or income. For purposes of section 613A(c)(7)(D) the partners' allocable shares of the amount realized upon the partnership's taxable disposition of an oil or gas property will, except to the extent governed by section 704(c) (or related principles under paragraph (b)(4)(i) of this section), be determined under this paragraph (b)(4)(v). If, pursuant to paragraph (b)(2)(iv)(k)(2) of this section, the partners' capital accounts are adjusted to reflect the simulated depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that represents recovery of its simulated adjusted tax basis therein will be allocated to the partners in the same proportion as the aggregate adjusted tax basis of such property was allocated to such partners (or their predecessors in interest). If, pursuant to paragraph (b)(2)(iv)(k)(3) of this section, the partners' capital accounts are adjusted to reflect the actual depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that equals the partners' aggregate remaining adjusted basis therein will be allocated to the partners in proportion to their respective remaining adjusted tax bases in such property. An allocation provided by the partnership agreement of the portion of the total amount realized by the partnership on its taxable disposition of an oil or gas property that exceeds the portion of the total amount realized allocated under either of the previous two sentences (whichever is applicable) shall be deemed to be made in accordance with the partners' allocable shares of such amount realized, provided (c) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(k) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(ii) of this section), and (d) all other allocations and capital account adjustments under the partnership agreement are recognized under this paragraph. Otherwise, the partners' allocable shares of the total amount realized by the partnership on its taxable disposition of an oil or gas property shall be determined in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. See example (19) of paragraph (b)(5) of this section. (See paragraph (b)(2)(iv)(k) of this section for the determination of appropriate adjustments to the partners' capital accounts relating to section 613A(c)(7)(D).)

(vi) Amendments to partnership agreement. If an allocation has substantial economic effect under paragraph (b)(2) of this section or is deemed to be made in accordance with the partners' interests in the partnership under paragraph (b)(4) of this section under the partnership agreement that is effective for the taxable year to which such allocation relates, and such partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the purported modification was part of the original agreement. If it is determined that the purported modification was part of the original agreement, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms. For example, if a partner is obligated by the partnership agreement to restore the deficit balance in his capital account (or any limited dollar amount thereof) in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section and, thereafter, such obligation is eliminated or reduced (other than as provided in paragraph (b)(2)(ii)(f) of this section), or is not complied with in a timely manner, such elimination, reduction, or noncompliance may be treated as if it always were part of the partnership agreement for purposes of making any reallocations and determining the appropriate limitations period.

(vii) Recapture. For special rules applicable to the allocation of recapture income or credit, see paragraph (e) of § 1.1245–1, paragraph (f) of § 1.1250–1, paragraph (c) of § 1.1254–1, and paragraph (a) of § 1.47–6.

(5) Examples. The operation of the rules in this paragraph is illustrated by the following examples:

Example (1). (i) A and B form a general partnership with cash contributions of $40,000 each, which cash is used to purchase depreciable personal property at a cost of $80,000. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that A and B will have equal shares of taxable income and loss (computed without regard to cost recovery deductions) and cash flow and that all cost recovery deductions on the property will be allocated to A. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of the section, but that upon liquidation of the partnership, distributions will be made equally between the partners (regardless of capital account balances) and no partner will be required to restore the deficit balance in his capital account for distribution to partners with positive capital accounts balances. In the partnership's first taxable year, it recognizes operating income equal to its operating expenses and has an additional $20,000 cost recovery deduction, which is allocated entirely to A. That A and B will be entitled to equal distributions on liquidation, even though A is allocated the entire $20,000 cost recovery deduction, indicates A will not bear the full risk of the economic loss corresponding to such deduction if such loss occurs. Under paragraph (b)(2)(ii) of this section, the allocation lacks economic effect and will be disregarded. The partners made equal contributions to the partnership, share equally in other taxable income and loss and in cash flow, and will share equally in liquidation proceeds, indicating that their actual economic arrangement is to bear the risk imposed by the potential decrease in the value of the property equally. Thus, under paragraph (b)(3) of this section the partners' interests in the partnership are equal, and the cost recovery deduction will be reallocated equally between A and B.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that liquidation proceeds will be distributed in accordance with capital account balances if the partnership is liquidated during the first five years of its existence but that liquidation proceeds will be distributed equally if the partnership is liquidated thereafter. Since the partnership agreement does not provide for the requirement contained in paragraph (b)(2)(ii)(b)(2) of this section to be satisfied throughout the term of the partnership, the partnership allocations do not have economic effect. Even if the partnership agreement provided for the requirement contained in paragraph (b)(2)(ii)(b)(2) to be satisfied throughout the term of the partnership, such allocations would not have economic effect unless the requirement contained in paragraph (b)(2)(ii)(b)(3) of this section or the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section were satisfied.

(iii) Assume the same facts as in (i) except that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances throughout the term of the partnership (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(ii)(d)(4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in A's capital account.

	A	B
Capital account upon formation	$40,000	$40,000
Less: year 1 cost recovery deduction	(20,000)	0
Capital account at end of year 1	$20,000	$40,000

Under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section, the allocation of the $20,000 cost recovery deduction to A has economic effect.

(iv) Assume the same facts as in (iii) and that in the partnership's second taxable year it recognizes operating income equal to its operating expenses and has a $25,000 cost recovery deduction which, under the partnership agreement, is allocated entirely to A.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: year 2 cost recovery deduction	(25,000)	0
Capital account at end of year 2	($5,000)	$40,000

The allocation of the $25,000 cost recovery deduction to A satisfies that alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section only to the extent of $20,000. Therefore, only $20,000 of such allocation has economic effect, and the remaining $5,000 must be reallocated in accordance with the partners' interests in the partnership. Under the partnership agreement, if the property were sold immediately following the end of the partnership's second taxable year for $35,000 (its adjusted tax basis), the $35,000 would be distributed to B. Thus, B, and not A, bears the economic burden corresponding to $5,000 of the $25,000 cost recovery deduction allocated to A. Under paragraph (b)(3)(iii) of this section, $5,000 of such cost recovery deduction will be reallocated to B.

(v) Assume the same facts as in (iv) except that the cost recovery deduction for the partnership's second taxable year is $20,000 instead of $25,000. The allocation of such cost recovery deduction to A has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section. Assume further that the property is sold for $35,000 immediately following the end of the partnership's second taxable year, resulting in a $5,000 taxable loss ($40,000 adjusted tax basis less $35,000 sales price), and the partnership is liquidated.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: year 2 cost recovery deduction	(20,000)	0
Capital account at end of year 2	0	$40,000
Less: loss on sale	(2,500)	(2,500)
Capital account before liquidation	($2,500)	$37,500

Under the partnership agreement the $35,000 sales proceeds are distributed to B. Since B bears the entire economic burden corresponding to the $5,000 taxable loss from the sale of the property, the allocation of $2,500 of such loss to A does not have economic effect and must be reallocated in accordance with the partners' interests in the partnership. Under paragraph (b)(3)(iii) of this section, such $2,500 loss will be reallocated to B.

(vi) Assume the same facts as in (iv) except that the cost recovery deduction for the partnership's second taxable year is

$20,000 instead of $25,000, and that as of the end of the partnership's second taxable year it is reasonably expected that during its third taxable year the partnership will (1) have operating income equal to its operating expenses (but will have no cost recovery deductions), (2) borrow $10,000 (recourse) and distribute such amount $5,000 to A and $5,000 to B, and (3) thereafter sell the partnership property, repay the $10,000 liability, and liquidate. In determining the extent to which the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section is satisfied as of the end of the partnership's second taxable year, the fair market value of partnership property is presumed to be equal to its adjusted tax basis (in accordance with paragraph (b)(2)(iii)(c) of this section). Thus, it is presumed that the selling price of such property during tbe partnership's third taxable year will be its $40,000 adjusted tax basis. Accordingly, there can be no reasonable expectation that there will be increases to A's capital account in the partnership's third taxable year that will offset the expected $5,000 distribution to A. Therefore, the distribution of the loan proceeds must be taken into account in determining to what extent the alternate economic effect test contained in paragraph (b)(2)(ii)(d) is satisfied.

	A	B
Capital account at beginning of year 2	$20,000	$40,000
Less: expected future distribution	(5,000)	(5,000)
Less: year 2 cost recovery deduction	(20,000)	(0)
Hypothetical capital account at end of year 2	($5,000)	$35,000

Upon sale of the partnership property, the $40,000 presumed sales proceeds would be used to repay the $10,000 liability, and the remaining $30,000 would be distributed to B. Under these circumstances the allocation of the $20,000 cost recovery deduction to A in the partnership's second taxable year satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section only to the extent of $15,000. Under paragraph (b)(3)(iii) of this section, the remaining $5,000 of such deduction will be reallocated to B. The results in this example would be the same even if the partnership agreement also provided that any gain (whether ordinary income or capital gain) upon the sale of the property would be allocated to A to the extent of the prior allocations of cost recovery deductions to him, and, at end of the partnership's second taxable year, the partners were confident that the gain on the sale of the property in the partnership's third taxable year would be sufficient to offset the expected $5,000 distribution to A.

(vii) Assume the same facts as in (iv) except that the partnership agreement also provides that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(3) of this section). Thus, if the property were sold for $35,000 immediately after the end of the partnership's second taxable year, the $35,000 would be distributed to B, A would contribute $5,000 (the deficit balance in his capital account) to the partnership, and that $5,000 would be distributed to B. The allocation of the entire $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(viii) Assume the same facts as in (vii) except that A's obligation to restore the deficit balance in his capital account is limited to a maximum of $5,000. The allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section. At the end of such year, A makes an additional $5,000 contribution to the partnership (thereby eliminating the $5,000 deficit balance in his capital account). Under paragraph (b)(2)(ii)(f) of this section, A's obligation to restore up to $5,000 of the deficit balance in his capital account may be eliminated after he contributes the additional $5,000 without affecting the validity of prior allocations.

(ix) Assume the same facts as in (iv) except that upon formation of the partnership A also contributes to the partnership his negotiable promissory note with a $5,000 principal balance. The note unconditionally obligates A to pay an additional $5,000 to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(c) of this section, A is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect. The results in this example would be the same if (1) the note A contributed to the partnership were payable only at the end of the partnership's fourth taxable year (so that A would not be required to satisfy the note upon liquidation of his interest in the partnership), and (2) the partnership agreement provided that upon liquidation of A's interest, the partnership would retain A's note, and A would contribute to the partnership the excess of the outstanding principal balance of the note over its then fair market value.

(x) Assume the same facts as in (ix) except that A's obligation to contribute an additional $5,000 to the partnership is not evidenced by a promissory note. Instead, the partnership agreement imposes upon A the obligation to make an additional $5,000 contribution to the partnership at the earlier of (a) the beginning of the partnership's fourth taxable year, or (b) the end of the partnership taxable year in which A's interest is liquidated. Under paragraph (b)(2)(ii)(c) of this section, as a result of A's deferred contribution requirement, A is considered obligated to restore up to $5,000 of the deficit balance in his capital account to the partnership. Accordingly, under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section, the allocation of the $25,000 cost recovery deduction to A in the partnership's second taxable year has economic effect.

(xi) Assume the same facts as in (vii) except that the partnership agreement also provides that any gain (whether ordinary income or capital gain) upon the sale of the property will be allocated to A to the extent of the prior allocations to A of cost recovery deductions from such property, and additional gain will be allocated equally between A and B. At the time the allocations of cost recovery deductions were made to A, the partners believed there would be gain on the sale of the property in an amount sufficient to offset the allocations of cost recovery deductions to A. Nevertheless, the existence of the gain chargeback provision will not cause the economic effect of the allocations to be insubstantial under paragraph (b)(2)(iii)(c) of this section, since in testing whether the economic effect of such allocations is substantial, the recovery property is presumed to decrease in value by the amount of such deductions.

Example (2). C and D form a general partnership solely to acquire and lease machinery that is 5-year recovery property under section 168. Each contributes $100,000, and the partnership obtains an $800,000 recourse loan to purchase the machinery. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such machinery. The partnership, C, and D have calendar taxable years. The partnership agreement pro-

vides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership agreement further provides that (a) partnership net taxable loss will be allocated 90 percent to C and 10 percent to D until such time as there is partnership net taxable income, and therefore C will be allocated 90 percent of such taxable income until he has been allocated partnership net taxable income equal to the partnership net taxable loss previously allocated to him, (b) all further partnership net taxable income or loss will be allocated equally between C and D, and (c) distributions of operating cash flow will be made equally between C and D. The partnership enters into a 12-year lease with a financially secure corporation under which the partnership expects to have a net taxable loss in each of its first 5 partnership taxable years due to cost recovery deductions with respect to the machinery and net taxable income in each of its following 7 partnership taxable years, in part due to the absence of such cost recovery deductions. There is a strong likelihood that the partnership's net taxable loss in partnership taxable years 1 through 5 will be $100,000, $90,000, $80,000, $70,000, and $60,000, respectively, and the partnership's net taxable income in partnership taxable years 6 through 12 will be $40,000, $50,000, $60,000, $70,000, $80,000, $90,000, and $100,000, respectively. Even though there is a strong likelihood that the allocations of net taxable loss in years 1 through 5 will be largely offset by other allocations in partnership taxable years 6 through 12, and even if it is assumed that the total tax liability of the partners in years 1 through 12 will be less than if the allocations had not been provided in the partnership agreement, the economic effect of the allocations will not be insubstantial under paragraph (b)(2)(iii)(c) of this section. This is because at the time such allocations became part of the partnership agreement, there was a strong likelihood that the allocations of net taxable loss in years 1 through 5 would not be largely offset by allocations of income within 5 years (determined on a first-in, first-out basis). The year 1 allocation will not be offset until years 6, 7, and 8, the year 2 allocation will not be offset until years 8 and 9, the year 3 allocation will not be offset until years 9 and 10, the year 4 allocation will not be offset until years 10 and 11, and the year 5 allocation will not be offset until years 11 and 12.

Example (3). E and F enter into a partnership agreement to develop and market experimental electronic devices. E contributes $2,500 cash and agrees to devote his full-time services to the partnership. F contributes $100,000 cash and agrees to obtain a loan for the partnership for any additional capital needs. The partnership agreement provides that all deductions for research and experimental expenditures and interest on partnership loans are to be allocated to F. In addition, F will be allocated 90 percent, and E 10 percent, of partnership taxable income or loss, computed net of the deductions for such research and experimental expenditures and interest, until F has received allocations of such taxable income equal to the sum of such research and experimental expenditures, such interest expense, and his share of such taxable loss. Thereafter, E and F will share all taxable income and loss equally. Operating cash flow will be distributed equally between E and F. The partnership agreement also provides that E's and F's capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). These allocations have economic effect. In addition, in view of the nature of the partnership's activities, there is not a strong likelihood at the time the allocations become part of the partnership agreement that the economic effect of the allocations to F of deductions for research and experimental expenditures and interest on partnership loans will be largely offset by allocations to F of partnership net taxable income. The economic effect of the allocations is substantial.

Example (4). (i) G and H contribute $75,000 and $25,000, respectively, in forming a general partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated equally between the partners, that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, but that all partnership distributions will, regardless of capital account balances, be made 75 percent to G and 25 percent to H. Following the liquidation of the partnership, neither partner is required to restore the deficit balance in his capital account to the partnership for distribution to partners with positive capital account balances. The allocations in the partnership agreement do not have economic effect. Since contributions were made in a 75/25 ratio and the partnership agreement indicates that all economic profits and losses of the partnership are to be shared in a 75/25 ratio, under paragraph (b)(3) of this section, partnership income, gain, loss, and deduction will be reallocated 75 percent to G and 25 percent to H.

(ii) Assume the same facts as in (i) except that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75 percent to G and 25 percent to H. G and H are ultimately liable (under a State law right of contribution) for 75 percent and 25 percent, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.

(iii) Assume the same facts as in (i) except that the partnership agreement provides that any partner with a deficit balance in his capital account must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.

Example (5). (i) Individuals I and J are the only partners of an investment partnership. The partnership owns corporate stocks, corporate debt instruments, and tax-exempt debt instruments. Over the next several years, I expects to be in the 50 percent marginal tax bracket, and J expects to be in the 15 percent marginal tax bracket. There is a strong likelihood that in each of the next several years the partnership will realize between $450 and $550 of tax-exempt interest and between $450 and $550 of a combination of taxable interest and dividends from its investments. I and J made equal capital contributions to the partnership, and they have agreed to share equally in gains and losses from the sale of the partnership's investment securities. I and J agree, however, that rather than share interest and dividends of the partnership equally, they will allocate the partnership's tax-exempt interest 80 percent to I and 20 percent to J and will distribute cash derived from interest received on the tax-exempt bonds in the same percentages. In addition, they agree to allocate 100 percent of the partnership's taxable interest and dividends to J and to distribute cash derived from interest and dividends received on the

corporate stocks and debt instruments 100 percent to J. The partnership agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The allocation of taxable interest and dividends and tax-exempt interest has economic effect, but that economic effect is not substantial under the general rules set forth in paragraph (b)(2)(iii) of this section. Without the allocation I would be allocated between $225 and $275 of tax-exempt interest and between $225 and $275 of a combination of taxable interest and dividends, which (net of Federal income taxes he would owe on such income) would give I between $337.50 and $412.50 after tax. With the allocation, however, I will be allocated between $360 and $440 of tax-exempt interest and no taxable interest and dividends, which (net of Federal income taxes) will give I between $360 and $440 after tax. Thus, at the time the allocations became part of the partnership agreement, I is expected to enhance his after-tax economic consequences as a result of the allocations. On the other hand, there is a strong likelihood that neither I nor J will substantially diminish his after-tax economic consequences as a result of the allocations. Under the combination of likely investment outcomes least favorable for J, the partnership would realize $550 of tax-exempt interest and $450 of taxable interest and dividends, giving J $492.50 after tax (which is more than the $466.25 after tax J would have received if each of such amounts had been allocated equally between the partners). Under the combination of likely investment outcomes least favorable for I, the partnership would realize $450 of tax-exempt interest and $550 of taxable interest and dividends, giving I $360 after tax (which is not substantially less than the $362.50 he would have received if each of such amounts had been allocated equally between the partners). Accordingly, the allocations in the partnership agreement must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i). In addition, assume that in the first partnership taxable year in which the allocation arrangement described in (i) applies, the partnership realizes $450 of tax-exempt interest and $550 of taxable interest and dividends, so that, pursuant to the partnership agreement, I's capital account is credited with $360 (80 percent of the tax-exempt interest), and J's capital account is credited with $640 (20 percent of the tax-exempt interest and 100 percent of the taxable interest and dividends). The allocations of tax-exempt interest and taxable interest and dividends (which do not have substantial economic effect for the reasons stated in (i) will be disregarded and will be reallocated. Since under the partnership agreement I will receive 36 percent (360/1,000) and J will receive 64 percent (640/1,000) of the partnership's total investment income in such year, under paragraph (b)(3) of this section the partnership's tax-exempt interest and taxable interest and dividends each will be reallocated 36 percent to I and 64 percent to J.

Example (6). K and L are equal partners in a general partnership formed to acquire and operate property described in section 1231(b). The partnership, K, and L have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). For a taxable year in which the partnership expects to incur a loss on the sale of a portion of such property, the partnership agreement is amended (at the beginning of the taxable year) to allocate such loss to K, who expects to have no gains from the sale of depreciable property described in section 1231(b) in that taxable year, and to allocate an equivalent amount of partnership loss and deduction for that year of a different character to L, who expects to have such gains. Any partnership loss and deduction in excess of these allocations will be allocated equally between K and L. The amendment is effective only for that taxable year. At the time the partnership agreement is amended, there is a strong likelihood that the partnership will incur deduction or loss in the taxable year other than loss from the sale of property described in section 1231(b) in an amount that will substantially equal or exceed the expected amount of the section 1231(b) loss. The allocations in such taxable year have economic effect. However, the economic effect of the allocations is insubstantial under the test described in paragraph (b)(2)(iii)(b) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that the net increases and decreases to K's and L's capital accounts will be the same at the end of the taxable year to which they apply with such allocations in effect as they would have been in the absence of such allocations, and that the total taxes of K and L for such year will be reduced as a result of such allocations. If in fact the partnership incurs deduction or loss, other than loss from the sale of property described in section 1231(b), in an amount at least equal to the section 1231(b) loss, the loss and deduction in such taxable year will be reallocated equally between K and L under paragraph (b)(3) of this section. If not, the loss from the sale of property described in section 1231(b) and the items of deduction and other loss realized in such year will be reallocated between K and L in proportion to the net decreases in their capital accounts due to the allocation of such items under the partnership agreement.

Example (7). (i) M and N are partners in the MN general partnership, which is engaged in an active business. Income, gain, loss, and deduction from MN's business is allocated equally between M and N. The partnership, M, and N have calendar taxable years. Under the partnership agreement the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partner's positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). In order to enhance the credit standing of the partnership, the partners contribute surplus funds to the partnership, which the partners agree to invest in equal dollar amounts of tax-exempt bonds and corporate stock for the partnership's first 3 taxable years. M is expected to be in a higher marginal tax bracket than N during those 3 years. At the time the decision to make these investments is made, it is agreed that, during the 3-year period of the investment, M will be allocated 90 percent and N 10 percent of the interest income from the tax-exempt bonds as well as any gain or loss from the sale thereof, and that M will be allocated 10 percent and N 90 percent of the dividend income from the corporate stock as well as any gain or loss from the sale thereof. At the time the allocations concerning the investments become part of the partnership agreement, there is not a strong likelihood that the gain or loss from the sale of the stock will be substantially equal to the gain or loss from the sale of the tax-exempt bonds, but there is a strong likelihood that the

tax-exempt interest and the taxable dividends realized from these investments during the 3-year period will not differ substantially. These allocations have economic effect, and the economic effect of the allocations of the gain or loss on the sale of the tax-exempt bonds and corporate stock is substantial. The economic effect of the allocations of the tax-exempt interest and the taxable dividends, however, is not substantial under the test described in paragraph (b)(2)(iii)(c) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that at the end of the 3-year period to which such allocations relate, the net increases and decreases to M's and N's capital accounts will be the same with such allocations as they would have been in the absence of such allocations, and that the total taxes of M and N for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the amounts of the tax-exempt interest and taxable dividends earned by the partnership during the 3-year period are equal, the tax-exempt interest and taxable dividends will be reallocated to the partners in equal shares under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts during such 3-year period due to the allocation of such items under the partnership agreement.

(ii) Assume the same facts as in (i) except that gain or loss from the sale of the tax-exempt bonds and corporate stock will be allocated equally between M and N and the partnership agreement provides that the 90/10 allocation arrangement with respect to the investment income applies only to the first $10,000 of interest income from the tax-exempt bonds and the first $10,000 of dividend income from the corporate stock, and only to the first taxable year of the partnership. There is a strong likelihood at the time the 90/10 allocation of the investment income became part of the partnership agreement that in the first taxable year of the partnership, the partnership will earn more than $10,000 of tax-exempt interest and more than $10,000 of taxable dividends. The allocations of tax-exempt interest and taxable dividends provided in the partnership agreement have economic effect, but under the test contained in paragraph (b)(2)(iii)(b) of this section, such economic effect is not substantial for the same reasons stated in (i) (but applied to the 1 taxable year, rather than to a 3-year period). If in fact the partnership realizes at least $10,000 of tax-exempt interest and at least $10,000 of taxable dividends in such year, the allocations of such interest income and dividend income will be reallocated equally between M and N under paragraph (b)(3) of this section. If not, the tax-exempt interest and taxable dividends will be reallocated between M and N in proportion to the net increases in their capital accounts due to the allocations of such items under the partnership agreement.

(iii) Assume the same facts as in (ii) except that at the time the 90/10 allocation of investment income becomes part of the partnership agreement, there is not a strong likelihood that (1) the partnership will earn $10,000 or more of tax-exempt interest and $10,000 or more of taxable dividends in the partnership's first taxable year, and (2) the amount of tax-exempt interest and taxable dividends earned during such year will be substantially the same. Under these facts the economic effect of the allocations generally will be substantial. (Additional facts may exist in certain cases, however, so that the allocation is insubstantial under the second sentence of paragraph (b)(2)(iii). See example (5) above.)

Example (8). (i) O and P are equal partners in the OP general partnership. The partnership, O, and P have calendar taxable years. Partner O has a net operating loss carryover from another venture that is due to expire at the end of the partnership's second taxable year. Otherwise, both partners expect to be in the 50 percent marginal tax bracket in the next several taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership agreement is amended (at the beginning of the partnership's second taxable year) to allocate all the partnership net taxable income for that year to O. Future partnership net taxable loss is to be allocated to O, and future partnership net taxable income to P, until the allocation of income to O in the partnership's second taxable year is offset. It is further agreed orally that in the event the partnership is liquidated prior to completion of such offset, O's capital account will be adjusted downward to the extent of one-half of the allocations of income to O in the partnership's second taxable year that have not been offset by other allocations, P's capital account will be adjusted upward by a like amount, and liquidation proceeds will be distributed in accordance with the partners' adjusted capital account balances. As a result of this oral amendment, all allocations of partnership net taxable income and net taxable loss made pursuant to the amendment executed at the beginning of the partnership's second taxable year lack economic effect and will be disregarded. Under the partnership agreement other allocations are made equally to O and P, and O and P will share equally in liquidation proceeds, indicating that the partners' interests in the partnership are equal. Thus, the disregarded allocations will be reallocated equally between the partners under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i) except that there is no agreement that O's and P's capital accounts will be adjusted downward and upward, respectively, to the extent of one-half of the partnership net taxable income allocated to O in the partnership's second taxable year that is not offset subsequently by other allocations. The income of the partnership is generated primarily by fixed interest payments received with respect to highly rated corporate bonds, which are expected to produce sufficient net taxable income prior to the end of the partnership's seventh taxable year to offset in large part the net taxable income to be allocated to O in the partnership's second taxable year. Thus, at the time the allocations are made part of the partnership agreement, there is a strong likelihood that the allocation of net taxable income to be made to O in the second taxable year will be offset in large part within 5 taxable years thereafter. These allocations have economic effect. However, the economic effect of the allocation of partnership net taxable income to O in the partnership's second taxable year, as well as the offsetting allocations to P, is not substantial under the test contained in paragraph (b)(2)(iii)(c) of this section because there is a strong likelihood that the net increases or decreases in O's and P's capital accounts will be the same at the end of the partnership's seventh taxable year with such allocations as they would have been in the absence of such allocations, and the total taxes of O and P for the taxable years to which such allocations relate will be reduced as a result of such allocations. If in fact the partnership, in its taxable years 3 through 7, realizes sufficient net taxable income to offset the amount allocated to O in the second taxable year, the allocations provided in the partnership agreement will be reallocated equally between the partners under paragraph (b)(3) of this section.

Example (9). Q and R form a limited partnership with contributions of $20,000 and $180,000, respectively. Q, the limited partner, is a corporation that has $2,000,000 of net operating loss carryforwards that will not expire for 8 years. Q does not expect to have sufficient income (apart from the

income of the partnership) to absorb any of such net operating loss carryforwards. R, the general partner, is a corporation that expects to be in the 46 percent marginal tax bracket for several years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership's cash, together with the proceeds of an $800,000 loan, are invested in assets that are expected to produce taxable income and cash flow (before debt service) of approximately $150,000 a year for the first 8 years of the partnership's operations. In addition, it is expected that the partnership's total taxable income in its first 8 taxable years will not exceed $2,000,000. The partnership's $150,000 of cash flow in each of its first 8 years will be used to retire the $800,000 loan. The partnership agreement provides that partnership net taxable income will be allocated 90 percent to Q and 10 percent to R in the first through eighth partnership taxable years, and 90 percent to R and 10 percent to Q in all subsequent partnership taxable years. Net taxable loss will be allocated 90 percent to R and 10 percent to Q in all partnership taxable years. All distributions of cash from the partnership to partners (other than the priority distributions to Q described below) will be made 90 percent to R and 10 percent to Q. At the end of the partnership's eighth taxable year, the amount of Q's capital account in excess of one-ninth of R's capital account on such date will be designated as Q's "excess capital account." Beginning in the ninth taxable year of the partnership, the undistributed portion of Q's excess capital account will begin to bear interest which will be paid and deducted under section 707(c) at a rate of interest below the rate that the partnership can borrow from commercial lenders, and over the next several years (following the eight year) the partnership will make priority cash distributions to Q in prearranged percentages of Q's excess capital account designed to amortize Q's excess capital account and the interest thereon over a prearranged period. In addition, the partnership's agreement prevents Q from causing his interest in the partnership from being liquidated (and thereby receiving the balance in his capital account) without R's consent until Q's excess capital account has been eliminated. The below market rate of interest and the period over which the amortization will take place are prescribed such that, as of the end of the partnership's eighth taxable year, the present value of Q's right to receive such priority distributions is approximately 46 percent of the amount of Q's excess capital account as of such date. However, because the partnership's income for its first 8 taxable years will be realized approximately ratably over that period, the present value of Q's right to receive the priority distributions with respect to its excess capital account is, as of the date the partnership agreement is entered into, less than the present value of the additional Federal income taxes for which R would be liable if, during the partnership's first 8 taxable years, all partnership income were to be allocated 90 percent to R and 10 to Q. The allocations of partnership taxable income to Q and R in the first through eighth partnership taxable years have economic effect. However, such economic effect is not substantial under the general rules set forth in paragraph (b)(2)(iii) of this section. This is true because R may enhance his after-tax economic consequences, on a present value basis, as a result of the allocations to Q of 90 percent of partnership's income during taxable years 1 through 8, and there is a strong likelihood that neither R nor Q will substantially diminish its after-tax economic consequences, on a present value basis, as a result of such allocation. Accordingly, partnership taxable income for partnership taxable years 1 through 8 will be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

Example (10). (i) S and T form a general partnership to operate a travel agency. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership agreement provides that T, a resident of a foreign country, will be allocated 90 percent, and S 10 percent, of the income, gain, loss, and deduction derived from operations conducted by T within his country, and all remaining income, gain, loss, and deduction will be allocated equally. The amount of such income, gain, loss, or deduction cannot be predicted with any reasonable certainty. The allocations provided by the partnership agreement have substantial economic effect.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all income, gain, loss, and deduction of the partnership will be shared equally, but that T will be allocated all income, gain, loss, and deduction derived from operations conducted by him within his country as a part of his equal share of partnership income, gain, loss, and deduction, upon[1] to the amount of such share. Assume the total tax liability of S and T for each year to which these allocations relate will be reduced as a result of such allocation. These allocations have economic effect. However, such economic effect is not substantial under the test stated in paragraph (b)(2)(iii)(b) of this section because, at the time the allocations became part of the partnership agreement, there is a strong likelihood that the net increases and decreases to S's and T's capital accounts will be the same at the end of each partnership taxable year with such allocations as they would have been in the absence of such allocations, and that the total tax liability of S and T for each year to which such allocations relate will be reduced as a result of such allocations. Thus, all items of partnership income, gain, loss, and income, gain, loss, and deduction will be reallocated equally between S and T under paragraph (b)(3) of this section.

Example (11). (i) U and V share equally all income, gain, loss, and deduction of the UV general partnership, as well as all non-liquidating distributions made by the partnership. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The agreement further provides that the partners will be allocated equal shares of any section 705(a)(2)(B) expenditures of the partnership. In the partnership's first taxable year, it pays qualified first-year wages of $6,000 and is entitled to a $3,000 targeted jobs tax credit under sections 44B and 51 of the Code. Under section 280C the partnership must reduce its deduction for wages paid by the

[1] So in original.

$3,000 credit claimed (which amount constitutes a section 705(a)(2)(B) expenditure). The partnership agreement allocates the credit to U. Although the allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect, the allocation of tax credit cannot have economic effect since it cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section. Under that rule, since the expenses that gave rise to the credit are shared equally by the partners, the credit will be shared equally between U and V.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, the partnership agreement is amended to allocate to U all wage expenses incurred in that year (including wage expenses that constitute section 705(a)(2)(B) expenditures) whether or not such wages qualify for the credit. The partnership agreement contains no offsetting allocations. That taxable year the partnership pays $8,000 in total wages to its employees. Assume that the partnership has operating income equal to its operating expenses (exclusive of expenses for wages). Assume further that $6,000 of the $8,000 wage expense constitutes qualified first-year wages. U is allocated the $3,000 deduction and the $3,000 section 705(a)(2)(B) expenditure attributable to the $6,000 of qualified first-year wages, as well as the deduction for the other $2,000 in wage expenses. The allocations of wage deductions and section 705(a)(2)(B) expenditures have substantial economic effect. Furthermore, since the wage credit is allocated in the same proportion as the expenses that gave rise to the credit, and the allocation of those expenses has substantial economic effect, the allocation of such credit to U is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(ii) of this section and is recognized thereunder.

Example (12). (i) W and X form a general partnership for the purpose of mining iron ore. W makes an initial contribution of $75,000, and X makes an initial contribution of $25,000. The partnership agreement provides that non-liquidating distributions will be made 75 percent to W and 25 percent to X, and that all items of income, gain, loss, and deduction will be allocated 75 percent to W and 25 percent to X, except that all percentage depletion deductions will be allocated to W. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). Assume that the adjusted tax basis of the partnership's only depletable iron ore property is $1,000 and that the percentage depletion deduction for the taxable year with respect to such property is $1,500. The allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the allocation of $1,000 of the percentage depletion deduction have substantial economic effect. The allocation to W of the remaining $500 of the percentage depletion deduction, representing the excess of percentage depletion over adjusted tax basis of the iron ore property, cannot have economic effect since such amount cannot properly be reflected in the partners' capital accounts. Furthermore, the allocation to W of that $500 excess percentage depletion deduction is not in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section, under which such $500 excess depletion deduction (and all further percentage depletion deductions from the mine) will be reallocated 75 percent to W and 25 percent to X.

(ii) Assume the same facts as in (i) except that the partnership agreement provides that all percentage depletion deductions of the partnership will be allocated 75 percent to W and 25 percent to X. Once again, the allocation of partnership income, gain, loss, and deduction (excluding the percentage depletion deduction) as well as the allocation of $1,000 of the percentage depletion deduction have substantial economic effect. Furthermore, since the $500 portion of the percentage depletion deduction that exceeds the adjusted basis of such iron ore property is allocated in the same manner as valid allocations of the gross income from such property during the taxable year (i.e., 75 percent to W and 25 percent to X), the allocation of the $500 excess percentage depletion contained in the partnership agreement is in accordance with the special partners' interests in the partnership rule contained in paragraph (b)(4)(iii) of this section.

Example (13). (i) Y and Z form a brokerage general partnership for the purpose of investing and trading in marketable securities. Y contributes cash of $10,000, and Z contributes securities of P corporation, which have an adjusted basis of $3,000 and a fair market value of $10,000. The partnership would not be an investment company under section 351(e) if it were incorporated. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership uses the interim closing of the books method for purposes of section 706. The initial capital accounts of Y and Z are fixed at $10,000 each. The agreement further provides that all partnership distributions, income, gain, loss, deduction, and credit will be shared equally between Y and Z, except that the taxable gain attributable to the precontribution appreciation in the value of the securities of P corporation will be allocated to Z in accordance with section 704(c). During the partnership's first taxable year, it sells the securities of P corporation for $12,000, resulting in a $2,000 book gain ($12,000 less $10,000 book value) and a $9,000 taxable gain ($12,000 less $3,000 adjusted tax basis). The partnership has no other income, gain, loss, or deductions for the taxable year. The gain from the sale of the securities is allocated as follows:

	Y		Z	
	Tax	Book	Tax	Book
Capital account upon formation	$10,000	$10,000	$3,000	$10,000
Plus: gain	1,000	1,000	8,000	1,000
Capital account at end of year 1	$11,000	$11,000	$11,000	$11,000

The allocation of the $2,000 book gain, $1,000 each to Y and Z, has substantial economic effect. Furthermore, under section 704(c) the partners' distributive shares of the $9,000 taxable gain are $1,000 to Y and $8,000 to Z.

(ii) Assume the same facts as in (i) and that at the beginning of the partnership's second taxable year, it invests its $22,000 of cash in securities of G Corp. The G Corp. securities increase in value to $40,000, at which time Y sells 50 percent of his partnership interest (*i.e.*, a 25 percent interest in the partnership) to LK for $10,000. The partnership does not have a section 754 election in effect for the partnership taxable year

during which such sale occurs. In accordance with paragraph (b)(2)(iv)(*l*) of this section, the partnership agreement provides that LK inherits 50 percent of Y's $11,000 capital account balance. Thus, following the sale, LK and Y each have a capital account of $5,500, and Z's capital account remains at $11,000. Prior to the end of the partnership's second taxable year, the securities are sold for their $40,000 fair market value, resulting in an $18,000 taxable gain ($40,000 less $22,000 adjusted tax basis). The partnership has no other income, gain, loss, or deduction in such taxable year. Under the partnership agreement the $18,000 taxable gain is allocated as follows:

	Y	Z	LK
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	4,500	9,000	4,500
Capital account at end of year 2	$10,000	$20,000	$10,000

The allocation of the $18,000 taxable gain has substantial economic effect.

(iii) Assume the same facts as in (ii) except that the partnership has a section 754 election in effect for the partnership taxable year during which Y sells 50 percent of his interest to LK. Accordingly, under § 1.743–1 there is a $4,500 basis increase to the G Corp. securities with respect to LK. Notwithstanding this basis adjustment, as a result of the sale of the G Corp. securities, LK's capital account is, as in (ii), increased by $4,500. The fact that LK recognizes no taxable gain from such sale (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(m)(2) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(iv) Assume the same facts as in (iii) except that immediately following Y's sale of 50 percent of this interest to LK, the G Corp. securities decrease in value to $32,000 and are sold. The $10,000 taxable gain ($32,000 less $22,000 adjusted tax basis) is allocated as follows:

	Y	Z	LK
Capital account before sale of securities	$5,500	$11,000	$5,500
Plus: gain	2,500	5,000	2,500
Capital account at end of year 2	$8,000	$16,000	$8,000

The fact that LK recognizes a $2,000 taxable loss from the sale of the G Corp. securities (due to his $4,500 section 743 basis adjustment) is irrelevant for capital accounting purposes since, in accordance with paragraph (b)(2)(iv)(m)(2) of this section, that basis adjustment is disregarded in the maintenance and computation of the partners' capital accounts.

(v) Assume the same facts as in (ii) except that Y sells 100 percent of his partnership interest (i.e., a 50 percent interest in the partnership) to LK for $20,000. Under section 708(b)(1)(B) the partnership terminates. Under paragraph (b)(1)(iv) of § 1.708–1, there is a constructive liquidation of the partnership. Immediately preceding the constructive liquidation, the capital accounts of Z and LK equal $11,000 each (LK having inherited Y's $11,000 capital account). In accordance with paragraph (b)(2)(iv)(e) of this section, the partnership agreement provides that the partners' capital accounts are adjusted to reflect how unrealized taxable gain would have been allocated if the securities had been sold for their $40,000 fair market value. Accordingly, the $18,000 of unrealized gain ($40,000 less $22,000 adjusted tax basis is credited to the partners' capital accounts as follows:

	Z	LK
Capital account following sale	$11,000	$11,000
Deemed sale adjustment	9,000	9,000
Capital account before constructive liquidation	$20,000	$20,000

Constructive liquidating distributions of the securities are made with reference to their $40,000 fair market value. Under section 732(b) the adjusted tax basis of the G Corp. securities constructively distributed to Z is equal to the $11,000 adjusted tax basis of Z's partnership interest before the constructive liquidation, and the adjusted tax basis of the G Corp. securities constructively distributed to Z is equal to the $20,000 adjusted tax basis of LK's partnership interest before the constructive liquidation. Under paragraph (b)(1)(iv) of § 1.708–1, the partners then are treated as contributing to a new partnership the property constructively distributed to them in connection with the partnership's termination. In accordance with paragraph (b)(2)(iv)(d) of this section, the capital accounts of Z and LK in the reconstituted partnership are stated at $20,000 each (i.e., the fair market value of the property constructively contributed to the new partnership by each of the partners).

Example (14). (i) MC and RW form a general partnership to which each contributes $10,000. The $20,000 is invested in securities of Ventureco (which are not readily tradable on an established securities market). In each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding gain or loss from the sale of securities). The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership uses the interim closing of the books method for purposes of section 706. Assume that the Ventureco securities subsequently appreciate in value to $50,000. At that time SK makes a $25,000 cash contribution to the partnership (thereby acquiring a one-third interest in the partnership), and the $25,000 is placed in a bank account. Upon SK's admission to the partnership, the capital accounts of MC and RW (which were $10,000 each prior to SK's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward (to $25,000 each) to reflect their shares of the unrealized appreciation in the Ventureco securities that occurred before SK was admitted to the partnership. Immediately after SK's admission to the partnership, the securities are sold for their $50,000 fair market value, resulting in taxable gain of $30,000 ($50,000 less $20,000 adjusted tax basis) and no book gain or loss. An allocation of the $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $30,000 taxable gain will, in accordance with section 704(c) principles, be shared $15,000 to MC and $15,000 to RW, the partners' capital accounts will not be

considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	15,000	0	15,000	0	0	0
Capital account following sale	$25,000	$25,000	$25,000	$25,000	$25,000	$25,000

(ii) Assume the same facts as (i), except that after SK's admission to the partnership, the Ventureco securities appreciate in value to $74,000 and are sold, resulting in taxable gain of $54,000 ($74,000 less $20,000 adjusted tax basis) and book gain of $24,000 ($74,000 less $50,000 book value). Under the partnership agreement the $24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $54,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the taxable gain will, in accordance with section 704(c) principles, be shared $23,000 to MC, $23,000 to RW, and $8,000 to SK, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	23,000	8,000	23,000	8,000	8,000	8,000
Capital account following sale	$33,000	$33,000	$33,000	$33,000	$33,000	$33,000

(iii) Assume the same facts as (i) except that after SK's admission to the partnership, the Ventureco securities depreciate in value to $44,000 and are sold, resulting in taxable gain of $24,000 ($44,000 less $20,000 adjusted tax basis) and a book loss of $6,000 ($50,000 book value less $44,000). Under the partnership agreement the $6,000 book loss is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $24,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $24,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between MC and RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account following SK's admission	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: gain	12,000	0	12,000	0	0	0
Less: loss	0	(2,000)	0	(2,000)	0	(2,000)
Capital account following sale	$22,000	$23,000	$22,000	$23,000	$25,000	$25,000

That SK bears an economic loss of $2,000 without a corresponding taxable loss is attributable entirely to the "ceiling rule." See paragraph (c)(2) of § 1.704–1.

(iv) Assume the same facts as in (ii) except that upon the admission of SK the capital accounts of MC and RW are not each adjusted upward from $10,000 to $25,000 to reflect the appreciation in the partnership's securities that occurred before SK was admitted to the partnership. Rather, upon SK's admission to the partnership, the partnership agreement is amended to provide that the first $30,000 of taxable gain upon the sale of such securities will be allocated equally between MC and RW, and that all other income, gain, loss, and deduction will be allocated equally between MC, RW, and SK. When the securities are sold for $74,000, the $54,000 of taxable gain is so allocated. These allocations of taxable gain have substantial economic effect. (If the agreement instead provides for all taxable gain (including the $30,000 taxable gain attributable to the appreciation in the securities prior to SK's admission to the partnership) to be allocated equally between MC, RW, and SK, the partners should consider whether, and to what extent, the provisions of paragraphs (b)(1)(iii) and (iv) of this section are applicable.)

(v) Assume the same facts as in (iv) except that instead of selling the securities, the partnership makes a distribution of the securities (which have a fair market value of $74,000). Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). In accordance with paragraph (b)(2)(iv)(e) of this section, the partners' capital accounts are adjusted immediately prior to the distribution to reflect how taxable gain ($54,000) would have been allocated had the securities been sold for their $74,000 fair market value, and capital account adjustments in respect of the distribution of the securities are made with reference to the $74,000 "booked-up" fair market value.

	MC	RW	SK
Capital account before adjustment	$10,000	$10,000	$25,000
Deemed sale adjustment	23,000	23,000	8,000
Less: distribution	(24,667)	(24,667)	(24,667)

	MC	RW	SK
Capital account after distribution	$8,333	$8,333	$8,333

(vi) Assume the same facts as in (i) except that the partnership does not sell the Ventureco securities. During the next 3 years the fair market value of the Ventureco securities remains at $50,000, and the partnership engages in no other investment activities. Thus, at the end of that period the balance sheet of the partnership and the partners' capital accounts are the same as they were at the beginning of such period. At the end of the 3 years, MC's interest in the partnership is liquidated for the $25,000 cash held by the partnership. Assume the distribution does not give rise to a transaction described in section 707(a)(2)(B). Assume further that the partnership has a section 754 election in effect for the taxable year during which such liquidation occurs. Under sections 734(b) and 755 the partnership increases the basis of the Ventureco securities by the $15,000 basis adjustment (the excess of $25,000 over the $10,000 adjusted tax basis of MC's partnership interest).

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Plus: basis adjustment..................	15,000	0	0	0	0	0
Less: distribution	(25,000)	(25,000)	0	0	0	0
Capital account after liquidation	0	0	$10,000	$25,000	$25,000	$25,000

(vii) Assume the same facts as in (vi) except that the partnership has no section 754 election in effect for the taxable year during which such liquidation occurs.

	MC		RW		SK	
	Tax	Book	Tax	Book	Tax	Book
Capital account before distribution	$10,000	$25,000	$10,000	$25,000	$25,000	$25,000
Less: distribution	(25,000)	(25,000)	0	0	0	0
Capital account after liquidation	($15,000)	0	$10,000	$25,000	$25,000	$25,000

Following the liquidation of MC's interest in the partnership, the Ventureco securities are sold for their $50,000 fair market value, resulting in no book gain or loss but a $30,000 taxable gain. An allocation of this $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that $15,000 of such taxable gain will, in accordance with section 704(c) principles, be included in RW's distributive share, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section. The remaining $15,000 of such gain will, under paragraph (b)(3) of this section, be shared equally between RW and SK.

Example (15). (i) JB and DK form a limited partnership for the purpose of purchasing residential real estate to lease. JB, the limited partner, contributes $13,500, and DK, the general partner, contributes $1,500. The partnership, which uses the cash receipts and disbursements method of accounting, purchases a building for $100,000 (on leased land), incurring a recourse mortgage of $85,000 that requires the payment of interest only for a period of 3 years. The partnership agreement provides that partnership net taxable income and loss will be allocated 90 percent to JB and 10 percent to DK, the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section), and JB is not required to restore any deficit balance in his capital account, but DK is so required. The partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section). As of the end of each of the partnership's first 3 taxable years, the items described in paragraphs (b)(2)(ii)(d)(4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in JB's capital account. In the partnership's first taxable year, it has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership's first taxable year.

	JB	DK
Capital account upon formation	$13,500	$1,500
Less: year 1 net loss...........	(10,800)	(1,200)
Capital account at end of year 1	$2,700	$300

The alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section is satisfied as of the end of the partnership's first taxable year. Thus, the allocation made in the partnership's first taxable year has economic effect.

(ii) Assume the same facts as in (i) and that in the partnership's second taxable year it again has rental income of $10,000, operating expenses of $2,000, interest expense of $8,000, and cost recovery deductions of $12,000. Under the partnership agreement JB and DK are allocated $10,800 and $1,200, respectively, of the $12,000 net taxable loss incurred in the partnership's second taxable year.

	JB	DK
Capital account at beginning of year 1	$2,700	$300
Less: year 2 net loss...........	(10,800)	(1,200)
Capital account at end of year 2......................	($8,100)	($900)

Only $2,700 of the $10,800 net taxable loss allocated to JB satisfies the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section as of the end of the partner-

ship's second taxable year. The allocation of such $2,700 net taxable loss to JB (consisting of $2,250 of rental income, $450 of operating expenses, $1,800 of interest expense, and $2,700 of cost recovery deductions) has economic effect. The remaining $8,100 of net taxable loss allocated by the partnership agreement to JB must be reallocated in accordance with the partners' interests in the partnership. Under paragraph (b)(3)(iii) of this section, the determination of the partners' interests in the remaining $8,100 net taxable loss is made by comparing how distributions (and contributions) would be made if the partnership sold its property at its adjusted tax basis and liquidated immediately following the end of the partnership's first taxable year with the results of such a sale and liquidation immediately following the end of the partnership's second taxable year. If the partnership's real property were sold for its $88,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's first taxable year, the $88,000 sales proceeds would be used to repay the $85,000 note, and there would be $3,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $300 and $2,700, respectively. If such property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining in the partnership to distribute. A comparison of these outcomes indicates that JB bore $2,700 and DK $9,300 of the economic burden that corresponds to the $12,000 net taxable loss. Thus, in addition to the $1,200 net taxable loss allocated to DK under the partnership agreement, $8,100 of net taxable loss will be reallocated to DK under paragraph (b)(3)(iii) of this section. Similarly, for subsequent taxable years, absent an increase in JB's capital account, all net taxable loss allocated to JB under the partnership agreement will be reallocated to DK.

(iii) Assume the same facts as in (ii) and that in the partnership's third taxable year there is rental income of $35,000, operating expenses of $2,000, interest expenses of $8,000, and cost recovery deductions of $10,000. The capital accounts of the partners maintained on the books of the partnership do not take into account the reallocation to DK of the $8,100 net taxable loss in the partnership's second taxable year. Thus, an allocation of the $15,000 net taxable income, $13,500 to JB and $1,500 to DK (as dictated by the partnership agreement and as reflected in the capital accounts of the partners) does not have economic effect. The partners' interests in the partnership with respect to such $15,000 taxable gain again is made in the manner described in paragraph (b)(3)(iii) of this section. If the partnership's real property were sold for its $76,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's second taxable year, DK would be required to contribute $9,000 to the partnership in order for the partnership to repay the $85,000 note, and there would be no assets remaining to distribute. If such property were sold for its $66,000 adjusted tax basis and the partnership were liquidated immediately following the end of the partnership's third taxable year, the $91,000 ($66,000 sales proceeds plus $25,000 cash on hand) would be used to repay the $85,000 note and there would be $6,000 remaining in the partnership, which would be used to make liquidating distributions to DK and JB of $600 and $5,400, respectively. Accordingly, under paragraph (b)(3)(iii) of this section the $15,000 net taxable income in the partnership's third taxable year will be reallocated $9,600 to DK (minus $9,000 at end of the second taxable year to positive $600 at end of the third taxable year) and $5,400 to JB (zero at end of the second taxable year to positive $5,400 at end of the third taxable year).

Example (16). (i) KG and WN form a limited partnership for the purpose of investing in improved real estate. KG, the general partner, contributes $10,000 to the partnership, and WN, the limited partner, contributes $990,000 to the partnership. The $1,000,000 is used to purchase an apartment building on leased land. The partnership agreement provides that (1) the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section; (2) cash will be distributed first to WN until such time as he has received the amount of his original capital contribution ($990,000), next to KG until such time as he has received the amount of his original capital contribution ($10,000), and thereafter equally between WN and KG; (3) partnership net taxable income will be allocated 99 percent to WN and 1 percent to KG until the cumulative net taxable income allocated for all taxable years is equal to the cumulative net taxable loss previously allocated to the partners, and thereafter equally between WN and KG; (4) partnership net taxable loss will be allocated 99 percent to WN and 1 percent to KG, unless net taxable income has previously been allocated equally between WN and KG, in which case such net taxable loss first will be allocated equally until the cumulative net taxable loss allocated for all taxable years is equal to the cumulative net taxable income previously allocated to the partners; and (5) upon liquidation, WN is not required to restore any deficit balance in his capital account, but KG is so required. Since distributions in liquidation are not required to be made in accordance with the partners' positive capital account balances, and since WN is not required, upon the liquidation of his interest, to restore the deficit balance in his capital account to the partnership, the allocations provided by the partnership agreement do not have economic effect and will be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section.

(ii) Assume the same facts as in (i) except that the partnership agreement further provides that distributions in liquidation of the partnership (or any partner's interest) are to be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Assume further that the partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section) and that, as of the end of each partnership taxable year, the items described in paragraphs (b)(2)(iii)(d)(4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in WN's capital account. The allocations provided by the partnership agreement have economic effect.

Example (17). FG and RP form a partnership with FG contributing cash of $100 and RP contributing property, with 2 years of cost recovery deductions remaining, that has an adjusted tax basis of $80 and a fair market value of $100. The partnership, FG, and RP have calendar taxable years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, liquidation proceeds will be made in accordance with capital account balances, and each partner is liable to restore the deficit balance in his capital account to the partnership upon liquidation of his interest (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). FG expects to be in a substantially higher tax bracket than RP in the partnership's first taxable year. In the partnership's second taxable year, and in subsequent taxable years, it is expected that both will be in approximately equivalent tax brackets. The partnership agreement allocates all items equally except that all $50 of book depreciation is allocated to FG in the partnership's first taxable year and all $50 of book depreciation is allocated to RP in the partnership's second taxable year. If the allocation to FG of all book depreciation in the

partnership's first taxable year is respected, FG would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. Likewise, if the allocation to RP of all the book depreciation in the partnership's second taxable year is respected, RP would be entitled under section 704(c) to the entire cost recovery deduction ($40) for such year. The allocation of book depreciation to FG and RP in the partnership's first 2 taxable years has economic effect within the meaning of paragraph (b)(2)(ii) of this section. However, the economic effect of these allocations is not substantial under the test described in paragraph (b)(2)(iii)(c) of this section since there is a strong likelihood at the time such allocations became part of the partnership agreement that at the end of the 2-year period to which such allocations relate, the net increases and decreases to FG's and RP's capital accounts will be the same with such allocations as they would have been in the absence of such allocation, and the total tax liability of FG and RP for the taxable years to which the section 704(c) determinations relate would be reduced as a result of the allocations of book depreciation. As a result the allocations of book depreciation in the partnership agreement will be disregarded. FG and RP will be allocated such book depreciation in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts the book depreciation deductions will be reallocated equally between the partners, and section 704(c) will be applied with reference to such reallocation of book depreciation.

Example (18). (i) WM and JL form a general partnership by each contributing $300,000 thereto. The partnership uses the $600,000 to purchase an item of tangible personal property, which it leases out. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement provides that (1) the partners' capital account will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, (2) distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section), (3) any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(3) of this section), (4) all income, gain, loss, and deduction of the partnership will be allocated equally between the partners, and (5) all non-liquidating distributions of the partnership will be made equally between the partners. Assume that in each of the partnership's taxable years, it recognizes operating income equal to its operating deductions (excluding cost recovery and depreciation deductions and gain or loss on the sale of its property). During its first 2 taxable years, the partnership has an additional $200,000 cost recovery deduction in each year. Pursuant to the partnership agreement these items are allocated equally between WM and JL.

	WM	JL
Capital account upon formation	$300,000	$300,000
Less: net loss for years 1 and 2	(200,000)	(200,000)
Capital account at end of year 2	$100,000	$100,000

The allocations made in the partnership's first 2 taxable years have substantial economic effect.

(ii) Assume the same facts as in (i) and that MK is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of his admission, the fair market value of the partnership property is $600,000. MK contributes $300,000 to the partnership in exchange for an equal one-third interest in the partnership, and, as permitted under paragraph (b)(2)(iv)(g), the capital accounts of WM and JL are adjusted upward to $300,000 each to reflect the fair market value of partnership property. In addition, the partnership agreement is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the partnership property that appreciated prior to MK's admission will be shared among the partners in a manner that takes account of the variation between such property's $200,000 adjusted tax basis and its $600,000 book value in accordance with paragraph (b)(2)(iv)(f) and the special rule contained in paragraph (b)(4)(i) of this section. Depreciation and gain or loss, as computed for book purposes, with respect to such property will be allocated equally among the partners and, in accordance with paragraph (b)(2)(iv)(g) of this section, will be reflected in the partner's capital accounts, as will all other partnership income, gain, loss, and deduction. Since the requirements of (b)(2)(iv)(g) of this section are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with paragraph (b)(2)(iv) of this section.

(iii) Assume the same facts as in (ii) and that immediately after MK's admission to the partnership, the partnership property is sold for $600,000, resulting in a taxable gain of $400,000 ($600,000 less $200,000 adjusted tax basis) and no book gain or loss, and the partnership is liquidated. An allocation of the $400,000 taxable gain cannot have economic effect because such gain cannot properly be reflected in the partners' book capital accounts. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $400,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between WM and JL.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	200,000	0	200,000	0	0	0
Capital account before liquidation	$300,000	$300,000	$300,000	$300,000	$300,000	$300,000

The $900,000 of partnership cash ($600,000 sales proceeds plus $300,000 contributed by MK) is distributed equally among WM, JL, and MK in accordance with their adjusted positive capital account balances, each of which is $300,000.

(iv) Assume the same facts as in (iii) except that prior to liquidation the property appreciates and is sold for $900,000, resulting in a taxable gain of $700,000 ($900,000 less $200,000 adjusted tax basis) and a book gain of $300,000 ($900,000 less $600,000 book value). Under the partnership agreement the $300,000 of book gain is allocated equally among the partners, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	300,000	100,000	300,000	100,000	100,000	100,000
Capital account before liquidation	$400,000	$400,000	$400,000	$400,000	$400,000	$400,000

Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $700,000 taxable gain is, in accordance with section 704(c) principles, shared $300,000 to JL, $300,000 to WM, and $100,000 to MK. This ensures that (1) WM and JL share equally the $400,000 taxable gain that is attributable to appreciation in the property that occurred prior to MK's admission to the partnership in the same manner as it was reflected in their capital accounts upon MK's admission, and (2) WM, JL, and MK share equally the additional $300,000 taxable gain in the same manner as they shared the $300,000 book gain.

(v) Assume the same facts as in (ii) except that shortly after MK's admission the property depreciates and is sold for $450,000, resulting in a taxable gain of $250,000 ($450,000 less $200,000 adjusted tax basis) and a book loss of $150,000 ($450,000 less $600,000 book value). Under the partnership agreement these items are allocated as follows:

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Plus: gain	125,000	0	125,000	0	0	0
Less: loss	0	(50,000)	0	(50,000)	0	(50,000)
Capital account before liquidation	$225,000	$250,000	$225,000	$250,000	$300,000	$250,000

The $150,000 book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $250,000 taxable gain is, in accordance with section 704(c) principles, shared equally between WM and JL. The fact that MK bears an economic loss of $50,000 without a corresponding taxable loss is attributable entirely to the "ceiling rule." See paragraph (c)(2) of § 1.704-1.

(vi) Assume the same facts as in (ii) except that the property depreciates and is sold for $170,000, resulting in a $30,000 taxable loss ($200,000 adjusted tax basis less $170,000) and a book loss of $430,000 ($600,000 book value less $170,000). The book loss of $430,000 is allocated equally among the partners ($143,333 each) and has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the entire $30,000 taxable loss is, in accordance with section 704(c) principles, included in MK's distributive share.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less: loss	0	(143,333)	0	(143,333)	(30,000)	(143,333)
Capital account before liquidation	$100,000	$156,667	$100,000	$156,667	$270,000	$156,667

(vii) Assume the same facts as in (ii) and that during the partnership's third taxable year, the partnership has an additional $100,000 cost recovery deduction and $300,000 book depreciation deduction attributable to the property purchased by the partnership in its first taxable year. The $300,000 book depreciation deduction is allocated equally among the partners, and that allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction for the partnership's third taxable year is, in accordance with section 704(c) principles, included in MK's distributive share. This is because under these facts those principles require MK to include the cost recovery deduction for such property in his distributive share up to the amount of the book depreciation deduction for such property properly allocated to him.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less: recovery/depreciation deduction for year 3	0	(100,000)	0	(100,000)	(100,000)	(100,000)
Capital account at end of year 3	$100,000	$200,000	$100,000	$200,000	$200,000	$200,000

(viii) Assume the same facts as in (vii) except that upon MK's admission the partnership property has an adjusted tax basis of $220,000 (instead of $200,000), and thus the cost recovery deduction for the partnership's third taxable year is $110,000. Assume further that upon MK's admission WM and JL have adjusted capital account balances of $110,000 and $100,000, respectively. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the excess $10,000 cost recovery deduction ($110,000 less $100,000 included in MK's distributive share) is, in accordance with section 704(c) principles, shared equally between WM and JL and is so included in their respective distributive shares for the partnership's third taxable year.

(ix) Assume the same facts as in (vii) except that upon MK's admission the partnership agreement is amended to allocate the first $400,000 of book depreciation and loss on partnership property equally between WM and JL and the last $200,000 of such book depreciation and loss to MK. Assume such allocations have substantial economic effect. Pursuant to this amendment the $300,000 book depreciation deduction in the partnership's third taxable year is allocated equally between WM and JL. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $100,000 cost recovery deduction is, in accordance with section 704(c) principles, shared equally between WM and JL. In the partnership's fourth taxable year, it has a $60,000 cost recovery deduction and a $180,000 book depreciation deduction. Under the amendment described above, the $180,000 book depreciation deduction is allocated $50,000 to WM, $50,000 to JL, and $80,000 to MK. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction is, in accordance with section 704(c) principles, included entirely in MK's distributive share.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less:						
(a) recovery/depreciation deduction for year 3	(50,000)	(150,000)	(50,000)	(150,000)	0	0
(b) recovery/depreciation deduction for year 4	0	(50,000)	0	(50,000)	(60,000)	(80,000)
Capital account at end of year 4	$50,000	$100,000	$50,000	$100,000	$240,000	$220,000

(x) Assume the same facts as in (vii) and that at the beginning of the partnership's third taxable year, the partnership purchases a second item of tangible personal property for $300,000 and elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such property. The partnership agreement is amended to allocate the first $150,000 of cost recovery deductions and loss from such property to WM and the next $150,000 of cost recovery deductions and loss from such property equally between JL and MK. Thus, in the partnership's third taxable year it has, in addition to the items specified in (vii), a cost recovery and book depreciation deduction of $100,000 attributable to the newly acquired property, which is allocated entirely to WM.

As in (vii), the allocation of the $300,000 book depreciation attributable to the property purchased in the partnership's first taxable year equally among the partners has substantial economic effect, and consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement properly provides for the entire $100,000 cost recovery deduction attributable to such property to be included in MK's distributive share. Furthermore, the allocation to WM of the $100,000 cost recovery deduction attributable to the property purchased in the partnership's third taxable year has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 3	$100,000	$300,000	$100,000	$300,000	$300,000	$300,000
Less:						
(a) recovery/depreciation deduction for property bought in year 1	0	(100,000)	0	(100,000)	(100,000)	(100,000)
(b) recovery/depreciation deduction for property bought in year 3	(100,000)	(100,000)	0	0	0	0
Capital account at end of year 3	0	$100,000	$100,000	$200,000	$200,000	$200,000

(xi) Assume the same facts as in (x) and that at the beginning of the partnership's fourth taxable year, the properties purchased in the partnership's first and third taxable years are disposed of for $90,000 and $180,000, respectively, and the partnership is liquidated. With respect to the property purchased in the first taxable year, there is a book loss of $210,000 ($300,000 book value less $90,000) and a taxable loss of $10,000 ($100,000 adjusted tax basis less $90,000). The book loss is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the taxable loss of $10,000 will, in accordance with section 704(c) principles, be included entirely in MK's distributive share. With respect to the property purchased in the partnership's third taxable year, there is a book and taxable loss of $20,000. Pursuant to the partnership agreement this loss is allocated entirely to WM, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 4	0	$100,000	$100,000	$200,000	$200,000	$200,000
Less:						
(a) loss on property bought in year 1	0	(70,000)	0	(70,000)	(10,000)	(70,000)
(b) loss on property bought in year 3	(20,000)	(20,000)	0	0	0	0
Capital account before liquidation	($20,000)	$10,000	$100,000	$130,000	$190,000	$130,000

Partnership liquidation proceeds ($270,000) are properly distributed in accordance with the partners' adjusted positive book capital account balances ($10,000 to WM, $130,000 to JL and $130,000 to MK).

(xii) Assume the same facts as in (x) and that in the partnership's fourth taxable year it has a cost recovery deduction of $60,000 and book depreciation deduction of $180,000 attributable to the property purchased in the partnership's first taxable year, and a cost recovery and book depreciation deduction of $100,000 attributable to the property purchased in the partnership's third taxable year. The $180,000 book depreciation deduction attributable to the property purchased in the partnership's first taxable year is allocated equally among the partners, and such allocation has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $60,000 cost recovery deduction attributable to the property purchased in the first taxable year is, in accordance with section 704(c) principles, included entirely in MK's distributive share. Furthermore, the $100,000 cost recovery deduction attributable to the property purchased in the third taxable year is allocated $50,000 to WM, $25,000 to JL, and $25,000 to MK, and such allocation has substantial economic effect.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 4	0	$100,000	$100,000	$200,000	$200,000	$200,000
Less:						
(a) recovery/depreciation deduction for property bought in year 1	0	(60,000)	0	(60,000)	(60,000)	(60,000)
(b) recovery/depreciation deduction for property bought in year 3	(50,000)	(50,000)	(25,000)	(25,000)	(25,000)	(25,000)
Capital account at end of year 4	($50,000)	($10,000)	$75,000	$115,000	$115,000	$115,000

At the end of the partnership's fourth taxable year the adjusted tax bases of the partnership properties acquired in its first and third taxable years are $40,000 and $100,000, respectively. If the properties are disposed of at the beginning of the partnership's fifth taxable year for their adjusted tax bases, there would be no taxable gain or loss, a book loss of $80,000 on the property purchased in the partnership's first taxable year ($120,000 book value less $40,000), and cash available for distribution of $140,000.

	WM		JL		MK	
	Tax	Book	Tax	Book	Tax	Book
Capital account at beginning of year 5	($50,000)	($10,000)	$75,000	$115,000	$115,000	$115,000
Less: loss	0	(26,667)	0	(26,667)	0	(26,667)
Capital account before liquidation	($50,000)	($36,667)	$75,000	$88,333	$115,000	$88,333

If the partnership is then liquidated, the $140,000 of cash on hand plus the $36,667 balance that WM would be required to contribute to the partnership (the deficit balance in his book capital account) would be distributed equally between JL and MK in accordance with their adjusted positive book capital account balances.

(xiii) Assume the same facts as in (i). Any tax preferences under section 57(a)(12) attributable to the partnership's cost recovery deductions in the first 2 taxable years will be taken into account equally by WM and JL. If the partnership agreement instead provides that the partnership's cost recovery deductions in its first 2 taxable years are allocated 25 percent to WM and 75 percent to JL (and such allocations have substantial economic effect), the tax preferences attributable to such cost recovery deductions would be taken into account 25 percent by WM and 75 percent by JL. The conclusion in the previous sentence is unchanged even if the partnership's operating expenses (exclusive of cost recovery and depreciation deductions) exceed its operating income in each of the partnership's first 2 taxable years, the resulting net loss is allocated entirely to WM, and the cost recovery deductions are allocated 25 percent to WM and 75 percent to JL (provided such allocations have substantial economic effect). If the partnership agreement instead provides that all income, gain, loss, and deduction (including cost recovery and depreciations) are allocated equally between JL and WM, the tax preferences attributable to the cost recovery deductions would be taken into account equally by JL and WM. In this case, if the partnership has a $100,000 cost recovery deduction in its first taxable year and an additional net loss of $100,000 in its first taxable year (i.e., its operating expenses exceed its operating income by $100,000) and purports to categorize JL's $100,000 distributive share of partnership loss as being attributable to the cost recovery deduction and WM's $100,000 distributive share of partnership loss as being attributable to the net loss, the economic effect of such allocations is not substantial, and each partner will be allocated one-half of all partnership income, gain, loss, and deduction and will take into account one-half of the tax preferences attributable to the cost recovery deductions.

Example (19). (i) DG and JC form a general partnership for the purpose of drilling oil wells. DG contributes an oil lease, which has a fair market value and adjusted tax basis of $100,000. JC contributes $100,000 in cash, which is used to finance the drilling operations. The partnership agreement provides that DG is credited with a capital account of $100,000, and JC is credited with a capital account of $100,000. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances, and any partner with a deficit balance in his capital account following the liquidation of his interest must restore such deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). The partnership chooses to adjust capital accounts on a simulated cost depletion basis and elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the basis of its section 38 property. The agreement further provides that (1) all additional cash requirements of the partnership will be borne equally by DG and JC, (2) the deductions attributable to the property (including money) contributed by each partner will be

allocated to such partner, (3) all other income, gain, loss, and deductions (and item thereof) will be allocated equally between DG and JC, and (4) all cash from operations will be distributed equally between DG and JC. In the partnership's first taxable year $80,000 of partnership intangible drilling cost deductions and $20,000 of cost recovery deductions on partnership equipment are allocated to JC, and the $100,000 basis of the lease is, for purposes of the depletion allowance under sections 611 and 613A(c)(7)(D), allocated to DG. The allocations of income, gain, loss, and deduction provided in the partnership agreement have substantial economic effect. Furthermore, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(iv)(k) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the $100,000 adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital for purposes of section 613A(c)(7)(D).

(ii) Assume the same facts as in (i) except that the partnership agreement provides that (1) all additional cash requirements of the partnership for additional expenses will be funded by additional contributions from JC, (2) all cash from operations will first be distributed to JC until the excess of such cash distributions over the amount of such additional expense equals his initial $100,000 contributions, (3) all deductions attributable to such additional operating expenses will be allocated to JC, and (4) all income will be allocated to JC until the aggregate amount of income allocated to him equals the amount of partnership operating expenses funded by his initial $100,000 contribution plus the amount of additional operating expenses paid from contributions made solely by him. The allocations of income, gain, loss, and deduction provided in partnership agreement have economic effect. In addition, the economic effect of the allocations provided in the agreement is substantial. Because the partnership's drilling activities are sufficiently speculative, there is not a strong likelihood at the time the disproportionate allocations of loss and deduction to JC are provided for by the partnership agreement that the economic effect of such allocations will be largely offset by allocations of income. In addition, since the allocation of the entire basis of the lease to DG will not result in capital account adjustments (under paragraph (b)(2)(iv)(k) of this section) the economic effect of which is insubstantial, and since all other partnership allocations are recognized under this paragraph, the allocation of the adjusted basis of the lease to DG is, under paragraph (b)(4)(v) of this section, recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D).

(iii) Assume the same facts as in (i) except that all distributions, including those made upon liquidation of the partnership, will be made equally between DG and JC, and no partner is obligated to restore the deficit balance in his capital account to the partnership following the liquidation of his interest for distribution to partners with positive capital account balances. Since liquidation proceeds will be distributed equally between DG and JC irrespective of their capital account balances, and since no partner is required to restore the deficit balance in his capital account to the partnership upon liquidation (in accordance with paragraph (b)(2)(ii)(b)(3) of this section), the allocations of income, gain, loss, and deduction provided in the partnership agreement do not have economic effect and must be reallocated in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. Under these facts all partnership income, gain, loss, and deduction (and item thereof) will be reallocated equally between JC and DG. Furthermore, the allocation of the $100,000 adjusted tax basis of the lease of DG is not, under paragraph (b)(4)(v) of this section, deemed to be in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), and such basis must be reallocated in accordance with the partners' interests in partnership capital or income as determined under section 613A(c)(7)(D). The results in this example would be the same if JC's initial cash contribution were $1,000,000 (instead of $100,000), but in such case the partners should consider whether, and to what extent, the provisions of paragraph (b)(1) of § 1.721-1, and principles related thereto, may be applicable.

(iv) Assume the same facts as in (i) and that for the partnership's first taxable year the simulated depletion deduction with respect to the lease is $10,000. Since DG properly was allocated the entire depletable basis of the lease (such allocation having been recognized as being in accordance with DG's interest in partnership capital with respect to such lease), under paragraph (b)(2)(iv)(k)(1) of this section the partnership's $10,-000 simulated depletion deduction is allocated to DG and will reduce his capital account accordingly. If (prior to any additional simulated depletion deductions) the lease is sold for $100,000, paragraph (b)(4)(v) of this section requires that the first $90,000 (i.e., the partnership's simulated adjusted basis in the lease) out of the $100,000 amount realized on such sale be allocated to DG (but does not directly affect his capital account). The partnership agreement allocates the remaining $10,000 amount realized equally between JC and DG (but such allocation does not directly affect their capital accounts). This allocation of the $10,000 portion of amount realized that exceeds the partnership's simulated adjusted basis in the lease will be treated as being in accordance with the partners' allocable shares of such amount realized under section 613A(c)(7)(D) because such allocation will not result in capital account adjustments (under paragraph (b)(2)(iv)(k) of this section) the economic effect of which is insubstantial, and all other partnership allocations are recognized under this paragraph. Under paragraph (b)(2)(iv)(k) of this section, the partners' capital accounts are adjusted upward by the partnership's simulated gain of $10,000 ($100,000 sales price less $90,000 simulated adjusted basis) in proportion to such partners' allocable shares of the $10,000 portion of the total amount realized that exceeds the partnership's $90,000 simulated adjusted basis ($5,000 to JC and $5,000 to DG). If the lease is sold for $50,000, under paragraph (b)(4)(v) of this section the entire $50,000 amount realized on the sale of the lease will be allocated to DG (but will not directly affect his capital account). Under paragraph (b)(2)(iv)(k) of this section the partners' capital accounts will be adjusted downward by the partnership's $40,000 simulated loss ($50,000 sales price less $90,-000 simulated adjusted basis) in proportion to the partners' allocable shares of the total amount realized from the property that represents recovery of the partnership's simulated adjusted basis therein. Accordingly, DG's capital account will be reduced by such $40,000.

Example (20). (i) RM and HB form a limited partnership to acquire and operate a commercial office building. RM, the limited partner, contributes $180,000, and HB, the general partner, contributes $20,000 to the partnership, which obtains an $800,000 nonrecourse loan and purchases the building (on leased land) for $1,000,000. The nonrecourse loan is secured only by the building, and no principal payments are due for 5 years. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section), HB will be required to restore any deficit balance in his capital account following the liquidation of his interest (as set

forth in paragraph (b)(2)(ii)(b)(3) of this section), and RM will not be required to restore any deficit balance in his capital account following the liquidation of his interest. The partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section), and, as of the end of each partnership taxable year discussed herein, the items described in paragraphs (b)(2)(ii)(d) (4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in RM's capital account. In addition, the agreement contains a minimum gain chargeback (in accordance with paragraph (b)(4)(iv)(e) of this section). The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, (a) all partnership items will be allocated 90 percent to RM and 10 percent to HB until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and (b) all further partnership items will be allocated equally between RM and HB. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made 90 percent to RM and 10 percent to HB until a total of $200,000 has been distributed, and thereafter all such distributions will be made equally to RM and HB. In each of the partnership's first 2 taxable years, it generates rental income of $95,000, operating expenses (including land lease payments) of $10,000, interest expense of $80,000, and a cost recovery deduction of $90,000, resulting in a net taxable loss of $85,000 in each of those years. The allocations of these losses, 90 percent to RM and 10 percent to HB, have substantial economic effect.

	RM	HB
Capital account upon formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Capital account at end of year 2	$27,000	$3,000

In the partnership's third taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a cost recovery deduction of $90,000, resulting in a net taxable loss of $85,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize $70,000 of gain ($800,000 amount realized less $730,000 adjusted tax basis). Since the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is $70,000, the amount of partnership nonrecourse deductions for that year is $70,000, consisting of cost recovery deductions allowable with respect to the building of $70,000. Pursuant to the partnership agreement all partnership items comprising the net taxable loss of $85,000, including the $70,000 nonrecourse deduction, are allocated 90 percent to RM and 10 percent to HB. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	RM	HB
Capital account at end of year 2	$27,000	$3,000
Less: net loss in year 3 (without nonrecourse deduction)	(13,500)	(1,500)
Less: nonrecourse deduction in year 3	(63,000)	(7,000)
Capital account at end of year 3	($49,500)	($5,500)

This allocation of the $70,000 nonrecourse deduction, 90 percent, to RM and 10 percent to HB, satisfies requirement (2) of paragraph (b)(4)(iv)(d) of this section because the allocation is consistent with allocations, which have substantial economic effect, of other significant partnership items attributable to the building. Since the remaining requirements of paragraph (b)(4)(iv)(d) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's third taxable year, RM's and HB's shares of partnership minimum gain are $63,000 and $7,000, respectively. Therefore, pursuant to the next to last sentence in paragraph (b)(4)(iv)(f) of this section, RM is treated as obligated to restore a deficit balance in his capital account of $63,000, so that in the succeeding year RM could be allocated up to an additional $13,500 of partnership deductions, losses, and section 705(a)(2)(B) expenditures that are not nonrecourse deductions, and that allocation would be considered to have economic effect under the alternate economic effect test contained in paragraph (b)(2)(ii)(d) of this section even though such an allocation would increase a deficit capital account balance. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the beginning of the partnership's fourth taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero. RM's and HB's shares of that net decrease would be $63,000 and $7,000, respectively. Upon such a disposition the minimum gain chargeback would require that RM be allocated an amount of that gain equal to $49,500 (the deficit balance in his capital account before any allocation is made to him under section 704(b) with respect to partnership items for the partnership's fourth taxable year).

(ii) Assume the same facts as originally stated in (i) except that the partnership agreement provides that all nonrecourse deductions of the partnership will be allocated equally between RM and HB. Furthermore, at the time the partnership agreement is entered into, there is a reasonable likelihood that over the partnership's life it will recognize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions). The allocation of such excess equally between the partners pursuant to the partnership agreement will have substantial economic effect. The allocation of all items, other than the nonrecourse deductions, 90 percent to RM and 10 percent to HB, has substantial economic effect.

	RM	HB
Capital account upon formation	$180,000	$20,000
Less: net loss in years 1 and 2	(153,000)	(17,000)
Capital account at end of year 2	27,000	3,000
Less: net loss in year 3 (without nonrecourse deduction)	(13,500)	(1,500)
Less: nonrecourse deduction in year 3	(35,000)	(35,000)
Capital account at end of year 3	($21,500)	($33,500)

The allocation of the $70,000 nonrecourse deduction equally between RM and HB satisfies requirement (2) of paragraph (b)(4)(iv)(d) of this section because the allocation is consistent with allocations, which will have substantial economic effect, of other significant partnership items attributable to the building. Since the remaining requirements of paragraph (b)(4)(iv)(d) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. The allocation of the nonrecourse deductions, 75 percent to RM and 25 percent to HB (or in any other ratio between 90 percent to RM/10 percent to HB and 50 percent to RM/50 percent to HB), also would satisfy requirement (2) of paragraph (b)(4)(iv)(d) of this section.

(iii) Assume the same facts as originally stated in (i) except that the partnership agreement provides that RM will be allocated 99 percent, and HB 1 percent, of all nonrecourse

deductions of the partnership. This allocation of the $70,000 nonrecourse deduction does not satisfy requirement (2) of paragraph (b)(4)(iv)(d) because it is not reasonably consistent with allocations, which have substantial economic effect, of any other significant partnership item attributable to the building. Therefore, the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners' overall economic interests in the partnership, determined with reference to the factors set forth in paragraph (b)(3)(ii) of this section.

(iv) Assume the same facts as originally stated in (i) except that, at the beginning of the partnership's fourth taxable year, RM contributes $144,000 and HB contributes $16,000 of additional capital to the partnership, which the partnership uses to reduce the amount of its nonrecourse liability from $800,000 to $640,000. In addition, in the partnership's fourth taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a cost recovery deduction of $90,000, resulting in a net taxable loss of $85,000. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($640,000 amount realized less $640,-000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of the year is zero, which represents a net decrease in partnership minimum gain of $70,000 during the year. RM's and HB's shares of this net decrease are $63,000 and $7,000, respectively, so that at the end of the partnership's fourth taxable year, RM's and HB's shares of partnership minimum gain are zero. Therefore, pursuant to the next to last sentence in paragraph (b)(4)(iv)(f) of this section, RM is no longer treated as being obligated to restore any deficit balance in his capital account. Assuming the sum of the reductions to RM's capital account described in paragraph (b)(2)(ii)(d) (4), (5), and (6) of this section do not exceed $94,500, the minimum gain chargeback does not require that either RM or HB be allocated items of income and gain in the partnership's fourth taxable year even though there is a net decrease in partnership minimum gain during that year. This is true because at the end of the year, before any allocation is made under section 704(b) to RM with respect to partnership items for the fourth taxable year, RM's capital account balance is $94,500 (his capital account balance at the end of the partnership's third taxable year increased by his $144,000 capital contribution), and HB has a full deficit makeup obligation.

	RM	HB
Capital account at end of year 3	($49,500)	($5,500)
Plus: contribution	144,000	16,000
Less: net loss in year 4	(76,500)	(8,500)
Capital account at end of year 4	$18,000	$2,000

(v) Assume the same facts as originally stated in (i) except that the partnership incurred only a $700,000 nonrecourse loan and, in addition, incurred a $100,000 recourse loan, subordinate in priority to the nonrecourse loan, to which the partnership's building is also subject. Under paragraph (b)(4)(iv)(c) of this section, $700,000 of the adjusted basis of the building at the end of the partnership's third taxahle year is allocated to the nonrecourse liability (with the remaining $30,000 allocated to the recourse liability) so that if the partnership disposed of the building in full satisfaction of the nonrecourse liability at the end of that year, it would realize no gain ($700,000 amount realized less $700,000 adjusted tax basis). Therefore, there is no minimum gain at the end of the partnership's third taxable year (and no increase in partnership minimum gain in such year). If, however, the $700,000 nonrecourse loan were subordinate in priority to the $100,000 recourse loan, under paragraph (b)(4)(iv)(c) of this section, only $630,000 of the adjusted basis of the building would be allocated to the $700,000 nonrecourse loan (the excess of the $730,000 adjusted tax basis of the building at the end of the partnership's third taxable year over the balance of the superior $100,000 recourse liability). In that case the balance of the $700,000 nonrecourse liability would exceed the adjusted tax basis of the building so allocated by $70,000 so that there would be $70,000 of minimum gain (and a $70,000 increase in partnership minimum gain) in the partnership's third taxable year.

(vi) Assume the same facts as originally stated in (i) except that RM and HB personally guarantee the "first" $100,000 of the $800,000 nonrecourse loan (i.e., only if the building is worth less than $100,000 will they be called upon to make up any deficiency). Under paragraph (b)(4)(iv)(c) of this section, only $630,000 of the adjusted tax basis of the building is allocated to the $700,000 nonrecourse portion of the loan because the collateral will be applied first to satisfy the $100,-000 guaranteed portion, in effect making it superior in priority to the remainder of the loan. On the other hand, if RM and HB were to guarantee the "last" $100,000 (i.e., if the building is worth less than $800,000, they will be called upon to make up the deficiency up to $100,000), $700,000 of the adjusted tax basis of the building would be allocated to the $700,000 nonrecourse portion of the loan because the guaranteed portion in effect would be inferior in priority to it.

(vii) Assume the same facts as originally stated in (i) except that the $800,000 loan is made by HB, the general partner. Under paragraph (b)(4)(iv)(g) of this section, the $800,000 obligation does not constitute a nonrecourse liability of the partnership for purposes of this paragraph (b)(4)(iv). To the extent that such obligation constitutes a nonrecourse liability under § 1.1001-2, $70,000 of the $90,000 cost recovery deduction in the partnership's third taxable year must be allocated in accordance with the partners' interests in the partnership, under paragraph (b)(3) of this section. HB bears the burden of any economic loss corresponding to that $70,000 deduction. Therefore, HB must be allocated the entire amount of such deduction.

(viii) Assume the same facts as in (vii) except that the $800,000 loan from HB to the partnership is a purchase money loan that "wraps around" a $700,000 underlying nonrecourse note (also secured by the building) issued by HB to an unrelated person in connection with HB's acquisition of the building. Under these circumstances if the partnership were to convey the building to HB in satisfaction of the partnership's $800,000 liability, HB would bear the economic risk of loss with respect to only $100,000 of the liability. Therefore, for purposes of this paragraph (b)(4)(iv), the $800,000 liability will be treated as a $700,000 nonrecourse liability of the partnership and a $100,000 liability (inferior in priority to the $700,000 liability) of the partnership to HB. Under paragraph (b)(4)(iv)(g) of this section, the $100,000 liability does not constitute a nonrecourse liability of the partnership for purposes of this paragraph (b)(4)(iv). To the extent that such obligation constitutes a nonrecourse liability under § 1.1001-2, $70,000 of the $90,000 cost recovery deduction realized in the partnership's third taxable year must be allocated to HB.

Example (21). (i) RD and PK form a general partnership to acquire and operate residential real properties. Each partner contributes $150,000 to the partnership. The partnership obtains a $1,500,000 nonrecourse loan and purchases 3 apartment buildings (on leased land) for $720,000 ("Property A"), $540,-000 ("Property B"), and $540,000 ("Property C"), respectively. The nonrecourse loan is secured only by the 3 buildings, and no principal payments are due for 5 years. In each of the partnership's first 3 taxable years, it generates rental income of $225,000, operating expenses (including land lease payments) of

$50,000, interest expense of $175,000, and cost recovery deductions on the 3 properties of $150,000 ($60,000 on Property A, $45,000 on Property B, and $45,000 on Property C), resulting in a net taxable loss of $150,000 in each of those years. If the partnership were to dispose of the 3 apartment buildings in full satisfaction of its nonrecourse liability at the end of its third taxable year, it would realize $150,000 of gain ($1,500,000 amount realized less $1,350,000 adjusted tax basis). Since the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is $150,000, the amount of partnership nonrecourse deductions for that year is $150,000, consisting of cost recovery deductions allowable with respect to the 3 apartment buildings of $150,000. The result would be the same if the partnership obtained 3 separate nonrecourse loans that were "cross-collateralized" (i.e., if each separate loan were secured by all 3 of the apartment buildings).

(ii) Assume the same facts as originally stated in (i) and that at the beginning of the partnership's fourth taxable year, the partnership (with the permission of the nonrecourse lender) disposes of Property A for $835,000 and uses a portion of the proceeds to repay $600,000 of the nonrecourse liability, reducing the balance to $900,000. As a result of the disposition, the partnerships recognizes gain of $295,000 ($835,000 amount realized less $540,000 adjusted tax basis). Also during the partnership's fourth taxable year it generates rental income of $135,000 and operating expenses of $30,000, interest expense of $105,000, and cost recovery deductions of $90,000 ($45,000 on each remaining building). If the partnership were to dispose of the remaining 2 buildings in full satisfaction of its nonrecourse liability at the end of the partnership's fourth taxable year, it would realize gain of $180,000 ($900,000 amount realized less $720,000 aggregate adjusted tax basis), which represents the amount of partnership minimum gain at the end of such year. Since the amount of partnership minimum gain increased from $150,000 to $180,000 during the partnership's fourth taxable year, the amount of partnership nonrecourse deductions for such year is $30,000, consisting of cost recovery deductions allowable with respect to the 2 remaining apartment buildings.

Example (22). (i) OC and DR form a limited partnership to acquire and lease machinery that is 5-year recovery property. OC, the limited partner, and DR, the general partner, contribute $100,000 each to the partnership, which obtains an $800,000 nonrecourse loan and purchases the equipment for $1,000,000. The partnership elects under section 48(q)(4) to reduce the amount of investment tax credit in lieu of adjusting the tax basis of such machinery. The nonrecourse loan is secured only by the machinery. The principal amount of the loan is to be repaid $50,000 per year during each of the partnership's first 5 taxable years, with the remaining $550,000 of unpaid principal due on the first day of the partnership's sixth taxable year. The partnership agreement provides that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, distributions in liquidation of the partnership (or any partner's interest) will be made in accordance with the partners' positive capital account balances (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). DR will be required to restore any deficit balance in his capital account following the liquidation of his interest (as set forth in paragraph (b)(2)(ii)(b)(3) of this section), and OC will not be required to restore any deficit balance in his capital account following the liquidation of his interest. The partnership agreement contains a qualified income offset (as defined in paragraph (b)(2)(ii)(d) of this section), and, as of the end of each partnership taxable year discussed herein, the items described in paragraphs (b)(2)(ii)(d) (4), (5), and (6) of this section are not reasonably expected to cause or increase a deficit balance in RM's capital account. In addition, the agreement contains a minimum gain chargeback (in accordance with paragraph (b)(4)(iv)(e) of this section). The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated equally between OC and DR. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner's interest in the partnership, will be made equally between OC and DR. In the partnership's first taxable year, it generates rental income of $130,000, interest expense of $80,000, and a cost recovery deduction of $150,000, resulting in a net taxable loss of $100,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $750,000. Allocations of these losses equally between OC and DR have substantial economic effect.

	OC	DR
Capital account upon formation	$100,000	$100,000
Less: net loss in year 1	(50,000)	(50,000)
Capital account at end of year 1	$50,000	$50,000

In the partnership's second taxable year it generates rental income of $130,000, interest expense of $75,000, and a cost recovery deduction of $220,000, resulting in a net taxable loss of $165,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $700,000, and distributes $2,500 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of that year, it would realize $70,000 of gain ($700,000 amount realized less $630,000 adjusted tax basis). Therefore, the amount of partnership minimum gain at the end of that year (and the net increase in partnership minimum gain during that year) is $70,000, and the amount of partnership nonrecourse deductions for that year is $70,000, consisting of cost recovery deductions allowable with respect to the machinery of $70,000. Pursuant to the partnership agreement all partnership items comprising the net taxable loss of $165,000, including the $70,000 nonrecourse deduction, are allocated equally between OC and DR. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect.

	OC	DR
Capital account at end of year 1	$50,000	$50,000
Less: net loss in year 2 (without nonrecourse deduction)	(47,500)	(47,500)
Less: nonrecourse deduction in year 2	(35,000)	(35,000)
Less: distribution	(2,500)	(2,500)
Capital account at end of year 2	($35,000)	($35,000)

This allocation of the $70,000 nonrecourse deduction equally between OC and DR satisfies requirement (2) of paragraph (b)(4)(iv)(d) of this section because the allocation is consistent with allocations, which have substantial economic effect, of other significant partnership items attributable to the machinery. Since the remaining requirements of paragraph (b)(4)(iv)(d) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be made in accordance with the partners' interests in the partnership. At the end of the partnership's second taxable year, OC's and DR's shares of partnership minimum gain are $35,000 each. Therefore, pursuant to the next to last sentence in paragraph (b)(4)(iv)(f) of this section, OC is treated as obligated to restore a deficit balance in his capital account of $35,000. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the beginning of the partnership's third taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,-

000 to zero. OC's and DR's shares of that net decrease would be $35,000 each. Upon such a disposition the minimum gain chargeback would require that OC be allocated an amount of that gain equal to $35,000 (the deficit balance in his capital account before any allocation is made to him under section 704(b) with respect to partnership items for the partnership's third taxable year). The minimum gain chargeback would not require that DR be allocated any amount of such gain, since he has a full deficit makeup obligation.

(ii) Assume the same facts as originally stated in (i) and that DT is admitted to the partnership at the beginning of the partnership's third taxable year. At the time of DT's admission, the fair market value of the machinery is $900,000. DT contributes $100,000 to the partnership (which amount the partnership invests in undeveloped land) in exchange for an interest in the partnership. Pursuant to paragraph (b)(2)(iv)(f) of this section, the capital accounts of OC and DR are adjusted upward to $100,000 each. This reflects the manner in which the partnership gain of $270,000 ($900,000 fair market value minus $630,000 adjusted basis) would be shared if the machinery were sold for its fair market value immediately prior to DT's admission to the partnership.

	OC	DR
Capital account before DT's admission	($35,000)	($35,000)
Deemed sale adjustment	135,000	135,000
Capital account adjusted for DT's admission	$100,000	$100,000

The partnership agreement is modified to provide that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, partnership income, gain, loss, and deduction, as computed for book purposes, will be allocated equally among the partners, and such allocations will be reflected in the partners' capital accounts. The partnership agreement also is modified to provide that depreciation and gain or loss, as computed for tax purposes, with respect to the machinery will be shared among the partners in a manner that takes account of the variation between such property's $630,000 adjusted tax basis and its $900,000 book value, in accordance with paragraph (b)(2)(iv)(f) of this section and the special rule contained in paragraph (b)(4)(i) of this section. Finally, the partnership agreement is modified to provide that DT will not be required to restore any deficit balance in his capital account following the liquidation of his interest. Since the requirements of paragraph (b)(2)(iv)(g) of this section are satisfied, the capital accounts of the partners (as adjusted) continue to be maintained in accordance with paragraph (b)(2)(iv) of this section. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability immediately following the revaluation of the machinery, it would realize no book gain ($700,000 amount realized less $900,000 book value). Thus, as a result of the revaluation of the machinery upward by $270,000, the partnership minimum gain is reduced from $70,000 immediately prior to such revaluation to zero. OC's and DR's shares of that decrease are $35,000 each.

(iii) Assume the same facts as in (ii) and that also during the partnership's third taxable year the partnership generates rental income of $130,000, interest expense of $70,000, a cost recovery deduction of $210,000, and a book depreciation deduction (attributable to the machinery) of $300,000. As a result the partnership has a net taxable loss of $150,000 and a net book loss of $240,000. In addition, the partnership repays $50,000 of the nonrecourse liability (after the date of DT's admission), reducing that liability to $650,000, and distributes $5,000 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, $50,000 of book gain would result ($650,000 amount realized less $600,000 book value). Therefore, the amount of partnership minimum gain at the end of the year is $50,000, which represents a net decrease in partnership minimum gain of $20,000 during the year. (This is so even though there would be an increase in partnership minimum gain in the partnership's third taxable year if minimum gain were computed with reference to the adjusted tax basis of the machinery.) Nevertheless, pursuant to the third sentence of paragraph (b)(4)(iv)(b) of this section the amount of nonrecourse deductions of the partnership for its third taxable year is $50,000 (the net increase in partnership minimum gain during the year determined by adding back the $70,000 decrease in partnership minimum gain attributable to the revaluation of the machinery to the $20,000 net decrease in partnership minimum gain during the year). The $50,000 of partnership nonrecourse deductions for the year consist of book depreciation deductions allowable with respect to the machinery of $50,000. Pursuant to the partnership agreement all partnership items comprising the net book loss of $240,000, including the $50,000 nonrecourse deduction, are allocated equally among the partners. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $210,000 cost recovery deduction for the partnership's third taxable year is, in accordance with section 704(c) principles, shared $55,000 to OC, $55,000 to DR, and $100,000 to DT.

	OC		DR		DT	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 2	($35,000)	$100,000	($35,000)	$100,000	$100,000	$100,000
Less: nonrecourse deduction	(9,166)	(16,666)	(9,166)	(16,666)	(16,666)	(16,666)
Plus: items other than nonrecourse deduction in year 3	(25,834)	(63,334)	(25,834)	(63,334)	(63,334)	(63,334)
Less: Distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 3	(75,000)	(15,000)	(75,000)	(15,000)	(15,000)	(15,000)

The allocation of the $50,000 nonrecourse deduction equally among OC, DR, and DT satisfies requirement (2) of paragraph (b)(4)(iv)(d) of this section because the allocation is consistent with allocations, which have substantial economic effect, of other significant partnership items attributable to the machinery. Since the remaining requirements of paragraph (b)(4)(iv)(d) of this section are satisfied, such allocation is deemed to be made in accordance with the partners' interest in the partnership. At the end of the partnership's third taxable year, OC's, DR's, and DT's shares of partnership minimum gain are $16,666 each.

(iv) Assume the same facts as in (iii) and that during the partnership's fourth taxable year the partnership generates rental income of $130,000, interest expense of $65,000, a cost recovery deduction of $210,000, and a book depreciation de-

duction (attributable to the machinery) of $300,000. As a result the partnership has a net taxable loss of $145,000 and a net book loss of $235,000. In addition, the partnership repays $50,000 of the nonrecourse liability, reducing that liability to $600,000, and distributes $5,000 of cash to each partner. If the partnership were to dispose of the machinery in full satisfaction of the nonrecourse liability at the end of the year, $300,000 of book gain would result ($600,000 amount realized less $300,000 book value). Therefore, the amount of partnership minimum gain as of the end of the year is $300,000, which represents a net increase in partnership minimum gain during the year of $250,000. Thus, the amount of partnership nonrecourse deductions for that year equals $250,000, consisting of book depreciation deductions of $250,000. Pursuant to the partnership agreement all partnership items comprising the net book loss of $235,000, including the $250,000 nonrecourse deduction, are allocated equally among the partners. That allocation of all items, other than the nonrecourse deductions, has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $210,000 cost recovery deduction for the partnership's fourth taxable year is, in accordance with section 704(c) principles, shared $55,000 to OC, $55,000 to DR, and $100,000 to DT.

	OC		DR		DT	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 3	($75,000)	$15,000	($75,000)	$15,000	$15,000	$15,000
Less: nonrecourse deduction	(45,833)	(83,333)	(45,833)	(83,333)	(83,333)	(83,333)
Plus: items other than nonrecourse deduction in year 4	(12,449)	5,000	12,449	5,000	5,000	5,000
Less: Distribution	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Capital account at end of year 4	(113,334)	(68,333)	(113,334)	(68,333)	(68,333)	(68,333)

The allocation of the $250,000 nonrecourse deduction equally among OC, DR, and DT satisfies requirement (2) of paragraph (b)(4)(iv)(d) of this section. Since the remaining requirements of paragraph (b)(4)(iv)(d) of this section are satisfied, such allocation is deemed to be made in accordance with the partners' interest in the partnership. At the end of the partnership's third taxable year, OC's, DR's, and DT's shares of partnership minimum gain are $100,000 each.

(v) Assume the same facts as (iv) and that at the beginning of the partnership's fifth taxable year it sells the machinery for $650,000 (using $600,000 of the proceeds to repay the nonrecourse liability), resulting in a taxable gain of $440,000 ($650,000 amount realized less $210,000 adjusted tax basis) and a book gain of $350,000 ($650,000 amount realized less $300,000 book basis). The partnership has no other items of income, gain, loss, or deduction for such year. As a result of the sale, partnership minimum gain is reduced from $300,000 to zero, reducing OC's DR's and DT's shares of partnership minimum gain to zero from $100,000 each. The minimum gain chargeback requires that OC and DT each be allocated an amount of that gain equal to $68,333 (the deficit balance in each of their capital accounts at the end of the partnership's fifth taxable year before any allocation is made to them under section 704(b) with respect to partnership items for that year). Thus, the allocation of the first $136,666 of book gain $68,333 to OC and $68,333 to DT is deemed to be made in accordance with the partners' interests in the partnership under paragraph (b)(4)(iv)(e) of this section. The allocation of the remaining $213,334 of book gain in a manner such that the total book gain is allocated equally among the partners has substantial economic effect. Consistent with the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, the partnership agreement provides that the $440,000 taxable gain is, in accordance with section 704(c) principles, shared $161,667 to OC, $161,667 DR, and $116,666 to DT.

	OC		DR		DT	
	Tax	Book	Tax	Book	Tax	Book
Capital account at end of year 4	($113,334)	($68,333)	($113,334)	($68,333)	($68,333)	($68,333)
Plus: minimum gain chargeback	94,691	68,333	0	0	68,333	68,333
Plus: additional gain	66,976	48,333	161,667	116,666	48,333	48,333
Capital account before liquidation	48,333	48,333	48,333	48,333	48,333	48,333

Example 23. (i) A partnership owns 4 properties, each of which is subject to a nonrecourse liability of the partnership. During a taxable year of the partnership, the following events take place. First, the partnership generates a cost recovery deduction (for both book and tax purposes) with respect to Property W of $10,000 and repays $5,000 of the nonrecourse liability secured only by that property, resulting in an increase in minimum gain with respect to that liability of $5,000. Second, the partnership generates a cost recovery deduction (for both book and tax purposes) with respect to Property X of $10,000 and repays none of the nonrecourse liability secured by that property, resulting in an increase in minimum gain with respect to that liability of $10,000. Third, the partnership generates a cost recovery deduction (for both book and tax purposes) of $2,000 on Property Y and repays $11,000 of the nonrecourse liability secured only by that property, resulting in a decrease in minimum gain with respect to that liability of $9,000 (although at the end of that year, there remains minimum gain with respect to that liability). Finally, the partnership borrows $5,000 on a nonrecourse basis, giving as the only security for that liability Property Z, which is a parcel of undeveloped land with an adjusted tax basis (and book value) of $2,000, resulting in a net increase in minimum gain with respect to that liability of $3,000. The net increase in partnership minimum gain during that year is $9,000, so that the amount of nonrecourse deductions of the partnership for that taxable year is $9,000. Those nonrecourse deductions consist of $3,000 of cost recovery deductions with respect to Property W and $6,000 of cost recovery deductions with respect to Property X. The amount of nonrecourse deductions consisting of cost recovery deductions is determined as follows. With respect to the nonrecourse liability secured by Property Z, with respect to which there is no cost recovery deduction, the amount of cost recovery deductions that constitutes nonrecourse deductions is zero. Similarly, with respect to the nonrecourse liability secured by Property Y, for which there is

no increase in minimum gain, the amount of cost recovery deductions that constitutes nonrecourse deductions is zero. With respect to each of the nonrecourse liabilities secured by Properties W and X, which are (i) secured by property with respect to which there are cost recovery deductions and (ii) for which there is an increase in minimum gain, the amount of cost recovery deductions that constitutes nonrecourse deductions equals the product obtained by multiplying the net increase in partnership minimum gain ($9,000) times a fraction, the numerator of which is the total cost recovery deductions with respect to the partnership property securing that particular liability to the extent of the increase in minimum gain with respect to that liability and the denominator of which is the sum of the numerators for each such liability. Thus, for the liability secured by Property W, the amount is $9,000 times $5,000/$15,000. For the liability secured by Property X, the amount is $9,000 times $10,000/$15,000. (If one depreciable property secured 2 partnership nonrecourse liabilities, the amount of cost recovery or book depreciation with respect to that property would be allocated among such liabilities in accordance with the method by which adjusted basis is allocated under paragraph (b)(2)(iv)(b) of this section.)

(ii) Assume the facts as in (i) except that the loan secured by Property Z is $15,000 (rather than $5,000), resulting in a net increase in minimum gain with respect to that liability of $13,000. Thus, the net increase in partnership minimum gain is $19,000, and the amount of nonrecourse deductions of the partnership for that taxable year is $19,000. Those nonrecourse deductions consist of $5,000 of cost recovery deductions with respect to Property W, $10,000 of cost recovery deductions with respect to Property X, and a pro rata portion of the partnership's other items of deduction, loss, and section 705(a)(2)(B) expenditure for that year. The method for computing the amounts of cost recovery deductions that constitute nonrecourse deductions is the same as in (i) for the liabilities secured by Properties Y and Z. With respect to each of the nonrecourse liabilities secured by Properties W and X, the amount of cost recovery deductions that constitutes nonrecourse deductions equals the total cost recovery deductions with respect to the partnership property securing that particular liability to the extent of the increase in minimum gain with respect to that liability.

(c) Contributed property—(1) In general. Where property has actually been contributed by a partner to a partnership (so as to become partnership property as among the partners and not merely property subject to the claims of partnership creditors), section 704(c) and this paragraph provide rules for determining a partner's distributive share of depreciation, depletion, or gain or loss with respect to such contributed property. These rules do not apply to property, only the use of which is permitted the partnership by the partner who owns it. Section 704(c) and this paragraph provide certain alternatives in determining the partners' distributive shares of such items in order to account for precontribution appreciation or diminution in value of the property contributed. When the partnership agreement is silent as to the treatment of such items with respect to contributed property (and if such property is not an undivided interest as described in section 704(c)(3)), depreciation, depletion, or gain or loss with respect to such property shall be treated in the same manner as though such items arose with respect to property purchased by the partnership. The application of this provision may be illustrated by the following examples:

Example (1). A and B form an equal partnership. A contributes $1,000 cash and B contributes inventory with an adjusted basis to him of $800 and a fair market value of $1,000. Under section 723, the basis of the inventory to the partnership is also $800. During the year, the inventory is sold for $1,100. There is no provision in the partnership agreement for treatment of items with respect to contributed property. Under section 704(c)(1), the $300 profit on the sale of the inventory is treated as if it were gain on property that had been purchased by the partnership and subsequently sold. Therefore, each partner's distributive share of such profit on the inventory is $150.

Example (2). C and D form an equal partnership. C contributes machinery worth $10,000 with an adjusted basis to him of $4,000. D contributes $10,000 cash. Under the provisions of section 722, the basis of C's partnership interest is $4,000 and the basis of D's interest is $10,000. There is no provision in the partnership agreement relating to contributed property. If the contributed property depreciates at an annual rate of 10 percent, the partnership will have an annual depreciation deduction of $400, which will result in a reduction of $200 in each partner's distributive share of partnership income. Thus, at the end of the first year, the adjusted basis of the contributed property will be $3,600. If the partnership has no other taxable income or loss for that year, each partner will have a deduction of $200, representing his distributive share of partnership loss for the year. C's adjusted basis for his interest will be $3,800 ($4,000, the original basis of his interest, reduced by $200); D's adjusted basis will be $9,800 ($10,000, reduced by $200).

Example (3). Assume that the property in example (2) of this subparagraph is sold at the beginning of the second year of partnership operation for $9,000. The partnership gain will be $5,400 ($9,000, the amount realized, less the adjusted basis of $3,600). Each partner's share of the $5,400 gain will be $2,700. If the partnership has no other taxable income or loss for that year, each partner will have a gain from the partnership of $2,700, representing his distributive share of gain from the sale of property used in the partnership business. C's adjusted basis for his interest will then be $6,500 (the basis of $3,800, increased by the gain of $2,700). D's adjusted basis will be $12,500 (the basis of $9,800, increased by the gain of $2,700). If the partnership is then terminated, and its assets consisting of $19,000 in cash are distributed to the partners *pro rata* in liquidation of their entire interests, C will have a capital gain of $3,000 ($9,500, the amount received, less $6,500, the adjusted basis of his interest). D will have a capital loss of $3,000 (D's adjusted basis, $12,500, reduced by the amount received $9,500).

(2) Effect of partnership agreement. (i) If the partners so provide in the partnership agreement, depreciation, depletion, or gain or loss with respect to contributed property may be allocated among the partners in a manner which takes into account all or any portion of the difference between the adjusted basis and the fair market value of contributed property at the time of contribution. The allocation may apply to all contributed property or to specific items. The appreciation or diminution in value represented by the difference between the

adjusted basis and the fair market value of contributed property at the time of contribution may thus be attributed to the contributing partner upon a subsequent sale or exchange of the property by the partnership. Such appreciation or diminution also may be used in allocating the allowable depreciation or depletion with respect to such property among the contributing partner and the noncontributing partners. In any case, however, the total depreciation, depletion, or gain or loss allocated to the partners is limited to a "ceiling" which cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it. The application of this subdivision may be illustrated by the following examples:

Example (1). Assume that partners C and D, in examples (2) and (3) of subparagraph (1) of this paragraph, agree under section 704(c)(2) to attribute to C, the contributor of the machinery, the potential gain of $6,000 represented by the difference between its adjusted basis of $4,000 and its fair market value of $10,000. With his contribution of $10,000 cash, D has, in effect, purchased an undivided one-half interest in the property for $5,000. Since the property depreciates at an annual rate of 10 percent, D would have been entitled to a depreciation deduction of $500 per year. However, since under the "ceiling" approach the partnership is allowed only $400 per year (10 percent of $4,000), no more than $400 may be allocated between the partners, *i.e.*, the partnership cannot allocate $500 of depreciation to D and thereby treat C as if C had received an additional $100 of income. Therefore, the partners allocate the $400 deduction for depreciation entirely to D and none to C, the contributor. At the end of the first year, the adjusted basis of the contributed property will be $3,600. Since the $400 deduction is allocated entirely to D, if the partnership has no other taxable income or loss, C will have no income or loss, and D will have a deduction of $400. C's basis for his interest will remain $4,000. D's adjusted basis for his interest will be $9,600 ($10,000, the original basis of his interest, reduced by the deduction of $400).

Example (2). Assume that the partners in example (1) of this subdivision also agree under section 704(c)(2) that, upon a sale of the contributed property, the portion of the proceeds attributable to the excess of the fair market value of the property at date of contribution (less accumulated depreciation on such value) over its basis at date of contribution (less accumulated depreciation on such basis) shall result in gain to the contributing partner only. If the property is sold at the beginning of the second year of partnership operation for $9,000, the partnership gain of $5,400 ($9,000, the amount realized, less the adjusted basis of $3,600) must be allocated to the partners under the terms of the agreement. The fair market value of the property as depreciated is $9,000 ($10,000, the value on contribution, less $1,000, the accumulated depreciation on such value). Under section 704(c)(2) and the terms of the partnership agreement, the $5,400 difference between $9,000, the fair market value as depreciated, and $3,600, the adjusted basis of the property, represents the portion of the gain to be allocated to C. None of this gain is allocated to D. (If the property were sold for more than $9,000, the portion of the gain in excess of $5,400 would be allocated equally between the partners in accordance with their agreement for sharing gains. If the property were sold for less than $9,000, the entire gain would be allocated to C and nothing to D.) If the partnership and partners engaged in no other transactions that year, C will report a gain of $5,400, and D, no income or loss. C's adjusted basis for his interest will then be $9,400 ($4,000, his original basis, increased by the gain of $5,400). D's adjusted basis will be $9,000 ($10,000, his original basis, less $400 depreciation deduction in the first partnership year). If the partnership is then terminated, and its assets consisting of $19,000 in cash are distributed to the partners *pro rata* in liquidation of their interests, C will have a capital gain of $100 ($9,500, the amount received, less $9,400, the adjusted basis of his interest). D will have a capital loss of $100 (the excess of D's adjusted basis, $9,600, over the amount received, $9,500).

(ii) For the effect of an agreement under section 704(c)(2) on undivided interests in property contributed to the partnership where the partners' interests in the capital and profits of the partnership do not correspond with such undivided interests, see subparagraph (3)(ii) of this paragraph.

(3) Undivided interests. (i) Section 704(c)(3) provides a special rule for the allocation of depreciation, depletion, or gain or loss with respect to undivided interests in property contributed by the partners to a partnership where the partnership agreement does not provide otherwise. This provision applies only to property contributed to a partnership by all of its partners and only where the relative undivided interests of the partners in the property prior to the contribution are in the same ratio as their interests in the capital and in the profits of the partnership (except for depreciation, depletion, or gain or loss with respect to the contributed undivided interest) after the contribution. Where these conditions are met, depreciation, depletion, or gain or loss with respect to the undivided interests in contributed property shall be determined in the same manner as though such undivided interests continued to be held by the partners outside the partnership. The rule stated in section 704(c)(3) applies only to the case where persons actually contribute undivided interests to a partnership. The provisions of this subdivision may be illustrated by the following examples:

Example (1). A and B are tenants in common owning undivided one-half interests in improved real estate consisting of land on which a factory is situated. They each contribute their respective undivided interests in the real estate to a partnership in which the profits are to be divided equally and, because the partners have equal shares in the capital, the assets will be divided equally on dissolution. A's basis for his undivided one-half interest is $4,000, of which $1,000 is allocable to the land and $3,000 to the factory. B's basis for his undivided one-half interest is $10,000, of which $3,000 is allocable to the land and $7,000 to the factory. The partnership agreement contains no provisions as to the allocation of depreciation or gain or loss on disposition of the property by the partnership. The factory depreciates at a rate of 5 percent a year. The annual partnership allowance for depreciation of $500 (5 percent of $10,000) will be allocated between the partners by allowing A a deduction of $150 (5 percent of $3,000, his basis for his undivided interest in the factory), and by allowing B a deduction of $350 (5 percent of $7,000, his basis for his undivided interest in the factory). At the end of the first year of partnership operation, A's adjusted basis for his

undivided interest in the factory is $2,850 ($3,000 less $150), and B's adjusted basis is $6,650 ($7,000 less $350).

Example (2). If, in example (1) of this subdivision, the partnership at the end of the first year's operation sells the factory and land for $12,000, each partner's share of the gain or loss would be determined as follows: Since the undivided interests in the factory and the land are to be treated as though held by the partners outside the partnership, A's share of the proceeds of the sale is $6,000. His adjusted basis in the contributed property is $3,850 ($1,000 for the land and $2,850 for the factory). Therefore, his gain from the sale is $2,150. Since B's share of the proceeds is also $6,000, and his adjusted basis in the contributed property is $9,650 ($3,000 for the land and $6,650 for the factory), his loss is $3,650.

Example (3). Assume the same facts as in examples (1) and (2) of this subdivision, except that A and B do not enter into a partnership agreement. Assume further that they are found to be a partnership for income tax purposes because of their joint business activity, but that the factory and the land are not actually contributed by them to the partnership. Although A and B have permitted the partnership to use such properties, they continue to own the factory and the land in their individual capacities (as tenants in common), and the same tax consequences result as in examples (1) and (2) of this subdivision.

(ii) The allocation illustrated in subdivision (i) of this subparagraph will not be affected by the contribution, either at the time of the original contribution or subsequent thereto, of additional property not held as undivided interests if the partners' respective interests in the capital and in the profits of the partnership (except for depreciation, depletion, or gain or loss with respect to the contributed undivided interests) remain the same as their undivided interests in the property previously contributed to the partnership. If the partners' interests in the capital and profits of the partnership are changed from their undivided interests in the property previously contributed to the partnership, the method of allocation of depreciation, depletion, or gain or loss with respect to such property no longer applies. Such a change of the partner's interests in capital and profits may result from a modification of the agreement, or from a change in a partner's respective interest in capital either as a result of a further contribution or as a result of a distribution. (However, drawings made throughout the year against profits, and loans will be disregarded.) Where such a change takes place, the partners may agree under section 704(c)(2) that depreciation, depletion, or gain or loss with respect to the property formerly held as undivided interests shall continue to be allocated in the same manner as prior to the change. These provisions may be illustrated by the following examples:

Example (1). C and D are tenants in common, each owning an undivided one-half interest in certain unimproved land. Each contributes his respective undivided interest in the land to a partnership in which each has an equal interest in capital and profits. C's basis for his one-half interest is $4,000; D's basis is $10,000. The fair market value of the land is $20,000. Subsequently, C contributes $5,000 cash to his share of partnership capital. As a result of C's additional contribution, he now has a 60-percent interest in partnership capital and D, a 40-percent interest, although profits and losses still are to be shared equally. Since the interests of the partners in the capital and profits of the partnership no longer correspond to their undivided interests in the land, the method of allocation prescribed by section 704(c)(3) no longer applies. Therefore, if the land is sold for $12,000, the partnership will have a loss of $2,000 ($14,000 partnership basis minus $12,000). Since the partnership agreement contains no special allocation for gain or loss with respect to contributed property, the $2,000 loss is allocated as if such property had been purchased by the partnership, *i.e.*, $1,000 to each partner.

Example (2). Assume in example (1) of this subdivision that the partners agree that, because of C's additional contribution of $5,000 cash, he is to have a 60-percent interest in partnership capital. Profits and losses still are to be shared equally, except that gain or loss with respect to the land is, under section 704(c)(2), to continue to be allocated in the same manner as it had been allocated under section 704(c)(3) prior to the additional contribution. The land is sold for $12,000. C's share of the proceeds is $6,000. His basis for the land is $4,000. Therefore, he has a $2,000 gain. D's loss is $4,000 ($10,000 basis less $6,000 proceeds).

(d) Limitation on allowance of losses. **(1)** A partner's distributive share of partnership loss will be allowed only to the extent of the adjusted basis (before reduction by current year's losses) of such partner's interest in the partnership at the end of the partnership taxable year in which such loss occurred. A partner's share of loss in excess of his adjusted basis at the end of the partnership taxable year will not be allowed for that year. However, any loss so disallowed shall be allowed as a deduction at the end of the first succeeding partnership taxable year, and subsequent partnership taxable years, to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).

(2) In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the

sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

(3) For the treatment of certain liabilities of the partner or partnership, see section 752 and § 1.752-1.

(4) The provisions of this paragraph may be illustrated by the following examples:

Example (1). At the end of the partnership taxable year 1955, partnership AB has a loss of $20,000. Partner A's distributive share of this loss is $10,000. At the end of such year, A's adjusted basis for his interest in the partnership (not taking into account his distributive share of the loss) is $6,000. Under section 704(d), A's distributive share of partnership loss is allowed to him (in his taxable year within or with which the partnership taxable year ends) only to the extent of his adjusted basis of $6,000. The $6,000 loss allowed for 1955 decreases the adjusted basis of A's interest to zero. Assume that, at the end of partnership taxable year 1956, A's share of partnership income has increased the adjusted basis of A's interest in the partnership to $3,000 (not taking into account the $4,000 loss disallowed in 1955). Of the $4,000 loss disallowed for the partnership taxable year 1955, $3,000 is allowed A for the partnership taxable year 1956, thus again decreasing the adjusted basis of his interest to zero. If, at the end of partnership taxable year 1957, A has an adjusted basis of his interest of at least $1,000 (not taking into account the disallowed loss of $1,000), he will be allowed the $1,000 loss previously disallowed.

Example (2). At the end of partnership taxable year 1955, partnership CD has a loss of $20,000. Partner C's distributive share of this loss is $10,000. The adjusted basis of his interest in the partnership (not taking into account his distributive share of such loss) is $6,000. Therefore, $4,000 of the loss is disallowed. At the end of partnership taxable year 1956, the partnership has no taxable income or loss, but owes $8,000 to a bank for money borrowed. Since C's share of this liability is $4,000, the basis of his partnership interest is increased from zero to $4,000. (See sections 752 and 722, and §§ 1.752-1 and 1.722-1.) C is allowed the $4,000 loss, disallowed for the preceding year under section 704(d), for his taxable year within or with which partnership taxable year 1956 ends.

Example (3). At the end of partnership taxable year 1955, partner C has the following distributive share of partnership items described in section 702(a): Long-term capital loss, $4,000; short-term capital loss, $2,000; income as described in section 702(a)(9), $4,000. Partner C's adjusted basis for his partnership interest at the end of 1955, before adjustment for any of the above items, is $1,000. As adjusted under section 705(a)(1)(A), C's basis is increased from $1,000 to $5,000 at the end of the year. C's total distributive share of partnership loss is $6,000. Since without regard to losses, C has a basis of only $5,000, C is allowed only $5,000/$6,000 of each loss, that is, $3,333 of his long-term capital loss, and $1,667 of his short-term capital loss. C must carry forward to succeeding taxable years $667 as a long-term capital loss and $333 as a short-term capital loss.

(e) Family partnerships—(1) In general—(i) Introduction. The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. The provisions of Subchapter K, Chapter 1 of the Code, are to be read in the light of their relationship to section 61, which requires, *inter alia*, that income be taxed to the person who earns it through his own labor and skill and the utilization of his own capital.

(ii) Recognition of donee as partner. With respect to partnerships in which capital is a material income-producing factor, section 704(e)(1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership whether or not such interest is derived by purchase or gift from any other person. If a capital interest in a partnership in which capital is a material income-producing factor is created by gift, section 704(e)(2) provides that the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such distributive share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. For rules of allocation in such cases, see subparagraph (3) of this paragraph.

(iii) Requirement of complete transfer to donee. A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a *bona fide* transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee. The existence of such dominion and control in the donee is to be determined from all the facts and circumstances. A transfer is not recognized if the transferor retains such incidents of ownership that the transferee has not acquired full and complete ownership of the partnership interest. Transactions between members of a family will be closely scrutinized, and the circumstances, not only at the time of the purported transfer but also during the periods preceding and following it, will be taken into consideration in determining the *bona fides* or lack of *bona fides* of the purported gift or sale. A partnership may be recognized for income tax purposes as to some partners but not as to others.

(iv) Capital as a material income-producing factor. For purposes of section 704(e)(1), the determination as to whether capital is a material income-producing factor must be made by reference to all the facts of each case. Capital is a material income-producing factor if a substantial portion of the gross income of the business is

attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(v) Capital interest in a partnership. For purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

(2) Basic tests as to ownership—(i) In general. Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case. Isolated facts are not determinative; the reality of the donee's ownership is to be determined in the light of the transaction as a whole. The execution of legally sufficient and irrevocable deeds or other instruments of gift under State law is a factor to be taken into account but is not determinative of ownership by the donee for the purposes of section 704(e). The reality of the transfer and of the donee's ownership of the property attributed to him are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formal test. Some of the more important factors to be considered in determining whether the donee has acquired ownership of the capital interest in a partnership are indicated in subdivisions (ii) to (x), inclusive, of this subparagraph.

(ii) Retained controls. The donor may have retained such controls of the interest which he has purported to transfer to the donee that the donor should be treated as remaining the substantial owner of the interest. Controls of particular significance include, for example, the following:

(a) Retention of control of the distribution of amounts of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business). If there is a partnership agreement providing for a managing partner or partners, then amounts of income may be retained in the partnership without the acquiescence of all the partners if such amounts are retained for the reasonable needs of the business.

(b) Limitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment.

(c) Retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership).

(d) Retention of management powers inconsistent with normal relationships among partners. Retention by the donor of control of business management or of voting control, such as is common in ordinary business relationships, is not by itself to be considered as inconsistent with normal relationships among partners, provided the donee is free to liquidate his interest at his discretion without financial detriment. The donee shall not be considered free to liquidate his interest unless, considering all the facts, it is evident that the donee is independent of the donor and has such maturity and understanding of his rights as to be capable of deciding to exercise, and capable of exercising, his right to withdraw his capital interest from the partnership.

The existence of some of the indicated controls, though amounting to less than substantial ownership retained by the donor, may be considered along with other facts and circumstances as tending to show the lack of reality of the partnership interest of the donee.

(iii) Indirect controls. Controls inconsistent with ownership by the donee may be exercised indirectly as well as directly, for example, through a separate business organization, estate, trust, individual, or other partnership. Where such indirect controls exist, the reality of the donee's interest will be determined as if such controls were exercisable directly.

(iv) Participation in management. Substantial participation by the donee in the control and management of the business (including participation in the major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest. Such participation presupposes sufficient maturity and experience on the part of the donee to deal with the business problems of the partnership.

(v) Income distributions. The actual distribution to a donee partner of the entire amount or a major portion of his distributive share of the business income for the sole benefit and use of the donee is substantial evidence of the reality of the donee's interest, provided the donor has not retained controls inconsistent with real ownership by the donee. Amounts distributed are not considered to be used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in such manner that the donor controls or can control the use or enjoyment of such funds.

(vi) Conduct of partnership business. In determining the reality of the donee's ownership of a capital interest in a partnership, consideration shall be given to whether the donee is actually treated as a partner in the operation of the business. Whether or not the donee has been held out publicly as a partner in the conduct of the business, in relations with customers, or with creditors or other sources of financing, is of primary significance. Other factors of significance in this connection include:

(a) Compliance with local partnership, fictitious names, and business registration statutes.

(b) Control of business bank accounts.

(c) Recognition of the donee's rights in distributions of partnership property and profits.

(d) Recognition of the donee's interest in insurance policies, leases, and other business contracts and in litigation affecting business.

(e) The existence of written agreements, records, or memoranda, contemporaneous with the taxable year or years concerned, establishing the nature of the partnership agreement and the rights and liabilities of the respective partners.

(f) Filing of partnership tax returns as required by law.

However, despite formal compliance with the above factors, other circumstances may indicate that the donor has retained substantial ownership of the interest purportedly transferred to the donee.

(vii) Trustees as partners. A trustee may be recognized as a partner for income tax purposes under the principles relating to family partnerships generally as applied to the particular facts of the trust-partnership arrangement. A trustee who is unrelated to and independent of the grantor, and who participates as a partner and receives distribution of the income distributable to the trust, will ordinarily be recognized as the legal owner of the partnership interest which he holds in trust unless the grantor has retained controls inconsistent with such ownership. However, if the grantor is the trustee, or if the trustee is amenable to the will of the grantor, the provisions of the trust instrument (particularly as to whether the trustee is subject to the responsibilities of a fiduciary), the provisions of the partnership agreement, and the conduct of the parties must all be taken into account in determining whether the trustee in a fiduciary capacity has become the real owner of the partnership interest. Where the grantor (or person amenable to his will) is the trustee, the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor. Furthermore, if the grantor (or person amenable to his will) is the trustee, the following factors will be given particular consideration:

(a) Whether the trust is recognized as a partner in business dealings with customers and creditors, and

(b) Whether, if any amount of the partnership income is not properly retained for the reasonable needs of the business, the trust's share of such amount is distributed to the trust annually and paid to the beneficiaries or reinvested with regard solely to the interests of the beneficiaries.

(viii) Interests (not held in trust) of minor children. Except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. The use of the child's property or income for support for which a parent is legally responsible will be considered a use for the parent's benefit. "Judicial supervision of the conduct of the fiduciary" includes filing of such accountings and reports as are required by law of the fiduciary who participates in the affairs of the partnership on behalf of the minor. A minor child will be considered as competent to manage his own property if he actually has sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and otherwise to conduct his affairs on a basis of

equality with adult persons, notwithstanding legal disabilities of the minor under State law.

(ix) Donees as limited partners. The recognition of a donee's interest in a limited partnership will depend, as in the case of other donated interests, on whether the transfer of property is real and on whether the donee has acquired dominion and control over the interest purportedly transferred to him. To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

(x) Motive. If the reality of the transfer of interest is satisfactorily established, the motives for the transaction are generally immaterial. However, the presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the reality of the ownership of a capital interest acquired by gift.

(3) Allocation of family partnership income—(i) In general. (a) Where a capital interest in a partnership in which capital is a material income-producing factor is created by gift, the donee's distributive share shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such distributive share attributable to donated capital is proportionately greater than the distributive share attributable to the donor's capital. For the purpose of section 704, a capital interest in a partnership purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual, for the purpose of the preceding sentence, shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(b) To the extent that the partnership agreement does not allocate the partnership income in accordance with (a) of this subdivision, the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.

(c) In determining a reasonable allowance for services rendered by the partners, consideration shall be given to all the facts and circumstances of the business, including the fact that some of the partners may have greater managerial responsibility than others. There shall also be considered the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership.

(d) The distributive share of partnership income, as determined under (b) of this subdivision, of a partner who rendered services to the partnership before entering the Armed Forces of the United States shall not be diminished because of absence due to military service. Such distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. However, the partners may by agreement allocate a smaller share to the absent partner due to his absence.

(ii) Special rules. (a) The provisions of subdivision (i) of this subparagraph, relating to allocation of family partnership income, are applicable where the interest in the partnership is created by gift, indirectly or directly. Where the partnership interest is created indirectly, the term "donor" may include persons other than the nominal transferor. This rule may be illustrated by the following examples:

Example (1). A father gives property to his son who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Example (2). A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently

conveys her interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

Example (3). A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, for purposes of section 704, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(b) The allocation rules set forth in section 704(e) and subdivision (i) of this subparagraph apply in any case in which the transfer or creation of the partnership interest has any of the substantial characteristics of a gift. Thus, allocation may be required where transfer of a partnership interest is made between members of a family (including collaterals) under a purported purchase agreement, if the characteristics of a gift are ascertained from the terms of the purchase agreement, the terms of any loan or credit arrangements made to finance the purchase, or from other relevant data.

(c) In the case of a limited partnership, for the purpose of the allocation provisions of subdivision (i) of this subparagraph, consideration shall be given to the fact that a general partner, unlike a limited partner, risks his credit in the partnership business.

(4) Purchased interest—(i) In general. If a purported purchase of a capital interest in a partnership does not meet the requirements of subdivision (ii) of this subparagraph, the ownership by the transferee of such capital interest will be recognized only if it qualifies under the requirements applicable to a transfer of a partnership interest by gifts. In a case not qualifying under subdivision (ii) of this subparagraph, if payment of any part of the purchase price is made out of partnership earnings, the transaction may be regarded in the same light as a purported gift subject to deferred enjoyment of income. Such a transaction may be lacking in reality either as a gift or as a *bona fide* purchase.

(ii) Tests as to reality of purchased interests. A purchase of a capital interest in a partnership, either directly or by means of a loan or credit extended by a member of the family, will be recognized as *bona fide* if:

(a) It can be shown that the purchase has the usual characteristics of an arm's-length transaction, considering all relevant factors, including the terms of the purchase agreement (as to price, due date of payment, rate of interest, and security, if any) and the terms of any loan or credit arrangement collateral to the purchase agreement; the credit standing of the purchaser (apart from relationship to the seller) and the capacity of the purchaser to incur a legally binding obligation; or

(b) It can be shown, in the absence of characteristics of an arm's-length transaction, that the purchase was genuinely intended to promote the success of the business by securing participation of the purchaser in the business or by adding his credit to that of the other participants.

However, if the alleged purchase price or loan has not been paid or the obligation otherwise discharged, the factors indicated in (a) and (b) of this subdivision shall be taken into account only as an aid in determining whether a *bona fide* purchase or loan obligation existed.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6771, 29 FR 15571, Nov. 20, 1964; T.D. 8365, 50 FR 53423, Dec. 31, 1985; T.D. 8065, 51 FR 10826, March 31, 1986; T.D. 8099, 51 FR 32062, 32068, Sept. 9, 1986; 52 FR 10223, March 31, 1987]

§ 1.705–1 Determination of basis of partner's interest.

(a) General rule. **(1)** Section 705 and this section provide rules for determining the adjusted basis of a partner's interest in a partnership. A partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person. The determination of the adjusted basis of a partnership interest is ordinarily made as of the end of a partnership taxable year. Thus, for example, such year-end determination is necessary in ascertaining the extent to which a partner's distributive share of partnership losses may be allowed. See section 704(d). However, where there has been a sale or exchange of all or a part of a partnership interest or a liquidation of a partner's entire interest in a partnership, the adjusted basis of the partner's interest should be determined as of the date of sale or exchange or liquidation. The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital", "equity", or similar account. For example, A contributes property with an adjusted basis to him of $400 (and a value of $1,000) to a partnership. B contributes $1,000 cash. While under their agreement each may have a "capital account" in the partnership of $1,000, the adjusted basis of A's interest is only $400 and B's interest $1,000.

(2) The original basis of a partner's interest in a partnership shall be determined under section 722

(relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests). Such basis shall be increased under section 722 by any further contributions to the partnership and by the sum of the partner's distributive share for the taxable year and prior taxable years of—

(i) Taxable income of the partnership as determined under section 703(a),

(ii) Tax-exempt receipts of the partnership, and

(iii) The excess of the deductions for depletion over the basis of the depletable property.

(3) The basis shall be decreased (but not below zero) by distributions from the partnership as provided in section 733 and by the sum of the partner's distributive share for the taxable year and prior taxable years of—

(i) Partnership losses (including capital losses), and

(ii) Partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures.

(4) For the effect of liabilities in determining the amount of contributions made by a partner to a partnership or the amount of distributions made by a partnership to a partner, see section 752 and § 1.752–1, relating to the treatment of certain liabilities. In determining the basis of a partnership interest on the effective date of Subchapter K, Chapter 1 of the Code, or any of the sections thereof, the partner's share of partnership liabilities on that date shall be included.

(b) Alternative rule. In certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of partnership property which would be distributable upon termination of the partnership. The alternative rule may be used to determine the adjusted basis of a partner's interest where circumstances are such that the partner cannot practicably apply the general rule set forth in section 705(a) and paragraph (a) of this section, or where, from a consideration of all the facts, it is, in the opinion of the Commissioner, reasonable to conclude that the result produced will not vary substantially from the result obtainable under the general rule. Where the alternative rule is used, adjustments may be necessary in determining the adjusted basis of a partner's interest in a partnership. Adjustments would be required, for example, in order to reflect in a partner's share of the adjusted basis of partnership property any significant discrepancies arising as a result of contributed property, transfers of partnership interests, or distributions of property to the partners. The operation of the alternative rules may be illustrated by the following examples:

Example (1). The ABC partnership, in which A, B, and C are equal partners, owns various properties with a total adjusted basis of $1,500 and has earned and retained an additional $1,500. The total adjusted basis of partnership property is thus $3,000. Each partner's share in the adjusted basis of partnership property is one-third of this amount, or $1,000. Under the alternative rule, this amount represents each partner's adjusted basis for his partnership interest.

Example (2). Assume that partner A in example (1) of this paragraph sells his partnership interest to D for $1,250 at a time when the partnership property with an adjusted basis of $1,500 had appreciated in value to $3,000, and when the partnership also had $750 in cash. The total adjusted basis of all partnership property is $2,250 and the value of such property is $3,750. D's basis for his partnership interest is his cost, $1,250. However, his one-third share of the adjusted basis of partnership property is only $750. Therefore, for the purposes of the alternative rule, D has an adjustment of $500 in determining the basis of his interest. This amount represents the difference between the cost of his partnership interest and his share of partnership basis at the time of his purchase. If the partnership subsequently earns and retains an additional $1,500, its property will have an adjusted basis of $3,750. D's adjusted basis for his interest under the alternative rule is $1,750, determined by adding $500, his basis adjustment to $1,250 (his one-third share of the $3,750 adjusted basis of partnership property). If the partnership distributes $250 to each partner in a current distribution, D's adjusted basis for his interest will be $1,500 ($1,000, his one-third share of the remaining basis of partnership property, $3,000, plus his basis adjustment of $500).

Example (3). Assume that BCD partnership in example (2) of this paragraph continues to operate. In 1960, D proposes to sell his partnership interest and wishes to evaluate the tax consequences of such sale. It is necessary, therefore, to determine the adjusted basis of his interest in the partnership. Assume further that D cannot determine the adjusted basis of his interest under the general rule. The balance sheet of the BCD partnership is as follows:

Assets	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Receivables	4,000	4,000
Depreciable property	5,000	5,000
Land held for investment	18,000	30,000
Total	30,000	42,000

Liabilities and capital	Per books
Liabilities	$6,000
Capital accounts:	
B	4,500
C	4,500
D	15,000
Total	30,000

The $15,000 representing the amount of D's capital account does not reflect the $500 basis adjustment arising from D's purchase of his interest. See example (2) of this paragraph. The adjusted basis of D's partnership interest determined under the alternative rule is as follows:

D's share of the adjusted basis of partnership property (reduced by the amount of liabilities) at time of proposed sale	$15,000
D's share of partnership liabilities (under the partnership agreement liabilities are shared equally)	2,000
D's basis adjustment from example (2)	500
Adjusted basis of D's interest at the time of proposed sale, as determined under alternative rule	17,500

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.706–1 Taxable years of partner and partnership.

(a) Year in which partnership income is includible. **(1)** In computing his taxable income for a taxable year, a partner is required to include his distributive share of partnership items set forth in section 702 for any partnership year ending within or with his taxable year. A partner shall also include in his taxable income for a taxable year "guaranteed payments" under section 707(c) which are made to him in a partnership taxable year ending within or with his taxable year. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A reports his income for a calendar year, while the partnership of which he is a member reports its income for a fiscal year ending May 31. During the partnership taxable year ending May 31, 1956, A received guaranteed payments of $1,200 for services and for the use of capital. Of this amount, $700 was received by A between June 1 and December 31, 1955, and the remaining $500 was received by him between January 1 and May 31, 1956. This entire $1,200 received by A is includible in his taxable income for the calendar year 1956 (together with his distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 1956).

(2) If a partner receives distributions under section 731 or sells or exchanges all or part of his partnership interest, any gain or loss arising therefrom does not constitute partnership income and is includible in the partner's gross income for his taxable year in which the payment is made. See sections 451 and 461.

(b) Adoption or change in taxable year—(1) Partnership taxable year. **(i)** The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(ii) A newly formed partnership may adopt a taxable year which is the same as the taxable year of all its principal partners (or the same as the taxable year to which all of its principal partners are concurrently changing) without securing prior approval from the Commissioner, or it may adopt a calendar year without securing prior approval from the Commissioner if all its principal partners are not on the same taxable year. In any other case, a newly formed partnership must secure prior approval from the Commissioner for the adoption of a taxable year.

(iii) An existing partnership may not change its taxable year without securing prior approval from the Commissioner, unless all its principal partners have the same taxable year to which the partnership changes, or unless all its principal partners concurrently change to such taxable year.

(2) Partner's taxable year. A partner may not change his taxable year without securing prior approval from the Commissioner. See section 442 and the regulations thereunder.

(3) Principal partner. For the purpose of this paragraph, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) Application for approval—(i) Change. Application for a change in a taxable year shall be filed on Form 1128 with the Commissioner of Internal Revenue, Washington, D.C. 20224. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period.

(ii) Adoption. Where a newly formed partnership is required to secure prior approval from the Commissioner for the adoption of a taxable year, the partnership shall file an application on Form 1128 with the Commissioner on or before the last day of the month following the close of the taxable year to be adopted. The partnership shall modify Form 1128 to the extent necessary to indicate that it is an application for adoption of a taxable year.

(iii) Business purpose. Where prior approval is required under this paragraph, the applicant must establish a business purpose to the satisfaction of the Commissioner. For example, partnership AB, which is on a calendar year, is engaged in a business which has a natural business year (the annual accounting period encompassing all related income and expenses) ending on September 30th. The intention of the partnership to make its tax year coincide with such natural business year constitutes a sufficient business purpose.

(5) Returns—(i) Partner. A partner who changes his taxable year shall make his return for a short period in accordance with section 443, and

shall attach to the return a copy of the letter from the Commissioner granting approval for the change of taxable year.

(ii) Partnership. (a) A partnership which changes its taxable year shall make its return for a short period in accordance with section 443, but shall not annualize the partnership taxable income. The partnership shall attach to the return either a copy of the letter from the Commissioner granting approval of the change of taxable year, or a statement indicating that the partnership is changing its taxable year to the same taxable year as that of all its principal partners or to the same taxable year as that to which all its principal partners are concurrently changing.

(b) Any newly formed partnership shall file with its first return either:

(1) A copy of the letter from the Commissioner approving the adoption of a partnership taxable year which is not the same as the taxable year of all its principal partners; or

(2) A statement indicating that the taxable year it has adopted is the same as the taxable year of all its principal partners, or that all its principal partners are concurrently changing to the taxable year it has adopted; or

(3) A statement that all its principal partners are not on the same taxable year and that it is adopting a calendar year without prior approval.

(6) Effective date. Section 706(b) applies to any partnership which adopts or changes to a taxable year beginning on or after April 2, 1954, and to any partner who changes to a taxable year beginning on or after that date. For the purpose of applying this provision, section 708 (relating to the continuation of a partnership) applies to any such taxable year. See section 771(b)(1) and paragraph (b)(1) of § 1.771–1. If a partnership has changed to or adopted, or if a partner has changed to, a taxable year beginning on or after April 2, 1954, without obtaining prior approval of the Commissioner, and if, under the provisions of this paragraph, prior approval is required for the change or adoption, such annual accounting period will not be accepted as a taxable year until approval thereof is secured. Under these circumstances, an application to change to or adopt the desired taxable year will be considered timely if filed before August 23, 1956.

(7) Cross-reference to § 1.442-2T and § 1.442-3T. For special rules applicable to certain changes in annual accounting period where the short period involved in the change ends in 1986 or 1987, see § 1.442-2T. For special rules applicable to certain adoptions and retentions of a taxable year ending in 1986 or 1987, see § 1.442-3T.

(c) Closing of partnership year—(1) General rule. Section 706(c) and this paragraph provide rules governing the closing of partnership years. The closing of a partnership taxable year or a termination of a partnership for Federal income tax purposes is not necessarily governed by the "dissolution", "liquidation", etc., of a partnership under State or local law. The taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's entire interest in the partnership (as defined in section 761(d)), or the sale or exchange of a partner's interest in the partnership, except in the case of a termination of a partnership and except as provided in subparagraph (2) of this paragraph. In the case of termination, the partnership taxable year closes for all partners as of the date of termination. See section 708(b) and paragraph (b) of § 1.708–1.

(2) Partner who retires or sells interest in partnership—(i) Disposition of entire interest. A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner's interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. See subparagraph (3) of this paragraph.

(ii) Inclusions in taxable income. In the case of a sale, exchange, or liquidation of a partner's entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner's distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his *pro rata* part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the

taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner's interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the *pro rata* part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership. The application of this subdivision may be illustrated by the following example:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of $5,000 on that date; that his *pro rata* share of partnership income up to June 30 is $15,000; and that he sells his interest for $20,000. Under the provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. The $15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to $20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his *pro rata* part of partnership income for the remainder of the partnership taxable year.

(3) **Partner who dies.** (i) When a partner dies, the partnership taxable year shall not close with respect to such partner prior to the end of the partnership taxable year. The partnership taxable year shall continue both for the remaining partners and the decedent partner. Where the death of a partner results in the termination of the partnership, the partnership taxable year shall close for all partners on the date of such termination under section 708(b)(1)(A). See also paragraph (b)(1)(i)(b) of § 1.708–1 for the continuation of a 2-member partnership under certain circumstances after the death of a partner. However, if the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest shall close on the date of such sale or exchange, or the date of completion of the liquidation.

(ii) The last return of a decedent partner shall include only his share of partnership taxable income for any partnership taxable year or years ending within or with the last taxable year for such decedent partner (*i.e.*, the year ending with the date of his death). The distributive share of partnership taxable income for a partnership taxable year ending after the decedent's last taxable year is includible in the return of his estate or other successor in interest. If the estate or other successor in interest of a partner continues to share in the profits or losses of the partnership business, the distributive share thereof is includible in the taxable year of the estate or other successor in interest within or with which the taxable year of the partnership ends. See also paragraph (a)(1)(ii) of § 1.736–1. Where the estate or other successor in interest receives distributions, any gain or loss on such distributions is includible in its gross income for its taxable year in which the distribution is made.

(iii) If a partner (or a retiring partner), in accordance with the terms of the partnership agreement, designates a person to succeed to his interest in the partnership after his death, such designated person shall be regarded as a successor in interest of the deceased for purposes of this chapter. Thus, where a partner designates his widow as the successor in interest, her distributive share of income for the taxable year of the partnership ending within or with her taxable year may be included in a joint return in accordance with the provisions of sections 2 and 6013(a)(2) and (3).

(iv) If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent partner's interest in the partnership occurs upon that date, then the taxable year of the partnership with respect to such decedent partner shall close upon the date of death. See section 706(c)(2)(A)(i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition.

(v) To the extent that any part of a distributive share of partnership income of the estate or other successor in interest of a deceased partner is attributable to the decedent for the period ending with the date of his death, such part of the distributive share is income in respect of the decedent under section 691. See section 691 and the regulations thereunder.

(vi) The provisions of this subparagraph may be illustrated by the following examples:

Example (1). B has a taxable year ending December 31 and is a member of partnership ABC, the taxable year of which ends on June 30. B dies on October 31, 1955. His estate (which as a new taxpayer may, under section 441 and the regulations thereunder, adopt any taxable year) adopts a taxable year ending October 31. The return of the decedent for the period January 1 to October 31, 1955, will include only his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955. The distributive share of taxable income of the partnership for its taxable year ending June 30, 1956, arising from the interest of the decedent, will be includible in the return of the estate for its taxable year ending

October 31, 1956. That part of the distributive share attributable to the decedent for the period ending with the date of his death (July 1 through October 31, 1955) is income in respect of a decedent under section 691.

Example (2). Assume the same facts as in example (1) of this subdivision, except that, prior to B's death, B and D had agreed that, upon B's death, D would purchase B's interest for $10,000. When B dies on October 31, 1955, the partnership taxable year beginning July 1, 1955, closes with respect to him. Therefore, the return for B's last taxable year (January 1 to October 31, 1955) will include his distributive share of taxable income of the partnership for its taxable year ending June 30, 1955, plus his distributive share of partnership taxable income for the period July 1 to October 31, 1955. See subdivision (iv) of this subparagraph.

Example (3). H is a member of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 1955. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 1955. Such distribution by the estate is not a sale or exchange of H's partnership interest. No part of the taxable income of the partnership for the taxable year ending December 31, 1955, which is allocable to H, will be included in H's taxable income for his last taxable year (January 1 through March 31, 1955) or in the taxable income of H's estate for the taxable year April 1 through November 30, 1955. The distributive share of partnership taxable income for the full calendar year that is allocable to H will be includible in the taxable income of W for her taxable year ending December 31, 1955, and she may file a joint return under sections 2 and 6013(a)(3). That part of the distributive share attributable to the decedent for the period ending with the date of his death (January 1 through March 31, 1955) is income in respect of a decedent under section 691.

Example (4). M is a member of partnership JKM which operates on a calendar year. M and his wife S file joint returns for calendar years. In accordance with the partnership agreement, M designated S to succeed to his interest in the partnership upon his death. M, who had withdrawn $10,000 from the partnership before his death, dies on October 20, 1955. S's distributive share of income for the taxable year 1955 is $15,000 ($10,000 of which represents the amount withdrawn by M). S shall include $15,000 in her income, even though M received $10,000 of this amount before his death. S may file a joint return with M for the year 1955 under sections 2 and 6013(a). That part of the $15,000 distributive share attributable to the decedent for the period ending with the date of his death (January 1 through October 20, 1955) is income in respect of a decedent under section 691.

(4) Disposition of less than entire interest. If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner's distributive share of items which he is required to include in his taxable income under the provisions of section 702(a) shall be determined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

(5) Transfer of interest by gift. The transfer of a partnership interest by gift does not close the partnership taxable year with respect to the donor. However, the income up to the date of gift attributable to the donor's interest shall be allocated to him under section 704(e)(2).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7286, 38 FR 26912, Sept. 27, 1973; T.D. 8123, 52 FR 3623, Feb. 5, 1987]

§ 1.706–1T Taxable years of certain partnerships (temporary).

(a) Taxable year determined by reference to the partners—(1) In general. If for any taxable year a partnership's taxable year cannot be determined by reference to the taxable year of its partners owning a majority interest in partnership profits and capital (as described in section 706(b)(1)(B)(i)) or by reference to the taxable year of all its principal partners (as described in section 706(b)(1)(B)(ii)), then the partnership must determine its taxable year under section 706(b)(1)(B)(iii). Under section 706(b)(1)(B)(iii), the taxable year of the partnership, except as provided in paragraph (b) of this section, shall be the taxable year that results in the least aggregate deferral of income to the partners (as determined under paragraph (a)(2) of this section). See § 1.706–3T(a) for special rules which provide that certain tax-exempt partners are disregarded.

(2) Taxable year that results in the least aggregate deferral of income. The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that produces the lowest sum when compared to the other partner's taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable year. The determination of the taxable year that results in the least aggregate deferral of income shall generally be made as of the beginning of the partnership's current taxable year. The district director, however, may determine that the first day

of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example, the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.

(3) Determination of the taxable year of a partner or partnership that uses a 52–53 week taxable year. For purposes of the calculation described in paragraph (a)(2) of this section, the taxable year of a partner or partnership that uses a 52–53 week taxable year shall be the same year determined under the rules of section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(4) Special de minimis rule. If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current taxable year, the partnership's current taxable year shall be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year. However, this de minimis rule will not apply to the first taxable period beginning after December 31, 1986.

(b) Business purpose. A partnership may have a taxable year other than the year described in paragraph (a) of this section if it establishes, to the satisfaction of the Commissioner of Internal Revenue, a business purpose for such taxable year in accordance with and under the procedures established in § 1.442–1(b)(1). For purposes of this paragraph (b), any deferral of income to partners shall not be treated as a business purpose.

(c) Procedural requirements and effective date—(1) In general. The change in accounting period required by paragraph (a) of this section shall be treated as initiated by the partnership and made with the consent of the Commissioner. To effect the change, a partnership must show that the requirements of this section are satisfied in a statement setting forth the computations required to establish the taxable year that results in the least aggregate deferral of income to the partners under paragraph (a) of this section. The partnership must attach the statement to the income tax return for the short period involved in the changes and must indicate the following at the top of page 1 of the return: "FILED UNDER § 1.706–1T."

(2) Effective date—(i) In general. Except as provided in paragraph (c)(2)(ii) of this section, the rules of this section are effective for partnership taxable years beginning after December 31, 1986.

(ii) Special rule for first taxable year beginning after December 31, 1986. A partnership otherwise required to change its accounting period for its first taxable year beginning after December 31, 1986 to a year resulting in the least aggregate deferral of income to its partners under paragraph (a) of this section, may, at its option, delay the application of the rules of that paragraph until its first taxable year beginning after December 31, 1987. In such a case, the partnership must conform its first taxable year beginning after December 31, 1986 to the calendar year and must apply the rules of paragraph (a) of this section to its first taxable year beginning after December 31, 1987. See § 1.702–3T(a)(1) regarding the availability of a 4–year spread provision with respect to a partnership required to change its taxable year for its first taxable year beginning after December 31, 1986.

(iii) Special eligibility for 4–year spread; years beginning after December 31, 1987. Notwithstanding the provisions of § 1.702–3T(a)(1) limiting the availability of the 4–year spread provisions to a partnership's first taxable year beginning after December 31, 1986, if—

(A) A partnership is required under section 706(b)(1)(B)(iii) and paragraph (a) of this section to change to a taxable year that results in the least aggregate deferral of income to the partners for a partnership's first taxable year beginning after December 31, 1987,

(B) The partnership did exercise its option, as provided in paragraph (c)(2)(ii) of this section, to delay the application of the rules of paragraph (a) of this section until the partnership's first taxable year beginning after December 31, 1987, and

(C) The partnership would have been required to change its accounting period under section 706(b)(1)(B)(iii) and paragraph (a) of this section for its first taxable year beginning after December 31, 1986, if paragraph (a) of this section had been applicable to such taxable year, the partners in the partnership will be eligible to utilize the 4–year

spread provision provided in § 1.702–3T (subject to the other requirements of that section) with respect to the partnership's change in accounting period required under section 706(b)(1)(B)(iii) and paragraph (a) of this section for the partnership's first taxable year beginning after December 31, 1987.

(d) Examples. The principles of this section may be illustrated by the following examples:

Example (1). Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent interest in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	6/30	.5	0	0
Partner B	7/31	.5	1	.5
Aggregate deferral				.5

Test 7/31	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral
Partner A	6/30	.5	11	5.5
Partner B	7/31	.5	0	0
Aggregate deferral				5.5

Example (2). The facts are the same as in *Example (1)* except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 12/31	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A	12/31	.5	0	0
Partner B	11/30	.5	11	5.5
Aggregate deferral				5.5

Test 11/30	Year End	Interest in Partnership Profits	Months of Deferral for 11/30 Year End	Interest x Deferral
Partner A	12/31	.5	1	.5
Partner B	11/30	.5	0	0
Aggregate deferral				.5

Example (3). The facts are the same as in *Example (2)* except that B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year ends June 30, it must retain its current taxable year.

Test 12/31	Year End	Interest in Partnership Profits	Months of Deferral for 12/31 Year End	Interest x Deferral
Partner A	12/31	.5	0	0
Partner B	6/30	.5	6	3.0
Aggregate deferral				3.0

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A	12/31	.5	6	3.0
Partner B	6/30	.5	0	0
Aggregate deferral				3.0

Example (4). The facts are the same as in *Example (1)* except that on December 31, 1987, partner A sells a 4 percent interest in the partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending June 30. The taxable year beginning July 1, 1987, is unaffected by the sale. However, for the taxable year beginning July 31, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that results in the least aggregate deferral of income to the partners.

Example (5). The facts are the same as in *Example (4)* except that Partner D reports income on the fiscal year ending April 30. As in Example (4), the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the

fiscal year ending April 30. This determination is made as follows:

Test 7/31	Year End	Interest in Partnership Profits	Months of Deferral for 7/31 Year End	Interest x Deferral.
Partner A.........	6/30	.06	11	.66
Partner B.........	7/31	.5	0	0
Partner C.........	6/30	.04	11	.44
Partner D.........	4/30	.4	9	3.60
Aggregate deferral..........................				4.70

Test 6/30	Year End	Interest in Partnership Profits	Months of Deferral for 6/30 Year End	Interest x Deferral
Partner A.........	6/30	.06	0	0
Partner B.........	7/31	.5	1	.5
Partner C.........	6/30	.04	0	0
Partner D.........	4/30	.4	10	4.0
Aggregate deferral..........................				4.5

Test 4/30	Year End	Interest in Partnership Profits	Months of Deferral for 4/30 Year End	Interest x Deferral
Partner A.........	6/30	.06	2	.12
Partner B.........	7/31	.5	3	1.50

Test 4/30	Year End	Interest in Partnership Profits	Months of Deferral for 4/30 Year End	Interest x Deferral.
Partner C.........	6/30	.04	2	.08
Partner D.........	4/30	.4	0	0
Aggregate deferral..........................				1.70

§ 1.706–1T(a)(4) Test:	
Current taxable year (June 30)	4.5
Less: Taxable year producing the least aggregate deferral (April 30)	1.7
Additional aggregate deferral (greater than .5)	2.8

Example (6). Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under § 1.706–1T(a)(2) to be the fiscal year ending March 31 as follows:

Test 3/31	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral
Partner A.........	3/31	.5	0	0
Partner B.........	7/31	.5	4	2
Aggregate deferral..........................				2

Test 7/31	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest x Deferral
Partner A.........	3/31	.5	8	4
Partner B.........	7/31	.5	0	0
Aggregate deferral..........................				4

In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (a)(4) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31	Year End	Interest in Partnership Profits	Deferral for 3/31 Year End	Interest x Deferral
Partner A.........	3/31	.05	0	0
Partner B.........	7/31	.5	4	2.0
Partner C.........	4/30	.45	1	.45
Aggregate deferral..........................				2.45

Test 7/31	Year End	Interest in Partnership Profits	Deferral for 7/31 Year End	Interest x Deferral
Partner A.........	3/31	.05	8	.40
Partner B.........	7/31	.5	0	0
Partner C.........	4/30	.45	9	4.05
Aggregate deferral				4.45

Test 4/30	Year End	Interest in Partnership Profits	Deferral for 4/30 Year End	Interest x Deferral
Partner A.........	3/31	.05	11	.55
Partner B.........	7/31	.5	3	1.50
Partner C.........	4/30	.45	0	0
Aggregate deferral				2.05
§ 1.706–1T(a)(4) Test:				
Current taxable year (3/31)				2.45
Less: Taxable year producing the least aggregate deferral (4/30)				2.05

Test 4/30	Year End	Interest in Partnership Profits	Deferral for 4/30 Year End	Interest x Deferral
Additional aggregate deferral (less tban .5)				.40

[T.D. 8169, 52 FR 48995, Dec. 29, 1987; T.D. 8169, 53 FR 1441, Jan. 19, 1988; T.D. 8205, 53 FR 19711, May 27, 1988]

§ 1.706–2T Temporary regulations; question and answer under the Tax Reform Act of 1984.

Question 1: For purposes of section 706(d), how is an otherwise deductible amount that is deferred under section 267(a)(2) treated?

Answer 1: In the year the deduction is allowed, the deduction will constitute an allocable cash basis item under section 706(d)(2)(B)(iv).

[T.D. 7991, 49 FR 47001, Nov. 30, 1984]

§ 1.706–3T Temporary regulations under the Tax Reform Act of 1986 and the Revenue Act of 1987 (temporary).

(a) Certain tax-exempt partners disregarded—(1) General rule. In determining the taxable year (the "current year") of a partnership under section 706(b) and the regulations thereunder, a partner that is tax-exempt under section 501(a) shall be disregarded if such partner was not subject to tax, under chapter 1 of the Code, on any income attributable to its investment in the partnership during the partnership's taxable year immediately preceding the current year. However, if a partner that is tax-exempt under section 501(a) was not a partner during the partnership's immediately preceding taxable year, such partner will be disregarded for the current year if the partnership reasonably believes that the partner will not be subject to tax, under chapter 1 of the Code, on any income attributable to such partner's investment in the partnership during the current year.

(2) Example. The provisions of paragraph (a)(1) of this section may be illustrated by the following example.

Example. Assume that partnership A has historically used the calendar year as its taxable year. In addition, assume that A is owned by 5 partners, 4 calendar year individuals (each owning 10 percent of A's profits and capital) and a tax-exempt organization (owning 60 percent of A's profits and capital). The tax-exempt organization has never had unrelated business taxable income with respect to A and has historically used a June 30 fiscal year. Finally, assume that A desires to retain the calendar year for its taxable year beginning January 1, 1987. Under tbese facts and but for the special rule in paragraph (a)(1) of this section, A would be required under section 706(b)(1)(B)(i) to change to a year ending June 30, for its taxable year beginning January 1, 1987. However, under the special rule provided in paragraph (a)(1) of this section, and assuming the optional effective date provided in paragraph (c) of this section is chosen, the partner that is tax-exempt is disregarded, and A must retain the calendar year, under section 706(b)(1)(B)(i), for its taxable year beginning January 1, 1987.

(b) Effect of partner elections under section 444. For purposes of section 706(b)(1)(B), any section 444 election by a partner in a partnership shall be taken into account in determining the taxable year of the partnership. See example (4) of § 1.7519-1T(d).

(c) Effective date. The provisions of this section are generally effective for taxable years beginning after December 31, 1987. However, a partnership may, at its option, apply the provisions of this section for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19710, May 27, 1988]

§ 1.707–1 Transactions between partner and partnership.

(a) Partner not acting in capacity as partner. A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See paragraph (c)(3) of § 1.731–1.

(b) Certain sales or exchanges of property with respect to controlled partnerships—(1) Losses disallowed. (i) No deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership, directly or indirect-

ly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership. A loss on a sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interest in each partnership shall not be allowed.

(ii) If a gain is realized upon the subsequent sale or exchange by a transferee of property with respect to which a loss was disallowed under the provisions of subdivision (i) of this subparagraph, section 267(d) (relating to amount of gain where loss previously disallowed) shall apply as though the loss were disallowed under section 267(a)(1).

(2) Gains treated as ordinary income. Any gain recognized upon the sale or exchange, directly or indirectly, of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset, as defined in section 1221, shall be ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 80 percent of the capital interest or profits interest in the partnership. This rule also applies where such a transaction is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interest or profits interest in each partnership. The term "property other than a capital asset" includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.

(3) Ownership of a capital or profits interest. In determining the extent of the ownership by a partner, as defined in section 761(b), of his capital interest or profits interest in a partnership, the rules for constructive ownership of stock provided in section 267(c)(1), (2), (4), and (5) shall be applied for the purpose of section 707(b) and this paragraph. Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761(b) in order that another partner may be considered the constructive owner of such interest under section 267(c). However, section 707(b)(1)(A) does not apply to a constructive owner of a partnership interest since he is not a partner as defined in section 761(b). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW only for the purpose of further attributing the ownership of such interest to A. See section 267(c)(1) and (5). If A, B, and T are equal partners, then A will be considered as owning more than 50 percent of the capital and profits interest in the partnership, and losses on transactions between him and the partnership will be disallowed by section 707(b)(1)(A). However, a loss sustained by AW on a sale or exchange of property with the partnership would not be disallowed by section 707, but will be disallowed to the extent provided in paragraph (b) of § 1.267(b)–1. See section 267(a) and (b), and the regulations thereunder.

(c) Guaranteed payments. Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of § 1.706–1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for

services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

Example (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Example (3). Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

Example (4). Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; as amended by T.D. 7891, 48 FR 20049, May 4, 1983]

§ 1.708–1 Continuation of partnership.

(a) General rule. For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.

(b) Termination—(1) General rule. (i) A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. For example, on November 20, 1956, A and B, each of whom is a 20-percent partner in partnership ABC, sell their interests to C, who is a 60-percent partner. Since the business is no longer carried on by any of its partners in a partnership, the ABC partnership is terminated as of November 20, 1956. However, where partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957.

(a) Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business.

(b) For the continuation of a partnership where payments are being made under section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), see paragraph (a)(6) of § 1.736–1.

(ii) A partnership shall terminate when 50-percent or more of the total interest in partnership capital and profits is sold or exchanged within a period of 12 consecutive months. Such sale or exchange includes a sale or exchange to another member of the partnership. However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of this subparagraph. Furthermore, the contribution of property to a partnership does not constitute such a sale or exchange. See, however, paragraph (c)(3) of § 1.731–1. Fifty percent or more of the total interest in partnership capital and profits means 50 percent or more of the total interest in partnership capital plus 50-percent or more of the total interest in partnership profits. Thus, the sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits is not the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. If one or more partners sell or exchange interests aggregating 50-percent or more of the total interest in partnership capital and 50-percent or more of the total interest in partnership profits within a period of 12 consecutive months, such sale or exchange is considered as being within the provisions of this subparagraph. When interests are sold or exchanged on different dates, the percentages to be added are determined as of the date of each sale. For example, with respect to the ABC partnership, the sale by A on May 12, 1956, of a 30-percent interest in capital and profits to D, and the sale by B on March 27, 1957, of a 30-percent interest in capital and profits to E, is a sale of a 50-percent or more interest. Accordingly, the partnership is terminated as of March 27, 1957. However, if, on March 27, 1957, D instead of B, sold his 30-percent interest in capital and profits to E, there would be no termination since only one

30-percent interest would have been sold or exchanged within a 12-month period.

(iii) For purposes of subchapter K, chapter 1 of the Code, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates. See section 706(c)(1) and paragraph (c)(1) of § 1.706–1. The date of termination is:

(a) For purposes of section 708(b)(1)(A), the date on which the winding up of the partnership affairs is completed.

(b) For purposes of section 708(b)(1)(B), the date of the sale or exchange of a partnership interest which, of itself or together with sales or exchanges in the preceding 12 months, transfers an interest of 50-percent or more in both partnership capital and profits.

(iv) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties; and, immediately thereafter, the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or for its dissolution and winding up. In the latter case, the new partnership terminates in accordance with subdivision (i) of this subparagraph. See sections 731 and 732 and §§ 1.731–1 and 1.732–1. For election of basis adjustments by the purchaser and other remaining partners, see sections 732(d) and 743(b) and paragraph (d) of § 1.732–1 and paragraph (b) of § 1.743–1.

(2) Special rules—(i) Merger or consolidation. If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. If the resulting partnership can, under the preceding sentence, be considered a continuation of more than one of the merging or consolidating partnerships, it shall, unless the Commissioner permits otherwise, be considered the continuation of that partnership which is credited with the contribution of the greatest dollar value of assets to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results. The taxable years of such merging or consolidating partnerships which are considered terminated shall be closed in accordance with the provisions of section 706(c), and such partnerships shall file their returns for a taxable year ending upon the date of termination, *i.e.*, the date of merger or consolidation. The resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing. The return shall state that the resulting partnership is a continuation of such merging or consolidating partnership and shall include the names and addresses of the merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and subsequent to the date of merger or consolidation shall be shown as a part of the return. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September 30, 1955, and form partnership ABCD. Partners A, B, C, and D are on a calendar year; partnership AB is also on a calendar year; and partnership CD is on a fiscal year ending June 30th. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. Since A and B together own an interest of more than 50 percent in the capital and profits of partnership ABCD, such partnership shall be considered a continuation of partnership AB and shall continue to file returns on a calendar year basis. Since C and D own an interest of less than 50 percent in the capital and profits of partnership ABCD, the taxable year of partnership CD closes as of September 30, 1955, the date of the merger, and CD partnership is terminated as of that date. Partnership ABCD is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that, until September 30, 1955, it was partnership AB. Partnership CD is required to file a return for its final taxable year, July 1 through September 30, 1955.

(ii) Division of a partnership. Upon the division of a partnership into two or more partnerships, any resulting partnership or partnerships shall be considered a continuation of the prior partnership if its members had an interest of more than 50 percent in the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the divided partnership, the divided partnership is terminated. Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partner-

ship, such partner's interests shall be considered liquidated as of the date of the division. The resulting partnership that is regarded as continuing shall file a return for the taxable year of the partnership that has been divided. The return shall state that the partnership is a continuation of the divided partnership and shall set forth separately the respective distributive shares of the partners for the periods prior to and subsequent to the date of division. The provisions of this subdivision may be illustrated by the following example:

Example. Partnership ABCD is in the real estate and insurance business. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of the partnership. The partnership and the partners report their income on a calendar year. They agree to separate the real estate and insurance business as of November 1, 1955, and to form two partnerships; partnership AB to take over the real estate business, and partnership CD to take over the insurance business. Since members of resulting partnership AB owned more than a 50-percent interest in the capital and profits of partnership ABCD (A, 40 percent, and B, 20 percent), partnership AB shall be considered a continuation of partnership ABCD. Partnership AB is required to file a return for the taxable year January 1 to December 31, 1955, indicating thereon that until November 1, 1955, it was partnership ABCD. In forming partnership CD, partners C and D may contribute the property distributed to them in liquidation of their entire interests in divided partnership ABCD. Partnership CD will be required to file a return for the taxable year it adopts pursuant to section 706(b) and paragraph (b) of § 1.706–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.709–1 Treatment of organization and syndication costs.

(a) General rule. Except as provided in paragraph (b) of this section, no deduction shall be allowed under Chapter 1 of the Code to a partnership or to any partner for any amounts paid or incurred, directly or indirectly, in partnership taxable years beginning after December 31, 1975, to organize a partnership, or to promote the sale of, or to sell, an interest in the partnership.

(b) Amortization of organization expenses. (1) Under section 709(b) of the Code, a partnership may elect to treat its organizational expenses (as defined in section 709(b)(2) and in § 1.709–2(a)) paid or incurred in partnership taxable years beginning after December 31, 1976, as deferred expenses. If a partnership elects to amortize organizational expenses, it must select a period of not less than 60 months, over which the partnership will amortize all such expenses on a straight line basis. This period must begin with the month in which the partnership begins business (as determined under § 1.709–2(c)). However, in the case of a partnership on the cash receipts and disbursements method of accounting, no deduction shall be allowed for a taxable year with respect to any such expenses that have not been paid by the end of that taxable year. Portions of such expenses which would have been deductible under section 709(b) in a prior taxable year if the expenses had been paid are deductible in the year of payment. The election is irrevocable and the period selected by the partnership in making its election may not be subsequently changed.

(2) If there is a winding up and complete liquidation of the partnership prior to the end of the amortization period, the unamortized amount of organizational expenses is a partnership deduction in its final taxable year to the extent provided under section 165 (relating to losses). However, there is no partnership deduction with respect to its capitalized syndication expenses.

(c) Time and manner of making election. The election to amortize organizational expenses provided by section 709(b) shall be made by attaching a statement to the partnership's return of income for the taxable year in which the partnership begins business. The statement shall set forth a description of each organizational expense incurred (whether or not paid) with the amount of the expense, the date each expense was incurred, the month in which the partnership began business, and the number of months (not less than 60) over which the expenses are to be amortized. A taxpayer on the cash receipts and disbursements method of accounting shall also indicate the amount paid before the end of the taxable year with respect to each such expense. Expenses less than $10 need not be separately listed, provided the total amount of these expenses is listed with the dates on which the first and last of such expenses were incurred, and, in the case of a taxpayer on the cash receipts and disbursements method of accounting, the aggregate amount of such expenses that was paid by the end of the taxable year is stated. In the case of a partnership which begins business in a taxable year that ends after March 31, 1983, the original return and statement must be filed (and the election made) not later than the date prescribed by law for filing the return (including any extensions of time) for that taxable year. Once an election has been made, an amended return (or returns) and statement (or statements) may be filed to include any organizational expenses not included in the partnership's original return and statement.

[T.D. 7891, 48 FR 20048, May 4, 1983]

§ 1.709–2 Definitions.

(a) Organizational expenses. Section 709(b)(2) of the Internal Revenue Code defines organizational expenses as expenses which:

(1) Are incident to the creation of the partnership;

(2) Are chargeable to capital account; and

(3) Are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would (but for section 709(a)) be amortized over such life.

An expenditure which fails to meet one or more of these three tests does not qualify as an organizational expense for purposes of section 709(b) and this section. To satisfy the statutory requirement described in paragraph (a)(1) of this section, the expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. In addition, the expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. To satisfy the statutory requirement described in paragraph (a)(3) of this section, the expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. The following are examples of organizational expenses within the meaning of section 709 and this section: Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement; accounting fees for services incident to the organization of the partnership; and filing fees. The following are examples of expenses that are not organizational expenses within the meaning of section 709 and this section (regardless of how the partnership characterizes them): Expenses connected with acquiring assets for the partnership or transferring assets to the partnership; expenses connected with the admission or removal of partners other than at the time the partnership is first organized; expenses connected with a contract relating to the operation of the partnership trade or business (even where the contract is between the partnership and one of its members); and syndication expenses.

(b) **Syndication expenses.** Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. Examples of syndication expenses are brokerage fees; registration fees; legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes; accounting fees for preparation of representations to be included in the offering materials; and printing costs of the prospectus, placement memorandum, and other selling and promotional material. These expenses are not subject to the election under section 709(b) and must be capitalized.

(c) **Beginning business.** The determination of the date a partnership begins business for purposes of section 709 presents a question of fact that must be determined in each case in light of all the circumstances of the particular case. Ordinarily, a partnership begins business when it starts the business operations for which it was organized. The mere signing of a partnership agreement is not alone sufficient to show the beginning of business.

If the activities of the partnership have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business. Accordingly, the acquisition of operating assets which are necessary to the type of business contemplated may constitute beginning business for these purposes. The term "operating assets", as used herein, means assets that are in a state of readiness to be placed in service within a reasonable period following their acquisition.

[T.D. 7891, 48 FR 20049, May 4, 1983]

Contributions, Distributions, and Transfers

Contributions to a Partnership

§ 1.721–1 Nonrecognition of gain or loss on contribution.

(a) No gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property, including installment obligations, to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating. Section 721 shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707. Rather than contributing property to

a partnership, a partner may sell property to the partnership or may retain the ownership of property and allow the partnership to use it. In all cases, the substance of the transaction will govern, rather than its form. See paragraph (c)(3) of § 1.731-1. Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, including a promissory obligation fixed in amount and time for payment, the transaction will be treated as a sale or exchange under section 707 rather than as a contribution under section 721. For the rules governing the treatment of liabilities to which contributed property is subject, see section 752 and § 1.752-1.

(b)(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital representing compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) Compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.722-1 Basis of contributing partner's interest.

The basis to a partner of a partnership interest acquired by a contribution of property, including money, to the partnership shall be the amount of money contributed plus the adjusted basis at the time of contribution of any property contributed. If the acquisition of an interest in partnership capital results in taxable income to a partner, such income shall constitute an addition to the basis of the partner's interest. See paragraph (b) of § 1.721-1. If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, the basis of the contributing partner's interest shall be reduced by the portion of the indebtedness assumed by the other partners, since the partnership's assumption of his indebtedness is treated as a distribution of money to the partner. Conversely, the assumption by the other partners of a portion of the contributor's indebtedness is treated as a contribution of money by them. See section 752 and § 1.752-1. The provisions of this section may be illustrated by the following examples:

Example (1). A acquired a 20-percent interest in a partnership by contributing property. At the time of A's contribution, the property had a fair market value of $10,000, an adjusted basis to A of $4,000, and was subject to a mortgage of $2,000. Payment of the mortgage was assumed by the partnership. The basis of A's interest in the partnership is $2,400, computed as follows:

Adjusted basis to A of property contributed ..	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $2,000)	1,600
Basis of A's interest	2,400

Example (2). If, in example (1) of this section, the property contributed by A was subject to a mortgage of $6,000, the basis of A's interest would be zero, computed as follows:

Adjusted basis to A of property contributed ..	$4,000
Less portion of mortgage assumed by other partners which must be treated as a distribution (80 percent of $6,000)	4,800
	(800)

Since A's basis cannot be less than zero, the $800 in excess of basis, which is considered as a distribution of money under section 752(b), is treated as capital gain from the sale or exchange or a partnership interest. See section 731(a).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.723-1 Basis of property contributed to partnership.

The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the

same basis in the hands of the partnership as it had in the hands of the contributing partner, the holding period of such property for the partnership includes the period during which it was held by the partner. See section 1223(2). For elective adjustments to the basis of partnership property arising from distributions or transfers of partnership interests, see sections 732(d), 734(b), and 743(b).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

Distributions by a Partnership

§ 1.731–1 Extent of recognition of gain or loss on distribution.

(a) Recognition of gain or loss to partner—(1) Recognition of gain. (i) Where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i.e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership. Thus, if a partner with a basis for his interest of $10,000 receives a distribution of cash of $8,000 and property with a fair market value of $3,000, no gain is recognized to him. If $11,000 cash were distributed, gain would be recognized to the extent of $1,000. No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items). See section 731(c) and paragraph (c) of this section.

(ii) For the purposes of sections 731 and 705, advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions made on the last day of the partnership taxable year with respect to such partner.

(2) Recognition of loss. Loss is recognized to a partner only upon liquidation of his entire interest in the partnership, and only if the property distributed to him consists solely of money, unrealized receivables (as defined in section 751(c)), and inventory items (as defined in section 751(d)(2)). The term "liquidation of a partner's interest", as defined in section 761(d), is the termination of the partner's entire interest in the partnership by means of a distribution or a series of distributions. Loss is recognized to the distributee partner in such cases to the extent of the excess of the adjusted basis of such partner's interest in the partnership at the time of the distribution over the sum of—

(i) Any money distributed to him, and

(ii) The basis to the distributee, as determined under section 732, of any unrealized receivables and inventory items that are distributed to him.

If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory items, then no loss will be recognized. Application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner A has a partnership interest in partnership ABC with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $5,000 cash and inventory with a basis to him (under section 732) of $3,000. Partner A realizes a capital loss of $2,000, which is recognized under section 731(a)(2).

Example (2). Partner B has a partnership interest in partnership BCD with an adjusted basis to him of $10,000. He retires from the partnership and receives, as a distribution in liquidation of his entire interest, his share of partnership property. This share is $4,000 cash, real property (used in the trade or business) with an adjusted basis to the partnership of $2,000, and unrealized receivables having a basis to him (under section 732) of $3,000. No loss will be recognized to B on the transaction because he received property other than money, unrealized receivables, and inventory items. As determined under section 732, the basis to B for the real property received is $3,000.

(3) Character of gain or loss. Gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

(b) Gain or loss recognized by partnership. A distribution of property (including money) by a partnership to a partner does not result in recognized gain or loss to the partnership under section 731. However, recognized gain or loss may result to the partnership from certain distributions which, under section 751(b), must be treated as a sale or exchange of property between the distributee partner and the partnership.

(c) Exceptions. (1) Section 731 does not apply to the extent otherwise provided by—

(i) Section 736 (relating to payments to a retiring partner or to a deceased partner's successor in interest) and

(ii) Section 751 (relating to unrealized receivables and inventory items).

For example, payments under section 736(a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section.

(2) The receipt by a partner from the partnership of money or property under an obligation to repay the amount of such money or to return such property does not constitute a distribution subject to section 731 but is a loan governed by section 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation.

(3) If there is a contribution of property to a partnership and within a short period:

(i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or

(ii) After such contribution the contributed property is distributed to another partner,

such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.732–1 Basis of distributed property other than money.

(a) Distributions other than in liquidation of a partner's interest. The basis of property (other than money) received by a partner in a distribution from a partnership, other than in liquidation of his entire interest, shall be its adjusted basis to the partnership immediately before such distribution. However, the basis of the property to the partner shall not exceed the adjusted basis of the partner's interest in the partnership, reduced by the amount of any money distributed to him in the same transaction. The provisions of this paragraph may be illustrated by the following examples:

Example (1). Partner A, with an adjusted basis of $15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of $10,000 to the partnership immediately before distribution, and $2,000 cash. The basis of the property in A's hands will be $10,000. Under sections 733 and 705, the basis of A's partnership interest will be reduced by the distribution to $3,000 ($15,000 less $2,000 cash, less $10,-000, the basis of the distributed property to A).

Example (2). Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

(b) Distribution in liquidation. Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him in the same transaction. Application of this rule may be illustrated by the following example:

Example. Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

(c) Allocation of basis among properties distributed to a partner. (1) Under section 732(a)(2) or (b), the basis to be allocated to properties distributed to a partner shall be allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) included in the distribution. However, such receivables or inventory items may not take a higher basis in the hands of the partner than their common adjusted basis to the partnership immediately before the distribution, unless such distribution is treated as a sale or exchange under section 751(b), or unless the distributee partner has a special basis adjustment for the distributed property under sections 732(d) or 743(b). Any basis not allocated to unrealized receivable or inventory items shall be allocated to any other properties distributed to the partner in the same transaction, in proportion to the bases of such other properties in the hands of the partnership before distribution. The provisions of this subparagraph may be illustrated by the following example:

Example. Partner A, whose partnership interest in partnership ABC has an adjusted basis of $15,000, receives as a distribution in liquidation of his entire interest inventory items having a basis to the partnership of $6,000. In addition, he receives cash of $5,000, and two parcels of real property with adjusted bases to the partnership of $6,000 and $2,000, respectively. Basis in the amount of $10,000 ($15,000 basis, less $5,000 cash received) is allocated $6,000 to inventory items,

and $3,000 (6,000/8,000×$4,000) and $1,000 (2,000/8,000×$4,000), respectively, to the two parcels of real property.

(2) If the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to a partner is greater than the partner's adjusted basis of his interest (reduced by the amount of money distributed to him in the same transaction), the amount of the basis to be allocated to such unrealized receivables and inventory items shall be allocated in proportion to the adjusted bases of such properties in the hands of the partnership. If the basis of the partner's interest to be allocated upon a distribution in liquidation of his entire interest is in excess of the adjusted basis to the partnership of the unrealized receivables and inventory items distributed, and if there is no other property distributed to which such excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of his partnership interest. The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner C, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $6,000, inventory items having an adjusted basis to the partnership of $6,000, and real property having a basis to the partnership of $4,000. The cash payment reduces C's basis to $3,000, which is allocated entirely to inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

Example (2). Partner B, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives as a distribution in liquidation cash of $1,000 and inventory items having a basis to the partnership of $6,000. The cash payment reduces B's basis to $8,000, which can be allocated only to the extent of $6,000 to the inventory items. The remaining $2,000 basis, not allocable to distributed property, constitutes a capital loss in that amount to partner B under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(d) Special partnership basis to transferee under section 732(d). **(1)(i)** A transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner. Section 732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under section 754 (relating to the optional adjustment to basis of partnership property) was not in effect.

(ii) Where an election under section 754 is in effect, see section 743(b) and paragraph (b) of § 1.743–1 and § 1.732–2.

(iii) If a transferee partner receives a distribution of property (other than money) from the partnership within 2 years after he acquired his interest or part thereof in the partnership by a transfer with respect to which the election under section 754 was not in effect, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in section 743(b) were in effect.

(iv) If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

(v) If property is distributed to a transferee partner who elects under section 732(d), and if such property is not the same property which would have had a special basis adjustment, then such special basis adjustment shall apply to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment. This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed or by the partnership. (For shift of transferee's special basis adjustment to like property, see paragraph (b)(2)(ii) of § 1.743–1.)

(vi) The provisions of this subparagraph may be illustrated by the following example:

Example. The basis to transferee partner K of his one-fourth interest in partnership WJKS is $17,000. At the time he acquired such interest by purchase, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a value of $16,000. K's purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by K for his one-fourth interest was attributable to his share of partnership inventory with a basis of $3,500. Within 2 years after acquiring his interest, K retired from the partnership and received in liquidation of his entire interest cash of $1,500, inventory with a basis to the partnership of $3,500, property X (a capital asset), with an adjusted basis to the partnership of $2,000, and property Y (a depreciable asset), with an adjusted basis to the partnership of $4,000. The value of the inventory received by K was one-fourth of the value of all partnership inventory and was his share of such property. It is immaterial whether the inventory K received was on hand when K acquired his interest. In accordance with K's election under section 732(d), the amount of his share of partnership basis which is attributable to partnership inventory

is increased by $500 (one-fourth of the $2,000 difference between the value of such property, $16,000, and its $14,000 basis to the partnership at the time K acquired his interest). This adjustment under section 732(d) applies only for purposes of distributions to partner K, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by K in the liquidating distribution is $15,500 ($17,000, K's basis for his interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: The basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis for such items, plus the special basis adjustment of $500 which K would have had under section 743(b). The remaining basis of $11,500 ($15,500 minus $4,000) is to be allocated to the remaining property distributed to K in proportion to their adjusted bases to the partnership. Since the adjusted basis to the partnership of property X is $2,000, and that of property Y is $4,000, the $11,500 is allocated $3,833 (2,000/6,000×$11,500) to X, and $7,667 (4,000/6,000×$11,5-00) to Y.

(2) A transferee partner who wishes to elect under section 732(d) shall make the election with his tax return—

(i) For the year of the distribution, if the distribution includes any property subject to the allowance for depreciation, depletion, or amortization, or

(ii) For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization.

(3) A taxpayer making an election under section 732(d) shall submit with the return in which the election is made a schedule setting forth the following:

(i) That under section 732(d) he elects to adjust the basis of property received in a distribution; and

(ii) The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, see section 755.

(4) A partner who acquired any part of his partnership interest in a transfer to which the election provided in section 754 was not in effect, is required to apply the special basis rule contained in section 732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest—

(i) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(ii) An allocation of basis under section 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

(iii) A special basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

The application of the rule presented in this subparagraph may be illustrated by the following examples:

Example (1). Partnership ABC owns three parcels of land, each of which has an adjusted basis to the partnership of $5,000 and is worth $55,000, and depreciable property with an adjusted basis and value of $150,000. D purchases A's partnership interest for $105,000 when the election under section 754 is not in effect. At the time of D's purchase, the fair market value of all partnership property (other than money) is $315,000, which exceeds 110 percent of $165,000, its adjusted basis to the partnership. Four years later, the partnership is dissolved. D receives one of the three parcels of land which has a basis to the partnership of $5,000, and one-third of the depreciable property with an adjusted basis to the partnership at that time of $45,000, one-third of $135,000 ($150,000 basis, minus $15,000 depreciation computed on the partnership basis. See subparagraph (1)(iv) of this paragraph.) If D's adjusted basis for his interest at the time of the distribution was $100,000 and was allocated under section 732(c) to the property received by him in proportion to their respective bases to the partnership, the basis to him for the distributed land would be $10,000 (5,000/50,000×$100,000) and the basis of the depreciable property would be $90,000 (45,000/50,000×$100,000). In effect, D would be attributing to the basis of the depreciable property a portion of the cost of his partnership interest properly attributable to appreciation in nondepreciable property. The application of section 743(b) to the transfer of the interest would have resulted in a different basis to D for the property actually distributed. Therefore, the special basis adjustment under section 732(d) must be made so that D must increase the basis of the land by a special basis adjustment of $50,000 ($55,000 fair market value less $5,000 partnership basis), making the basis of his interest therein $55,000 (55,000/-100,000×$100,000). D's basis for the depreciable property will then be $45,000 (45,000/100,000×$100,000).

Example (2). Assume the same facts as in example (1) of this subparagraph, except that the partnership does not dissolve but distributes one parcel of land to each of the partners in a current distribution. Since the conditions of this subparagraph have been met, D's basis for the distributed land is the adjusted basis such land would have if the adjustment provided in section 743(b) were in effect with respect to the partnership property. Therefore, D's basis for the land is $55,000 ($5,000 basis of the land to the partnership, plus $50,000 special basis adjustment under section 732(d)). D's basis for his partnership interest is reduced by $55,000, his basis for the property distributed.

(e) Exception. When a partnership distributes unrealized receivables (as defined in section 751(c)) or substantially appreciated inventory items (as defined in section 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, part-

nership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of section 751(b). In such case, section 732 (including subsection(d) thereof) applies in determining the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See section 751(b) and paragraph (b) of § 1.751–1. However, section 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under section 751(b). Consequently, the basis of such property shall be its cost to the partner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.732–2 Special partnership basis of distributed property.

(a) Adjustments under section 734(b). In the case of a distribution of property to a partner, the partnership bases of the distributed properties shall reflect any increases or decreases to the basis of partnership property which have been made previously under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) in connection with previous distributions.

(b) Adjustments under section 743(b). In the case of a distribution of property to a partner who acquired any part of his interest in a transfer as to which an election under section 754 was in effect, then, for the purposes of section 732 (other than subsection (d) thereof), the adjusted partnership bases of the distributed property shall take into account, in addition to any adjustments under section 734(b), the transferee's special basis adjustment for the distributed property under section 743(b). The application of this paragraph may be illustrated by the following example:

Example. Partner D acquired his interest in partnership ABD from a previous partner. Since the partnership had made an election under section 754, a special basis adjustment with respect to D is applicable to the basis of partnership property in accordance with section 743(b). One of the assets of the partnership at the time D acquired his interest was property X, which is later distributed to D in a current distribution. Property X has an adjusted basis to the partnership of $1,000 and with respect to D it has a special basis adjustment of $500. Therefore, for purposes of section 732(a)(1), the adjusted basis of such property to the partnership with respect to D immediately before its distribution is $1,500. However, if property X is distributed to partner A, a nontransferee partner, its adjusted basis to the partnership for purposes of section 732(a)(1) is only $1,000. In such case, D's $500 special basis adjustment may shift over to other property. See paragraph (b)(2)(ii) of § 1.743–1.

(c) Adjustments to basis of distributed inventory and unrealized receivables. Under section 732, the basis to be allocated to distributed properties shall be allocated first to any unrealized receivables and inventory items. If the distributee partner is a transferee of a partnership interest and has a special basis adjustment for unrealized receivables or inventory items under either section 743(b) or section 732(d), then the partnership adjusted basis immediately prior to distribution of any unrealized receivables or inventory items distributed to such partner shall be determined as follows: If the distributee partner receives his entire share of the fair market value of the inventory items or unrealized receivables of the partnership, the adjusted basis of such distributed property to the partnership, for the purposes of section 732, shall take into account the entire amount of any special basis adjustment which the distributee partner may have for such assets. If the distributee partner receives less than his entire share of the fair market value of partnership inventory items or unrealized receivables, then, for purposes of section 732, the adjusted basis of such distributed property to the partnership shall take into account the same proportion of the distributee's special basis adjustment for unrealized receivables or inventory items as the value of such items distributed to him bears to his entire share of the total value of all such items of the partnership. The provisions of this paragraph may be illustrated by the following example:

Example. Partner C acquired his 40-percent interest in partnership AC from a previous partner. Since the partnership had made an election under section 754, C has a special basis adjustment to partnership property under section 743(b). C retires from the partnership when the adjusted basis of his partnership interest is $3,000. He receives from the partnership in liquidation of his entire interest, $1,000 cash, certain capital assets, depreciable property, and certain inventory items and unrealized receivables. C has a special basis adjustment of $800 with respect to partnership inventory items and of $200 with respect to unrealized receivables. The common partnership basis for the inventory items distributed to him is $500 and for the unrealized receivables is zero. If the value of inventory items and the unrealized receivables distributed to C in his 40 percent share of the total value of all partnership inventory items and unrealized receivables, then, for purposes of section 732, the adjusted basis of such property in C's hands will be $1,300 for the inventory items ($500 plus $800) and $200 for the unrealized receivables (zero plus $200). The remaining basis of $500, which constitutes the basis of the capital assets and depreciable property distributed to C, is determined as follows: $3,000 (total basis) less $1,000 cash, or $2,000 (the

amount to be allocated to the basis of all distributed property), less $1,500 ($800 and $200 special basis adjustments, plus $500 common partnership basis, the amount allocated to inventory items and unrealized receivables). However, if the value of the inventory items and unrealized receivables distributed to C consisted of only 20 percent of the total fair market value of such property (*i.e.*, only one-half of C's 40-percent share), then only one-half of C's special basis adjustment of $800 for partnership inventory items and $200 for unrealized receivables would be taken into account. In that case, the basis of the inventory items in C's hands would be $650 ($250, the common partnership basis for inventory items distributed to him, plus $400, one-half of C's special basis adjustment for inventory items). The basis of the unrealized receivables in C's hands would be $100 (zero plus $100, one-half of C's special basis adjustment for unrealized receivables).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.733–1 Basis of distributee partner's interest.

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's entire interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by the amount of any money distributed to such partner and by the amount of the basis to him of distributed property other than money as determined under section 732 and §§ 1.732–1 and 1.732–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.734–1 Optional adjustment to basis of undistributed partnership property.

(a) General rule. A partnership shall not adjust the basis of partnership property as the result of a distribution of property to a partner, unless the election provided in section 754 (relating to optional adjustment to basis of partnership property) is in effect.

(b) Method of adjustment—(1) Increase in basis. Where an election under section 754 is in effect and a distribution of partnership property is made, whether or not in liquidation of the partner's entire interest in the partnership, the adjusted basis of the remaining partnership assets shall be increased by—

(i) The amount of any gain recognized under section 731(a)(1) to the distributee partner, or

(ii) The excess of the adjusted basis to the partnership immediately before the distribution of any property distributed (including adjustments under section 743(b) or section 732(d) when applied) over the basis under section 732 (including such special basis adjustments) of such property to the distributee partner.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner A has a basis of $10,000 for his one-third interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and a value of $22,000. A receives $11,000 in cash in liquidation of his entire interest in the partnership. He has a gain of $1,000 under section 731(a)(1). If the election under section 754 is in effect, the partnership basis for the property becomes $20,000 ($19,-000 plus $1,000).

Example (2). Partner D has a basis of $10,000 for his one-third interest in partnership DEF. The partnership balance sheet before the distribution shows the following:

Assets

	Adjusted basis	Value
Cash	$4,000	$4,000
Property X	11,000	11,000
Property Y	15,000	18,000
Total	30,000	33,000

Liabilities and Capital

	Adjusted basis	Value
Liabilities	$0	$0
Capital:		
D	10,000	11,000
E	10,000	11,000
F	10,000	11,000
Total	30,000	33,000

In liquidation of his entire interest in the partnership, D received property X with a partnership basis of $11,000. D's basis for property X is $10,000 under section 732(b). Where the election under section 754 is in effect, the excess of $1,000 (the partnership basis before the distribution less D's basis for property X after distribution) is added to the basis of property Y. The basis of property Y becomes $16,000 ($15,000 plus $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734–2.

(2) Decrease in basis. Where the election provided in section 754 is in effect and a distribution is made in liquidation of a partner's entire interest, the partnership shall decrease the adjusted basis of the remaining partnership property by—

(i) The amount of loss, if any, recognized under section 731(a)(2) to the distributee partner, or

(ii) The excess of the basis of the distributed property to the distributee, as determined under section 732 (including adjustments under section 743(b) or section 732(d) when applied) over the adjusted basis of such property to the partnership (including such special basis adjustments) immediately before such distribution.

The provisions of this subparagraph may be illustrated by the following examples:

Example (1). Partner G has a basis of $11,000 for his one-third interest in partnership GHI. Partnership assets con-

sist of cash of $10,000 and property with a basis of $23,000 and a value of $20,000. There are no partnership liabilities. In liquidation of his entire interest in the partnership, G receives $10,000 in cash. He has a loss of $1,000 under section 731(a)(2). If the election under section 754 is in effect, the partnership basis for the property becomes $22,000 ($23,000 less $1,000).

Example (2). Partner J has a basis of $11,000 for his one-third interest in partnership JKL. The partnership balance sheet before the distribution shows the following:

ASSETS

	Adjusted basis	Value
Cash	$5,000	$5,000
Property X	10,000	10,000
Property Y	18,000	15,000
Total	33,000	30,000

LIABILITIES AND CAPITAL

	Adjusted basis	Value
Liabilities	$0	$0
Capital:		
J	11,000	10,000
K	11,000	10,000
L	11,000	10,000
Total	33,000	30,000

In liquidation of his entire interest in the partnership, J receives property X with a partnership basis of $10,000. J's basis for property X under section 732(b) is $11,000. Where the election under section 754 is in effect, the excess of $1,000 ($11,000 basis of property X to J, the distributee, less its $10,000 adjusted basis to the partnership immediately before the distribution) decreases the basis of property Y in the partnership. Thus, the basis of property Y becomes $17,000 ($18,000 less $1,000). If the distribution is made to a transferee partner who elects under section 732(d), see § 1.734–2.

(c) Allocation of basis. For allocation among the partnership properties of basis adjustments under section 734(b) and paragraph (b) of this section, see section 755 and § 1.755–1.

(d) Returns. A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.734–2 Adjustment after distribution to transferee partner.

(a) In the case of a distribution of property by the partnership to a partner who has obtained all or part of his partnership interest by transfer, the adjustments to basis provided in section 743(b) and section 732(d) shall be taken into account in applying the rules under section 734(b). For determining the adjusted basis of distributed property to the partnership immediately before the distribution where there has been a prior transfer of a partnership interest with respect to which the election provided in section 754 or section 732(d) is in effect, see §§ 1.732–1 and 1.732–2.

(b)(1) If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property to him under section 732, the unused special basis adjustment of the distributee shall be applied as an adjustment to the partnership basis of the property retained by the partnership and as to which the distributee did not use his special basis adjustment. The provisions of this subparagraph may be illustrated by the following example:

Example. Upon the death of his father, partner S acquires by inheritance a half-interest in partnership ACS. Partners A and C each have a one-quarter interest. The assets of the partnership consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made the election under section 754 at the time of transfer, partner S had a special basis adjustment of $4,500 under section 743(b) with respect to his undivided half-interest in the real estate. The basis of S's partnership interest, in accordance with section 742, is $10,000. S retires from the partnership and receives $10,000 in cash in exchange for his entire interest. Since S has received no part of the real estate, his special basis adjustment of $4,500 will be allocated to the real estate, the remaining partnership property, and will increase its basis to the partnership to $5,500.

(2) The provisions of this paragraph do not apply to the extent that certain distributions are treated as sales or exchanges under section 751(b)(relating to unrealized receivables and substantially appreciated inventory items). See section 751(b) and paragraph (b) of § 1.751–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.735–1 Character of gain or loss on disposition of distributed property.

(a) Sale or exchange of distributed property—(1) **Unrealized receivables.** Any gain realized or loss sustained by a partner on a sale or exchange or other disposition of unrealized receivables (as defined in paragraph (c)(1) of § 1.751–1) received by him in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset.

(2) **Inventory items.** Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in section 751(d)(2))

received in a distribution from a partnership shall be considered gain or loss from the sale or exchange of property other than a capital asset if such inventory items are sold or exchanged within 5 years from the date of the distribution by the partnership. The character of any gain or loss from a sale or exchange by the distributee partner of such inventory items after 5 years from the date of distribution shall be determined as of the date of such sale or exchange by reference to the character of the assets in his hands at that date (inventory items, capital assets, property used in a trade or business, etc.).

(b) Holding period for distributed property. A partner's holding period for property distributed to him by a partnership shall include the period such property was held by the partnership. The provisions of this paragraph do not apply for the purpose of determining the 5-year period described in section 735(a)(2) and paragraph (a)(2) of this section. If the property has been contributed to the partnership by a partner, then the period that the property was held by such partner shall also be included. See section 1223(2). For a partnership's holding period for contributed property, see § 1.723–1.

(c) Effective date. Section 735(a) applies to any property distributed by a partnership to a partner after March 9, 1954. See section 771(b)(2) and paragraph (b)(2) of § 1.771–1. However, see section 771(c).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

§ 1.736–1 Payments to a retiring partner or a deceased partner's successor in interest.

(a) Payments considered as distributive share or guaranteed payment. (1)(i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

(ii) A partner retires when he ceases to be a partner under local law. However, for the purposes of subchapter K, chapter 1 of the Code, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated.

(2) When payments (including assumption of liabilities treated as a distribution of money under section 752) are made to a withdrawing partner, that is, a retiring partner or the estate or other successor in interest of a deceased partner, the amounts paid may represent several items. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner's interest in all the assets of the partnership (including inventory) unreduced by partnership liabilities. Also, part of such payments may be attributable to his interest in unrealized receivables and part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between (i) payments for the value of his interest in assets, except unrealized receivables and, under some circumstances, good will (section 736(b)), and (ii) other payments (section 736(a)). The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under sections 731, 732, and, where applicable, 751. See paragraph (b)(4)(ii) of § 1.751–1. The remaining partners are allowed no deduction for these payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners).

(3) Under section 736(a), the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets under the rules contained in paragraph (b) of this section will be considered either—

(i) A distributive share of partnership income, if the amount of payment is determined with regard to income of the partnership; or

(ii) A guaranteed payment under section 707(c), if the amount of the payment is determined without regard to income of the partnership.

(4) Payments, to the extent considered as a distributive share of partnership income under section 736(a)(1), are taken into account under section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of the remaining partners. Payments, to

the extent considered as guaranteed payments under section 736(a)(2), are deductible by the partnership under section 162(a) and are taxable as ordinary income to the recipient under section 61(a). See section 707(c).

(5) The amount of any payments under section 736(a) shall be included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment. On the other hand, payments under section 736(b) shall be taken into account by the recipient for his taxable year in which such payments are made. See paragraph (b)(4) of this section.

(6) A retiring partner or a deceased partner's successor in interest receiving payments under section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time. Similarly, if a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. See section 708(b).

(b) Payments for interest in partnership. (1) Payments made in liquidation of the entire interest of a retiring partner or deceased partner shall, to the extent made in exchange for such partner's interest in partnership property (except for unrealized receivables and good will as provided in subparagraphs (2) and (3) of this paragraph), be considered as a distribution by the partnership (and not as a distributive share or guaranteed payment under section 736(a)). Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. If such valuation reflects only the partner's net interest in the property (*i.e.*, total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. Gain or loss with respect to distributions under section 736(b) and this paragraph will be recognized to the distributee to the extent provided in section 731 and, where applicable, section 751.

(2) Payments made to a retiring partner or to the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, shall not be considered as made in exchange for such partner's interest in partnership property. Such payments shall be treated as payments under section 736(a) and paragraph (a) of this section. For definition of unrealized receivables, see section 751(c).

(3) For the purposes of section 736(b) and this paragraph, payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will. Such payments shall be considered as payments under section 736(a). To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

(4) Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory shall be considered as made in exchange for such partner's interest in partnership property for the purposes of section 736(b) and this paragraph. However, payments for an interest in substantially appreciated inventory items, as defined in section 751(d), are subject to the rules provided in section 751(b) and paragraph (b) of § 1.751–1. The partnership basis in inventory items as to a deceased partner's successor in interest does not change because of the death of the partner unless the partnership has elected the optional basis adjustment under section 754. But see paragraph (b)(3)(iii) of § 1.751–1.

(5) Where payments made under section 736 are received during the taxable year, the recipient must segregate that portion of each such payment which is determined to be in exchange for the

partner's interest in partnership property and treated as a distribution under section 736(b) from that portion treated as a distributive share or guaranteed payment under section 736(a). Such allocation shall be made as follows—

(i) If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736 (a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a)(1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount, $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736(b) for 1956; $1,500, as a payment under section 736(a).

(ii) If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

(iii) In lieu of the rules provided in subdivisions (i) and (ii) of this subparagraph, the allocation of each annual payment between section 736(a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under section 736(b) does not exceed the fair market value of such property at the date of death or retirement.

(6) Except to the extent section 751(b) applies, the amount of any gain or loss with respect to payments under section 736(b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under section 731. However, where the total of section 736(b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments), to report and to measure the amount of any gain or loss by the difference between—

(i) The amount treated as a distribution under section 736(b) in that year, and

(ii) The portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (*i.e.*, the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under section 736(b) in that year bears to the total amount to be distributed under section 736(b)).

A recipient who elects under this subparagraph shall attach a statement to his tax return for the first taxable year for which he receives such payments, indicating his election and showing the computation of the gain included in gross income.

(7) The provisions of this paragraph may be illustrated by the following examples:

Example (1). Partnership ABC is a personal service partnership and its balance sheet is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$13,000	$13,000
Unrealized receivables	0	30,000
Capital and section 1231 assets	20,000	23,000
Total	33,000	66,000

LIABILITIES AND CAPITAL

	Adjusted basis per books	Market value
Liabilities	$3,000	$3,000
Capital:		
A	10,000	21,000
B	10,000	21,000
C	10,000	21,000
Total	33,000	66,000

Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in section 736(b) partnership property is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and section 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in section 736(b). Since the basis of A's interest is $11,000 ($10,000 plus $1,000, his share of partner-

ship liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c). The payment for the first year is $10,000, consisting of $9,000 in cash, plus $1,000 in liability assumed (section 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a section 736(a)(2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in section 736(b) partnership property. (The partnership may deduct the $6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under section 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under section 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A's interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is a return of capital.

Example (2). Assume the same facts as in example (1) of this subparagraph except that the agreement between the partners provides for payments to A for 3 years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to $12,000 shall be treated under section 736(b) as payments for A's interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under section 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under section 736(a)(1).

Example (3). Assume the same facts as in example (1) of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to be $9,000. The value of A's interest in partnership property described in section 736(b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash, plus $23,000, the value of capital and section 1231 assets, plus $9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000 minus $11,000) the basis of his interest. The remaining $15,000 ($30,000 minus $15,000) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

Example (4). Assume the same facts as in example (1) of this subparagraph except that the capital and section 1231 assets consist of an item of section 1245 property (as defined in section 1245(a)(3)). Assume further that under paragraph (c)(4) of § 1.751–1 the section 1245 property is an unrealized receivable to the extent of $2,000. Therefore, the value of A's interest in section 736(b) partnership property is only $11,333 (one-third of $34,000, the sum of $13,000 cash and $21,000, the fair market value of section 1245 property to the extent not an unrealized receivable). From the disposition of his interest in partnership property, A will realize a capital gain of $333 ($11,333 minus $11,000, the basis of his interest). The remaining $18,667 ($30,000 minus $11,333) will constitute payments under section 736(a)(2) which are taxable to A as guaranteed payments under section 707(c).

(c) Cross reference. See section 753 for treatment of payments under section 736(a) as income in respect of a decedent under section 691.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8574, July 7, 1965]

Transfers Of Interests In A Partnership

§ 1.741–1 Recognition and character of gain or loss on sale or exchange.

(a) The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705. For treatment of selling partner's distributive share up to date of sale, see section 706(c)(2). Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items. See section 751 and § 1.751–1.

(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. Section 741 shall also apply even though the sale of the partnership interest results in a termination of the partnership under section 708(b). Thus, the provisions of section 741 shall be applicable (1) to the transferor partner in a 2-man partnership when he sells his interest to the other partner, and (2) to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

(c) See section 351 for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferor.

(d) For rules relating to the treatment of liabilities on the sale or exchange of interests in a partnership see §§ 1.752–1 and 1.1001–2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§ 1.742–1 Basis of transferee partner's interest.

The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), subchapter O, chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706–1 and paragraph (b) of § 1.753–1) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.743–1 Optional adjustment to basis of partnership property.

(a) General rule. The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership. However, whether or not the election provided in section 754 is in effect, the basis of partnership property shall not be adjusted as the result of a contribution of property, including money, to the partnership.

(b) Adjustment to basis of partnership property—(1) Determination of adjustment. In the case of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership as to which the election under section 754 is in effect shall:

(i) Increase the adjusted basis of partnership property by the excess of the transferee's basis for his partnership interest over his share of the adjusted basis to the partnership of all partnership property, or

(ii) Decrease the adjusted basis of partnership property by the excess of the transferee partner's share of the adjusted basis of all partnership property over his basis for his partnership interest. The amount of the increase or decrease constitutes an adjustment affecting the basis of partnership property with respect to the transferee partner only. Thus, for purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties which are adjusted under section 743(b) and this paragraph. This special basis is his share of the common partnership basis (*i.e.*, the adjusted basis of such properties to the partnership without regard to any special basis adjustments of any transferee) plus or minus his special basis adjustments. A partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities. Where an agreement with respect to contributed property is in effect under section 704(c)(2), such agreement shall be taken into account in determining a partner's share of the adjusted basis of partnership property. Generally, if a partner's interest in partnership capital and profits is one-third, his share of the adjusted basis of partnership property will be one-third of such basis. The provisions of this paragraph may be illustrated by the following examples:

Example (1). A is a member of partnership ABC in which the partners have equal interests in capital and profits. The partnership has made the election under section 754, relating to the optional adjustment to the basis of partnership property. A sells his interest to P for $22,000. The balance sheet of the partnership at the date of sale shows the following:

ASSETS

	Adjusted basis per books	Market value
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000
Total	55,000	76,000

LIABILITIES AND CAPITAL

	Adjusted basis per books	Market value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and his share of the adjusted basis of partnership property. Under section 742, the basis of P's interest is $25,333 (the cash paid for A's interest, $22,000, plus $3,333, P's share of partnership liabilities). P's share of the adjusted basis of partnership property is $18,333, *i.e.*, $15,000 plus

$3,333. The amount to be added to the basis of partnership property is, therefore, $7,000, the difference between $25,333 and $18,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Example (2). D is a member of partnership DEF in which the partners have equal interests in profits, but not in capital. The partnership has made the election under section 754. D dies and his interest passes to W, his widow. The balance sheet of the partnership at the date of D's death shows the following:

ASSETS

	Adjusted basis per books	Market value
Cash	$7,000	$7,000
Accounts receivable	10,000	10,000
Inventory	20,000	24,000
Depreciable assets	20,000	40,000
Total	57,000	81,000

LIABILITIES AND CAPITAL

	Adjusted basis per books	Value
Liabilities	$10,000	$10,000
Capital:		
D	18,000	26,000
E	15,000	23,000
F	14,000	22,000
Total	57,000	81,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and her share of the adjusted basis of partnership property. Under section 742, the basis of W's interest is $29,333 (the fair market value of D's interest at his death, $26,000, plus $3,333, his share of partnership liabilities). W's share of the adjusted basis of partnership property is $21,333 (*i.e.*, $18,000 plus $3,333, her share of partnership liabilities). The amount to be added to the basis of partnership property is, therefore, $8,000, the difference between $29,333 and $21,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755–1.

Note that in examples (1) and (2) of this subparagraph the amount of the adjustment does not depend upon the adjusted basis to the transferor for his interest in partnership capital.

(2) Determination of partner's share of adjusted basis of partnership property. (i) Under the provisions of section 743(b), a partner's share of the adjusted basis of partnership property shall be determined by taking into account the effect of any partnership agreement with respect to contributed property as described in section 704(c)(2), or the effect of the contribution of undivided interests under section 704(c)(3). This rule may be illustrated by the following examples:

Example (1). A, B, and C form partnership ABC, to which A contributes land worth $1,000 (property X) with an adjusted basis to him of $400, and B and C each contributes $1,000 cash. Each partner has $1,000 credited to him on the books of the partnership as his capital contribution. The partners share in profits equally. During the partnership's first taxable year, property X appreciates in value to $1,300. A sells his one-third interest in the partnership to D for $1,100, when the election under section 754 is in effect. No agreement under section 704(c)(2) is in effect. The adjusted basis of the partnership property is increased with respect to D by the excess of his basis for his partnership interest, $1,100, over his share of the adjusted basis of partnership property, $800 (⅓ of $2,400, the total adjusted basis of partnership property). The amount of the adjustment, therefore, is $300 ($1,100 minus $800), which is an increase in the basis of partnership property with respect to D only. This special basis adjustment will be allocated to property X. (See section 755 and § 1.755–1.) If property X is sold for $1,600, the gain to the partnership is $1,200 ($1,600 received, less the adjusted common partnership basis of $400 for property X). Thus, each partner's distributive share of the gain on the sale is $400. However, D's recognized gain is only $100 (his $400 distributive share of the gain, reduced by $300, his special basis adjustment with respect to property X). If D purchased his interest from B or C, the partners who contributed cash, D's adjustment under section 743(b) would also be $300, computed in exactly the same manner as in the case of a purchase from A.

Example (2). Assume that partnership ABC described in example (1) of this subdivision has an agreement under section 704(c)(2) with respect to property X, stating that upon the sale of that property any gain, to the extent attributable to the precontribution appreciation of $600 (the difference between its value, $1,000, and its basis, $400, at the time of the contribution) is to be allocated entirely to A, who contributed property X. Upon the purchase of A's interest by D for $1,100, the computation of D's special basis would differ from that indicated in example (1) of this subdivision as follows: Under the partnership agreement, A's share of the $2,400 adjusted basis of partnership property is only $400 (his basis for property X prior to its contribution to the partnership), and B's and C's share is $1,000 each (the amount of the cash investment of each). The amount of the increase to D in the adjusted basis of partnership property under section 743(b)(1) is $700 (the excess of $1,100, D's cost basis for his interest, over $400, A's share of the adjusted basis of partnership property to which D succeeds). This amount constitutes an adjustment to the basis of partnership property with respect to D only. If X is sold by the partnership for $1,600, the gain is $1,200 ($1,600 received less the adjusted common partnership basis of $400). Under the partnership agreement, $600 of this gain, which is attributable to precontribution appreciation in value, is allocable to D, who is A's successor. The remaining $600 gain is not subject to the agreement and is allocable to the partners equally, $200 each. D's distributive share of the partnership gain is thus $600 plus $200, or $800. However, D has a special basis adjustment of $700 under section 743(b)(1), which reduces his gain from $800 to $100. B and C each has a gain of $200, which is unaffected by the transfer of A's interest to D.

Example (3). Assume the same facts as in example (2) of this subdivision, except that D has purchased his interest from B instead of from A. His special basis adjustment for partnership property in this case differs from that where he had purchased his interest from A, because of the effect of the agreement under section 704(c)(2). In this case, D is a successor to B, whose share of the adjusted basis of partnership property is $1,000, instead of A, whose share is only $400. As a result, the adjustment under section 743(b)(1) is the excess of D's cost basis for his interest, $1,100, over his share of the adjusted basis of partnership property, $1,000, or $100. In this

case, if property X is sold for $1,600, the partnership gain is $1,200 ($1,600 less the adjusted partnership basis of $400). Of this gain, $600, representing precontribution appreciation, is allocable to A under the partnership agreement. The remaining $600 is allocable in the amount of $200 to each partner. Since D as a transferee has a special basis adjustment of $100 under section 743(b)(1), his gain is reduced from $200 to $100.

(ii) If a partner receives a distribution of property with respect to which another partner has a special basis adjustment, the distributee shall not take into account the special basis adjustment of the other partner. However, the partner with the special basis adjustment will reallocate it under section 755 to remaining partnership property of a like kind or, if he receives a distribution of like property, to such distributed property. If a partner receives a distribution of property with respect to which he has a special basis adjustment, such basis adjustment will be taken into account when relevant under section 732. See paragraph (b) of § 1.732–2. If, at the time a partner receives property (whether or not he has a special basis adjustment with respect to such property), he relinquishes his interest in other property of a like kind with respect to which he has a special basis adjustment, the adjusted basis to the partnership of the distributed property shall include his special basis adjustment for the property in which he relinquished his interest. For the purposes of the preceding sentence, a partner will be considered as having relinquished his interest in any remaining partnership properties when his interest has been completely liquidated; however, when a partner receives a distribution not in liquidation, he will be considered as relinquishing his interest only in property distributed to other partners. For the purposes of this subdivision, like property means property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc. For certain adjustments to the basis of remaining partnership property after a distribution to a transferee partner, see paragraph (b) of § 1.734–2. The provisions of this subdivision may be illustrated by the following examples:

Example (1). C is a transferee partner in partnership BC. The partnership owns, among other assets, X, a depreciable asset with a common basis to the partnership of $1,000 and a special basis adjustment to C of $200, and Y, another depreciable asset with a common basis of $800 and a special basis adjustment to C of $300. B and C agree that B will receive a distribution of property Y, and C will receive a distribution of property X, with all other property to remain in the partnership. With respect to B, the partnership basis of property Y is $800, the common partnership basis. Y will, therefore, have a basis of $800 in B's hands under section 732(a) which provides for the use of a carryover basis in the case of current distributions. With respect to C, however, the partnership basis of property X is $1,500, the common partnership basis of $1,000, plus C's special basis adjustment of $200 for property X, plus C's additional special basis adjustment of $300 for property Y, in which he has relinquished his interest.

Example (2). (a) Partner D acquired his one-third interest in partnership BCD for $14,000 from a previous partner when an election under section 754 was in effect. Therefore, under section 743(b), D has a special basis adjustment for certain partnership property. Assume that at the time of the distribution in paragraph (b) of this example, the partnership assets consist of cash and rental property and that such assets and D's special basis adjustments under section 743(b) are as follows:

Item	Fair market value	Common partnership basis	D's share	D's special basis adjustment	Partnership basis to D
Cash	$12,000	$12,000	$4,000	......	$4,000
House:					
U	9,000	1,200	400	......	400
V	6,000	4,500	1,500	......	1,500
W	8,000	1,500	500	......	500
X	9,000	4,800	1,600	$2,000	3,600
Y	9,000	6,000	2,000	......	2,000
Z	7,000	3,000	1,000	1,000	2,000
Total ...	60,000	33,000	11,000	3,000	14,000

(b) Assume further that D receives $4,000 in cash and houses Y and Z in complete liquidation of his interest in partnership BCD. In determining the basis to D of houses Y and Z under section 732(b) and (c), D must allocate $10,000 basis ($14,000 basis for his interest, less $4,000 cash received) to houses Y and Z in proportion to their adjusted basis to the partnership. For purposes of section 732(c), the adjusted basis of house Y is $7,200 ($6,000 common partnership basis, plus $1,200, allocated share of D's special basis adjustment of $2,000 for house X, in which D relinquished his interest). The adjusted basis of house Z is $4,800 ($3,000 common partnership basis, plus $1,000, D's special basis for house Z, plus $800, allocated share of D's special basis of $2,000 for house X, in which D relinquished his interest). Under the rule of this subdivision, 6,000/10,000 of the $2,000 special basis adjustment for X is allocated to Y and 4,000/10,000 of such amount to Z. Therefore, $6,000 basis (7,200/12,000 of $10,000) is allocated to house Y and $4,000 basis (4,800/12,000 of $10,000) to house Z.

(c) Since houses Y and Z had $12,000 basis to the partnership, as computed in paragraph (b) of this example, and only $10,000 basis to D, as determined under section 732, the partnership, under section 734(b)(1)(B), must increase the basis of remaining partnership property (houses U, V, W, and X) by $2,000 (excess of $12,000 over $10,000). For allocation of this amount, see section 755 and § 1.755–1.

(iii) Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for each partner, including the transferee partner, based on his interest in such property. See paragraph (a)(8) of § 1.702–1. This rule may be illustrated by the following example:

Example. A, B, and C each contributes $5,000 cash to form partnership ABC, which purchases oil property for $15,000. C subsequently sells his partnership interest to D for $100,000 when the election under section 754 is in effect. D has a special basis adjustment for the oil property of $95,000 (the

difference between D's basis, $100,000, and his share of the basis of partnership property, $5,000). Assume that the depletion allowance computed under the percentage method would be $21,000 for the taxable year so that each partner would be entitled to $7,000 as his share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to D's one-third interest which has a basis to him of $100,000 ($5,000, plus his special basis adjustment of $95,000) is $10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the oil property, each of which has a basis of $5,000, is only $500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct $7,000 based on the percentage depletion method. However, as to D, the transferee partner, the cost depletion method results in a greater allowance and D will, therefore, deduct $10,000 based on cost depletion. See section 613(a).

(iv) Where there has been more than one transfer of partnership interests, the last transferee's special basis adjustment, if any, under section 743(b) shall be determined by reference to the partnership common basis for its property without regard to any prior transferee's special basis adjustment. For example, A, B, and C form a partnership. A and B each contributes $1,000 cash and C contributes land with a basis and value of $1,000. When the land has appreciated in value to $1,300, A sells his interest to D for $1,100 (⅓ of $3,300, the value of the partnership property). The election under section 754 is in effect; therefore, D has a special basis adjustment of $100 with respect to the land under section 743(b). After the land has further appreciated in value to $1,600, D sells his interest to E for $1,200 (⅓ of $3,600, the value of the partnership property). Under section 743(b), E has a special basis adjustment of $200. This amount is determined without regard to any special basis adjustment that D may have had in the partnership assets.

(3) **Returns.** A transferee partner who has a special basis adjustment under section 743(b) shall attach a statement to his income tax return for the first taxable year in which the basis of any partnership property subject to the adjustment is pertinent in determining his income tax, showing the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(c) **Allocation of basis.** For the allocation of basis among partnership properties where section 743(b) applies, see section 755 and § 1.755-1.
[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

Provisions Common To Part II, Subchapter K, Chapter 1 Of The Code

§ 1.751-1 Unrealized receivables and inventory items.

(a) **Sale or exchange of interest in a partnership—(1) Character of amount realized.** To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of "unrealized receivables" and "inventory items which have appreciated substantially in value", see section 751(c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". See paragraph (e) of this section.

(2) **Determination of gain or loss.** The income or loss realized by a partner upon the sale or exchange of his interest in section 751 property is the difference between (i) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the selling partner's basis for his entire interest allocated to such property. Generally, the portion of the total amount realized which the seller and the purchaser allocate to section 751 property in an arm's length agreement will be regarded as correct. The portion of the partner's adjusted basis for his partnership interest to be allocated to section 751 property shall be an amount equal to the basis such property would have had under section 732 (including subsection (d) thereof) if the selling partner had received his share of such properties in a current distribution made immediately before the sale. See §§ 1.732-1 and 1.732-2. Such basis shall reflect the rules of section 704(c)(3), if applicable, or any agreement under section 704(c)(2). Any gain or loss recognized which is attributable to section 751 property will be ordinary gain or loss. The difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any, of the amount realized is the transferor's capital gain or loss on the sale of his partnership interest.

(3) **Statement required.** A transferor partner selling or exchanging any part of his interest in a

partnership which has any section 751 property at the time of sale or exchange shall submit with his income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information:

(i) The date of the sale or exchange, the amount of the transferor partner's adjusted basis for his partnership interest, and the portion thereof attributable to section 751 property under section 732; and

(ii) The amount of any money and the fair market value of any other property received or to be received for the transferred interest in the partnership, and the portion thereof attributable to section 751 property.

(iii) If the transferor partner computes his adjusted basis for section 751 property under the provisions of section 732(d), he must also include in the statement the information required by paragraph (d)(3) of § 1.732-1.

(iv) If the transferor partner has a special basis adjustment under section 743(b), he must also include in the statement the computation of his special basis adjustment and the partnership properties to which the adjustment has been allocated.

(b) Certain distributions treated as sales or exchanges—(1) In general. (i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of $100,000 in which partner A has an interest of 30 percent, or $30,000. If A receives $20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the $80,000 of section 751 property remaining in the partnership after the distribution, only $6,000 ($30,000 minus $24,000 (30 percent of $80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining $14,000 ($20,000 minus $6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items). (i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income or loss shall be allocated only

to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) Distribution of partnership property other than section 751 property. (i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).

(4) Exceptions. (i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736–1.

(5) Statement required. A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in

section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) **Unrealized receivables.** (1) The term "unrealized receivables", as used in Subchapter K, Chapter 1 of the Code, means any rights (contractual or otherwise) to payment for—

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, any arm's length agreement between the buyer and the seller, or between the partnership and the distributee partner, will generally establish the amount or value. In the absence of such an agreement, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(4)(i) With respect to any taxable year of a partnership beginning after December 31, 1962, the term "unrealized receivables," for purposes of this section and sections 731, 736, 741, and 751, also includes "potential section 1245 income." With respect to each item of partnership section 1245 property (as defined in sec. 1245(a)(3)), "potential section 1245 income" is the amount which would be treated as gain to which section 1245(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1245 property were sold by the partnership at its fair market value. See paragraph (e)(1) of § 1.1245-1. For example, if a partnership would recognize under section 1245(a)(1) gain of $600 upon a sale of one item of section 1245 property and gain of $300 upon a sale of its only other item of such property, the potential section 1245 income of the partnership would be $900.

(ii) With respect to any taxable year of a partnership ending after December 31, 1963, the term "unrealized receivables," for purposes of this section and sections 731, 736, 741, and 751, also includes "potential section 1250 income." With respect to each item of partnership section 1250 property (as defined in section 1250(c)), "potential section 1250 income" is the amount which would be treated as gain to which section 1250(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1250 property were sold by the partnership at its fair market value. See paragraph (f)(1) of § 1.1250-1.

(iii) For purposes of determining potential section 1245 income or potential section 1250 income, any arm's-length agreement between the buyer and seller, or between the partnership and distributee partner, will generally establish the fair market value of section 1245 property or section 1250 property (as the case may be).

(5) For purposes of Subtitle A of the Code, the basis of potential section 1245 income and of potential section 1250 income is zero.

(6)(i) If (at the time of the transaction referred to in subparagraph (4) of this paragraph) a partnership holds section 1245 (or 1250) property and if (a) a partner had a special basis adjustment under section 743(b) in respect of the property, or (b) the basis under section 732 of the property if distributed to the partner would reflect a special basis adjustment under section 732(d), or (c) on the date a partner acquires his partnership interest by way of a sale or exchange (or upon death of another partner) the partnership owned the property and an election under section 754 was in effect with respect to the partnership, then the partner's share of the potential section 1245 (or 1250) income of the partnership in respect of the

property shall be determined under subdivision (ii) of this subparagraph.

(ii) The partner's share of the potential section 1245 (or 1250) income of the partnership in respect of the property to which this subdivision applies shall be that amount of gain which the partner would recognize under paragraph (e)(3) of § 1.1245–1 (or paragraph (f) of § 1.1250–1) upon a sale of the property by the partnership, except that, for purposes of this subparagraph (a) the items which are allocated under (or in a manner consistent with the principles provided in) paragraph (e)(3)(ii) of § 1.1245–1 shall be allocated to the partner in the same manner as his share of partnership property is determined, and (b) the amount of a special basis adjustment under section 732(d) shall be treated as if it were the amount of a special basis adjustment under section 743(b).

(d) Inventory items which have substantially appreciated in value—(1) Substantial appreciation. Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms "inventory items which have appreciated substantially in value" or "substantially appreciated inventory items" refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the "fair market value" of inventory items has the same meaning as "market" value in the regulations under section 471, relating to general rule for inventories.

(2) Inventory items. The term "inventory items" as used in Subchapter K, Chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(1).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivision (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) Section 751 property and other property. For the purposes of this section, "section 751 property" means unrealized receivables or substantially appreciated inventory items, and "other property" means all property (including money) except section 751 property.

(f) Effective date. Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of Subchapter K, Chapter 1 of the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of § 1.771–1. See also section 771(c) and paragraph (c) of § 1.771–1.

(g) Examples. Application of the provisions of section 751 may be illustrated by the following examples:

Example (1). C buys B's interest in personal service partnership AB for $15,000, when the balance sheet of the firm (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Loans receivable	10,000	10,000
Other assets	7,000	7,000
Unrealized receivables	0	12,000
Total	20,000	32,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$2,000	$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

Section 751(a) applies to the sale. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by C. See section 752. B's undivided half interest in the partnership property includes a half-interest in the partnership's unrealized receivables which are worth $12,000. Consequently, $6,000 of the $16,000 realized by B shall be considered received in exchange for B's interest in the partnership attributable to its unrealized receivables. The remaining $10,000 realized by B is in exchange for a capital asset. B's basis for his partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). No portion of this basis is attributable to B's share of the unrealized receivables of the partnership since such property has a zero basis in the hands of the partnership; therefore, B has a basis of zero for the unrealized receivables because the partnership basis for such receivables would have carried over to him under section 732 had they been distributed to him. The difference between the zero basis and the $6,000 B realized for the unrealized receivables is ordinary income to him. The entire $10,000 of B's basis is the basis for his interest in partnership property other than unrealized receivables and is applied against the remaining $10,000 ($16,000 minus $6,000) received from the sale of his interest. Therefore, B has no capital gain or loss. (If B's basis for his interest in partnership property, other than unrealized receivables, were $9,000, he would realize capital gain of $1,000. If his basis were $11,000, he would sustain a capital loss of $1,000).

Example (2). **(a) Facts.** Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$15,000	$15,000
Accounts receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable property	42,000	48,000
Land	9,000	9,000
Total	96,000	111,000

LIABILITIES AND CAPITAL

	Per books	Value
Current liabilities	$15,000	$15,000
Mortgage payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	20,000	25,000
Total	96,000	111,000

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

(b) Presence of section 751 property. The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, $39,000 (inventory $30,000, and accounts receivable $9,000), exceeds 120 percent of the $30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, $39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of $96,000 or $9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash ($5,000) and $15,000 in depreciable property ($1,000 less than his $16,000 share). In addition, he received other partnership property ($5,000 cash and $12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable ($3,000), inventory ($10,000), land ($3,000), and the balance of his interest in depreciable property ($1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (*i.e.*, inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of $13,000 ($3,000 in accounts receivable and $10,000 in inventory). Thus, $13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) Distributee partner's tax consequences. C's tax consequences on the distribution are as follows:

(1) The section 751(b) sale or exchange. C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus,

C has a basis of $22,000 for the remainder of his partnership interest. The total distribution to C was $37,000 ($22,000 in cash and liabilities assumed, and $15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732(b), C's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

(e) **Partnership's tax consequences.** The tax consequences to the partnership on the distribution are as follows:

(1) **The section 751(b) sale or exchange.** The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the $22,000 money distributed (in cash and the assumption of C's share of liabilities), $13,000 was paid to acquire C's interest in inventory ($10,000 fair market value) and in accounts receivable ($3,000). Since under section 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is $13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable ($30,000) by $10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by $13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from $21,000 to $24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See paragraph (e) of § 1.732–1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) **The part of the distribution not under section 751(b).** In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: $15,000 in depreciable property (with a basis to the partnership of $15,000) and $9,000 in money ($22,000 less $13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property before the distribution, $42,000, is reduced by the basis of the depreciable property distributed, $15,000, leaving a basis for the depreciable property in the partnership of $27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been $15,000, and is only $13,000 in C's hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by $2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be $38,000 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities each assumed).

(f) **Partnership trial balance.** A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

Example (3). (a) **Facts.** Assume that the distribution to partner C in example (2) of this paragraph in liquidation of his entire interest in partnership ABC consists of $5,000 in cash and $20,000 worth of partnership inventory with a basis of $14,000.

	I		II	
	Sec. 754, Election in effect		Sec. 754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	$5,000	$5,000	$5,000	$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
	76,000	86,000	74,000	86,000
Current liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
....	20,000	25,000	20,000	25,000
....	20,000	25,000	20,000	25,000
	76,000	86,000	76,000	86,000

(b) **Presence of section 751 property.** For the same reason as stated in paragraph (b) of example (2), the partnership inventory items have substantially appreciated in value.

(c) **The properties exchanged.** In the distribution, C received his share of cash ($5,000) and his share of appreciated inventory items ($13,000). In addition, he received appreciated inventory with a fair market value of $7,000 (and with an adjusted basis to the partnership of $4,900) and $12,000 in money (liabilities assumed). C has relinquished his interest in $16,000 of depreciable property and $3,000 of land. Although C relinquished his interest in $3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751(b) applies only to the extent of the exchange of other property for section 751 property (*i.e.*, depreciable property or land for inventory items). Assume that the partners agree that the $7,000 of inventory in excess of

C's share was received by him in exchange for $7,000 of depreciable property.

(d) Distributee partner's tax consequences. C's tax consequence on the distributions are as follows:

(1) The section 751(b) sale or exchange. C is treated as if he had received his 7/16ths share of the depreciable property in a current distribution. His basis for that share is $6,125 (42,000/48,000 of $7,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for $7,000, realizing a gain of $875.

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000, plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of $25,875 for the remainder of his partnership interest. Of the $37,000 total distribution to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of $13,000 (which had an adjusted basis to the partnership of $9,100) is limited to $8,875, the amount of the remaining basis for his partnership interest, $25,875, reduced by $17,000, the money received. Thus, C's total aggregate basis for the inventory received is $15,875 ($7,000 plus $8,875), and not its $14,000 basis in the hands of the partnership.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of the $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is $42,875 ($42,000 less $6,125, the basis of the 7/16ths share considered as distributed to C, plus $7,000, the partnership purchase price for this share).

(2) The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100, and C's basis for such inventory after distribution is only $8,875. The basis of the inventory remaining in the partnership must be increased by $225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities now assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example (4). (a) Facts. Assume the same facts as in example (3) of this paragraph, except that the partners did not identify the property which C relinquished in exchange for the $7,000 of inventory which he received in excess of his share.

(b) **Presence of section 751 property.** For the same reasons stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) **The properties exchanged.** The analysis stated in paragraph (c) of example (3) of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received $7,000 of inventory in exchange for his release of 7/19ths of the depreciable property and 7/19ths of the land. ($7,000, fair market value of property released, over $19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.)

(d) Distributee partner's tax consequences. C's tax consequences on the distribution are as follows:

(1) The section 751(b) sale or exchange. C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is $6,263 (51,000/57,000 of $7,000, their fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership for $7,000, realizing a gain of $737.

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of $25,737 for the remainder of his partnership interest. Of the total $37,000 distributed to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory (with a fair market value of $13,000 and an adjusted basis to the partnership of $9,100) is limited to $8,737, the amount of the remaining basis for his partnership interest ($25,737 less $17,000), money received. Thus, C's total aggregate basis for the inventory he received is $15,737 ($7,000 plus $8,737), and not the $14,000 basis it had in the hands of the partnership.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/19ths of C's interest in the depreciable property and land. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be $42,737 and $9,000, respectively. The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $5,158 basis (42,000/48,000 of $5,895) for C's 7/19ths interest constructively distributed and increased by $5,895 (16,000/19,000 of $7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $1,105 basis (9,000/9,000 of $1,105) of land constructively distributed to C, and increased by $1,105 (3,000/19,000 of $7,000), the portion of the purchase price allocated to the land.

(2) The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100 and C's basis for such inventory after the distribution is only $8,737. The basis of the inventory remaining in the partnership must be increased by the difference of $363. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example (5). (a) Facts. Assume that partner C in example (2) of this paragraph agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by $4,800 from $12,000 (⅓ of $36,000) to $7,200 (⅕ of $36,000).

(b) Presence of section 751 property. For the same reasons as stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

Item	C's interest Fair Market Value		C received		C relinquished
	One-third before	One-fifth after	Distribution of share	In excess of share	
Cash	$5,000	$2,000	$3,000	$2,000	....
Liabilities assumed	(12,000)	(7,200)	....	4,800	....
Inventory items:					
Accounts receivable	3,000	300	2,700	4,800	....
Inventory	10,000	6,000	....	....	$4,000
Depreciable property	16,000	9,600	....	....	6,400
Land	3,000	1,800	....	....	1,200
Total	25,000	12,500	5,700	11,600	11,600

Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute section 751 property and C has received only $800 of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within section 751(b) and is a current distribution under section 732(a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

(d) Distributee partner's tax consequences. C's tax consequences on the distribution are as follows:

(1) The section 751(b) sale or exchange. Assuming that the partners paid $800 worth of accounts receivable for $800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C's interest are illustrated in the following table:

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Original basis for C's interest	$32,000	$32,000	$32,000
Less basis of property distributed prior to sec. 751(b) sale or exchange	–700	–800	–716
	31,300	31,200	31,284
Less money received in distribution	–9,800	–9,800	–9,800
	21,500	21,400	21,484
Less basis of property received in a current distribution under sec. 732	–6,700	–6,700	–6,700
Resulting basis for C's interest	14,800	14,700	14,784

C's basis for the $1,500 worth of accounts receivable which he received in the distribution will be $7,500, composed of $800 for the portion purchased in the section 751(b) exchange, plus $6,700, the basis carried over under section 732(a) for the portion received in the current distribution.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership realizes no gain or loss in the section 751 sale or exchange because it had a basis of $800 for the accounts receivable for which it received $800 worth of other property. If the partnership agreed to purchase $800 worth of depreciable property, the partnership basis of depreciable property becomes $42,100 ($42,000 less $700 basis of property constructively distributed to C, plus $800, price of property purchased). If the partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be $51,084 (depreciable property, $42,084 and land $9,000). The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000 of $674) for C's $674 interest constructively distributed, and increased by $674 (6,400/7,600 of $800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land constructively distributed to C, and increased by $126 (1,200/7,600 of $800), the portion of the purchase price allocated to the land.

(2) The part of the distribution not under section 751(b). The partnership will realize no gain or loss in the balance of the distribution under section 731. Since the property in C's hands after the distribution will have the same basis it had in the partnership, the basis of partnership property remaining in the partnership after the distribution will not be adjusted (whether or not an election under 754 is in effect).

Example (6). (a) **Facts.** Partnership ABC distributes to partner C, in liquidation of his entire one-third interest in the partnership, a machine which is section 1245 property with a recomputed basis (as defined in section 1245(a)(2)) of $18,000. At the time of the distribution, the balance sheet of the partnership is as follows:

ASSETS

	Adjusted basis per books	Market value
Cash	$3,000	$3,000
Machine (section 1245 property)	9,000	15,000
Land	18,000	27,000
Total	30,000	45,000

LIABILITIES AND CAPITAL

	Per books	Value
Liabilities	$0	$0
Capital:		
A	10,000	15,000
B	10,000	15,000
C	10,000	15,000
Total	30,000	45,000

(b) Presence of section 751 property. The section 1245 property is an unrealized receivable of the partnership to the extent of the potential section 1245 income in respect of the property. Since the fair market value of the property ($15,000) is lower than its recomputed basis ($18,000), the excess of the fair market value over its adjusted basis ($9,000), or $6,000, is the potential section 1245 income of the partnership in respect of the property. The partnership has no other section 751 property.

(c) The properties exchanged. In the distribution C received his share of section 751 property (potential section 1245 income of $2,000, *i.e.*, ⅓ of $6,000) and his share of section 1245 property (other than potential section 1245 income) with a fair market value of $3,000, *i.e.*, ⅓ of ($15,000 minus $6,000), and an adjusted basis of $3,000, *i.e.*, ⅓ of $9,000. In addition he received $4,000 of section 751 property (consisting of $4,000 ($6,000 minus $2,000) of potential section 1245 income) and section 1245 property (other than potential section 1245 income) with a fair market value of $6,000 ($9,000 minus $3,000) and an adjusted basis of $6,000 ($9,000 minus $3,000). C relinquished his interest in $1,000 of cash and $9,000 of land. Assume that the partners agree that the $4,000 of section 751 property in excess of C's share was received by him in exchange for $4,000 of land.

(d) Distributee partner's tax consequences. C's tax consequences on the distributions are as follows:

(1) The section 751(b) sale or exchange. C is treated as if he received in a current distribution ⁴⁄₉ths of his share of the land with a basis of $2,667 (18,000/27,000×$4,000). Then C is considered as having sold his ⁴⁄₉ths share of the land to the partnership for $4,000, realizing a gain of $1,333. C's basis for the remainder of his partnership interest after the current distribution is $7,333, *i.e.*, the basis of his partnership interest before the current distribution ($10,000) minus the basis of the land treated as distributed to him ($2,667).

(2) The part of the distribution not under section 751(b). Of the $15,000 total distribution to C, $11,000 ($2,000 of potential section 1245 income and $9,000 section 1245 property other than potential section 1245 income) is not within section 751(b). Under section 732(b) and (c), C's basis for his share of potential section 1245 income is zero (see paragraph (c)(5) of this section) and his basis for $9,000 of section 1245 property (other than potential section 1245 income) is $7,333, *i.e.*, the amount of the remaining basis for his partnership interest ($7,333) reduced by the basis for his share of potential section 1245 income (zero). Thus C's total aggregate basis for the section 1245 property (fair market value of $15,000) distributed to him is $11,333 ($4,000 plus $7,333). For an illustration of the computation of his recomputed basis for the section 1245 property immediately after the distribution, see example (2) of paragraph (f)(3) of § 1.1245-4.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. Upon the sale of $4,000 potential section 1245 income, with a basis of zero,

for ⅙ths of C's interest in the land, the partnership consisting of the remaining members has $4,000 ordinary income under sections 751(b) and 1245(a)(1). See section 1245(b)(3) and (6)(A). The partnership's new basis for the land is $19,333, *i.e.*, $18,000, less the basis of the ⅙ths share considered as distributed to C ($2,667), plus the partnership purchase price for this share ($4,000).

(2) The part of the distribution not under section 751(b). The analysis under this subparagraph should be made in accordance with the principles illustrated in paragraph (e)(2) of examples (3), (4), and (5) of this paragraph.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8575, July 7, 1965; T.D. 7084, 36 FR 268, Jan. 8, 1971]

§ 1.752-1 Treatment of certain liabilities.

(a) Increase in partner's liabilities. (1) Where the liabilities of a partnership are increased, and each partner's share of such liabilities is thereby increased, the amount of each partner's increase shall be treated as a contribution of money by that partner to the partnership. For example, partnership AB borrows $1,000. If A and B are equal partners, the basis of the partnership interest of each is increased by $500 since each is considered under section 752(a) to have contributed that amount of money to the partnership.

(2) Any increase in a partner's individual liabilities because of the assumption by him of partnership liabilities shall also be considered as a contribution of money by him to the partnership. For example, equal partnership AB owns real property with an adjusted basis to the partnership of $1,000, a fair market value of $800, and which is subject to a mortgage of $400 which the partnership has not assumed. The mortgage is considered as a liability of the partnership under section 752(c). Since A and B each share one-half thereof, under section 752(a) the liability of each has been increased $200. Under section 722 such $200 increase is reflected in the basis of each partner for his interest. The real property is distributed by the partnership to A. Under the provisions of section 733(2), there is a net decrease of $800 in A's basis for his partnership interest. This amount is computed as follows: The basis of A's partnership interest is decreased in the distribution by $1,000 (the partnership basis for the distributed property) and further decreased under section 752(b) by $200 (the decrease in A's share of partnership liabilities) and increased under section 752(a) by $400 (the increase in A's individual liability by reason of section 752(c)). Conversely, the basis of B's partnership interest is decreased by $200 since the distribution of the real property to A resulted in a decrease in B's share of the partnership liability under section 752(b).

(b) Decrease in partner's liabilities. (1) Where the liabilities of a partnership are decreased, and each partner's share of such liabilities is thereby decreased, the amount of the decrease shall be treated as a distribution of money to the partner by the partnership. For example, partnership AB, in which A and B are equal partners, repays an obligation of $10,000. The repayment reduces each partner's share of partnership liabilities by $5,000 and is considered a distribution of money which reduces the basis of each partner's interest in the partnership by that amount. For the effect of a discharge of indebtedness on the basis of partnership property, see sections 108 and 1017.

(2) Where a partnership assumes the separate liabilities of a partner or a liability to which property owned by such partner is subject (see paragraph (c) of this section), the amount of the decrease in such partner's liabilities is treated as a distribution of money by the partnership to such partner. For example, partner A contributes property with a basis of $1,000 to partnership ABC in exchange for a one-third interest in the partnership. The property is subject to a mortgage of $150. (It is immaterial whether the mortgage is assumed by the partnership. See section 752(c).) The basis of A's partnership interest is $900, computed as follows: $1,000, A's basis for the contributed property, reduced by $100, two-thirds of A's original liability of $150 now attributable to partners B and C and reflected in their bases under the provisions of paragraph (a) of this section.

(c) Liability to which property is subject. Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee. For example, A contributes property with a basis to him of $1,000 to equal partnership AB. The property is subject to a mortgage of $2,500 and its value exceeds $2,500. Under paragraph (b) of this section, A will be treated as receiving a distribution in money of $1,250, one-half of the liability of $2,500 assumed by the partnership. Since the basis of A's partnership interest is $1,000 (the basis of the property contributed by him), the distribution to him of $1,250 results in his realizing a capital gain of $250 under section 731(a). A's basis for his partnership interest is zero. Although as a partner A

has a $1,250 share of the $2,500 partnership liability, this $1,250 is not added to the basis of A's partnership interest since it does not represent an increase in liabilities as to him.

(d) Sale or exchange of a partnership interest. Where there is a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. For example, if a partner sells his interest in a partnership for $750 cash and at the same time transfers to the purchaser his share of partnership liabilities amounting to $250, the amount realized by the seller on the transaction is $1,000.

(e) Partner's share of partnership liabilities. A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits. The provisions of this paragraph may be illustrated by the following example:

Example. G is a general partner and L is a limited partner in partnership GL. Each makes equal contributions of $20,000 cash to the partnership upon its formation. Under the terms of the partnership agreement, they are to share profits equally but L's liabilities are limited to the extent of his contribution. Subsequently, the partnership pays $10,000 for real property which is subject to a mortgage of $5,000. Neither the partnership nor any of the partners assume any liability on the mortgage. The basis of such property to the partnership is $15,000. The basis of G and L for their partnership interests is increased by $2,500 each, since each partner's share of the partnership liability (the $5,000 mortgage) has increased by that amount. However, if the partnership had assumed the mortgage so that G had become personally liable thereunder, G's basis for his interest would have been increased by $5,000 and L's basis would remain unchanged.

(f) Limitation. In determining the amount of liabilities for the purposes of section 752 and this section, the amount of an indebtedness is to be taken into account only once, even though a partner (in addition to his liability for such indebtedness as a partner) may be separately liable therefor in a capacity other than as a partner.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.753–1 Partner receiving income in respect of decedent.

(a) Income in respect of a decedent under section 736(a). All payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of the decedent under section 691. The estate or other successor in interest of a deceased partner shall be considered to have received income in respect of a decedent to the extent that amounts are paid by a third person in exchange for rights to future payments from the partnership under section 736(a). When a partner who is receiving payments under section 736(a) dies, section 753 applies to any remaining payments under section 736(a) made to his estate or other successor in interest.

(b) Other income in respect of a decedent. When a partner dies, the entire portion of the distributive share which is attributable to the period ending with the date of his death and which is taxable to his estate or other successor constitutes income in respect of a decedent under section 691. This rule applies even though that part of the distributive share for the period before death which the decedent withdrew is not included in the value of the decedent's partnership interest for estate tax purposes. See paragraph (c)(3) of § 1.706–1.

(c) Example. The provisions of this section may be illustrated by the following example:

Example. A and the decedent B were equal partners in a business having assets (other than money) worth $40,000 with an adjusted basis of $10,000. Certain partnership business was well advanced towards completion before B's death and, after B's death but before the end of the partnership year, payment of $10,000 was made to the partnership for such work. The partnership agreement provided that, upon the death of one of the partners, all partnership property, including unfinished work, would pass to the surviving partner, and that the surviving partner would pay the estate of the decedent the undrawn balance of his share of partnership earnings to the date of death, plus $10,000 in each of the three years after death. B's share of earnings to the date of his death was $4,000, of which he had withdrawn $3,000. B's distributive share of partnership income of $4,000 to the date of his death is income in respect of a decedent (although only the $1,000 undrawn at B's death will be reflected in the value of B's partnership interest on B's estate tax return). Assume that the value of B's interest in partnership property at the date of his death was $22,000, composed of the following items: B's one-half share of the assets of $40,000, plus $2,000, B's interest in partnership cash. It should be noted that B's $1,000 undrawn share of earnings to the date of his death is not a separate item but will be paid from partner-

ship assets. Under the partnership agreement, A is to pay B's estate a total of $31,000. The difference of $9,000 between the amount to be paid by A ($31,000) and the value of B's interest in partnership property ($22,000) comes within section 736(a) and, thus, also constitutes income in respect of a decedent. (However, the $17,000 difference between the $5,000 basis for B's share of the partnership property and its $22,000 value at the date of his death does not constitute income in respect of a decedent.) If, before the close of the partnership taxable year, A pays B's estate $11,000, of which they agree to allocate $3,000 as the payment under section 736(a), B's estate will include $7,000 in its gross income (B's $4,000 distributive share plus $3,000 payment under section 736(a)). In computing the deduction under section 691(c), this $7,000 will be considered as the value for estate tax purposes of such income in respect of a decedent, even though only $4,000 ($1,000 of distributive share not withdrawn, plus $3,000, payment under section 736(a)) of this amount can be identified on the estate tax return as part of the partnership interest.

(d) Effective date. The provisions of section 753 apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954. See section 771(b)(4) and paragraph (b)(4) of § 1.771–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.754–1 Time and manner of making election to adjust basis of partnership property.

(a) In general. A partnership may adjust the basis of partnership property under sections 734(b) and 743(b) if it files an election in accordance with the rules set forth in paragraph (b) of this section. An election may not be filed to make the adjustments provided in either section 734(b) or section 743(b) alone, but such an election must apply to both sections. An election made under the provisions of this section shall apply to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent partnership taxable years unless the election is revoked pursuant to paragraph (c) of this section.

(b) Time and method of making election. **(1)** An election under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b), with respect to a distribution of property to a partner or a transfer of an interest in a partnership, shall be made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed by paragraph (e) of § 1.6031–1 (including extensions thereof) for filing the return for such taxable year (or before August 23, 1956, whichever is later). Notwithstanding the preceding two sentences, if a valid election has been made under section 754 and this section for a preceding taxable year and not revoked pursuant to paragraph (c) of this section, a new election is not required to be made. The statement required by this subparagraph shall (i) set forth the name and address of the partnership making the election, (ii) be signed by any one of the partners, and (iii) contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b). For rules regarding extensions of time for filing elections, see § 1.9100–1.

(2) The principles of this paragraph may be illustrated by the following example:

Example. A, a U.S. citizen, is a member of partnership ABC, which has not previously made an election under section 754 to adjust the basis of partnership property. The partnership and the partners use the calendar year as the taxable year. A sells his interest in the partnership to D on January 1, 1971. The partnership may elect under section 754 and this section to adjust the basis of partnership property under sections 734(b) and 743(b). Unless an extension of time to make the election is obtained under the provisions of § 1.9100–1, the election must be made in a written statement filed with the partnership return for 1971 and must contain the information specified in subparagraph (1) of this paragraph. Such return must be filed by April 17, 1972 (unless an extension of time for filing the return is obtained). The election will apply to all distributions of property to a partner and transfers of an interest in the partnership occurring in 1971 and subsequent years, unless revoked pursuant to paragraph (c) of this section.

(c) Revocation of election. A partnership having an election in effect under this section may revoke such election with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. A partnership which wishes to revoke such an election shall file with the district director for the internal revenue district in which the partnership return is required to be filed an application setting forth the grounds on which the revocation is desired. The application shall be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect and shall be signed by any one of the partners. Examples of situations which may be considered sufficient reason for approving an application for revocation include a change in the nature of the partnership business, a substantial increase in the assets of the partnership, a change in the character of partnership assets, or an increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. However, no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid

stepping down the basis of partnership assets upon a transfer or distribution.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972]

§ 1.755–1 Rules for allocation of basis.

(a) General rule. (1)(i) A partnership which has elected under section 754 must adjust the basis of partnership property under the provisions of section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) and section 743(b) (relating to the optional adjustment to the basis of partnership property where a partnership interest is transferred). The amount of the increase or decrease (as determined in those sections) in the adjusted basis of the partnership property shall first be divided, under paragraph (b) of this section, between the two classes of property described in section 755(b). Then, the portion of the increase or decrease allocated to each class shall be further allocated to the bases of the properties within the class in a manner which will reduce the difference between the fair market value and the adjusted basis of partnership properties. In the alternative, any increase or decrease may be allocated in any other manner approved by the district director under subparagraph (2) of this paragraph.

(ii) If there is an increase in basis to be allocated to partnership assets, such increase must be allocated only to assets whose values exceed their bases and in proportion to the difference between the value and basis of each. No increase shall be made to the basis of any asset the adjusted basis of which equals or exceeds its fair market value.

(iii) If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to assets whose bases exceed their value and in proportion to the difference between the basis and value of each. No decrease shall be made to the basis of any asset, the fair market value of which equals or exceeds its adjusted basis.

(iv) The application of the rules with respect to the allocation of an adjustment in basis under subdivisions (ii) and (iii) of this subparagraph requires that a portion of such adjustment be allocated to partnership good will, to the extent that good will exists and is reflected in the value of the property distributed, the price at which the partnership interest is sold, or the basis of the partnership interest determined under section 1014, in accordance with the difference between such value of the good will and its adjusted basis at the time of the transaction.

(2) If a partnership (or a partner electing under section 732(d)) desires to adjust the basis of assets under section 734(b) or 743(b) in a manner other than that prescribed in subparagraph (1) of this paragraph, it must file an application for permission to use such method with the district director no later than 30 days after the close of the partnership taxable year in which the proposed adjustment is to be made. The application must describe the proposed adjustments in detail and set forth the reasons for the desired use of the other method. Under section 755(a)(2), the district director may permit the partnership to increase the bases of some partnership properties and decrease the bases of other partnership properties under section 734(b) or 743(b). Each increase or decrease to the basis of an asset must reduce or eliminate the difference between such basis and the value of the asset. The net amount of all such adjustments must equal the amount of the adjustment under section 734(b) or 743(b). Adjustments that both increase and decrease the basis of partnership assets will be permitted by the district director only upon a satisfactory showing of the values for partnership assets used by the parties to determine the price at which a partnership interest was sold, the value of the decedent's partnership interest at date of death (or at the alternate valuation date, if used), or the amount of a distribution.

(b) Special rules. For the purposes of applying section 755, all partnership property shall be classified into two categories: Capital assets and property described in section 1231(b) (certain property used in the trade or business), or any other property of the partnership.

(1) Distributions. **(i)** Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), such adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership adjusted basis of distributed capital assets and section 1231(b) property immediately prior to distribution exceeds the basis of such property to the distributee partner (as determined under section 732), the basis of the undistributed capital assets and section 1231(b) property remaining in the partnership shall be increased by an amount equal to such excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital assets and section 1231(b) property exceeds the partnership adjusted basis of such property immediately prior to the

distribution, the basis of the undistributed capital assets and section 1231(b) property remaining in the partnership shall be decreased by an amount equal to such excess. Similarly, where there is a distribution of partnership property other than capital assets and section 1231(b) property, and the basis of such other property to the distributee partner (as determined under section 732) is not the same as the partnership adjusted basis of such property immediately prior to distribution, the adjustment shall be made only to undistributed property of the same category remaining in the partnership.

(ii) Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, such adjustment must be allocated only to capital assets or section 1231(b) property.

(2) **Transfers.** Where there is a basis adjustment under section 743(b) arising from a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, the amount of the adjustment shall be allocated between the two classes of property described in section 755(b) and then the amount allocated to each class shall be further allocated under the rules of paragraph (a)(1) of this section. Thus, to the extent that an amount paid by a purchaser of a partnership interest (or the basis of the partnership interest to the estate or other successor in interest of a deceased partner) is attributable to the value of capital assets and section 1231(b) property, any difference between the amount so attributable and the transferee partner's share of the partnership basis of such property shall constitute a special basis adjustment with respect to partnership capital assets and section 1231 (b) property. Similarly, any such difference attributable to any other property of the partnership shall constitute a special basis adjustment with respect to such property.

(3) **Limitation on decrease of basis.** Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property shall be reduced to zero (but not below zero), and the balance of the decrease in basis shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(4) **Carryover of adjustment.** Where, in the case of a distribution, an increase or decrease required under paragraph (a) of this section in the basis of undistributed partnership property cannot be made because the partnership owns no property of the character required to be adjusted, or because the adjustment has been limited under subparagraph (3) of this paragraph, the adjustment shall be made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(c) **Examples.** The provisions of this section may be illustrated by the following examples:

Example (1). Assume that partnership ABC has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $900; and Z, inventory items with an adjusted basis of $700 and a value of $600. A sells his interest to D (when an election under 754 is in effect) for $1,000 (⅓ of $3,000, the total value of partnership assets). D's share of the adjusted basis of partnership property is $900 (⅓ of $2,700). Therefore, under section 743(b), D has a special basis adjustment of $100 ($1,000 minus $900). This adjustment must be allocated entirely to property X, since such allocation will have the effect of reducing the difference between the value and basis of such asset. Therefore, D has a special basis adjustment of $100 with respect to property X, which now has a special basis to him of $1,100. No part of the adjustment is made to depreciable property Y or inventory items Z, since any such adjustment would increase the difference between the basis and value of each such asset.

Example (2). Assume the same facts as in example (1) of this paragraph, except that capital asset X has a value of $1,500, depreciable property Y has a value of $1,100, and inventory items Z have a value of only $400. Therefore, under section 743(b), D has a special basis adjustment of $100, the excess of D's basis for his interest in the partnership ($1,000) over his share of the adjusted basis of partnership property ($900). This $100 adjustment must be allocated entirely to capital asset X and depreciable property Y in proportion to the difference between the value and basis of each since such allocation has the effect of reducing the difference between the value and basis of each such asset. Therefore, D has a special basis adjustment of $83 ($500/$600 of $100) with respect to capital asset X, which now has a special basis to him of $1,083, and of $17 ($100/$600 of $100) with respect to depreciable property Y, which now has a special basis to him of $1,017. No part of the adjustment is made to inventory items Z, since any such adjustment would increase the difference between the basis of such asset and its value.

Example (3). Assume that partnership EFG has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $700; and Z, inventory items with an adjusted basis of $700 and a value of $800. E sells his interest to H (when an election under section 754 is in effect) for $1,000 (⅓ of $3,000, the total value of the partnership assets). H's share of the adjusted basis of partnership is $900 (⅓ of $2,700). Therefore, H has a special basis adjustment of $100 ($1,000 minus $900) under section 743(b). Since, of the total $300 difference between the value and the adjusted basis of all partnership property, $200 ($500, appreciation in value of X, minus $300, depreciation in value of Y) is attributable to the class of capital assets and depreciable property, and $100 (appreciation in value of inventory items Z) to the class of other property, H's special basis adjustment of $100 must be allocated ⅔ to capital assets and depreciable property and ⅓ to other property (inventory). The $67 increase (⅔ of $100) to be

allocated to capital assets and depreciable property must further be allocated so as to reduce the difference between the value and basis of such assets. This can be done only by allocating the entire $67 increase to capital asset X (the basis of which is less than its value), and no part of the increase to depreciable property Y (the basis of which exceeds its value). Therefore, H has a special basis adjustment of $67 for capital asset X, which now has a special basis to him of $1,067; he has no special basis adjustment for depreciable property Y. H also has a special basis adjustment of $33 (⅓ of $100) for inventory items Z, the special basis of which is now $733.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.755–2T Coordination of sections 755 and 1060 (temporary).

(a) Coordination with section 1060—(1) In general. If there is a basis adjustment to which this section applies—

(i) The fair market value of each item of partnership property must be determined under this section; and

(ii) The rules of § 1.755-1 must be applied using the values so determined.

(2) Application of this section. This section applies to any basis adjustment made under section 743(b) (relating to certain transfers of interests in a partnership) or section 732(d) (relating to certain partnership distributions), if assets of the partnership constitute a trade or business for purposes of section 1060(c).

(b) Determining the fair market value of partnership property—(1) Property other than that in the nature of goodwill or going concern value. For purposes of this section, the fair market value of each item of partnership property (other than property in the nature of goodwill or going concern value) shall be determined on the basis of all the facts and circumstances.

(2) Property in the nature of goodwill or going concern value. For purposes of paragraph (a) of this section, the fair market value of partnership property in the nature of goodwill or going concern value (referred to hereinafter in this section as goodwill) shall be deemed to equal the amount (not below zero) which if assigned to such property would result in a liquidating distribution to the transferee partner equal to such partner's basis for the transferred partnership interest immediately after the transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities) if—

(i) All partnership property were sold immediately after such transfer for an amount equal to the fair market value of such property (as determined under this section), and

(ii) The proceeds of that sale were, after the payment of all partnership liabilities (within the meaning of section 752 and the regulations thereunder), distributed to the partners.

(c) Cross-reference. See §§ 1.732-1(d)(3) and 1.743-1(b)(3) for rules requiring a transferee partner to attach a statement to such partner's return showing the computation of the special basis adjustment and the partnership properties to which the adjustment is allocated under section 755.

(d) Effective date. This section applies to any basis adjustment under section 743(b) made as a result of any transfer of a partnership interest made after May 6, 1986, unless such transfer is made pursuant to a binding contract that was in effect on May 6, 1986, and at all times thereafter prior to such transfer. However, the requirements of this section shall be deemed to be satisfied with respect to any transfer made on or before July 15, 1988, if the amount of any basis adjustment under section 743(b) or section 732(d) made as a result of such transfer that is allocated to each item of partnership property (other than goodwill) does not exceed the amount equal to the difference between the transferee partner's share of the partnership basis of such property and such partner's share of the fair market value of such property.

(e) Example. The provisions of this section may be illustrated by the following example which assumes that the assets of the partnership constitute a trade or business under section 1060 and that the partnership has an election in effect under section 754 at the time of the sale of the partnership interest.

Example (1). A is a member of partnership ABC. ABC has three assets: a building with a fair market value of $2,000,000, equipment with a fair market value of $800,000 and goodwill. ABC has no liabilities. A has a one-third interest in partnership capital and profits. A sells his partnership interest to D for $1,000,000. Under paragraph (b)(2) of this section, the fair market value of goodwill is deemed to equal the value that must be assigned to goodwill in order for the partnership to distribute $1,000,000 to D if it were to sell all of its property at fair market value (in the case of goodwill, its assigned value) and completely liquidate after D's purchase of A's partnership interest. In order for D, a one-third partner, to receive a liquidation distribution of $1,000,000, the partnership would have to sell all partnership property for a total of $3,000,000. The fair market value of partnership property other than goodwill is $2,800,000. Therefore, goodwill must be assigned a value of $200,000 ($3,000,000 - $2,800,000) in order for D to receive a liquidating distribution of $1,000,000. Accordingly, D's section 743(b) basis adjustment must be allocated under § 1.755-1 using a fair market value of $200,000 for goodwill.

[T.D. 8215, 53 FR 27044, July 18, 1988]

Definitions

§ 1.761–1 Terms defined.

(a) **Partnership.** The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate within the meaning of the Code. The term "partnership" is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships. See section 7701(a)(2). See regulations under section 7701(a)(1), (2), and (3) for the description of those unincorporated organizations taxable as corporations or trusts. A joint undertaking merely to share expenses is not a partnership. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they are not partners. Mere coownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby. Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if coowners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. For rules relating to the exclusion of certain partnerships from the application of all or part of subchapter K of chapter 1 of the Code, see § 1.761–2.

(b) **Partner.** The term "partner" means a member of a partnership.

(c) **Partnership agreement.** For the purposes of subchapter K, a partnership agreement includes the original agreement and any modifications thereof agreed to by all the partners or adopted in any other manner provided by the partnership agreement. Such agreement or modifications can be oral or written. A partnership agreement may be modified with respect to a particular taxable year subsequent to the close of such taxable year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. As to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law shall be considered to constitute a part of the agreement.

(d) **Liquidation of partner's interest.** The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made. For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, and distributions of the partner's distributive share. See paragraph (a)(1)(ii) of § 1.731–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 7208, 37 FR 20686, Oct. 3, 1972]

§ 1.761–2 Exclusion of certain unincorporated organizations from the application of all or part of Subchapter K of Chapter 1 of the Code.

(a) **Exclusion of eligible unincorporated organizations—(1) In general.** Under conditions set forth in this section, an unincorporated organization described in subparagraph (2) or (3) of this paragraph may be excluded from the application of all or a part of the provisions of subchapter K of chapter 1 of the Code. Such organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. The members of such organization must be able to compute their income without the necessity of computing partnership taxable income. Any syndicate, group, pool, or joint venture which is classifiable as an association, or any group operating under an agreement which creates an organization classifiable as an association, does not fall within these provisions.

(2) **Investing partnership.** Where the participants in the joint purchase, retention, sale, or exchange of investment property—

(i) Own the property as coowners,

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section.

(3) Operating agreements. Where the participants in the joint production, extraction, or use of property—

(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year, then

such group may be excluded from the application of the provisions of subchapter K under the rules set forth in paragraph (b) of this section. However, the preceding sentence does not apply to any unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

(b) Complete exclusion from subchapter K—(1) Time for making election for exclusion. Any unincorporated organization described in subparagraph (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) not later than the time prescribed by paragraph (e) of § 1.6031–1 (including extensions thereof) for filing the partnership return for the first taxable year for which exclusion from subchapter K is desired. Notwithstanding the prior sentence such organization may be deemed to have made the election in the manner prescribed in subparagraph (2)(ii) of this paragraph.

(2) Method of making election. (i) Except as provided in subdivision (ii) of this subparagraph, any unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section which wishes to be excluded from all of subchapter K must make the election provided in section 761(a) in a statement attached to, or incorporated in, a properly executed partnership return, Form 1065, which shall contain the information required in this subdivision. Such return shall be filed with the internal revenue officer with whom a partnership return, Form 1065, would be required to be filed if no election were made. Where, for the purpose of determining such officer, it is necessary to determine the internal revenue district (or service center serving such district) in which the electing organization has its principal office or place of business, the principal office or place of business of the person filing the return shall be considered the principal office or place of business of the organization. The partnership return must be filed not later than the time prescribed by paragraph (e) of § 1.6031–1 (including extensions thereof) for filing the partnership return with respect to the first taxable year for which exclusion from subchapter K is desired. Such partnership return shall contain, in lieu of the information required by Form 1065 and by the instructions relating thereto, only the name or other identification and the address of the organization together with information on the return, or in the statement attached to the return, showing the names, addresses, and identification numbers of all the members of the organization; a statement that the organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section; a statement that all of the members of the organization elect that it be excluded from all of subchapter K; and a statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained).

(ii) If an unincorporated organization described in subparagraphs (1) and either (2) or (3) of paragraph (a) of this section does not make the election provided in section 761(a) in the manner prescribed by subdivision (i) of this subparagraph, it shall nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of subchapter K beginning with the first taxable

year of the organization. Although the following facts are not exclusive, either one of such facts may indicate the requisite intent:

(a) At the time of the formation of the organization there is an agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or

(b) The members of the organization owning substantially all of the capital interests report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization.

(3) Effect of election—(i) In general. An election under this section to be excluded will be effective unless within 90 days after the formation of the organization (or by October 15, 1956, whichever is later) any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such election is irrevocable as long as the organization remains qualified under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, or unless approval of revocation of the election is secured from the Commissioner. Application for permission to revoke the election must be submitted to the Commissioner of Internal Revenue, Attention: T:I, Washington, D.C. 20224, no later than 30 days after the beginning of the first taxable year to which the revocation is to apply.

(ii) Special rule. Notwithstanding subdivision (i) of this subparagraph, an election deemed made pursuant to subparagraph (2)(ii) of this paragraph will not be effective in the case of an organization which had a taxable year ending on or before November 30, 1972, if any member of the organization notifies the Commissioner that the member desires subchapter K to apply to such organization, and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail. Such notification to the Commissioner must be made on or before January 2, 1973 and must include the names and addresses of all of the members of the organization.

(c) Partial exclusion from subchapter K. An unincorporated organization which wishes to be excluded from only certain sections of subchapter K must submit to the Commissioner, no later than 90 days after the beginning of the first taxable year for which partial exclusion is desired, a request for permission to be excluded from certain provisions of subchapter K. The request shall set forth the sections of subchapter K from which exclusion is sought and shall state that such organization qualifies under subparagraphs (1) and either (2) or (3) of paragraph (a) of this section, and that the members of the organization elect to be excluded to the extent indicated. Such exclusion shall be effective only upon approval of the election by the Commissioner and subject to the conditions he may impose.

(d) Cross reference. For requirements with respect to the filing of a return on Form 1065 by a partnership, see § 1.6031–1.

[T.D. 7208, 37 FR 20687, Oct. 3, 1972; 37 FR 23161, Oct. 31, 1972]

Effective Date For Subchapter K, Chapter 1 Of The Code

§ 1.771–1 Effective date.

(a) General rule. Except as provided in paragraph (b) or (c) of this section, the provisions of Subchapter K, Chapter 1 of the Code, shall apply to any taxable year of a partnership beginning after December 31, 1954, and to any part of a partner's taxable year falling within such partnership taxable year. The provisions of the Internal Revenue Code of 1939 relating to partnerships shall apply to any taxable year of a partnership beginning before January 1, 1955, and to any part of a partner's taxable year falling within such partnership taxable year. If a partnership and the partners are on different taxable years, Subchapter K shall become effective at the same time both for the partnership and for the partners.

(b) Special rules. Certain provisions of section 771 apply after specific dates in 1954, as follows:

(1) Adoption of taxable year. Section 706(b) (relating to the adoption of taxable years by partners and partnerships), shall apply to any partnership which adopts or changes to, and any partner who changes to, a taxable year beginning on or after April 2, 1954. For the purpose of applying this subparagraph, the rules of section 708 (relating to the continuation of partnerships) shall ap-

ply. For example, if two or more partnerships merge after April 1, 1954, and the new partnership uses the taxable year of the partnership of which it is deemed to be the successor under section 708(b)(2)(A), it will not need prior approval to continue to use such taxable year even though such year may be different from the taxable years of the partners. Such a partnership is not "adopting" or "changing" its taxable year.

(2) Property distributed by a partnership. Section 735(a), relating to the character of gain or loss on disposition of property distributed by a partnership to a partner, shall apply only to property distributed after March 9, 1954. Although a partnership whose taxable year begins before January 1, 1955, generally will be subject to the provisions of the Internal Revenue Code of 1939, any unrealized receivables or inventory items distributed by any such partnership after March 9, 1954, will be subject to the provisions of section 735(a), and the gain or loss on the subsequent disposition of such property will be ordinary gain or loss rather than capital gain or loss. In the case of property distributed before March 10, 1954, section 735(a) will not apply, even though the property is disposed of by the distributee partner after that date, unless the partnership elects under paragraph (c) of this section to apply section 735.

(3) Unrealized receivables and inventory items. Section 751 (providing for the realization of ordinary income on certain transfers or distributions of unrealized receivables or substantially appreciated inventory items) shall be applicable to any such transfer or distribution occurring after March 9, 1954. For the purpose of applying section 751 in the case of a taxable year beginning before January 1, 1955, a partnership or partner may elect to treat as applicable any other section of Subchapter K. See paragraph (f) of § 1.751–1.

(4) Partner receiving income in respect of a decedent. Section 753, which provides that the amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691, shall apply only in the case of payments made with respect to decedents whose death occurred after December 31, 1954.

(c) Optional treatment of certain distributions. (1) For a partnership taxable year beginning after December 31, 1953, and before January 1, 1955, a partnership may elect to apply the rules of certain sections of Subchapter K with respect to current distributions made by the partnership in such year. These sections are 731, 732(a), (c), and (e), 733, 735, and 751(b), (c), and (d). If an election is made, it shall apply to the partnership and all its members for all current distributions made by the partnership during the taxable year. Such distributions shall also be subject to the rules of section 705 (relating to determination of basis of a partner's interest), 752 (relating to treatment of certain liabilities), and 761(d) (relating to the definition of liquidation of a partner's interest), to the extent that such sections apply to current distributions.

(2) An election under this paragraph shall be made by a statement filed with the partnership return for the taxable year to which such election applies, or before August 23, 1956, whichever date is later. The statement shall be signed by all members of the partnership and the election once made shall be binding on the partnership and on all of its members.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

INSURANCE COMPANIES

Life Insurance Companies

Definition; Tax Imposed

§ 1.801–1 Definitions.

(a) Life insurance company. The term "life insurance company" as used in subtitle A of the Code is defined in section 801. For the purpose of determining whether a company is a "life insurance company" within the meaning of that term as used in section 801, it must first be determined whether the company is taxable as an insurance company under the Code. For the definition of an "insurance company", see paragraph (b) of this section. In determining whether an insurance company is a life insurance company, the life insurance reserves (as defined in section 803(b)) plus any unearned premiums and unpaid losses on noncancellable life, health, or accident policies, not included in "life insurance reserves" must comprise more than 50 percent of its total reserves (as defined in section 801). An insurance company writing only noncancellable life, health, or accident policies and having no "life insurance re-

serves" may qualify as a life insurance company if its unearned premiums and unpaid losses on such policies comprise more than 50 percent of its total reserves. A noncancellable insurance policy means a contract which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premium must be carried to cover that obligation. For the purpose of the preceding sentence, the term "unearned premium" means the amount which will cover the cost of carrying the insurance risk for the period for which the premium has been paid in advance. A burial or funeral benefit insurance company qualifying as a life insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services will be taxable under section 821 or section 831 as an insurance company other than life.

(b) **Insurance companies.** (1) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund, but the income therefrom shall be included in the return of the corporation.

(2) Though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a corporation is authorized and intends to carry on, the character of the business actually done in the taxable year determines whether it is taxable as an insurance company under the Code. For example, during the year 1954 the M Corporation, incorporated under the insurance laws of the State of R, carried on the business of lending money in addition to guaranteeing the payment of principal and interest of mortgage loans. Of its total income for the year, one-third was derived from its insurance business of guaranteeing the payment of principal and interest of mortgage loans and two-thirds was derived from its noninsurance business of lending money. The M Corporation is not an insurance company for the year 1954 within the meaning of the Code and the regulations thereunder.

[T.D. 6513, 25 FR 12654, Dec. 10, 1960]

§ 1.801-2 Taxable years affected.

Section 1.801-1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.801-3 through 1.801-7 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112). Section 1.801-8 is applicable only to taxable years beginning after December 31, 1961, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 3 of the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6513, 25 FR 12654, Dec. 10, 1960, as amended by T.D. 6886, 31 FR 8681, June 23, 1966]

§ 1.801-3 Definitions.

For purposes of Part I, Subchapter L, Chapter 1 of the Code, this section defines the following terms, which are to be used in determining if a taxpayer is a life insurance company (as defined in section 801(a) and paragraph (b) of this section):

(a) **Insurance company.** (1) The term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

(2) Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. For taxable years beginning before January 1, 1970, a voluntary unincorporated association of employees, including an association fulfilling the requirements of section 801(b)(2)(B) (as in effect for such years), formed for the purpose of relieving sick and aged members and the dependents of deceased members, is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. A corporation which merely sets aside a fund for the insurance of

its employees is not an insurance company, and the income from such fund shall be included in the return of the corporation.

(b) Life insurance company. (1) The term "life insurance company", as used in subtitle A of the Code, is defined in section 801(a). For the purpose of determining whether a company is a "life insurance company" within the meaning of that term as used in section 801(a), it must first be determined whether the company is taxable as an insurance company (as defined in paragraph (a) of this section). An insurance company shall be taxed as a life insurance company if it is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, and its life insurance reserves (as defined in section 801(b) and § 1.801–4), plus unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in section 801(c) and § 1.801–5). For purposes of determining whether it satisfies the percentage requirements of the preceding sentence, a company shall first make any adjustments to life insurance reserves and total reserves required by section 806(a) (relating to adjustments for certain changes in reserves and assets) and then as required by section 801(d) (relating to adjustments in reserves for policy loans). For examples of the adjustments required under section 806(a), see paragraph (b)(4) of § 1.806–3. For an example of the adjustments required under section 801(d), see paragraph (c) of § 1.801–6. Furthermore, if an insurance company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), such revalued basis shall be disregarded for purposes of section 801.

(2) An insurance company writing only noncancellable life, health, or accident policies and having no "life insurance reserves" may qualify as a life insurance company if its unearned premiums, and unpaid losses (whether or not ascertained), on such policies comprise more than 50 percent of its total reserves.

(3) Section 801(f) provides that a burial or funeral benefit insurance company engaged directly in the manufacture of funeral supplies or the performance of funeral services shall not be taxable under section 802 but shall be taxable under section 821 or section 831 as an insurance company other than life.

(c) Noncancellable life, health, or accident insurance policy. The term "noncancellable life, health, or accident insurance policy" means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which the insurance company is under an obligation to renew or continue at a specified premium and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. Such a health and accident contract shall be considered noncancellable even though it states a termination date at a stipulated age, if, with respect to the health and accident contract, such age termination date is 60 or over. Such a contract, however, shall not be considered to be noncancellable after the age termination date stipulated in the contract has passed. However, if the age termination date stipulated in the contract occurs during the period covered by a premium received by the life insurance company prior to such date, and the company cannot cancel or modify the contract during such period, the age termination date shall be deemed to occur at the expiration of the period for which the premium has been received.

(d) Guaranteed renewable life, health, and accident insurance policy. The term "guaranteed renewable life, health, and accident insurance policy" means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved, and with respect to which a reserve in addition to the unearned premiums (as defined in paragraph (e) of this section) must be carried to cover that obligation. Section 801(e) provides that such policies shall be treated in the same manner as noncancellable life, health, and accident insurance policies. For example, the age termination date requirements applicable to noncancellable health and accident insurance policies shall also apply to guaranteed renewable life, health, and accident insurance policies. See paragraph (c) of this section.

(e) Unearned premiums. The term "unearned premiums" means those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law.

(f) Life insurance reserves. For the definition of the term "life insurance reserves", see section 801(b) and § 1.801–4.

(g) Unpaid losses (whether or not ascertained). The term "unpaid losses (whether or not ascertained)" means a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases)—

(1) Reported and ascertained by the end of the taxable year but where the amount of the loss has not been paid by the end of the taxable year,

(2) Reported by the end of the taxable year but where the amount thereof has not been either ascertained or paid by the end of the taxable year, or

(3) Which have occurred by the end of the taxable year but which have not been reported or paid by the end of the taxable year.

(h) Total reserves. For the definition of the term "total reserves", see section 801(c) and § 1.801–5.

(i) Amount of reserves. For purposes of subsections (a), (b), and (c) of section 801 and this section, section 801(b)(5) provides that the amount of any reserve (or portion thereof) for any taxable year shall be the mean of such reserve (or portion thereof) at the beginning and end of the taxable year.

[T.D. 6513, 25 FR 12655, Dec. 10, 1960, as amended by T.D. 7172, 37 FR 5619, March 17, 1972]

§ 1.801–4 Life insurance reserves.

(a) Life insurance reserves defined. For purposes of Part I, Subchapter L, Chapter 1 of the Code, the term "life insurance reserves" (as defined in section 801(b)) means those amounts—

(1) Which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;

(2) Which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies; and

(3) Which, except as otherwise provided by section 801(b)(2) and paragraphs (b) and (c) of this section, are required by law. For the meaning of the term "reserves required by law", see paragraph (b) of § 1.801–5.

For purposes of determining life insurance reserves, only those amounts shall be taken into account which must be reserved either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute. Moreover, such amounts must actually be held by the company during the taxable year for which the reserve is claimed. However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. For example, if an ordinary life policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10, the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves. Generally, life insurance reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. For examples of reserves which qualify as life insurance reserves, see paragraph (d) of this section. For examples of reserves which do not qualify as life insurance reserves, see paragraph (e) of this section.

(b) Certain reserves which need not be required by law. Section 801(b)(2) sets forth certain reserves which, though not required by law, may still qualify as life insurance reserves, provided, however, that they first satisfy the requirements of section 801(b)(1)(A) and (B) and paragraph (a)(1) and (2) of this section. Thus, reserves need not be required by law—

(1) In the case of policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, and

(2) For taxable years beginning before January 1, 1970, in the case of policies issued by an organization which met the requirements of section 501(c)(9) (as it existed prior to amendment by the Tax Reform Act of 1969) other than the requirement of subparagraph (B) thereof.

(c) Assessment companies. Section 801(b)(3) provides that in the case of an assessment life insurance company or association, the term "life insurance reserves" includes—

(1) Sums actually deposited by such company or association with officers of a State or Territory pursuant to law as guaranty or reserve funds, and

(2) Any funds maintained, under the charter or articles of incorporation or association of such company or association (or bylaws approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

For purposes of part I, subchapter L, chapter 1 of the Code, the reserves described in this paragraph shall be included as life insurance reserves even though such reserves do not meet the requirements of section 801(b) and paragraph (a) of this section. However, for such reserves to be included as life insurance reserves, they must be deposited or maintained to liquidate future unaccrued claims arising from life insurance, annuity, or noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is deposited or maintained, life, health, or accident contingencies. The rate of interest assumed in calculating the reserves described in this paragraph shall be 3 percent, regardless of the rate of interest (if any) specified in the contract in respect of such reserves.

(d) Reserves which qualify as life insurance reserves. The following reserves, provided they meet the requirements of section 801(b) and paragraph (a) of this section, are illustrative of reserves which shall be included as life insurance reserves:

(1) Reserves held under life insurance contracts.

(2) Reserves held under annuity contracts (including reserves held under variable annuity contracts as described in section 801(g)(1)).

(3) Reserves held under noncancellable health and accident insurance contracts (as defined in paragraph (c) of § 1.801–3) and reserves held under guaranteed renewable health and accident insurance contracts (as defined in paragraph (d) of § 1.801–3).

(4) Reserves held either separately or combined under contracts described in subparagraphs (1), (2), or (3) of this paragraph.

(5) Reserves held under deposit administration contracts. Generally, the reserves held by a life insurance company on both the active and retired lives under deposit administration contracts will meet the requirements of section 801(b) and paragraph (a) of this section.

However, reserves held by the company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) shall be deducted from the company's life insurance reserves. See paragraph (a) of this section.

(e) Reserves and liabilities which do not qualify as life insurance reserves. The following are illustrative of reserves and liabilities which do not meet the requirements of section 801(b) and paragraph (a) of this section and, accordingly, shall not be included as life insurance reserves:

(1) Liability for supplementary contracts not involving at the time with respect to which the liability is computed, life, health, or accident contingencies.

(2) In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums and unpaid losses (whether or not ascertained).

(3) The unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies (and guaranteed renewable life, health, and accident policies) not included in life insurance reserves. (However, such amounts shall be taken into account under section 801(a)(2) for purposes of determining whether an insurance company is a life insurance company.)

(4) The deficiency reserve (as defined in section 801(b)(4)) for each individual contract, that is, that portion of the reserve for such contract equal to the amount (if any) by which—

(i) The present value of the future net premiums required for such contract, exceeds

(ii) The present value of the future actual premiums and consideration charged for such contract.

(5) Reserves required to be maintained to provide for the ordinary operating expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage.

(6) Liability for premiums received in advance.

(7) Liability for premium deposit funds.

(8) Liability for annual and deferred dividends declared or apportioned.

(9) Liability for dividends left on deposit at interest.

(10) Liability for accrued but unsettled policy claims whether known or unreported.

(11) A mandatory securities valuation reserve.

(f) Adjustments to life insurance reserves. In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid. [T.D. 6513, 25 FR 12656, Dec. 10, 1960, as amended by T.D. 7172, 37 FR 5619, March 17, 1972]

§ 1.801–5 Total reserves.

(a) Total reserves defined. For purposes of section 801(a) and § 1.801–3, the term "total reserves" is defined in section 801(c) as the sum of—

(1) Life insurance reserves (as defined in section 801(b) and § 1.801–4),

(2) Unearned premiums (as defined in paragraph (e) of § 1.801–3), and unpaid losses (whether or not ascertained) (as defined in paragraph (g) of § 1.801–3), not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The term "total reserves" does not, however, include deficiency reserves (within the meaning of section 801(b)(4), and paragraph (e)(4) of § 1.801–4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held during the taxable year for which the reserve is claimed. For example, during the taxable year 1958 a life insurance company sells life insurance and annuity contracts in States A and B. State A requires reserves of 10 against the life and 5 against the annuity business. State B requires reserves of 9 against the life and 7 against the annuity business. Assuming the company actually holds these reserves during the taxable year 1958, its highest aggregate reserve for such taxable year is the 16 required by State B. Thus, the company is not permitted to compute its highest aggregate reserve by taking State A's requirement of 10 against its life insurance business and adding it to State B's requirement of 7 against its annuity business.

(b) Reserves required by law defined. For purposes of Part I, Subchapter L, Chapter 1 of the Code, the term "reserves required by law" means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

(c) Information to be filed. In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. See section 6012 and paragraph (c) of § 1.6012–2. If the basis (for Federal income tax purposes) for determining the amount of any of the life insurance reserves as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year then the following information must be filed with respect to all such changes in basis:

(1) The nature of the life insurance reserve (*i.e.*, life, annuity, etc.);

(2) The mortality or morbidity table, assumed rate of interest, method used in computing or estimating such reserve on the old basis, and the amount of such reserve at the beginning and close of the taxable year computed on the old basis;

(3) The mortality or morbidity table, assumed rate of interest, method used in computing or estimating such reserve on the new basis, and the amount of such reserve at the close of the taxable year computed on the new basis;

(4) The deviation, if any, from recognized mortality or morbidity tables, or recognized methods of computation;

(5) The reasons for the change in basis of such reserve; and

(6) Whether such change in the reserve has been approved or accepted by the regulatory authorities of the State of domicile, and if so, a copy of the letter, certificate, or other evidence of such approval or acceptance.

(d) Illustration of principles. The provisions of section 801 relating to the percentage requirements for qualification as a life insurance company may be illustrated by the following example:

Example. The books of Y, an insurance company, selling life insurance, noncancellable health and accident insurance, and cancellable accident and health insurance, reflect (after adjustment under sections 806(a) and 801(d)) the following facts for the taxable year 1958:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	$3,000	$5,000	$4,000
2. Unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable accident and health insurance not included in life insurance reserves	400	600	500
3. Unearned premiums, and unpaid losses (whether or not ascertained), on cancellable accident and health insurance........	1,800	2,200	2,000
4. All other insurance reserves required by law ...	900	1,100	1,000
5. Total reserves ..	....	....	7,500

The rules provided by section 801 require that the sum of the mean of the year figures in items 1 and 2 comprise more than 50 percent of the mean of the year figure in item 5 for an insurance company to qualify as a life insurance company. Thus, Y would qualify as a life insurance company for the taxable year 1958 as the sum of the mean of the year figures in items 1 and 2 ($4,500) comprise 60 percent of the mean of the year figure in item 5 ($7,500).

[T.D. 6513, 25 FR 12657, Dec. 10, 1960]

§ 1.801–6 Adjustments in reserves for policy loans.

(a) In General. Section 801(d) provides that for purposes only of determining whether or not an insurance company is a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), the life insurance reserves (as defined in section 801(b) and § 1.801–4), and the total reserves (as defined in section 801(c) and paragraph (a) of § 1.801–5), shall each be reduced by an amount equal to the mean of the aggregates, at the beginning and end of the taxable year, of the policy loans outstanding with respect to contracts for which life insurance reserves are maintained. Such reduction shall be made after any adjustments required under section 806(a) and § 1.806–3 have been made.

(b) Policy loans defined. The term "policy loans" includes loans made by the insurance company, by whatever name called, for which the reserve on a contract is the collateral.

(c) Illustration of principles. The provisions of section 801(d) and this section may be illustrated by the following example:

Example. The books of T, an insurance company, selling only life insurance and cancellable accident and health insurance, reflect (after adjustment under section 806(a)) the following facts for the taxable year 1958:

	Jan. 1	Dec. 31	Mean of year
1. Life insurance reserves	$1,000	$2,000	$1,500
2. Policy loans ...	50	850	450
3. Life insurance reserves less policy loans	....	....	1,050
4. Unearned premiums, and unpaid losses (whether or not ascertained), on cancellable accident and health insurance........	900	1,600	1,250
5. Total reserves adjusted for policy loans (item 3 plus item 4)	....	....	2,300

As the rules provided by section 801(a) and (d) require that the figure in item 3 ($1,050) be more than 50 percent of the mean of the year figure in item 5 ($2,300) for an insurance company to qualify as a life insurance company, T would not qualify as a life insurance company for the taxable year 1958.

[T.D. 6513, 25 FR 12657, Dec. 10, 1960]

§ 1.801–7 Variable annuities.

(a) In general. (1) Section 801(g)(1) provides that for purposes of Part I, Subchapter L, Chapter 1 of the Code, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing such a contract. A variable annuity differs from the ordinary or fixed dollar annuity in that the annuity benefits payable under a variable annuity contract vary with the insurance company's investment experience with respect to such contracts while the annuity benefits paid under a fixed dollar annuity contract are guaranteed irrespective of the company's actual investment earnings.

(2) The reserves held with respect to the annuity contracts described in section 801(g)(1) and subparagraph (1) of this paragraph shall qualify as life insurance reserves within the meaning of sec-

tion 801(b)(1) and paragraph (a) of § 1.801–4 provided such reserves are required by law (as defined in paragraph (b) of § 1.801–5) and are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from such contracts involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Accordingly, a company issuing variable annuity contracts shall qualify as a life insurance company for Federal income tax purposes if it satisfies the requirements of section 801(a) (relating to the definition of a life insurance company) and paragraph (b) of § 1.801–3.

(b) Special rules for variable annuities—(1) Adjusted reserves rate; assumed rate. The adjusted reserves rate for any taxable year with respect to the annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section, and the rate of interest assumed by the taxpayer for any taxable year in calculating the reserve on any such contract, shall be a rate equal to the current earnings rate determined under section 801(g)(3) and subparagraph (2) of this paragraph. However, any change in the rate of interest assumed by the taxpayer in calculating the reserve on a variable annuity contract for any taxable year which is attributable to an increase or decrease in the current earnings rate, shall not be treated as a change of basis in computing reserves for purposes of section 806(b) (relating to certain changes in reserves) or section 810(d)(1) (relating to adjustment for change in computing reserves).

(2) Current earnings rate. (i) The current earnings rate for any taxable year with respect to the annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section shall be the current earnings rate determined under section 805(b)(2) and paragraph (a)(2) of § 1.805–5 with respect to such contracts, reduced by the percentage obtained by dividing (a) the amount of the actuarial margin charge on all such variable annuity contracts issued by the taxpayer, by (b) the mean of the reserves for such contracts.

(ii) For purposes of section 801(g)(3) and subdivision (i) of this subparagraph, the term "actuarial margin charge" means any amount retained by the company from gross investment income pursuant to the terms of the variable annuity contract in excess of any portion of the investment expenses which is attributable to such contract and which is deductible under section 804(c) and paragraph (b) of § 1.804–4.

(3) Increases and decreases in reserves. (i) Section 801(g)(4) provides that for purposes of section 810(a) and (b) (relating to adjustments for increases or decreases in certain reserves), the sum of the items described in section 810(c) and paragraph (b) of § 1.810–2 taken into account as of the close of the taxable year shall be adjusted—

(a) By subtracting therefrom the sum of any amounts added from time to time (for the taxable year) to the reserves for variable annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section by reason of realized or unrealized appreciation in the value of the assets held in relation thereto, and

(b) By adding thereto the sum of any amounts subtracted from time to time (for the taxable year) from such reserves by reason of realized or unrealized depreciation in the value of such assets.

(ii) The application of section 801(g)(4) and subdivision (i) of this subparagraph may be illustrated by the following example:

Example. Company M, a life insurance company issuing only variable annuity contracts of the type described in section 801(g)(1) and paragraph (a)(1) of this section, increased its life insurance reserves held with respect to such contracts during the taxable year 1959 by $275,000. Of the total increase in the reserves, $100,000 was attributable to premium receipts, $50,000 to dividends and interest, $100,000 to unrealized appreciation in the value of the assets held in relation to such reserves, and $25,000 to realized capital gains on the sale of such assets. As of the close of the taxable year 1959, the reserves held by company M with respect to all variable annuity contracts amounted to $1,275,000. However, under section 801(g)(4) and subdivision (i) of this subparagraph, this amount must be reduced by the $100,000 unrealized asset value appreciation and the $25,000 of realized capital gains. Accordingly, for purposes of section 810(a) and (b), the amount of these reserves which is to be taken into account as of the close of the taxable year 1959 under section 810(c) is $1,150,000 ($1,275,000 less $125,000).

(c) Companies issuing variable annuities and other contracts. **(1)** In the case of a life insurance company which issues both annuity contracts described in section 801(g)(1) and paragraph (a)(1) of this section and other contracts, the policy and other contract liability requirements (as defined in section 805(a) and paragraph (b) of § 1.805–4) of such a company for any taxable year shall be considered to be the sum of—

(i) The policy and other contract liability requirements computed with respect to the items which relate to such variable annuity contracts, and

(ii) The policy and other contract liability requirements computed by excluding the items taken into account under subdivision (i) of this subparagraph.

(2) [Reserved for regulations to be issued under section 801(g)(5)(B).]

(d) Termination. Paragraphs (1), (2), (3), (4), and (5) of section 801(g) and paragraphs (a), (b), (c), and (d) of this section shall not apply with respect to any taxable year beginning after December 31, 1962.

[T.D. 6610, 27 FR 8717, Aug. 31, 1962]

§ 1.801–8 Contracts with reserves based on segregated asset accounts.

(a) Definitions—(1) Annuity contracts include variable annuity contracts. Section 801(g)(1)(A) provides that for purposes of part I, subchapter L, chapter 1 of the Code, an annuity contract includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing such a contract. A variable annuity differs from the ordinary or fixed dollar annuity in that the annuity benefits payable under a variable annuity contract vary with the insurance company's investment experience with respect to such contracts while the annuity benefits paid under a fixed dollar annuity contract are guaranteed irrespective of the company's actual investment earnings.

(2) Contracts with reserves based on a segregated asset account. (i) For purposes of part I, section 801(g)(1)(B) defines the term "contract with reserves based on a segregated asset account" as a contract (individual or group)—

(a) Which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

(b) Which provides for the payment of annuities, and

(c) Under which the amounts paid in, or the amount paid as annuities, reflect the investment return and the market value of the segregated asset account.

(ii) The term "contract with reserves based on a segregated asset account" includes a contract such as a variable annuity contract, which reflects the investment return and the market value of the segregated asset account, even though such contract provides for the payment of an annuity computed on the basis of recognized mortality tables, but the term includes such contract only for the period during which it satisfies the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph. However, such term does not include a pension contract written on the basis of the so-called new-money concept. Thus, for example, such term does not include a pension contract whereby reserves are credited on the basis of the company's new high yield investments. Furthermore, such term does not include a contract which during the taxable year contains a right to participate in the divisible surplus of the company where such right merely reflects the company's investment return. Nevertheless, the term does include a contract which meets the requirements of section 801(g)(1)(B) and of this subparagraph even if part of the amounts received are, for example, allocated to reserves under provisions of the contract which are written on the basis of the new-money concept. However, such reserves do not qualify as a segregated asset account referred to in section 801(g) and this section.

(iii) If at any time during the taxable year a contract otherwise satisfying the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of section 801(g)(1)(B)(iii) and subdivision (i)(c) of this subparagraph after such cessation. Thus, a contract with reserves based on a segregated asset account includes a contract under which the reflection of investment return and market value terminates at the beginning of the annuity payments, but only for the period prior to such termination. For example, if the purchaser of a variable annuity contract which meets such requirements elects an option which provides for the payment of a fixed dollar annuity, then such contract shall be considered as satisfying such requirements only for the period prior to the time such contract ceases to reflect current investment return and current market value. Furthermore, a group annuity contract which satisfies the requirements of section 801(g)(1)(B) and subdivision (i) of this subparagraph shall be considered as continuing to meet such requirements even though a certificate holder under the group contract elects an option which provides for the payment of a fixed dollar annuity. However, the annuity attributable to such certificate holder shall not be considered as satisfying such requirements as of the time such annuity ceases to reflect current investment return and current market value. On the other hand, a group annuity contract which does not reflect current market value shall not be considered as satisfying such requirements even though a certificate holder under the group contract elects an

option which provides for the payment of a variable annuity. However, the variable annuity attributable to such certificate holder shall be considered as satisfying such requirements as of the time such variable annuity commences to reflect current investment return and current market value.

(b) **Life insurance reserves.** Section 801(g)(2) provides that for purposes of section 801(b)(1)(A), the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest. Thus, the reserves held with respect to contracts described in section 801(g)(1) and paragraph (a) of this section shall qualify as life insurance reserves within the meaning of section 801(b)(1) and paragraph (a) of § 1.801–4 provided such reserves are required by law (as defined in paragraph (b) of § 1.801–5) and are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from such contracts with reserves based on segregated asset accounts involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Accordingly, a company issuing contracts with reserves based on segregated asset accounts shall qualify as a life insurance company for Federal income tax purposes if it satisfies the requirements of section 801(a) (relating to the definition of a life insurance company) and paragraph (b) of § 1.801–3.

(c) **Separate accounting.** (1) For purposes of part I, section 801(g)(3) provides that a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3) which issues contracts with reserves based on segregated asset accounts (as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section) shall separately account for each and every income, exclusion, deduction, asset, reserve, and other liability item which is properly attributable to such segregated asset accounts. In those cases where such items are not directly accounted for, separate accounting shall be made—

(i) According to the method regularly employed by the company, if such method is reasonable, and

(ii) In all other cases in a manner which, in the opinion of the district director, is reasonable.

A method of separate accounting for such items as are not accounted for directly will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before issued contracts with reserves based on segregated asset accounts, the company initiates in the first taxable year for which it issues such contracts a reasonable method of separate accounting for such items and consistently follows such method thereafter. Ordinarily, a company regularly employs a method of accounting in accordance with the statute of the State, Territory, or the District of Columbia, in which it operates.

(2) Every life insurance company issuing contracts with reserves based on segregated asset accounts shall keep such permanent records and other data relating to such contracts as is necessary to enable the district director to determine the correctness of the application of the rules prescribed in section 301(g) and this section and to ascertain the accuracy of the computations involved.

(d) **Investment yield.** (1) For purposes of part I, section 801(g)(4)(A) provides that the policy and other contract liability requirements (as determined under section 805), and the life insurance company's share of investment yield (as determined under section 804(a) or 809(b)), shall be separately computed—

(i) With respect to the items separately accounted for in accordance with section 801(g)(3) and paragraph (c) of this section, and

(ii) Excluding the items taken into account under subdivision (i) of this subparagraph.

Thus, for purposes of determining both taxable investment income and gain or loss from operations, a life insurance company shall separately compute the life insurance company's share of the investment yield on the assets in its segregated asset account without regard to the policy and other contract liability requirements of, and the investment income attributable to, contracts with reserves that are not based on the segregated asset account. Such separate computations shall be made after any allocation required under section 801(g)(4)(B) and subparagraph (2) of this paragraph.

(2)(i) Section 801(g)(4)(B) provides that if the net short-term capital gain (as defined in section 1222(5)) exceeds the net long-term capital loss (as defined in section 1222(8)), determined without regard to any separate computations under section 801(g)(4)(A) and subparagraph (1) of this paragraph, then such excess shall be allocated between section 801(g)(4)(A)(i) and (ii) and subparagraph (1)(i) and (ii) of this paragraph. Such allocation shall be in proportion to the respective contributions to such excess of the items taken into ac-

count under each such section and subparagraph. The allocation under this subparagraph shall be made before the separate computations prescribed by section 801(g)(4)(A) and subparagraph (1) of this paragraph.

(ii) The operation of the allocation required under section 801(g)(4)(B) and subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). For the taxable year 1962, T, a life insurance company which issues regular life insurance and annuity contracts and contracts with reserves based on segregated asset accounts, had (without regard to section 801(g)(4)(A)) realized short-term capital gains of $10,000 and short-term capital losses of $10,000 attributable to its general asset accounts and realized short-term capital gains of $12,000 attributable to its segregated asset accounts. For the taxable year 1962, the excess of the net short-term capital gain ($10,000+$12,000–$10,000, or $12,000) over the net long-term capital loss (0) was $12,000. Of the excess of $12,000, 100 percent was contributed by the segregated asset accounts. Applying the provisions of section 801(g)(4)(B), T would allocate the entire $12,000 to its segregated asset accounts for such taxable year.

Example (2). The facts are the same as in example (1), except that for the taxable year 1962, T had (without regard to section 801(g)(4)(A)) realized short-term capital losses of $8,000 attributable to its general asset accounts and realized long-term capital gains of $1,000 and long-term capital losses of $5,000 attributable to its segregated asset accounts. For the taxable year 1962, the excess of the net short-term capital gain ($10,000+$12,000–$8,000, or $14,000) over the net long-term capital loss ($5,000–$1,000, or $4,000) was $10,000. Of the excess of $10,000, the general asset accounts contributed 20 percent ($2,000 ($10,000–$8,000)÷$10,000) and the segregated asset accounts contributed 80 percent ($8,000 ($12,000–$4,000)÷$10,000). Applying the provisions of section 801(g)(4)(B), T would allocate $2,000 ($10,000×20 percent) to its general asset accounts and $8,000 ($10,000×80 percent) to its segregated asset accounts for such taxable year.

Example (3). W is a life insurance company which issues regular life insurance and annuity contracts and contracts with reserves based on either of two segregated asset accounts, Separate Account C or Separate Account D. For the taxable year 1962, W had (without regard to section 801(g)(4)(A)) realized short-term capital gains of $16,000 and long-term capital losses of $15,000 attributable to its general asset accounts, long-term capital gains of $12,000 and short-term capital losses of $6,000 attributable to Separate Account C and long-term capital gains of $7,000 and short-term capital losses of $5,000 attributable to Separate Account D. For the taxable year 1962, the excess of the net short-term capital gain ($16,000–$6,000–$5,000) over the net long-term capital loss (0) was $5,000. Of the $5,000 excess, 20 percent ($16,000–$15,000÷$5,000) was contributed by the general asset accounts, leaving 80 percent as the amount contributed by the segregated asset accounts. Applying the provisions of section 801(g)(4)(B) W would allocate $1,000 (20 percent of $5,000) to the general asset accounts, leaving $4,000 (80 percent of $5,000) to be allocated among the segregated asset accounts, Separate Account C and Separate Account D. W would allocate $3,000 of the $4,000 to Separate Account C computed as follows:

$$\$3{,}000 = \frac{(\$4{,}000)\times(\$12{,}000\text{–}\$6{,}000)}{(\$12{,}000\text{–}\$6{,}000)+(\$7{,}000\text{–}\$5{,}000)}$$

W would allocate $1,000 of the $4,000 to Separate Account D computed as follows:

$$\$1{,}000 = \frac{(\$4{,}000)\times(\$7{,}000\text{–}\$5{,}000)}{(\$12{,}000\text{–}\$6{,}000)+(\$7{,}000\text{–}\$5{,}000)}$$

(e) Policy and other contract liability requirements. **(1)** For purposes of part I, section 801(g)(5)(A) provides that with respect to life insurance reserves based on segregated asset accounts (as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section), the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed by the taxpayer for purposes of sections 805(c) and 809(a)(2), shall be a rate equal to the current earnings rate determined under section 805(b)(2) and paragraph (a)(2) of § 1.805–5 with respect to the items separately accounted for in accordance with section 801(g)(3), reduced by the percentage obtained by dividing—

(i) Any amount retained with respect to all of the reserves based on a segregated asset account by the life insurance company from gross investment income (as defined in section 804(b) and paragraph (a) of § 1.804–3) on segregated assets, to the extent such retained amount exceeds the deductions allowable under section 804(c) which are attributable to such reserves, by

(ii) The means of such reserves.

(2) For purposes of part I, section 801(g)(5)(B) provides that with respect to reserves based on segregated asset accounts other than life insurance reserves, there shall be included as interest paid within the meaning of section 805(e)(1) and paragraph (b)(1) of § 1.805–8, an amount equal to the product of the means of such reserves multiplied by the rate of interest assumed as defined in section 801(g)(5)(A) and subparagraph (1) of this paragraph.

(3) For purposes of this paragraph, any change in the rate of interest assumed by the taxpayer in calculating the reserve on a contract with reserves based on a segregated asset account for any taxable year beginning after December 31, 1961, which is attributable to an increase or decrease in the current earnings rate, shall not be treated as a change of basis in computing reserves for purposes of section 806(b) (relating to certain changes in reserves) or section 810(d)(1) (relating to adjustment for change in computing reserves).

(4) The provisions of section 801(g)(3) through (5) may be illustrated by the following example. For purposes of this example, it is assumed that all computations have been carried out to a sufficient

number of decimal places to insure substantial accuracy and to eliminate any significant error in the resulting tax liability.

Example. The books of R, a life insurance company, discloses the following facts with respect to items of investment yield, deductions, assets, and reserves for the taxable year 1962:

(a) Excerpts from Company Financial Statements.

(1) Investment yield	Company regular account	Separate account A	Separate account B
Interest wholly tax-exempt	$100,000	$3,000	$1,000
Interest—other	10,000,000	8,000	15,000
Dividends received	200.000	25,000	27,000
Other items of investment yield	100,000	2,000	1,000
Gross investment income	10,400,000	38,000	44,000
Less deductions (sec. 804(c))	1,000,000	4,000	4,400
Investment yield	9,400,000	34,000	39,600
(2) Assets and reserves:			
(i) Assets:			
Jan. 1, 1962	190,000,000	....	....
Dec. 31, 1962	210,000,000	1,600,000	1,800,000
Mean	200,000,000	800,000	900,000
(ii) Life insurance reserves:			
Jan. 1, 1962	152,000,000	....	....
Dec. 31, 1962	168,000,000	1,600,000	1,640,000
Mean	160,000,000	800,000	820,000
(iii) Reserves based on segregated asset accounts other than life insurance reserves:			
Jan. 1, 1962	....	....	....
Dec. 31, 1962	....	....	120,000
Mean	....	....	60,000

(b) Additional facts. In addition to the facts assumed in (a) above, assume the following: The company retained with respect to reserves based upon segregated asset accounts a total of $4,720 from gross investment income on Separate Account A and $5,720 from gross investment income on Separate Account B. With respect to the Company Regular Account computed without regard to the items in either of the separate accounts, the policy and other contract liability requirement is $6,580,000 and the required interest is $5,640,000. There are no items of interest paid with respect to the separate accounts other than those computed under section 801(g)(5)(B). Based on these facts, the current earnings rate (sec. 805(b)); adjusted reserves rate (sec. 805 (b)); and rate of interest assumed (secs. 805(c) and 809(a)(2)); and the policy and other contract liability requirements are determined for each of the Separate Accounts A and B (and the policy and other contract liability requirements for the Company Regular Account) as set forth in items (c) through (l) below.

(c) Separate Account A. The current earnings rate determined under section 805(b)(2) with respect to the items separately accounted for under Separate Account A, prior to the reduction provided for under section 801(g)(5)(A), is 4.25 percent (the investment yield, $34,000, divided by the mean of the assets, $800,000). The company retained with respect to such reserves from gross investment income on Separate Account A a total of $4,720. The company had deductions allowable under section 804(c) with respect to such account of $4,000. Accordingly, for purposes of section 801(g)(5)(A)(i), the amount retained by the company was $720 (the total amount retained of $4,720 less the deductions allowable under section 804(c) of $4,000). The reduction percentage for purposes of section 801(g)(5)(A) is 0.09 percent (the amount retained of $720 divided by the mean of the life insurance reserves of $800,000). Therefore, the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed for purposes of sections 805(c) and 809(a)(2) is equal to 4.16 percent (the current earnings rate of 4.25 percent less the reduction percentage of 0.09 percent).

The policy and other contract liability requirements with respect to Separate Account A is determined as follows: For purposes of section 805(a)(1) and (2), the amount is $33,280 (the mean of the life insurance reserves, $800,000, multiplied by the current earnings rate, as determined under section 801(g)(5)(A), 4.16 percent). Thus, the policy and other contract liability requirement for Separate Account A is $33,280.

(d) Separate Account B. The current earnings rate determined under section 805(b)(2) with respect to the items separately accounted for under Separate Account B, prior to the reduction provided for under section 801(g)(5)(A), is 4.40 percent (the investment yield, $39,600 divided by the mean of the assets, $900,000). The company retained with respect to such reserves from gross investment income on Separate Account B a total of $5,720. The company had deductions allowable under section 804(c) with respect to such account of $4,400. Accordingly, for purposes of section 801(g)(5)(A)(i) the amount retained by the company was $1,320 (the total amount retained of $5,720 less the deductions allowable under section 804(c) of $4,400). The reduction percentage for purposes of section 801(g)(5)(A) is 0.15 percent (the amount retained of $1,320 divided by the mean of the reserves based on Separate Account B of $880,000 ($820,000 plus $60,000)). Therefore, the adjusted reserves rate and the current earnings rate for purposes of section 805(b), and the rate of interest assumed for purposes of section 805(c) and 809(a)(2) is equal to 4.25 percent (the current earnings rate of 4.40 percent less the reduction percentage of 0.15 percent).

With respect to reserves based on segregated asset accounts other than life insurance reserves, Separate Account B had such reserves at December 31, 1962, of $120,000. The mean of such reserves was $60,000. The rate of interest assumed with respect to such reserves is 4.25 percent, as computed above. Accordingly, there shall be included as interest paid within the meaning of section 805(e)(1) the amount of $2,550 (the mean of such reserves, $60,000 multiplied by the rate of interest assumed of 4.25 percent).

The policy and other contract liability requirements with respect to Separate Account B is determined as follows:

(1) For purposes of section 805(a)(1) and (2), the amount is $34,850 (the mean of the life insurance reserves, $820,000, multiplied by the current earnings rate, as determined under section 801(g)(5)(A), 4.25 percent).

(2) For purposes of section 805(a)(3), the amount is $2,550 (the mean of the reserves based on Separate Account B other than life insurance reserves, $60,000, multiplied by the rate of interest assumed, as determined under section 801(g)(5)(A), 4.25 percent). It has been assumed that there was no other interest paid on Separate Account B within the meaning of section 805(e). If there was other interest paid with respect to Separate Account B that met the requirements of section 805(e), however, then such interest would be included under section 805(a)(3). Thus, the policy and other contract liability

requirement for Separate Account B is $37,400 ($34,850+$2,550).

(e) Company Regular Account. The policy and other contract liability requirements with respect to the Company Regular Account is $6,580,000 (this amount is determined by the company in the manner provided by section 805 (and the regulations thereunder) without regard to either Separate Account A or Separate Account B).

(f) Policyholders' share and company's share of investment yield—section 804. The policyholders' and company's share of investment yield and taxable investment income are computed as follows:

(1) Company Regular Account

Policyholders' share of investment yield.	70% ($6,580,000 ÷ $9,400,000).
Company's share of investment yield (100% less 70%).	30%.

(2) Separate Account A

Policyholders' share of investment yield.	97.8824% ($33,280 ÷ $34,000).
Company's share of investment yield (100% less 97.8824%).	2.1176%.

(3) Separate Account B

Policyholders' share of investment yield.	94.444% ($37,400 ÷ $39,600).
Company's share of investment yield (100% less 94.444%).	5.556%.

(g) The company's share of investment yield under section 804 is determined as follows:

Investment yield (from item (a)(1))	Company regular account (30 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item(a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Interest wholly tax-exempt	$30,000	$63.53	$55.56
Interest—other	3,000,000	169.41	833.40
Dividends received	60,000	529.40	1,500.12
Other items of gross investment income	30,000	42.35	55.56
	3,120,000	804.69	2,444.64
Less deductions	300,000	84.70	244.46
Investment yield	2,820,000	719.99	2,200.18

(h) Taxable investment income. The company's taxable investment income (without regard to any excess of net long-term capital gain over net short-term capital loss) is determined as follows:

Life insurance company's share of investment yield ($2,820,000 + $719.99 + $2,200.18)		$2,822,920.17
Less:		
Company's share of interest wholly tax-exempt ($30,000 + $63.53 + $55.56) =	$30,119.09	
85 percent of company's share of dividends received (but not to exceed 85% of taxable investment income computed without regard to this deduction) (85% × $62,029.52) ($60,000 + $529.40 + $1,500.12) =	52,725.09	
Small business deduction (10% of investment yield, $9,473,600, not to exceed $25,000) =$25,000.00		107,844.18
Taxable investment income		2,715,075.99

(i) Required interest—section 809(a)(2)—(1) Separate Account A. The rate of interest assumed by the company, with respect to Separate Account A is 4.16 percent (see (c) above). The required interest for purposes of section 809(a)(2) is determined as follows:

Life insurance reserves: 4.16% (rate assumed) times $800,000 (mean of life insurance reserves)	$33,280.00

(2) Separate Account B. The rate of interest assumed by the company with respect to Separate Account B is 4.25 percent (see (d) above). The required interest for purposes of section 809(a)(2) is determined as follows:

(i) Life insurance reserves: 4.25% (rate assumed) times $820,000 (mean of life insurance reserves)	$34,850.00
(ii) Other section 810(c) reserves: 4.25% (rate assumed) times $60,000 (mean of reserves other than life insurance reserves)	$2,550.00
	$37,400.00

(3) Company Regular Account. The required interest with respect to the Company Regular Account is $5,640,000 (this amount is assumed for purposes of this example, but it would be determined by the company in the manner provided by section 809 without regard to either Separate Account A or Separate Account B).

(j) Policyholders' share and company's share of investment yield—section 809. The policyholders' share and the company's share of investment yield for purposes of section 809 is determined as follows:

(1) Company Regular Account:

Policyholders' share of investment yield	60% ($5,640,000 ÷ $9,400,000).
Company's share of investment yield (100 percent − 60%)	40%.

(2) Separate Account A:	
Policyholders' share of investment yield	97.8824% ($33,280 ÷ $34,000).
Company's share of investment yield (100% − 97.8824 percent)	2.1176%.
(3) Separate Account B:	
Policyholders' share of investment yield	94.444% ($37,400 ÷ $39,600).
Company's share of investment yield (100% − 94.444%)	5.556%.

(k) The company's share of investment yield under section 809 is determined as follows:

Investment yield (from item (a)(1))	Company regular account (40 percent times each amount in item (a)(1))	Separate account A (2.1176 percent times each amount in item (a)(1))	Separate account B (5.556 percent times each amount in item (a)(1))
Interest wholly tax-exempt	$40,000	$63.53	$55.56
Interest—other	4,000,000	169.41	833.40
Dividends received	80,000	529.40	1,500.12
Other items of gross investment income	40,000	42.35	55.56
	4,160,000	804.69	2,444.64
Less deductions	400,000	84.70	244.46
Investment yield	3,760,000	719.99	2,200.18

(*l*) Deductions under section 809(d)(8). For purposes of section 809(d)(8), the life insurance company's share of each of such items is determined as follows:

(1) Wholly tax-exempt interest ($40,000 + $63.53 + $55.56)	$40,119.09
(2) Dividends received 85% × $82,029.52 ($80,000 + $529.40 + $1,500.12) (it is assumed for purposes of this example that this amount does not exceed 85% of the gain from operations as computed under sec. 809(d)(8)(B))	69,725.09

(f) **Increases and decreases in reserves.** (1) Section 801(g)(6) provides that for purposes of section 810(a) and (b) (relating to adjustments for increases or decreases in certain reserves), the sum of the items described in section 810(c) and paragraph (b) of § 1.810–2 taken into account as of the close of the taxable year shall be adjusted—

(i) By subtracting therefrom the sum of any amounts added from time to time (for the taxable year) to the reserves separately accounted for in accordance with section 801(g)(3) and paragraph (c) of this section by reason of realized or unrealized appreciation in value of the assets held in relation thereto, and

(ii) By adding thereto the sum of any amounts subtracted from time to time (for the taxable year) from such reserves by reason of realized or unrealized depreciation in the value of such assets.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Company M, a life insurance company issuing only contracts with reserves based on segregated asset accounts as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section (other than contracts described in section 805(d)(1)(A), (B), (C), or (D)), increased its life insurance reserves held with respect to such contracts during the taxable year 1962 by $275,000. Of the total increase in the reserves, $100,000 was attributable to premium receipts, $50,000 to dividends and interest, $100,000 to unrealized appreciation in the value of the assets held in relation to such reserves, and $25,000 to realized capital gains on the sale of such assets. As of the close of the taxable year 1962, the reserves held by company M with respect to all such contracts amounted to $1,275,000. However, under section 801(g)(6) and this subparagraph, this amount must be reduced by the $100,000 unrealized asset value appreciation and the $25,000 of realized capital gains. Accordingly, for purposes of section 810(a) and (b), the amount of these reserves which is to be taken into account as of the close of the taxable year 1962 under section 810(c) is $1,150,000 ($1,275,000 less $125,000). However, for purposes of section 810(a) and (b), the amount of these reserves which is to be taken into account as of the beginning of the taxable year 1963 under section 810(c) is $1,275,000 (the amount as of the close of the taxable year 1962 before reduction of $125,000 for unrealized appreciation and realized capital gains).

(3)(i) Under section 801(g)(6), the deduction allowable for items described in section 809(d)(1) and (7) (relating to death benefits and assumption reinsurance, respectively) with respect to segregated asset accounts shall be reduced to the extent that the amount of such items is increased for the taxable year by appreciation (or shall be increased to the extent that the amount of such items is decreased for the taxable year by depreciation) not reflected in adjustments required to be made under subparagraph (1) of this paragraph.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. On June 30, 1962, X, a life insurance company, reinsured a portion of its insurance contracts with reserves based on segregated asset accounts with Y, a life insurance company, under an agreement whereby Y agreed to assume and become solely liable under the contracts reinsured. The re-

serves on the contracts reinsured by X were $90,000, of which $10,000 was attributable to unrealized appreciation in the value of the assets held in relation to such reserves. However, no amounts had been added to the reserves by reason of the unrealized appreciation of $10,000 and consequently, the $10,000 was not reflected in adjustments to reserves under section 809(g)(6) or subparagraph (1) of this paragraph. Under the reinsurance agreement, X made a payment of $90,000 in cash to Y for assuming such contracts. Applying the provisions of section 809(d)(7), and assuming no other such reinsurance transactions by X during the taxable year, X would have an allowable deduction of $90,000 as a result of this payment on June 30, 1962. However, applying the provisions of section 801(g)(6) and this subparagraph, the actual deduction allowed would be $80,000 ($90,000 less $10,000). See section 806(a) and § 1.806–3 for the adjustments in reserves and assets to be made by X and Y as a result of this transaction. For the treatment by Y of this $90,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809–4.

(g) **Basis of assets held for certain pension plan contracts.** Section 801(g)(7) provides that in the case of contracts described in section 805(d)(1)(A), (B), (C), (D), or (E) (relating to the definition of pension plan reserves), the basis of each asset in a segregated asset account shall (in addition to all other adjustments to basis) be (i) increased by the amount of any appreciation in value, and (ii) decreased by the amount of any depreciation in value; but only to the extent that such appreciation and depreciation are reflected in the increases and decreases in reserves, or other items described in section 801(g)(6), with respect to such contracts. Thus, there shall be no capital gains tax payable by a life insurance company on appreciation realized on assets in a segregated asset account to the extent such appreciation has been reflected in reserves, or other items described in section 801(g)(6), for contracts described in section 805(d)(1)(A), (B), (C), (D), or (E) based on segregated asset accounts.

(h) **Additional separate computation—(1) Assets and total insurance liabilities.** A life insurance company which issues contracts with reserves based on segregated asset accounts (as defined in section 801(g)(1)(B) and paragraph (a)(2) of this section) shall separately compute and report with its return the assets and total insurance liabilities which are properly attributable to all of such segregated asset accounts. Each foreign corporation carrying on a life insurance business which issues such contracts shall separately compute and report with its return assets held in the United States and total insurance liabilities on United States business which are properly attributable to all of such segregated asset accounts.

(2) **Foreign life insurance companies.** For adjustment under section 819 in the case of a foreign life insurance company which issues contracts based on segregated asset accounts under section 801(g), see § 1.819–2(b)(4).

[T.D. 6886, 31 FR 8681, June 23, 1966, as amended by T.D. 6970, 33 FR 12044, Aug. 24, 1968; T.D. 7501, 42 FR 42341, Aug. 23, 1977]

§ 1.802(b)–1 Tax on life insurance companies.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, section 802(b) imposes a tax on the 1954 life insurance company taxable income of all life insurance companies (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801). The tax so imposed is equal to 3¾ percent of the amount of such income not in excess of $200,000, plus 6½ percent of the amount of such income in excess of $200,000. For the definition of the term "1954 life insurance company taxable income", see § 1.805–1.

(b) The taxable income of life insurance companies differs from the taxable income of other corporations. See section 803. Life insurance companies are entitled, in computing life insurance company taxable income, to the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. The gross income, the deduction under section 803(g)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 803(i) and § 1.803–6. Such companies are not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code, relating to capital gains and losses, nor to the provisions of section 171 (amortizable bond premium).

(c) All provisions of the Code and of the regulations in this part not inconsistent with the specific provision of sections 801 to 807, inclusive, are applicable to the assessment and collection of the tax imposed by section 802, and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(d) Foreign life insurance companies not carrying on an insurance business within the United

States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.802-2 Taxable years affected.

Section 1.802(b)-1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.802-3 through 1.802-5 (other than paragraph (f)(2) of § 1.802-3), except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 235(c)(1) of the Revenue Act of 1964 (78 Stat. 126). Paragraph (f)(2) of § 1.802-3 is applicable only to taxable years beginning after December 31, 1961, and all reference to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), section 3 of the Act of October 23, 1962 (76 Stat. 1134) and section 235(c)(1) of the Revenue Act of 1964 (78 Stat. 126).

[T.D. 6513, 25 FR 12654, Dec. 10, 1960, as amended by T.D. 6845, 30 FR 9740, Aug. 5, 1965; T.D. 6886, 31 FR 8685, June 23, 1966]

§ 1.802-3 Tax imposed on life insurance companies.

(a) In general. For taxable years beginning after December 31, 1957, section 802(a)(1) imposes a tax on the life insurance company taxable income (as defined in section 802(b) and paragraph (a) of § 1.802-4) of every life insurance company (including a foreign life insurance company carrying on a life insurance business within the United States if with respect to its United States business it would qualify as a life insurance company under section 801(a)). The tax imposed by section 802(a)(1) is payable upon the basis of returns rendered by the life insurance companies liable thereto. See subchapter A, chapter 61 (section 6001 and following) of the Code.

(b) Tax imposed. The tax imposed by section 802(a)(1) consists of a normal tax and a surtax computed as provided in section 11 as though the life insurance company taxable income (as defined in section 802(b)) were the taxable income referred to in section 11.

(c) Normal tax. The normal tax is computed by applying to the life insurance company taxable income the regular corporate normal tax rate (as in effect for the taxable year) provided by section 11(b).

(d) Surtax. The surtax is computed by applying the regular corporate surtax rate (as in effect for the taxable year) provided by section 11(c) to the amount by which the life insurance company taxable income exceeds the surtax exemption for the taxable year as determined under section 11(d). See sections 269 and 1551 and the regulations thereunder, for certain circumstances in which the surtax exemption may be disallowed in whole or in part.

(e) Special rule for 1959 and 1960. See section 802(a)(3) and paragraph (a) of § 1.802-5 for a transitional rule applicable in certain cases in determining tax liability for the taxable years 1959 and 1960 by reason of the operation of section 802(b)(3).

(f) Tax imposed in case of certain capital gains—(1) Taxable years beginning after December 31, 1958, and before January 1, 1962. For taxable years beginning after December 31, 1958, and before January 1, 1962, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) imposes a separate tax equal to 25 percent of such excess. This separate 25 percent tax rate applies whether or not there is life insurance company taxable income, taxable investment income, or a gain or loss from operations for the taxable year. For taxable years beginning after December 31, 1958, and before January 1, 1962, only the excess (if any) of net short-term capital gain (as defined in section 1222(5)) over net long-term capital loss (as defined in section 1222(8)) shall be taken into account in computing taxable investment income and gain or loss from operations. See sections 804(b) and 809(b). Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses (such as the rules for determining the amount, characterization, and treatment thereof) shall apply with respect to life insurance companies.

(2) Alternative tax in case of capital gains for taxable years beginning after December 31, 1961. For taxable years beginning after December 31, 1961, if the net long-term capital gain (as defined

in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) imposes an alternative tax in lieu of the tax imposed by section 802(a)(1), if and only if such alternative tax is less than the tax imposed by section 802(a)(1). The alternative tax is the sum of—

(i) A partial tax, computed as provided by section 802(a)(1), on the life insurance company taxable income determined by reducing the taxable investment income, and the gain from operations, by the amount of the excess of its net long-term capital gain over its net short-term capital loss, and

(ii)(a) In the case of a taxable year beginning before January 1, 1970, an amount equal to 25 percent of such excess, or

(b) In the case of a taxable year beginning after December 31, 1969, an amount determined as provided in section 1201(a) and paragraph (a)(3) of § 1.1201–1 on such excess.

In the computation of the partial tax, the deductions provided by sections 170 (as modified by section 809(a)(3)), 243, 244, 245 (as modified by sections 804 (a)(5) and 809(d)(8)(B)), and the limitation provided by section 809(f), shall not be recomputed as a result of the reduction of taxable investment income, and gain from operations, by the amount of such excess. Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses (such as the rules for determining the amount, characterization and treatment thereof) shall apply with respect to life insurance companies.

(g) Foreign life insurance companies. Foreign life insurance companies not carrying on an insurance business within the United States are not taxable under section 802, but are taxable as other foreign corporations. See section 881.

(h) Assessment and collection of tax imposed. All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of sections 801 to 820, inclusive, are applicable to the assessment and collection of the tax imposed by section 802(a), and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120L.

(i) Illustration of principles. The provisions of section 802(a), other than paragraph (3) thereof, and this section may be illustrated by the following example:

Example. For the taxable year 1959, T, a life insurance company, has life insurance company taxable income of $300,000 (including $25,000 of net short-term capital gain) and $80,000 of net long-term capital gain. The tax of T under section 802(a) for 1959 is $170,500 ($90,000 normal tax, $60,500 surtax, and $20,000 capital gains tax) computed as follows:

COMPUTATION OF NORMAL TAX

Life insurance company taxable income	$300,000
Normal tax (30% of $300,000)	90,000

COMPUTATION OF SURTAX

Life insurance company taxable income	$300,000
Less: Exemption from surtax	25,000
Excess of life insurance company taxable income subject to surtax	275,000
Surtax (22% of $275,000)	60,500

COMPUTATION OF CAPITAL GAINS TAX

Excess of net long-term capital gain over net short-term capital loss	$80,000
Capital gains tax (25% of $80,000)	20,000

(j) Cross reference. In the case of a taxable year of a life insurance company ending after December 31, 1963, for which an election under section 1562(a)(1) by a controlled group of corporations is effective, the additional tax imposed by section 1562 may apply. See section 1562 and the regulations thereunder.

[T.D. 6513, 25 FR 12658, Dec. 10, 1960, as amended by T.D. 6845, 30 FR 9740, Aug. 5, 1965; T.D. 6886, 31 FR 8685, June 23, 1966; T.D. 7337, 39 FR 44972, Dec. 30, 1974]

§ 1.802–4 Life insurance company taxable income.

(a) Life insurance company taxable income defined. Section 802(b) defines the term "life insurance company taxable income", for purposes of Part I, Subchapter L, Chapter 1 of the Code, as the sum of—

(1) The taxable investment income (as defined in section 804), or, if smaller, the gain from operations (as defined in section 809),

(2) If the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) The amount subtracted from the policyholders surplus account for the taxable year, as determined under section 815.

If for any taxable year there is a loss from operations (as defined in section 809(b)(2)), the amount taken into account under paragraphs (1) and (2) of section 802(b) and subparagraphs (1) and (2) of

this paragraph shall be zero. However, even in such a case, there may still be an amount includible in life insurance company taxable income (and hence an amount subject to tax) by reason of an amount includible under section 802(b)(3) and subparagraph (3) of this paragraph.

(b) Illustration of principles. The provisions of section 802(b) and this section may be illustrated by the following examples:

Example (1). For the taxable year 1959, Y, a life insurance company, has taxable investment income of $250,000, and a gain from operations of $175,000. Y made no subtractions from the policyholders surplus account during such taxable year. For the taxable year 1959, Y has life insurance company taxable income of $175,000.

Example (2). The facts are the same as in example (1) except that for the taxable year 1959, Y has a gain from operations of $400,000. For the taxable year 1959, Y has life insurance company taxable income of $325,000, computed by adding taxable investment income ($250,000) and 50 percent ($75,000) of the amount ($150,000) by which the gain from operations ($400,000) exceeds the taxable investment income ($250,000).

Example (3). For the taxable year 1959, W, a life insurance company, has taxable investment income of zero (0) and a gain from operations of $90,000. W made no subtractions from the policyholders surplus account during such taxable year. For the taxable year 1959, W has life insurance company taxable income of $45,000, computed by adding taxable investment income (0) and 50 percent ($45,000) of the amount ($90,000) by which the gain from operations ($90,000) exceeds the taxable investment income (0).

Example (4). For the taxable year 1961, Z, a life insurance company, has taxable investment income of $100,000, a policyholders surplus account of $50,000 as of the beginning of such taxable year, a loss from operations (as defined in section 809(b)(2)) of $25,000, and subtractions from the policyholders surplus account in the amount of $20,000. For the taxable year 1961, Z has life insurance company taxable income of $20,000, as only the amount ($20,000) subtracted from the policyholders surplus account is taken into account.

[T.D. 6513, 25 FR 12658, Dec. 10, 1960]

§ 1.802–5 Special rule for 1959 and 1960.

(a) Transitional rule. Section 802(a)(3) provides a transitional rule for the determination of the tax liability of a life insurance company for the taxable years 1959 and 1960 by reason of the operation of section 802(b)(3). Except as limited by section 802(a)(3) and paragraph (b) of this section, any increase in a life insurance company's tax that is attributable to the operation of section 802(b)(3) is taken into account only to the extent of one-third and two-thirds for the taxable years 1959 and 1960, respectively. To the extent there is an increase in a life insurance company's tax that is attributable to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the transitional rule provided by section 802(a)(3) and this paragraph, such amounts shall be included in "other accounts" under section 815(a)(3). For taxable years commencing after December 31, 1960, the full amount of any increase in tax due to the operation of section 802(b)(3) shall be imposed without any further transitional reduction.

(b) Limitations. The transitional rule provided by section 802(a)(3) is limited solely to an increase in tax under section 802(b)(3) that is occasioned by the operation of section 815(c)(3) (relating to subtractions from the policyholders surplus account by reason of distributions to shareholders). This rule is further limited to actual distributions that are made by life insurance companies in 1959 or 1960 and does not extend to other distributions that are treated under section 815(d)(2)(B) as made by life insurance companies in 1959 or 1960. Furthermore, section 802(a)(3) shall not apply to any increase in tax under section 802(b)(3) that is attributable to other subtractions from the policyholders surplus account by reason of the operation of the special rules contained in section 815(d). However, the transitional rule provided by section 802(a)(3) does apply in the case of a distribution to which section 815(e)(1)(B)(ii) applies.

(c) Illustration of principles. The provisions of section 802(a)(3) and this section may be illustrated by the following example:

Example. For the taxable year 1960, X, a life insurance company, had taxable investment income of $9,000, gain from operations of $27,000, and subtractions from the policyholders surplus account of $22,000. Based upon these figures, X had life insurance company taxable income of $40,000 for 1960, of which $18,000 was includible under section 802(b)(1) and (2) and $22,000 under section 802(b)(3). Applying the tax imposed by section 802(a)(1) (at rates as in effect for 1960), without regard to the transitional rule of section 802(a)(3), X would have a tax liability of $15,300 ($40,000 multiplied by 52 percent, less $5,500). However, applying the transitional rule of section 802(a)(3), the actual tax liability of X, for 1960, would be $12,000, computed as follows:

(1) Total tax liability (without regard to sec. 802(a)(3))		$15,300
(2) Life insurance company taxable income	$40,000	
(3) Amount subtracted from policyholders surplus account	22,000	
(4) Item (2) less item (3)	18,000	
(5) Tax on amount includible under sec. 802(b)(1) and (2) (30% of $18,000)		5,400
(6) Tax attributable to sec. 802(b)(3) (item (1) less item (5))		9,900
(7) Less: 33⅓ percent of tax attributable to sec. 802(b)(3) (⅓ of $9,900)		3,300
(8) Tax liability for 1960 after application of sec. 802(a)(3) (item (1) less item (7))		12,000

[T.D. 6513, 25 FR 12659, Dec. 10, 1960]

§ 1.803–1 Life insurance reserves.

(a) The term "life insurance reserves" is defined in section 803(b). Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of cancellable health and accident policies and similar cancellable contracts, the unearned premiums held to cover the risk for the unexpired period covered by the premiums are not included in life insurance reserves. Unpaid loss reserves for noncancellable health and accident policies are included in life insurance reserves if they are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest.

(b) In the case of an assessment life insurance company or association, life insurance reserves include sums actually deposited by such company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation or association of such company or association, or bylaws (approved by the State insurance commissioner) of such company or association, exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(c) Life insurance reserves, except as otherwise provided in section 803(b), must be required by law either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute but such requirement, without more, is not conclusive; for example, life insurance reserves do not include reserves required to be maintained to provide for the ordinary running expenses of a business which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, and unpaid brokerage; nor do they include the net value of risks reinsured in other solvent companies; liability for premiums paid in advance; liability for annual and deferred dividends declared or apportioned; liability for dividends left on deposit as interest; liability for accrued but unsettled policy claims whether known or unreported; liability for supplementary contracts not involving, at the time with respect to which the liability is computed, life, health, or accident contingencies.

(d) In any case where reserves are claimed, sufficient information must be filed with the return to enable the district director to determine the validity of the claim. Only reserves which are required by law or insurance department ruling, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will, except as otherwise specifically provided in section 803(b), be considered as life insurance reserves. A company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

(e) In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized mortality or morbidity tables covering disability benefits of the kind contained in policies issued by this particular class of companies but they need not be required by law.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.803–2 Adjusted reserves.

For the purpose of determining "required interest" for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, certain reserves computed on a preliminary term method are to be adjusted by increasing such reserves by 7 percent. The reserves to be thus adjusted are reserves computed on preliminary term methods, such as the Illinois Standard, or the Select and Ultimate methods. Only reserves on policies in the modification period are to be so adjusted. Where reserves under a preliminary term method are the same as on the level premium method, and in the case of reserves for extended or paid-up insurance, no adjustment is to be made. The reserves are thus adjusted, and the rate of interest on which they are computed, should be reported in Schedule A, Form 1120L.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.803–3 Interest paid or accrued.

Interest paid or accrued is one of the elements to be used in computing the amount of "required interest" for purposes of determining the reserve interest credit provided in section 805. See § 1.805–1. Interest paid or accrued consists of (a) interest paid or accrued on indebtedness (except indebtedness incurred or continued to purchase or carry tax-exempt securities as set forth in section 803(f)(1)) and (b) amounts in the nature of interest paid or accrued on certain contracts, as provided

in section 803(f)(2). Interest on indebtedness includes interest on dividends held on deposit and surrendered during the taxable year but does not include interest paid or accrued on deferred dividends. Life insurance reserves as defined in § 1.803-1 are not indebtedness. Dividends left with the company to accumulate at interest are a debt and not a reserve liability. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which, at the time of payment, do not involve life, health, or accident contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by a beneficiary after the policy has matured, frequently referred to as a supplementary contract not involving life contingencies; for example, a contract to pay the insurance benefit in 10 annual installments. No distinction is made based on the person choosing the method of payment, and the full amount of the interest paid or accrued and not merely the guaranteed interest is considered as interest paid or accrued.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.803-4 Taxable income and deductions.

(a) In general. The taxable income of a life insurance company is its gross amount of income received or accrued during the taxable year from interest, dividends, and rents, less the deductions provided in section 803(g) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, and the special deductions provided in Part VIII (section 241 and following, except section 248), Subchapter B, Chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a life insurance company provided in section 803(h), the limitations on the adjustment for amortization of premium and accrual of discount provided in section 803(i), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 803(g)(2), life insurance companies are subject to the limitations on deductions relating to wholly tax-exempt income provided in section 265. Life insurance companies are not entitled to the net operating loss deduction provided in section 172.

(b) Wholly tax-exempt interest. Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross income of a life insurance company by section 803(a)(2) is allowed as a deduction from gross income by section 803(g)(1).

(c) Investment expenses. (1) As used in the Code, the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. Any assignment of such expense to the investment department of the company for which a deduction is claimed under section 803(g)(2) subjects the entire deduction for investment expenses to the limitation provided in that section. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes.

(2) If no general expenses are assigned to or included in investment expenses the deduction may consist of investment expenses paid or incurred during the taxable year in which case an itemized schedule of such expenses must be appended to the return.

(3) Invested assets for the purpose of section 803(g)(2) and this section are those which are owned and used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2). They do not include real estate owned and occupied, and to the extent owned and occupied, by the company. If general expenses are assigned to or included in investment expenses, the maximum allowance will not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses.

(d) Taxes and expenses with respect to real estate. The deduction for taxes and expenses under section 803(g)(3) includes taxes and expenses paid or accrued during the taxable year exclusively upon or with respect to real estate owned by the company and any sum representing taxes imposed upon a shareholder of the company upon his interest as shareholder which is paid or accrued by the company without reimbursement from the shareholder. No deduction shall be allowed, however, for taxes, expenses, and depreciation upon or with respect to any real estate owned by the company except to the extent used for the purpose of producing investment income. See paragraph (c) of this section. As to real estate

owned and occupied by the company, see § 1.803–5.

(e) Depreciation. The deduction allowed for depreciation is, except as provided in section 803(h), identical with that allowed other corporations by section 167. The amount allowed by section 167 in the case of life insurance companies is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 803(a)(2).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.803–5 Real estate owned and occupied.

The amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a life insurance company is limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.803–6 Amortization of premium and accrual of discount.

(a) Section 803(i) provides for certain adjustments on account of amortization of premium and accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases, and for accrual of discount increases, (1) the gross income, (2) the deduction for wholly tax-exempt interest, and (3) the deduction for partially tax-exempt interest.

(b) The premium for any such security is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, then its fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest call date specified therein as a day certain, the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(c) The adjustments for amortization of premium and accrual of discount will be determined—

(1) According to the method regularly employed by the company, if such method is reasonable, or

(2) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(d) The method of amortization and accrual prescribed by this section is as follows:

(1) The premium (or discount) shall be determined in accordance with this section; and

(2) The appropriate amortization of premium (or accrual of discount) attributable to the taxable

year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For the purpose of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.803–7 Taxable years affected.

Sections 1.803–1 through 1.803–6 are applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments.

[T.D. 6513, 25 FR 12660, Dec. 10, 1960]

Investment Income

§ 1.804–1 Taxable years affected.

Sections 1.804–2 through 1.804–4 (other than paragraph (d)(1)(ii) of § 1.804–2) are applicable only to taxable years beginning after December 31, 1957, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112). Paragraph (d)(1)(ii) of § 1.804–2 is applicable only to taxable years beginning after December 31, 1961, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), section 3 of the Act of October 23, 1962 (Public Law 87–858, 76 Stat. 1134), and section 214(b)(3) of the Revenue Act of 1964 (78 Stat. 55).

[T.D. 6513, 25 FR 12660, Dec. 10, 1960, as amended by T.D. 6886, 31 FR 8687, June 23, 1966; T.D. 6992, 34 FR 826, Jan. 18, 1969]

§ 1.804–2 Taxable investment income.

(a) In general. Section 804 provides the rules for determining the taxable investment income of a life insurance company, which amount is necessary to determine life insurance company taxable income. In order to determine taxable investment income, a life insurance company must first determine its gross investment income (as defined in section 804(b) and § 1.804–3). After making such determination, the next step is to determine its investment yield (as defined in section 804(c) and § 1.804–4). After determining its investment yield, a company shall then determine the policyholders' share of each and every item of its investment yield (as computed under section 804(a)(1) and paragraph (b) of this section), as this share is excluded from taxable investment income (as defined in section 804(a)(2) and paragraph (d) of this section). Thus, only the life insurance company's share of the items comprising investment yield (less certain reductions) shall be taken into account in computing taxable investment income.

(b) Exclusion of policyholders' share of investment yield. Section 804(a)(1) provides that the policyholders' share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company shall not be included in taxable investment income. For this purpose, the percentage used in determining the policyholders' share of each of these items comprising the investment yield shall be determined by dividing the policy and other contract liability requirements (as defined in section 805(a) and paragraph (b) of § 1.805–4) by the investment yield. The percentage thus obtained is then applied to each and every item of the investment yield so that the policyholders' share of each and every item of investment yield shall be excluded from taxable investment income. However, if in any case the policy and other contract liability requirements exceed the investment yield, then the policyholders' share of any item shall be 100 percent.

(c) Computation of life insurance company's share of investment yield. Section 804(a)(2) provides that the percentage used in determining the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be the percentage obtained by subtracting the percentage obtained under paragraph (b) of this section from 100 percent. Only the life insurance company's share of the items comprising investment yield (less certain reductions specified in section 804(a)(2) and paragraph (d)(1) of this section) shall be taken into account

in computing taxable investment income. For example, if the policyholders' percentage (as determined under section 804(a)(1) and paragraph (b) of this section) is 80 percent, then the life insurance company's share is 20 percent (100 percent minus 80 percent). In such a case, if the amount of a particular item is $1,000, then the life insurance company's share of such item included in determining taxable investment income is $200 ($1,000 multiplied by 20 percent) and the policyholders' share of such item (which is excluded from taxable investment income) is $800 ($1,000 multiplied by 80 percent).

(d) Taxable investment income of a life insurance company—(1) Definition. Section 804(a)(2) defines the term "taxable investment income", for purposes of Part I, as an amount (not less than zero) equal to the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, plus the sum of the life insurance company's share (as determined under paragraph (c) of this section) of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by the sum of—

(i) The life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3) and subparagraph (2)(i) of this paragraph) computed with respect to the life insurance company's share of such interest,

(iii) The deduction for dividends received provided by sections 243, 244, and 245 (as modified by section 804(a)(5) and subparagraph (2)(ii) of this paragraph) computed with respect to the life insurance company's share of the dividends received, and

(iv) The small business deduction provided by section 804(a)(4). For purposes of Part I, such small business deduction shall be an amount equal to 10 percent of the investment yield for the taxable year, except that such amount shall not exceed $25,000, or, in the case of a component member of a controlled group of corporations (as defined in section 1563), the amount allowable under section 1561 (for taxable years beginning after December 31, 1974) or section 1564(a) (for taxable years beginning before January 1, 1975).

(2) Modifications—(i) Partially tax-exempt interest. For purposes of Part I, the deduction allowed by section 242 (relating to partially tax-exempt interest) shall be determined by applying to the life insurance company's share of such interest the ratio which the normal tax rate (as prescribed by section 11) for the taxable year bears to the sum of the normal tax rate and the surtax rate (as prescribed by section 11) for the taxable year. For example, if for the taxable year 1959 the life insurance company's share of partially tax-exempt interest is $104, the deduction provided by section 804(a)(2)(A)(ii) (as modified by this subdivision) is $60 (thirty fifty-seconds of such partially tax-exempt interest).

(ii) Application of section 246(b). The sum of the deductions allowed by sections 243(a)(1) (relating to dividends received by corporations), 244(a) (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations) shall be limited to 85 percent of the taxable investment income (as defined in subparagraph (1) of this paragraph). The taxable investment income of the company for this purpose shall be computed without regard to the deductions provided in sections 243(a)(1), 244(a), and 245.

(e) Illustration of principles. The provisions of section 804(a)(1) through (5) and paragraphs (a) through (d) of this section may be illustrated by the following example:

Example. For the taxable year 1958, R, a life insurance company, had investment yield of $1,000,000, including $200,000 of dividends received from domestic corporations subject to taxation under Chapter 1 of the Code, $16,800 of wholly tax-exempt interest, and $83,200 of partial interest. For such taxable year, the policyholders' share of each and every item of investment yield was 75 percent and the company's share of each and every item of investment yield was 25 percent. Based upon these figures, R had taxable investment income of $166,300 for the taxable year 1958, computed as follows:

	Col. 1 Total	Col. 2 (75% Col. 1) Policyholders' share	Col. 3 (25% Col. 1) Company's share
Interest wholly tax-exempt	$16,800	$12,600	$4,200
Interest partially tax-exempt	83,200	62,400	20,800
Dividends received	200,000	150,000	50,000
Other items of investment yield	700,000	525,000	175,000
Investment yield	1,000,000	750,000	250,000
Less:			
Company's share of interest wholly tax-exempt		$4,200	....
30/52 of company's share of interest partially tax-exempt (30/52 × $20,800)		12,000	....

	Col. 1 Total	Col. 2 (75% Col. 1) Policyholders' share	Col. 3 (25% Col. 1) Company's share
85% of company's share of dividends received (but not to exceed 85% of taxable investment income computed without regard to this deduction) (85% × $50,000)		42,500	....
Small business deduction (10% of investment yield, not to exceed $25,000)		25,000	83,700
Taxable investment income			166,300

(f) Exception. (1) In accordance with section 804(a)(6), if it is established in any case to the satisfaction of the Commissioner, or by a determination of The Tax Court of the United States, or of any other court of competent jurisdiction, which has become final, that the application of the definition of taxable investment income contained in section 804(a)(2) results in the imposition of tax on—

(i) Any interest which under section 103 is excluded from gross income,

(ii) Any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(iii) Any amount of dividends received which under sections 243, 244, and 245 (as modified by section 804(a)(5)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(2) For the date upon which a decision by the Tax Court becomes final, see section 7481. For the date upon which a judgment of any other court becomes final, see paragraph (c) of § 1.1313(a)–1.

[T.D. 6513, 25 FR 12660, Dec. 10, 1960, as amended by T.D. 6886, 31 FR 8687, June 23, 1966; T.D. 6992, 34 FR 826, Jan. 18, 1969; T.D. 7181, 37 FR 8067, April 25, 1972; T.D. 7528, 42 FR 64694, Dec. 28, 1977; T.D. 7528, 43 FR 2169, 4603, Jan. 16, 1978]

§ 1.804–3 Gross investment income of a life insurance company.

(a) Gross investment income defined. For purposes of Part I, Subchapter L, Chapter 1 of the Code, section 804(b) defines the term "gross investment income" of a life insurance company as the sum of the following:

(1) The gross amount of income from—

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 818(b) and the regulations thereunder.

(ii) Dividends, as described in § 1.61–9.

(iii) Rents and royalties, as described in § 1.61–8.

(iv) The entering into of any lease, mortgage, or other instrument or agreement from which the life insurance company may derive interest, rents, or royalties.

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph.

For example, gross investment income includes amounts received as commitment fees, as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage.

(2) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net short-term capital gain (as defined in section 1222(5)) exceeds the net long-term capital loss (as defined in section 1222(8)), and

(3) The gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner.

(b) No double inclusion of income. In computing the gross income from any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner, any item described in section 804(b)(1) and paragraph (a)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business or partnership, but shall be taken into account under section 804(b)(1) and paragraph (a)(1) of this section.

(c) Exclusion of net long-term capital gains. Any net long-term capital gains from the sale or exchange of a capital asset (or any gain considered to be from the sale or exchange of a capital asset under applicable law) shall be excluded from the gross investment income of a life insurance company. However, section 804(b)(2) and paragraph (a)(2) of this section provide that the amount (if any) by which the net short-term capital gain exceeds the net long-term capital loss shall be

included in the gross investment income of a life insurance company.

[T.D. 6513, 25 FR 12661, Dec. 10, 1960]

§ 1.804–4 Investment yield of a life insurance company.

(a) Investment yield defined. Section 804(c) defines the term "investment yield" of a life insurance company for purposes of Part I, Subchapter L, Chapter 1 of the Code. Investment yield means gross investment income (as defined in section 804(b) and paragraph (a) of § 1.804–3), less the deductions provided in section 804(c) and paragraph (b) of this section for investment expenses, real estate expenses, depreciation, depletion, and trade or business (other than an insurance business) expenses. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code. For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162, and under section 265, no deduction is allowable for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under Chapter 1 of the Code. A deduction shall not be permitted with respect to the same item more than once.

(b) Deductions from gross investment income—(1) Investment expenses. (i) Section 804(c)(1) provides for the deduction of investment expenses by a life insurance company in determining investment yield. "Investment expenses" are those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a life insurance company for which a deduction is claimed under section 804(c)(1) subjects the entire deduction for investment expenses to the limitation provided in that section and subdivision (iii) of this subparagraph. As used in section 804(c)(1), the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if real estate taxes, depreciation, or other expenses attributable to office space owned by the company and utilized by it in connection with its investment function are assigned to investment expenses, such items shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. Similarly, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expenses are allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 804(c)(1) and subdivision (iii) of this subparagraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 804(c)(1)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any. In cases where the investment expenses allowable as deductions under section 804(c)(1) exceed the limitation contained therein, see section 809(d)(9).

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 804(c)(1) shall not exceed the sum of—

(a) One-fourth of one percent of the mean of the assets (as defined in section 805(b)(4) and paragraph (a)(4) of § 1.805–5) held at the beginning and end of the taxable year,

(b) The amount of the mortgage service fees for the taxable year, plus

(c) Whichever of the following is the greater:

(1) One-fourth of the amount by which the investment yield (computed without any deduction for investment expenses allowed by section 804(c)(1)) exceeds 3¾ percent of the mean of the assets (as defined in section 805(b)(4)) held at the beginning and end of the taxable year, reduced by the amount of the mortgage service fees for the taxable year, or

(2) One-fourth of one percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no

mortgage service fees for the taxable year. For purposes of the preceding sentence, the term "mortgages held" refers to mortgages, and other similar liens, on real property which are held by the company as security for "mortgage loans". For purposes of section 804(c)(1)(B) and (C)(i) and (b) and (c)(1) of this subdivision, the term "mortgage service fees" includes mortgage origination fees. Such mortgage origination fees shall be amortized in accordance with the rules prescribed in section 818(b) and the regulations thereunder.

(iv) The operation of the limitation contained in section 804(c)(1) and subdivision (iii) of this subparagraph may be illustrated by the following example:

Example. The books of S, a life insurance company, reflect the following items for the taxable year 1958:

Investment expenses (including general expenses assigned to or included in investment expenses)	$ 125,000
Mean of the assets held at the beginning and end of the taxable year	20,000,000
Mortgage service fees	25,000
Investment yield computed without regard to investment expenses	1,200,000
Mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees	6,000,000

In order to determine the limitation on investment expenses, S would make up the following schedule:

1. Mean of the assets held at the beginning and end of the taxable year	$20,000,000	
2. One-fourth of 1 percent of item 1 (¼ of 1% of $20,000,000)	50,000	
3. Mortgage service fees	25,000	
4. The greater of (a) or (b)		
(a) (i) Investment yield computed without regard to investment expenses	$1,200,000	
(ii) Three and three-fourths percent of item 1 (3¾% × $20,000,000)	750,000	
(iii) Excess of (i) over (ii) ($1,200,000 minus $750,000)	450,000	
(iv) One-fourth of (iii) (¼ × $450,000)	112,500	
(v) Less: Mortgage service fees (item 3)	25,000	
(vi) Excess of (iv) over (v) ($112,500 minus $25,00)	$87,500	
(b) One-fourth of 1 percent of the mean of the value of mortgages held at the beginning and end of the taxable year for which there are no mortgage service fees (¼ of 1% × $6,000,000) 15,000		
5. The greater of item 4(a) or (b)		$87,500
6. Limitation on investment expenses (items 2, 3, and 4(a))		162,500

As the investment expenses (including general expenses assigned to or included in investment expenses) of S for the taxable year 1958 ($125,000) do not exceed the limitation on such expenses ($162,500), S would be entitled to deduct the entire $125,000 under section 804(c)(1).

(2) **Real estate expenses and taxes.** The deduction for expenses and taxes under section 804(c)(2) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 804(c)(2) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 804(c)(2) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See subparagraph (4) of this paragraph for limitation of such deduction.

(3) **Depreciation.** The deduction allowed for depreciation is, except as provided in section 804(c)(3) and subparagraph (4) of this paragraph, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining investment yield is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 804(b). An election with respect to any of the methods of depreciation provided in section 167 shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112). However, in appropriate cases, the method of depreciation may be changed with the consent of the Commissioner. See section 167(e) and § 1.167(e)–1. See subparagraph (4) of this paragraph for limitation of such deduction. See section 809(d)(12) and the regulations thereunder for the treatment of depreciable property used in the operation of a life insurance business.

(4) **Limitation on deductions allowable under section 804(c)(2) and (c)(3).** Section 804(c)(3) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied for insurance purposes in whole or in part by a life insurance company shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, T, a life insurance company, owns a twenty-story downtown home office building. The rental value of each floor of the building is identical. T

rents nine floors to various tenants, one floor is utilized by it in operating its investment department, and the remaining ten floors are occupied by it in carrying on its insurance business. Since floor space equivalent to eleven-twentieths, or 55 percent, of the rental value of the entire property is owned and occupied for insurance purposes by the company, the deductions allowable under section 804(c)(2) and (3) for taxes, depreciation, and other real estate expenses shall be limited to nine-twentieths, or 45 percent, of the taxes, depreciation, and other real estate expenses on account of the entire property. However, the portion of such allowable deductions attributable to the operation of the investment department (one-twentieth, or 5 percent) may be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitations of section 804(c)(1). Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company in carrying on its insurance business, together with the respective rental values thereof, must be shown in a schedule accompanying the return.

(5) Depletion. The deduction for depletion (and depreciation) provided in section 804(c)(4) is identical to that allowed other corporations by section 611. The amount allowed by section 611 in the case of a life insurance company is limited to depletion (and depreciation) sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 804(b). See section 611 and § 1.611–5 for special rules relating to the depreciation of improvements in the case of mines, oil and gas wells, other natural deposits, and timber.

(6) Trade or business deductions. (i) Under section 804(c)(5), the deductions allowed by Subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner are, subject to the limitations in subdivisions (ii), (iii), and (iv) of this subparagraph, allowable as deductions from the gross investment income of a life insurance company in determining its investment yield. Such deductions are allowable, however, only to the extent that they are attributable to the production of income which is included in the life insurance company's gross investment income by reason of section 804(b)(3). However, since any interest, dividends, rents, and royalties received by any trade or business (other than an insurance business) carried on by the life insurance company, or by a partnership of which the life insurance company is a partner, is included in the life insurance company's gross investment income by reason of section 804(b)(1) and paragraph (b) of § 1.804–3, any expenses fairly chargeable against the production of such income may be deductible under section 804(c)(1), (2), (3), or (4). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 804(c)(5), there shall be excluded losses—

(a) From (or considered as from) sales or exchanges of capital assets,

(b) From sales or exchanges of property used in the trade or business (as defined in section 1231(b)), and

(c) From the compulsory or involuntary conversion (as a result of destruction, in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business (as so defined).

(iii) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if a life insurance company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(iv) The deduction for net operating losses provided in section 172, and the special deductions for corporations provided in Part VIII, Subchapter B, Chapter 1 of the Code, shall not be allowed.
[T.D. 6513, 25 FR 12662, Dec. 10, 1960]

§ 1.805–1 Tax on life insurance companies in the case of a taxable year beginning in 1954.

(a) Section 802(b) imposes a tax on the "1954 life insurance company taxable income" of all life insurance companies for taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954. See paragraph (a) of § 1.802(b)–1.

(b) For purposes of section 802(b), the term "1954 life insurance company taxable income"

means the taxable income (consisting of income computed as provided in § 1.803–4) for the taxable year beginning in 1954 plus eight times the amount of the adjustment for certain reserves computed as provided in section 806 (see § 1.806–1), and minus the reserve interest credit, if any, provided in section 805(b).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.805–2 Reserve interest credit.

(a) In computing 1954 life insurance company taxable income, a reserve interest credit is allowed where the "adjusted taxable income" of the company is less than 105 percent of its required interest. For the purpose of computing the reserve interest credit, the term "adjusted taxable income" means the taxable income of the company computed without the deductions provided in section 803(g)(1) or (5), less 50 percent of the adjustment for certain reserves on contracts other than life insurance or annuity contracts provided in section 806.

(b) The required interest for which a credit may be allowed consists of the total of—

(1) The sum of amounts obtained by multiplying each rate of interest assumed in computing life insurance reserves (see section 803(b) and § 1.803–1) by the means of the amounts of the adjusted reserves, as defined in section 803(c), computed at that rate at the beginning and the end of the taxable year;

(2) Two percent of the reserve for deferred dividends; and

(3) Interest paid or accrued.

(c) To determine the amount of the reserve interest credit, it is necessary to divide the amount of the adjusted taxable income by the amount of the required interest. If the adjusted taxable income is 100 percent or less of the required interest, the reserve interest credit is an amount equal to 50 percent of the life insurance company taxable income. If the adjusted taxable income is 105 percent or more of the required interest, the reserve interest credit is zero. If the adjusted taxable income is more than 100 percent and less than 105 percent of the required interest, the reserve interest credit is computed by multiplying the life insurance company taxable income by ten times the difference between 105 percent and the percentage established. Thus, if the adjusted taxable income of a life insurance company for the calendar year 1954 is $103,000 and the required interest for such year is $100,000, the adjusted taxable income is 103 percent of the required interest and the reserve interest, accordingly, is the life insurance company taxable income multiplied by 20 percent (10 times 2 percent, the difference between 105 percent and 103 percent).

(d) In determining the percentage of the adjusted taxable income to required interest for purposes of determining the reserve interest credit, the figures shall be computed to at least the nearest one-tenth of a percentage point.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.805–3 Taxable years affected.

Sections 1.805–1 and 1.805–2 are applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.805–4 through 1.805–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and the Self-Employed Individuals Tax Retirement Act of 1962 (76 Stat. 809).

[T.D. 6513, 25 FR 12664, Dec. 10, 1960, as amended by T.D. 6886, 31 FR 8686, June 23, 1966]

§ 1.805–4 Policy and other contract liability requirements.

(a) Introduction. Section 805 relates to the determination of the policy and other contract liability requirements of a life insurance company. This determination furnishes the numerator of a fraction to be used in determining the policyholders' share of each and every item of the investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received). The denominator of this fraction is the investment yield (as determined under section 804(c) and § 1.804–4). The percentage obtained from this fraction is used in determining the policyholders' share of each and every item of the investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), which shall not be included in taxable investment income (as determined under section 804(a)(2) and paragraph (d) of § 1.804–2).

(b) Policy and other contract liability requirements defined. Section 805(a) defines the term "policy and other contract liability requirements"

of a life insurance company, for any taxable year, for purposes of Part I, Subchapter L, Chapter 1 of the Code, as the sum of—

(1) The adjusted life insurance reserves (as defined in section 805(c)(1)), multiplied by the adjusted reserves rate (as defined in section 805(b)(1)),

(2) The mean of the pension plan reserves (as defined in section 805(d)(1)) at the beginning and end of the taxable year, multiplied by the current earnings rate (as defined in section 805(b)(2)), and

(3) The interest paid (as defined in section 805(e)).

[T.D. 6513, 25 FR 12664, Dec. 10, 1960]

§ 1.805–5 Adjusted reserves rate and earnings rates.

(a) In general. For purposes of part I, subchapter L, chapter 1 of the Code, section 805(b) defines the terms "adjusted reserves rate", "current earnings rate", "average earnings rate", and "assets". These terms, with such meaning ascribed to them, are to be used in computing the policy and other contract liability requirements (as determined under section 805(a)). For the meaning of the term "current earnings rate" in the case of variable annuity contracts, see section 801(g)(3). The terms "adjusted reserves rate", "current earnings rate", "average earnings rate", and "assets" are defined as follows:

(1) Adjusted reserves rate. For any taxable year, the term "adjusted reserves rate" means the average earnings rate (as defined in section 805(b)(3) and subparagraph (3) of this paragraph), or, if lower, the current earnings rate (as defined in section 805(b)(2) and subparagraph (2) of this paragraph).

(2) Current earnings rate. For any taxable year, the term "current earnings rate" means the amount determined by dividing—

(i) The taxpayer's investment yield (as determined under section 804(c)) for such taxable year, by

(ii) The mean of the taxpayer's assets (as defined in section 805(b)(4) and subparagraph (4) of this paragraph) at the beginning and end of such taxable year.

(3) Average earnings rate—(i) Definition. For any taxable year, the term "average earnings rate" means the average of the current earnings rate for such taxable year and the current earnings rate for each of the 4 taxable years immediately preceding such taxable year (excluding any of such 4 taxable years for which the taxpayer was not an insurance company).

(ii) Special rules. For purposes of computing the 5-year average earnings rate under section 805(b)(3)(A) and subdivision (i) of this subparagraph, the following special rules are to be applied—

(a) The current earnings rate for any taxable year beginning before January 1, 1958, shall be determined as if part I (as in effect for 1958) and section 381(c)(22) applied to such taxable year;

(b) The current earnings rate for any taxable year of any company which, for such year, is an insurance company (but not a life insurance company as defined in section 801(a)) shall be determined as if part I applied to such company for such year; and

(c) A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) shall be a preceding taxable year for the purpose of determining the first, second, third, or fourth preceding taxable year. For the determination of the current earnings rate for such short taxable year, see section 818(d) and the regulations thereunder.

(4) Assets—(i) Definition. Section 805(b)(4) defines the term "assets" as meaning all assets of the life insurance company (including nonadmitted assets), other than real and personal property (excluding money) used by the life insurance company in carrying on an insurance trade or business. For purposes of the preceding sentence, the term "money" includes cash, currency, bank deposits (including time deposits) whether or not interest bearing, share accounts in savings and loan associations, checks (whether or not certified), drafts, money orders, and any other item of similar nature. The following items are the only ones to be excluded from the term "assets" as being considered "used by the life insurance company in carrying on an insurance trade or business":

(a) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(b) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company;

(c) Supplies, stationery, and printed matter used in the operations conducted in the home office and branch office buildings occupied by the life insur-

ance company where for tax purposes such items are inventoried; and

(d) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company. However, if any item, or portion thereof, of property falls within one of the above-listed groups and also is an "investment asset" (an asset from which gross investment income, as defined in section 804(b), is derived), such item, or portion thereof, shall not be excluded from the term "assets". Any item, or portion thereof, excluded from the definition of the term "assets" shall not be taken into account in computing the denominator used in determining the current earnings rate under section 805(b)(2) and subparagraph (2) of this paragraph. Conversely, any item or portion thereof, included in the term "assets" shall be taken into account in computing the denominator used in determining the current earnings rate.

(ii) Illustration of principles. The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds, stocks, mortgages, home office and branch office buildings owned and wholly occupied by the company, furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations. For purposes of section 805(b)(4) and this subparagraph, the home office and branch office buildings owned and wholly occupied by the company, and the furniture and equipment owned by the company and used by it in connection with the operations conducted in the home office and branch office buildings occupied by the company, shall be excluded from the term "assets" since such items are the only ones considered as being used by P in carrying on an insurance trade or business. Accordingly, since bonds, stocks, mortgages, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations are not considered as being used by P in carrying on an insurance trade or business, they are included within the term "assets" and, therefore, shall be taken into account by P in determining its current earnings rate.

Example (2). M, a life insurance company, owns an eleven-story downtown home office building, the ground floor of which it rents to various tenants and the remaining ten floors of which are occupied by it in carrying on its insurance business and operating its investment department. Under the provisions of section 805(b)(4) and this subparagraph, the ten floors occupied by M in carrying on its insurance business and operating its investment department shall be excluded from the term "assets". However, the ground floor rented to various tenants is an "investment asset" and as such shall be included within the term "assets" and, therefore, shall be taken into account by M in determining its current earnings rate.

(iii) Valuation of assets. For purposes of section 805(b)(4)—

(a) The amount attributable to real property and to stock shall be the fair market value thereof, and

(b) The amount attributable to any other asset shall be the adjusted basis (determined without regard to fair market value on December 31, 1958) of such asset for purposes of determining gain on sale or other disposition.

In applying the provisions of section 805(b)(4) and this subdivision, the fair market value or the adjusted basis (as the case may be) shall not be reduced by the amount of any incumbrance, lien, mortgage, etc.

(iv) Special rules. (a) All items included within the term "assets" shall be valued at the beginning and end of the taxable year. If, during the taxable year, there is a change in life insurance reserves (either increases or decreases) attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, the mean of the assets shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. See section 806(a) and paragraph (b)(3) and (4) of § 1.806–3.

(b) In the case of real property, under appropriate circumstances the fair market value may be determined on the basis of a reasonable approximation of fair market value as shown to the satisfaction of the district director, rather than on the basis of an annual reappraisal.

(c) In determining the fair market value of stocks, any reasonable valuation method may be used. Such methods include the valuation methods described in § 20.2031–2 of this chapter (Estate Tax Regulations).

(b) Illustration of principles. The provisions of section 805(b) and paragraph (a) of this section may be illustrated by the following examples. For purposes of these examples, it is assumed that all computations have been carried out to a sufficient number of decimal places to insure substantial accuracy and to eliminate any significant error in the resulting tax liability.

Example (1). For the taxable year 1958, T, a life insurance company (as defined in section 801(a)) organized in 1951, had the following current earnings rate history:

Taxable year	*Current earnings rate*
1951	3.1
1952	3.3
1953	3.2
1954	3.3
1955	3.5
1956	3.8
1957	3.6
1958	3.8

For the taxable year 1958, T would have an average earnings rate of 3.6 percent, computed by taking into account only the current earnings rates for the taxable year 1958 and each of the 4 taxable years immediately preceding such taxable year. The adjusted reserves rate for such taxable year would be 3.6 percent since the average earnings rate of 3.6 percent is lower than the 1958 current earnings rate of 3.8 percent.

Example (2). The facts are the same as in example (1) except that the taxable year in issue is 1959, and the current earnings rate for such taxable year was 2.8 percent. For the taxable year 1959, T would have an average earnings rate of 3.5 percent, computed by taking into account only the current earnings rates for the taxable year 1959 and each of the 4 taxable years immediately preceding such taxable year. The adjusted reserves rate for such taxable year would be 2.8 percent since the current earnings rate of 2.8 percent for 1959 is lower than the average earnings rate of 3.5 percent.

Example (3). For the taxable year 1959, P, a life insurance company (as defined in section 801(a)) organized in 1957, had the following current earnings rate history:

Taxable year	*Current earnings rate*
1957	3.1
1958	3.3
1959	3.8

For the taxable year 1959, P would have an average earnings rate of 3.4 percent. Since P has been in existence for only 3 years, the average earnings rate is computed on the basis of the current earnings rate for the taxable year 1959 and the 2 taxable years immediately preceding such taxable year. The adjusted reserves rate for such taxable year would be 3.4 percent.

Example (4). Y was organized as an insurance company (other than life) in 1954. In 1957, Y qualified as a life insurance company (as defined in section 801(a)) and has remained a life insurance company since that date. Since its formation, Y has had the following current earnings rate history:

Taxable year	*Current earnings rate*
1954	3.1
1955	3.3
1956	3.5
1957	3.4
1958	3.6
1959	3.7

For the taxable year 1959, Y would have an average earnings rate of 3.5 percent, computed by taking into account the current earnings rate for the year 1959 and the 4 taxable years immediately preceding such taxable year. The taxable years 1956 and 1955 are included in this computation since Y was an insurance company (though not a life insurance company) during such taxable years. The adjusted reserves rate for such taxable year would be 3.5 percent.

Example (5). The facts are the same as in example (4) except that prior to becoming a life insurance company in 1957, Y was an ordinary corporation. For the taxable year 1959, Y would have an average earnings rate of 3.57 percent, computed by taking into account only the current earnings rates for those taxable years during which Y was a life insurance company (1957, 1958, 1959). The adjusted reserves rate for such taxable year would be 3.57 percent.

[T.D. 6513, 25 FR 12665, Dec. 10, 1960]

§ 1.805–6 Adjusted life insurance reserves.

(a) Adjusted life insurance reserves defined. For purposes of part I, subchapter L, chapter 1 of the Code, section 805(c)(1) defines the term "adjusted life insurance reserves" as—

(1) The mean of the life insurance reserves (as defined in section 801(b)), other than pension plan reserves (as defined in section 805(d)), at the beginning and end of the taxable year, multiplied by

(2) That percentage which equals 100 percent—

(i) Increased by that percentage which is 10 times the average rate of interest assumed by the taxpayer (as determined under section 805(c)(2) and paragraph (b) of this section) in calculating such reserves, and

(ii) Reduced by that percentage which is 10 times the adjusted reserves rate (as defined in section 805(b)(1) and paragraph (a)(1) of § 1.805–5).

(b) Average rate of interest assumed defined. For purposes of part I, section 805(c)(2) defines the term "average rate of interest assumed" by the company in calculating reserves, as the rate determined by—

(1) Multiplying each assumed rate of interest by the means of the amounts of such reserves computed at that rate at the beginning and end of the taxable year, and

(2) Dividing the sum of the products ascertained under subparagraph (1) of this paragraph by the mean of the total of such reserves at the beginning and end of the taxable year.

(c) Special rule. For purposes of section 805(c) and this section, the amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves comput-

ed on a preliminary term basis), and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets). However, no adjustment shall be made under section 806(b) (relating to change in basis in computing reserves) for the year in which the change occurs, since such adjustment is not taken into account until the beginning of the next taxable year.

(d) Illustration of principles. The provisions of section 805(c) and this section may be illustrated by the following examples:

Example (1). The books of R, a life insurance company, reflect the following:

Mean of the life insurance reserves (other than pension plan reserves)	$800,000
Company's current earnings rate	4%
Company's average earnings rate (for the current and 4 prior years)	3.5%
Company's average assumed rate (as defined in section 805(c)(2))	2.5%

In order to determine the amount of its adjusted life insurance reserves, R would first determine its adjusted reserves rate. This rate would be 3.5 percent since R's average earnings rate (3.5 percent) is lower than its current earnings rate (4 percent). R would then make up the following schedule:

1. Mean of the life insurance reserves (other than pension plan reserves)		$800,000
2. Item 1 multiplied by:		
(a) That percentage which equals	100%	
(b) Increased by 10 times the average rate of interest assumed (10 × 2.5%)	25%	
(c) Total	125%	
(d) Less: 10 times the adjusted reserves rate (10 × 3.5%)	35%	
(e) Item 2(c) minus item 2(d) (125% minus 35%)	90%	
3. Adjusted life insurance reserves (800,000 multiplied by 90%)		$720,000

Example (2). The books of S, a life insurance company, reflect the following items:

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5
Reserves at beginning of year	Reserves at end of year	Means of reserves	Assumed rate of interest (*Percent*)	(Col. 3 × Col. 4) Product
$850,000	$1,150,000	$1,000,000	2	20,000
750,000	1,250,000	1,000,000	2.5	25,000
300,000	500,000	400,000	2.25	9,000
Total		2,400,000	......	54,000

For purposes of section 805(c), the average rate of interest assumed for the taxable year would be 2.25 percent (54,-000 ÷ 2,400,000).

[T.D. 6513, 25 FR 12666, Dec. 10, 1960]

§ 1.805–7 Pension plan reserves.

(a) In general. One of the elements to be taken into account in computing the amount of the policy and other contract liability requirements (as defined in section 805(a) and paragraph (b) of § 1.805–4) of a life insurance company is the investment income attributable to pension plan reserves (as defined in section 805(d)(1) and paragraph (b) of this section). The amount of this element to be included in the policy and other contract liability requirements shall be determined by multiplying the mean of such pension plan reserves at the beginning and end of the taxable year by the current earnings rate (as defined in section 805(b)(2)) of the company. However, the amount of such reserves taken into account must be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets) before applying the current earnings rate thereto. Reserves held by a life insurance company under deposit administration contracts shall be included in pension plan reserves if they qualify as life insurance reserves (as defined in section 801(b) and paragraph (a) of § 1.801–4) and otherwise meet the definition of pension plan reserves.

(b) Pension plan reserves defined. For purposes of part I, subchapter L, chapter 1 of the Code, section 805(d)(1) defines the term "pension plan reserves" as that portion of the life insurance reserves (as defined in section 801(b)) which is allocable to contracts—

(1) Purchased under contracts entered into with trusts which (as of the time the contracts were entered into) were deemed to be trusts described in section 401(a) and exempt from tax under section 501(a) of the Internal Revenue Code of 1954, or trusts exempt from tax under section 165 of the Internal Revenue Code of 1939 (prior to, or after, the 1942 amendments) or the corresponding provisions of prior revenue laws;

(2) Purchased under contracts entered into under plans which (as of the time the contracts were entered into) were deemed to be plans—

(i) Meeting the requirements of section 165(a)(3), (4), (5), and (6) of the Internal Revenue Code of 1939, for taxable years beginning before January 1, 1954, and ending before August 17, 1954, or

(ii) Described in section 403(a) of the Internal Revenue Code of 1954;

(3) Provided for employees of the life insurance company under a plan which for the taxable year meet the requirements of section 401(a)(3), (4), (5), (6), (7), (8), (11), (12), (13), (14), (15), (16), and (19) for the taxable year to which such paragraphs apply. For the purposes of this paragraph, the term "employees" includes full-time life insurance salesmen treated as employees under section 7701(a)(20);

(4) Purchased to provide retirement annuities. (i) For its employees by an organization which (as of the time the contracts were purchased) was an organization described in section 501(c)(3) which was exempt from tax under section 501(a) or was an organization exempt from tax under section 101(6) of the Internal Revenue Code of 1939 or the corresponding provisions of prior revenue laws, or

(ii) For taxable years beginning after December 31, 1963, for employees described in section 403(b)(1)(A)(ii) by an employer which is a State, a political subdivision of a State, or an agency or instrumentality of any one or more of the foregoing.

The definition of pension plan reserves described in paragraph (b)(4)(i) of this section includes only life insurance reserves held under contracts purchased by those organizations described in section 501(c)(3) and exempt from tax under section 501(a), and does not include life insurance reserves held under contracts purchased by organizations described under any other provision of section 501(c). Accordingly, the reserves held under contracts purchased by such other exempt organizations, or by entities not subject to Federal income tax (such as a State, municipality, etc.) shall not be treated as pension plan reserves unless they qualify as such under section 805(d)(1), (2), (3), or (5) or paragraph (b)(4)(ii) of this section.

(5) Purchased under contracts entered into with trusts which (at the time the contracts were entered into) were individual retirement accounts described in section 408(a) or under contracts entered into with individual retirement annuities described in section 408(b).

[T.D. 6513, 25 FR 12667, Dec. 10, 1960, as amended by T.D. 6886, 31 FR 8686, June 23, 1966; T.D. 7326, 39 FR 35353, Oct. 1, 1974; T.D. 7501, 42 FR 42341, Aug. 23, 1977; T.D. 7531, 43 FR 1065, Jan. 6, 1978]

§ 1.805–8 Interest paid.

(a) In general. Section 805(e) provides four categories of interest items the sum of which constitutes the "interest paid" for any taxable year. Interest paid is one of the elements of the policy and other contract liability requirements of a life insurance company. The amount of the policy and other contract liability requirements is used in determining the policyholders' share of each and every item of investment yield which is not included in taxable investment income. See section 804(a) and § 1.804–2. Interest paid includes interest on indebtedness, discounts on prepaid premiums, and interest on insurance or annuity contracts for which no provision is made in the life insurance reserves. Interest paid does not include dividends to policyholders (as defined in section 811(a) and paragraph (a) of § 1.811–2) or amounts derived from mortality savings or expense savings. In computing the interest paid for any taxable year the same item may not be included more than once.

(b) Interest paid defined. For purposes of part I, subchapter L, chapter 1 of the Code, the term "interest paid" as used in section 805(e) means the sum of—

(1) All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax under chapter 1 of the Code. Indebtedness does not include reserves such as life insurance reserves (as defined in section 801(b) and § 1.801–4) nor does it include deferred dividends. Interest on indebtedness includes interest on deferred policy and contract benefit funds as well as interest on a mortgage. See section 163 and the regulations thereunder.

(2) All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies. Amounts in the nature of interest do not include amounts derived from or representing mortality gains, expense savings, underwriting profits, or other items not in the nature of interest. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest accrued within the taxable year on such contracts. A contract to pay insurance benefits in installments over a specified period, for example, a contract to pay the insurance benefit in 10 annual installments, is considered as a supplementary contract not involving life contingencies. It is immaterial whether the optional mode of settlement

specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by either the insured or a beneficiary after the policy matured. Thus, no distinction is made based on the person choosing the method of payment, and the full amount of the interest accrued, and not merely the guaranteed interest, is considered as interest paid. Amounts in the nature of interest include interest on dividends left on deposit with the company and interest on premiums paid in advance.

(3) All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts. Such accrual shall be determined in accordance with the rules prescribed in section 818(b) and the regulations thereunder. For example, if at the beginning of the taxable year 1958 a life insurance company granted a discount in the nature of interest of $40 as the result of the prepayment of life insurance premiums for 5 years, the company may, under the straight line method, accrue $8 in 1958 and each of the four succeeding taxable years ($40÷5=$8) and include this $8 as interest paid for each such taxable year.

(4) Interest for the taxable year on special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

[T.D. 6513, 25 FR 12667, Dec. 10, 1960, as amended by T.D. 7163, 37 FR 4189, Feb. 29, 1972]

§ 1.806–1 Adjustment for certain reserves.

(a) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, a life insurance company writing contracts other than life insurance or annuity contracts (either separately or combined with noncancellable health and accident insurance contracts) must add to its life insurance company taxable income (as a factor in determining 1954 adjusted taxable income) an amount equal to eight times the amount of the adjustment for certain reserves provided in paragraph (b) of this section.

(b) The adjustment for certain reserves referred to in paragraph (a) of this section shall be an amount equal to 3¼ percent of the mean of the unearned premiums and unpaid losses at the beginning and end of the taxable year on such other contracts as are not included in life insurance reserves. If such unearned premiums, however, are less than 25 percent of the net premiums written during the taxable year on such other contracts, then the adjustment shall be 3¼ percent of 25 percent of the net premiums written during the taxable year on such other contracts plus 3¼ percent of the mean of the unpaid losses at the beginning and end of the taxable year on such other contracts. As used in this section, the term "unearned premiums" has the same meaning as in section 832(b)(4) and § 1.832–1.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.806–2 Taxable years affected.

Section 1.806–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.806–3 and 1.806–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6513, 25 FR 12668, Dec. 10, 1960]

§ 1.806–3 Certain changes in reserves and assets.

(a) *In general.* For purposes of Part I, Subchapter L, Chapter 1 of the Code, section 806(a) provides that if there is a change in life insurance reserves (as defined in section 801(b)), during the taxable year, which is attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such life insurance reserves, then the means of such reserves, and the mean of the assets, shall be appropriately adjusted to reflect the amounts involved in such transfer. For example, the adjustments required under section 806(a) are applicable to transfers in which one life insurance company purchases or acquires a part or all of the business of another life insurance company under an arrangement whereby the purchaser or transferee becomes solely liable on the contracts transferred. This provision shall apply in the case of assumption reinsurance but not in the case of indemnity reinsurance or reinsurance ceded. Thus, no adjustments shall be required under section 806(a) when, in the ordinary course of business, an indemnity reinsurance contract is entered into with another company (on a yearly renewable term

basis, on a coinsurance basis, or otherwise) whereby there is a sharing of risks under one or more individual contracts. It will be necessary for each life insurance company participating in a transfer described in section 806(a) to make the adjustments required by such section. Such adjustments shall be made without regard to whether or not the transferor of the liabilities was the original insurer.

(b) Manner in which adjustments shall be made—(1) Daily basis. The means of the life insurance reserves, and the mean of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in a transfer described in section 806(a) and paragraph (a) of this section. The transferor and the transferee shall be treated as having held such life insurance reserves and assets for a fraction of the year in which the transfer occurs.

(2) Determination of period held. In determining the fraction which represents the fractional year that such reserves and assets were held, the numerator shall be the number of days during the taxable year which such reserves and assets were actually held, and the denominator shall be the number of days in the calendar year of the transfer. In computing the period held for purposes of the numerator, the day on which such reserves and assets are transferred is included by the transferor and excluded by the transferee.

(3) Adjustments to the means of life insurance reserves and assets not transferred. All life insurance reserves and assets transferred during the taxable year, within the meaning of section 806(a), shall be excluded from the beginning and end of the taxable year balances of the transferor and transferee, respectively. The amount of assets to be excluded from the beginning of the taxable year balance of the transferor shall be an amount equal to the value of such reserves at the beginning of the taxable year. The amount of assets to be excluded from the end of the taxable year balance of the transferee shall be an amount equal to the value of such reserves at the end of the taxable year. The means of the life insurance reserves and assets not so transferred shall be determined in the ordinary manner, that is, the arithmetic means. There shall be added to these means an amount to appropriately adjust them, on a daily basis, for the life insurance reserves and assets that were transferred during the taxable year. This adjustment shall be determined by multiplying (i) the mean of the transferred life insurance reserves (or assets, as the case may be) at the beginning of the taxable year (or, if acquired later, at the beginning of the period held as defined in subparagraph (2) of this paragraph) and the end of the period held as defined in subparagraph (2) of this paragraph (or at the end of the taxable year, if held at such time) by (ii) the fraction determined under subparagraph (2) of this paragraph.

(4) Examples. The application of this paragraph may be illustrated by the following examples:

Example (1). On March 14, 1958, the M Company, a life insurance company, transferred to the N Company, a life insurance company, pursuant to an assumption reinsurance agreement, all of its life insurance reserves, and related assets, on one block of policies. The reserves (and assets) for this block were held by the M Company on January 1, 1958, and totaled $60,000; on March 14, the reserves (and assets) totaled $64,000. The M Company had life insurance reserves of $1,000,000 at the beginning of 1958 (including those subsequently transferred) and $1,040,000 at the end of 1958. The M Company had assets of $1,300,000 at the beginning of 1958 (including those subsequently transferred) and $1,380,000 at the end of 1958. The mean of M's life insurance reserves for the taxable year 1958 is computed as follows:

Reserves at 1-1-58	$1,000,000	
Exclude reserves (at beginning of year) on contracts transferred to N	60,000	
Recomputed amount at 1-1-58		$940,000
Reserves at 12-31-58		1,040,000
Sum		1,980,000
Mean		990,000
Adjustment for reserves transferred on 8-14-58:		
Reserves at 1-1-58 on contracts transferred to N	$60,000	
Reserves at 3-14-58 on such contracts	64,000	
Sum	124,000	
Mean	62,000	
Fraction taken into account	73/365	
Adjustment (73/365 × $62,000)		$12,400
Mean of M's life insurance reserves after section 806(a) adjustment		1,002,400

Example (2). Assuming the facts to be the same as in example (1), the mean of M's assets for the taxable year 1958 is computed as follows:

Assets at 1-1-58	$1,300,000	
Exclude assets (at beginning of year) on contracts transferred to N	60,000	
Recomputed amount at 1-1-58		$1,240,000
Assets at 12-31-58		1,380,000
Sum		2,620,000
Mean		1,310,000
Adjustments for assets transferred on 3-14-58:		
Assets at 1-1-58 on contracts transferred to N	$60,000	
Assets at 3-14-58 on such contracts	64,000	

Sum	$124,000	
Mean	62,000	
Fraction taken into account	73/365	
Adjustment (73/365 × $62,000)		$12,400
Mean of M's assets after section 806(a) adjustment		1,322,400

Example (3). Assume the facts are the same as in example (1). At the end of 1958, N Company had life insurance reserves (and assets) of $80,000 on the contracts transferred on March 14, 1958. The N Company had life insurance reserves of $6,000,000 at the beginning of 1958 and $6,400,000 at the end of 1958 (including those transferred). The N Company had assets of $6,800,000 at the beginning of 1958 and $7,300,000 at the end of 1958 (including those on the contracts transferred). The mean of N's life insurance reserves for the taxable year 1958 is computed as follows:

Reserves at 1–1–58		$6,000,000
Reserves at 12–31–58	$6,400,000	
Exclude reserves (at end of year) on contracts transferred from M	80,000	
Recomputed amount at 12–31–58		6,320,000
Sum		12,320,000
Mean		6,160,000
Adjustment for reserves transferred on 3–14–58:		
Reserves at 3–14–58 on contracts transferred from M	$64,000	
Reserves at 12–31–58 on such contracts	80,000	
Sum	144,000	
Mean	72,000	
Fraction taken into account	292/365	
Adjustment (292/365 × $72,000)		$57,600
Mean of N's life insurance reserves after section 806(a) adjustment		6,217,600

Example (4). Assuming the facts to be the same as in example (3), the mean of N's assets for the taxable year 1958 is computed as follows:

Assets at 1–1–58		$6,800,000
Assets at 12–31–58	$7,300,000	
Exclude assets (at end of year) on contracts transferred from M	80,000	
Recomputed amount at 12–31–58		7,220,000
Sum		14,020,000
Mean		7,010,000
Adjustments for assets transferred on 3–14–58:		
Assets at 3–14–58 on contracts transferred from M	$64,000	
Assets at 12–31–58 on such contracts	80,000	
Sum	144,000	
Mean	72,000	
Fraction taken into account	292/365	
Adjustment (292/365 × $72,000)		$57,600
Mean of N's assets after section 806(a) adjustment		7,067,600

Example (5). The facts are the same as in example (1), except that on October 19, 1958, company N transfers to company P, a life insurance company, all of the life insurance reserves, and related assets, on the block of policies it had received from company M on March 14, 1958. The reserves (and assets) for this block totaled $76,000 on October 19, 1958. The means of company M's life insurance reserves and assets, as computed in examples (1) and (2), respectively, would be unchanged by the transfer of October 19, 1958. Since company N did not own this block of policies at either the beginning or end of the taxable year, it would not have to recompute its beginning or end of the taxable year reserves or assets. Company N will, however, have to adjust (or increase) the mean of its life insurance reserves and assets on account of the policies it received from company M. This adjustment will be $42,000, which is determined by multiplying the means of the life insurance reserves (or assets) on these policies as of March 15, 1958, and October 19, 1958, $70,000 ($64,000+$76,000=$140,000÷2) by the fraction 219/365 (the numerator of 219 is determined by excluding the day of the transfer to N, March 14, 1958, and including the day of the transfer from N to P, October 19, 1958). Company P will have to recompute its end of the year life insurance reserves and assets (in the same manner as illustrated in examples (3) and (4)). Assuming the end of the year reserves (and assets) on this block of policies is $80,000, company P will have an adjustment under section 806(a) of $15,600, which is determined by multiplying the means of the reserves on these policies as of October 20, 1958, and December 31, 1958, $78,000 ($76,000+$80,000=$156,000÷2) by the fraction 73/365.

[T.D. 6513, 25 FR 12663, Dec. 10, 1960]

§ 1.806–4 Change of basis in computing reserves.

(a) **In general.** For purposes of Subpart B, Part I, Subchapter L, Chapter 1 of the Code, section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) (relating to items taken into account) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then in determining taxable investment income the amount of the item as of the close of the taxable year shall be the amount computed on the old basis, and the amount of the item as of the beginning of the next taxable year shall be the amount computed on the new basis. For purposes of the preceding sentence, an election under section 818(c) shall not be treated as a change in basis for determining the amount of an item referred to in section 810(c). A change of basis in computing any of the items referred to in section 810(c) is not a change of accounting method requiring the consent of the Secretary or his delegate under section 446(e).

(b) **Illustration of change of basis in computing reserves.** The application of section 806(b) and paragraph (a) of this section may be illustrated by the following examples:

Example (1). Assume that the life insurance reserves of Y, a life insurance company, at the beginning of the taxable year 1959 are $100 and that during such taxable year a portion of the reserves is strengthened (by reason of a change in mortality

or interest assumptions, or otherwise), so that at the end of the taxable year 1959 the reserves (computed on the new basis) are $130 but computed on the old basis would be $120. Assume further that at the close of the next taxable year, 1960, the reserves (computed on the new basis) are $142. Under the provisions of section 806(b) and paragraph (a) of this section, the mean of such reserves for the taxable year of the reserve strengthening, namely 1959, is $110 (the mean of $100, the balance at the beginning of the taxable year 1959, and $120, the balance at the end of the taxable year 1959 computed on the old basis). The mean of such reserves for the next taxable year, 1960, is $136 (the mean of $130, the balance at the beginning of the taxable year 1960 computed on the new basis, and $142, the balance at the end of the taxable year 1960 computed on the new basis).

Example (2). The life insurance reserves of S, a life insurance company, computed with respect to contracts for which such reserves are determined on a recognized preliminary term basis amount to $50 on January 1, 1959, and $80 on December 31, 1959. For the taxable year 1959, S elects to revalue such reserves on a net level premium basis under section 818(c). Such reserves computed under section 818(c) amount to $60 on January 1, 1959, and $96 on December 31, 1959. Under the provisions of paragraph (a) of this section, the mean of such reserves for the taxable year 1959 is $78 (the mean of $60), the balance at the beginning of the taxable year 1959 computed under section 818(c), and $96, the balance at the end of the taxable year 1959 computed under section 818(c).

[T.D. 6513, 25 FR 12669, Dec. 10, 1960]

§ 1.807–1 Foreign life insurance companies.

A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, is taxable on its income received during the taxable year from interest, dividends, and rents, from sources within and without the United States, pertaining to its United States business. Such a company is taxable in the same manner as a domestic life insurance company except that the determinations necessary for the purposes of subtitle A, such as gross income, the adjustment for certain reserves, deductions and limitations on deductions, amortization of premiums and accrual of discount, and the deductions allowed the company in Part VIII, Subchapter B, Chapter 1 of the Code, shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Life Insurance Commissioners. This statement is presumed to reflect the income, disbursements, assets, and liabilities of the United States business of the company and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.807–1T Mortality and morbidity tables (temporary).

Q-1. What mortality and morbidity tables must be used to compute reserves under section 807 (d)(2) for insurance contracts for which no commissioners' standard tables are applicable when the contract is issued?

A-1. The following tables must be used:

Type of Contract	Table
1. Group term life insurance (active life reserves).	1960 Commissioners' Standard Group Mortality Table.
2. Group life insurance (active life reserves); accidental death benefits.	1959 Accidental Death Benefits Table.
3. Permanent and paid-up group life insurance (active life reserves).	Same table as are applicable to males for ordinary life insurance.
4. Group life insurance (active life reserves); disability income benefits.	The tables of period 2 disablement rates and the 1930 to 1950 termination rates of the 1952 Disability Study of the Society of Actuaries.
5. Group life insurance; survivor income benefits insurance.	Same tables as are applicable to group annuities.
6. Group life insurance; extended death benefits for disabled lives.	1970 Intercompany Group Life Disability Valuation Table.
7. Credit life insurance	1958 Commissioners' Extended Term Table.
8. Supplementary contracts involving life contingencies.	Same tables as are applicable to individual immediate annuities.
9. Noncancellable accident and health insurance (active life reserves); benefits issued before 1984.	Tables used for NAIC annual statement reserves as of December 31, 1983.
10. Noncancellable accident and health insurance (active life reserves); disability benefits issued after 1983.	1964 Commissioners' Disability Tables.
11. Noncancellable accident and health insurance (active life reserves); accidental death benefits issued after 1983.	1959 Accidental Death Benefits Tables.
12. Noncancellable accident and health insurance (active life reserves); all benefits issued after 1983 other than disability and accidental death.	Tables used for NAIC annual statement reserves.
13. Noncancellable accident and health insurance (claim reserves); disability benefits for all years of issue.	1964 Commissioners' Disability Tables.
14. Noncancellable accident and health insurance (claim reserves); all benefits other than disability for all years of issue.	Tables used for annual statement reserves.

Q-2. May the tables specified in A-1 of this section be adjusted to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

A-2. Yes. Appropriate adjustment may be made for such risks.

Q-3. For what taxable years must the tables in A-1 be used?

A-3. The tables in A-1 must be used for taxable years beginning after December 31, 1983.

[T.D. 8120, 52 FR 39, Jan. 2, 1987]

§ 1.807–2 Taxable years affected.

Section 1.807–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments.

[T.D. 6535, 26 FR 524, Jan. 20, 1961]

Gain And Loss From Operations

§ 1.809–1 Taxable years affected.

Sections 1.809 through 1.809–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all reference to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), the Act of June 27, 1961 (75 Stat. 120), the Act of October 10, 1962 (76 Stat. 808); the Act of October 23, 1962 (76 Stat. 1134), and section 214(b)(4) of the Revenue Act of 1964 (78 Stat. 55).

[T.D. 6535, 26 FR 524, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8687, June 23, 1966; T.D. 6992, 34 FR 827, Jan. 18, 1969]

§ 1.809–2 Exclusion of share of investment yield set aside for policyholders.

(a) In general. Section 809 provides the rules for determining the gain or loss from operations of a life insurance company, which amount is necessary to determine life insurance company taxable income. In order to determine gain or loss from operations, a life insurance company must first determine the share of each and every item of its investment yield (as defined in section 804(c) and paragraph (a) of § 1.804–4) set aside for policyholders (as computed under section 809(a)(1) and paragraph (b) of this section), as this share is excluded from gain or loss from operations (as defined in section 809(b)(1) and (2) and paragraphs (a) and (b) of § 1.809–3, respectively). The life insurance company shall then add its share of each and every item of its investment yield to the sum of the items comprising gross amount (as described in section 809(c) and paragraph (a) of § 1.809–4). In addition, the life insurance company shall, for taxable years beginning after December 31, 1961, add the amount (if any) by which its net long-term capital gain exceeds its net short-term loss. From the sum so computed (which includes the capital gains item only for taxable years beginning after December 31, 1961) there shall then be subtracted the deductions provided in section 809(d) and paragraph (a) of § 1.809–5. The amount thus obtained is the gain or loss from operations for the taxable year.

(b) Computation of share of investment yield set aside for policyholders. Section 809(a)(1) provides that the share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For this purpose, the percentage used in determining the share of each of these items comprising the investment yield set aside for policyholders shall be determined by dividing the required interest (as defined in section 809(a)(2) and paragraph (d) of this section) by the investment yield (as defined in section 804(c) and paragraph (a) of § 1.804–4). The percentage thus obtained is then applied to each and every item of the investment yield so that the share of each and every item of investment yield set aside for policyholders shall be excluded from gain or loss from operations. However, if in any case the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(c) Computation of life insurance company's share of investment yield. For purposes of subpart C, part I, subchapter L, chapter 1 of the Code, section 809(b)(3) provides that the percentage used in determining the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be

obtained by subtracting the percentage obtained under paragraph (b) of this section from 100 percent. For example, if the policyholders' percentage (as determined under section 809(a)(1) and paragraph (b) of this section) is 72.38 percent, then the life insurance company's share is 27.62 percent (100 percent minus 72.38 percent). In such a case, if the amount of a particular item is $200, then the life insurance company's share of such item included in determining gain or loss from operations is $55.24 ($200 multiplied by 27.62 percent) and the share of such item set aside for policyholders (which is excluded from gain or loss from operations) is $144.76 ($200 multiplied by 72.38 percent). For purposes of determining gain or loss from operations, the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be added to the sum of the items comprising gross amount (as described in section 809(c) and paragraph (a) of § 1.809–4).

(d) Required interest defined. (1) For purposes of part I, section 809(a)(2) defines the term "required interest" for any taxable year as the sum of the products obtained by multiplying (i) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by (ii) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year. In the case of the reserves described in section 810(c)(1), such rate of interest shall be the same as that used by the taxpayer for purposes of paragraph (b) of § 1.801–5 (relating to the definition of reserves required by law) with respect to such reserves. In the case of the reserves described in section 810(c)(2) through (5), such rate of interest shall be the same as that actually paid, credited, or accrued by the taxpayer with respect to such reserves. Thus, the required interest for any taxable year includes the elements of interest paid (as defined in section 805(e)) with respect to the reserves described in section 810(c).

(2) For purposes of computing required interest under section 809(a)(2) and subparagraph (1) of this paragraph, the amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets) before applying the rate of interest required, or assumed by the taxpayer, thereto. However, in the case of the adjustments required by section 810(d) as a result of a change in the basis of computing reserves, the adjustments to any of the reserves described in section 810(c) shall be taken into account in accordance with the rules prescribed in section 810(d) and § 1.810–3.

[T.D. 6535, 26 FR 525, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8687, June 23, 1966]

§ 1.809–3 Gain and loss from operations defined.

(a) Gain from operations. For purposes of part I, subchapter L, chapter 1 of the Code, section 809(b)(1) defines the term "gain from operations" as the excess of the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of § 1.809–4, and (3) for taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, over the sum of the deductions provided by section 809(d) and § 1.809–5.

(b) Loss from operations. For purposes of part I, section 809(b)(2) defines the term "loss from operations" as the excess of the sum of the deductions provided by section 809(d) and § 1.809–5 over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of § 1.809–4, and (3) for taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss.

(c) Illustration of principles. The provisions of section 809(b)(1) through (3) and paragraphs (a) and (b) of this section may be illustrated by the following example:

Example. For the taxable year 1958, T, a life insurance company, had investment yield of $900,000, including $150,000 of dividends received from domestic corporations subject to taxation under chapter 1 of the Code, $10,000 of wholly tax-exempt interest, and $78,000 of partially tax-exempt interest. T also had items of gross amount under section 809(c) in the amount of $12,000,000 and deductions under section 809(d) of $6,963,500 (exclusive of any deductions for wholly tax-exempt interest, partially tax-exempt interest, and dividends received). For such taxable year, the share of each and every item of investment yield set aside for policyholders was 80 percent and the company's share of each and every item of investment yield was 20 percent. Based upon these figures, T

had a gain from operations of $5,180,000 for the taxable year 1958, computed as follows:

	Col. 1	Col. 2 (80% × Col. 1) exclusion of policyholder's share	Col. 3 (20% × Col. 1) company's share
Interest wholly tax-exempt	$10,000	$8,000	$2,000
Interest partially tax-exempt	78,000	62,400	15,600
Dividends received	50,000	120,000	30,000
Other items of investment yield ...	662,000	529,600	132,400
Investment yield	900,000	720,000	180,000

Gross amount (sum of items under sec. 809(c))		$12,000,000
Total		12,180,000
Less:		
Deductions under sec. 809(d)(8):		
Company's share of interest wholly tax-exempt........	$2,000	
30/52 of company's share of interest partially tax-exempt (30/52 × $15,600)........	9,000	
85% of company's share of dividends received (but not to exceed 85% of gain from operations as computed under sec. 809(d)(8)(B)) (85% × $30,000).........	25,500	
All other deductions under sec. 809(d)	6,963,500	
		7,000,000
Gain from operations................		5,180,000

(d) Exception. (1) In accordance with section 809(b)(4), if it is established in any case to the satisfaction of the Commissioner, or by a determination of The Tax Court of the United States, or of any other court of competent jurisdiction, which has become final, that the application of the definition of gain from operations contained in section 809(b)(1) results in the imposition of tax on—

(i) Any interest which under section 103 is excluded from gross income,

(ii) Any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(iii) Any amount of dividends received which under sections 243, 244, and 245 (as modified by section 809(d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(2) For the date upon which a decision by the Tax Court becomes final, see section 7481. For the date upon which a judgment of any other court becomes final, see paragraph (c) of § 1.1313(a)–1.

[T.D. 6535, 26 FR 526, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8687, June 28, 1966]

§ 1.809–4 Gross amount.

(a) Items taken into account. For purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809(a)(1) and paragraph (c) of § 1.809–2), and the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (such capital gains item is included in determining gain or loss from operations only for taxable years beginning after December 31, 1961). The additional three categories of items taken into account are:

(1) Premiums. (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums and premiums and other consideration arising out of reinsurance ceded. The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration provided in the insurance or annuity contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a)(7)(ii) of § 1.809–5). The term also includes amounts a life insurance company charges itself representing premiums with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)).

(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a)(7)(ii) of § 1.809–5 for the definition of assumption reinsurance.

(2) Decreases in certain reserves. Each net decrease in reserves which is required by section 810(a) and (d)(1) or 811(b)(2) to be taken into account for the taxable year as a net decrease for purposes of section 809(c)(2).

(3) Other amounts. All amounts, not included in computing investment yield and not otherwise taken into account under section 809(c)(1) or (2), shall be taken into account under section 809(c)(3) to the extent that such amounts are includible in gross income under subtitle A of the Code. See section 61 (relating to gross income defined) and the regulations thereunder.

(b) Treatment of net long-term capital gains. For taxable years beginning before January 1, 1962, any net long-term capital gains (as defined in section 1222(7)) from the sale or exchange of a capital asset (or any gain considered to be from the sale or exchange of a capital asset under applicable law) shall be excluded from the determination of gain or loss from operations of a life insurance company. On the other hand, with respect to taxable years beginning after December 31, 1961, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss (as defined in section 1222(6)) shall be taken into account in determining gain or loss from operations under section 809. However, for any taxable year beginning after December 31, 1958, the excess of net short-term capital gain (as defined in section 1222(5)) over net long-term capital loss (as defined in section 1222(8)) is included in computing investment yield (as defined in section 804(c)) and, to that extent, is taken into account in determining gain or loss from operations under section 809.

[T.D. 6535, 26 FR 527, Jan. 20, 1961, as amended by T.D. 6610, 27 FR 8718, Aug. 31, 1962, T.D. 6886, 31 FR 8687, June 23, 1966]

§ 1.809–5 Deductions.

(a) Deductions allowed. Section 809(d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively:

(1) Death benefits, etc. All claims and benefits accrued (less reinsurance recoverable), and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto). The term "all claims and benefits accrued" includes, for example, matured endowments and amounts allowed on surrender. The term "losses incurred (whether or not ascertained)" includes a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases) incurred but not reported by the end of the taxable year as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year.

(2) Increases in certain reserves. The net increase in reserves which is required by section 810(b) and (d)(1) to be taken into account for the taxable year as a net increase for purposes of section 809(d)(2).

(3) Dividends to policyholders. The deduction for dividends to policyholders as determined under section 811(b) and § 1.811–2. Except as provided in section 809(d)(3) and this subparagraph, no amount shall be allowed as a deduction in respect of dividends to policyholders under section 809(d). See section 809(f) and § 1.809–7 for limitation of such deduction.

(4) Operations loss deduction. The operations loss deduction as determined under section 812.

(5) Certain nonparticipating contracts. (i) An amount equal to the greater of:

(a) 10 percent of the increase for the taxable year in certain life insurance reserves for nonparticipating contracts (other than group contracts); or

(b) 3 percent of the premiums for the taxable year attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more.

(ii) For purposes of section 809(d)(5) and this subparagraph, the term "nonparticipating contracts" means those contracts which during the taxable year contain no right to participate in the divisible surplus of the company. For example, if at any time during the taxable year for which the deduction allowed under section 809(d)(5) and this subparagraph is claimed such contracts have rights to dividends or similar distributions (as defined in section 811(a) and paragraph (a) of § 1.811–2), such contracts shall no longer be deemed nonparticipating contracts and, therefore, no deduction shall be allowed. Thus, if a class of contracts having no right to participate in the divisible surplus of the company is in force for nine years and on March 10, 1958, it is announced that such contracts shall be accorded dividend rights as of August 1, 1958, no deduction shall be allowed under section 809(d)(5) and this subparagraph for the taxable year 1958 or any succeeding taxable year, whether or not dividends are actually paid on such contracts. However, if the announcement of March 10, 1958, states that such contracts shall be accorded dividend rights as of January 1, 1959, a deduction under section 809(d)(5) and this subparagraph shall be allowed for the taxable year 1958 but not for any succeeding taxable year.

(iii) For purposes of section 809(d)(5) and this subparagraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (as defined in section 801(b) and § 1.801–4), other than that portion of such reserves which is allocable to annuity features, as relates to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph). The amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets). In the case of the adjustments required by section 810(d) (relating to adjustment for change in computing reserves), the increase in life insurance reserves attributable to reserve strengthening shall be taken into account in accordance with the rules prescribed in section 810(d) and § 1.810–3.

(iv) For purposes of section 809(d)(5) and this subparagraph, the term "premiums" means the net amount of the premiums and other consideration attributable to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph) which are taken into account under section 809(c)(1). For this purpose, premiums include only such amounts attributable to such contracts which are issued or renewed for periods of 5 years or more, but does not include that portion of the premiums which is allocable to annuity features. No portion of a premium shall be deemed allocable to annuity features solely because a contract, such as an endowment contract, provides that at maturity the insured shall have an option to take an annuity. The determination of whether a contract meets the 5-year requirement shall be made as of the date the contract is issued, or as of the date it is renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy shall qualify for the deduction under section 809(d)(5), even though the insured subsequently dies at the end of the second year, since the policy is issued for a period of 5 years or more. However, a 1-year renewable term contract shall not qualify, since as of the date it is issued (or of any renewal date) it is not issued (or renewed) for a period of 5 years or more. In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period shall not qualify. However, if this policy is renewed for a period of 5 years or more, the policy shall qualify for the deduction under section 809(d)(5) from the date it is renewed.

(v) The provisions of section 809(d)(5) and this subparagraph may be illustrated by the following example:

Example. Assume the following facts with respect to X, a life insurance company, for the taxable year 1958:

Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1–1–58	$150,000
Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12–31–58	225,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 1–1–58	48,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 12–31–58	57,000
Premiums on nonparticipating contracts without annuity features (other than group contracts) issued or renewed for 5 years or more	85,000
Premiums on nonparticipating contracts allocable to annuity features (other than group contracts) issued or renewed for 5 years or more	14,000
Return premiums on nonparticipating contracts without annuity features (other than group contracts)	5,000

In order to determine the deduction under section 809(d)(5) (without regard to the limitation of section 809(f)), X would make up the following schedule:

(1) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12-31-58..	$225,000	
(2) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1-1-58....	150,000	
(3) Excess of item (1) over item (2) ($225,000 minus $150,000)....	75,000	
(4) 10 percent of item (3) (10% × $75,000)		7,500
(5) Net premiums on nonparticipating contracts without annuity features issued or renewed for 5 years or more (other than group contracts) (gross premiums on such contracts ($85,000) minus return premiums ($5,000) on such contracts)	80,000	
(6) 3 percent of item (5) (3% × $80,000)		2,400
(7) The greater of item (4) or item (6)		7,500
(8) Tentative deduction under sec. 809(d)(5) (computed without regard to the limitation of sec. 809(f))		7,500

(vi) See section 809(f) and § 1.809-7 for limitation of the deduction provided by this subparagraph.

(6) Certain accident and health insurance and group life insurance. (i) For taxable years beginning before January 1, 1963, an amount equal to two percent of the premiums for the taxable year attributable to group life insurance contracts, group accident and health insurance contracts, or group accident and health insurance contracts with a life feature. For taxable years beginning after December 31, 1962, the deduction shall be an amount equal to two percent of the premiums for the taxable year attributable to group life insurance contracts, accident and health insurance contracts (other than those to which section 809(d)(5) applies), or accident and health insurance contracts with a life feature (other than those to which section 809(d)(5) applies). For purposes of section 809(d)(6) and this subparagraph, the term "premiums" means the net amount of the premiums and other consideration attributable to such contracts taken into account under section 809(c)(1). The deduction allowed by section 809(d)(6) and this subparagraph for the taxable year and all preceding taxable years shall not exceed 50 percent of the net amount of the premiums attributable to such contracts for the taxable year. For example, assume that premiums attributable to group life insurance and group accident and health insurance contracts are $103,000 for the taxable year 1962. Assume further that there are $3,000 of return premiums attributable to such contracts for the taxable year. Under the provisions of section 809(d)(6) and this subparagraph, a deduction (determined without regard to section 809(f) of $2,000 (2 percent of $100,000 ($103,000–$3,000)) is allowed. Assuming that the company continues to receive net premiums of $100,000 attributable to such contracts for 15 years, the cumulative amount of these deductions is $30,000 ($2,000 for 15 years). If, in the sixteenth year, net premiums attributable to such contracts amount to $60,000, no deduction shall be allowed under section 809(d)(6) and this subparagraph since the cumulative amount of these deductions ($30,000) equals 50 percent of the current year's premiums ($60,000) from such contracts.

(ii) In computing the deduction under section 809(d)(6), the determination as to when the 50 percent limitation on such deduction has been reached shall be based upon the amount allowed as a deduction for the taxable year and all preceding taxable years after the application of the limitation provided in section 809(f) and § 1.809-7. Thus, if in the example set forth in paragraph (c) of § 1.809-7 the application of the limitation provided by section 809(f) limited the deduction allowed for the taxable year under section 809(d)(6) to $3,250,000, then for purposes of determining the 50 percent limitation on such deduction, only $3,250,000 (the amount allowed) shall be taken into account.

(iii) For purposes of determining whether the 50 percent limitation applies to any taxable year, the deduction provided by section 809(d)(6) for all preceding taxable years shall be taken into account, irrespective of whether or not the life insurance company claimed a deduction for these amounts for such preceding taxable years.

(iv) See section 809(f) and § 1.809-7 for limitation of the deduction provided by this subparagraph.

(7) Assumption by another person of liabilities under insurance, etc., contracts. (i) The consideration (other than consideration arising out of reinsurance ceded as defined in paragraph (a)(1)(iii) of § 1.809-4) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto) of the taxpayer.

(ii) For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policy-

holders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809–4).

(iii) The provisions of section 809(d)(7) and this subparagraph may be illustrated by the following example:

Example. During the taxable year 1958, T, a life insurance company, transferred a block of insurance policies and made a payment of $50,000 to R, a life insurance company, under an arrangement whereby R became solely liable to the policyholders on the policies transferred by T. Under the provisions of section 809(d)(7) and this subparagraph, T is allowed a deduction of $50,000 for the taxable year 1958. For the treatment by R of this $50,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809–4. See section 806(a) and § 1.806–3 for the adjustments in reserves and assets to be made by T and R as a result of this transaction.

(8) Tax-exempt interest, dividends, etc. (i) Each of the following items:

(a) The life insurance company's share of interest which under section 103 is excluded from gross income;

(b) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3) and paragraph (d)(2)(i) of § 1.804–2) computed with respect to the life insurance company's share of such interest; and

(c) The deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B) and subdivision (ii) of this subparagraph) computed with respect to the life insurance company's share of the dividends received.

(ii) The modification contained in section 809(d)(8)(B) provides the method for applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of section 809(d)(8)(A)(iii) and subdivision (i)(c) of this subparagraph. Under this method, the sum of the deductions allowed by sections 243(a)(1) (relating to dividends received by corporations), 244(a) (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations) shall be limited to 85 percent of the gain from operations computed without regard to:

(a) The deductions provided by section 809(d)(3), (5), and (6);

(b) The operations loss deductions provided by section 812; and

(c) The deductions allowed by sections 243(a)(1), 244(a), and 245.

If a life insurance company has a loss from operations (as determined under sec. 812) for the taxable year, the limitation provided in section 809(d)(8)(B) and this subdivision shall not be applicable for such taxable year. In that event, the deductions provided by sections 243(a)(1), 244(a), and 245 shall be allowable for all tax purposes to the life insurance company for such taxable year without regard to such limitation. If the life insurance company does not have a loss from operations for the taxable year, however, the limitation shall be applicable for all tax purposes for such taxable year. In determining whether a life insurance company has a loss from operations for the taxable year under section 812, the deductions allowed by sections 243(a)(1), 244(a), and 245 shall be computed without regard to the limitation provided in section 809(d)(8)(B) and this subdivision.

(9) Investment expenses, etc. (i) The amount of investment expenses to the extent not allowed as a deduction under section 804(c)(1) in computing investment yield. For example, if a deduction in the amount of $100,000 is claimed for investment expenses, which amount includes general expenses assigned to or included in investment expenses, and due to the operation of the limitation provided by section 804(c)(1) only $85,000 is allowed, then the excess ($15,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(ii) The amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income. For example, if gross investment income under section 804(b) equals $400,000, and the sum of the deductions allowable under section 804(c) equals $425,000, then the excess ($25,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(iii) In determining the amount of the deductions allowed under subdivisions (i) and (ii) of this subparagraph, a life insurance company shall first take such deductions to the full extent allowable under section 804(c)(1), and any amount which is allowed as a deduction under section 804(c) shall not again be allowed as a deduction under section 809(d)(9).

(10) Small business deduction. The small business deduction as determined under section 804(a)(4).

(11) Certain mutualization distributions. The amount of distributions to shareholders actually made by the life insurance company in 1958, 1959,

1960, and 1961 in acquisition of stock pursuant to a plan of mutualization adopted by the company before January 1, 1958. If such deduction is claimed, there must be attached to the return of the company claiming such deduction a certified copy of the plan of mutualization and proof that such plan was adopted prior to January 1, 1958. See section 809(g) and § 1.809–8 for limitation of such deduction.

(12) Other deductions. Except as modified by section 809(e) and § 1.809–6, all other deductions allowed under subtitle A of the Code for purposes of computing taxable income to the extent not allowed as a deduction in computing investment yield. For example, a life insurance company shall be allowed a deduction under section 809(d)(12) and this subparagraph for amounts representing premiums charged itself with respect to liability for insurance and annuity benefits for its employees (including full-time life insurance salesmen within the meaning of section 7701(a)(20)) in accordance with the rules prescribed in sections 162 and 404 and the regulations thereunder, to the extent that a deduction for such amounts is not allowed under section 804(c)(1) and paragraph (b)(1) of § 1.804–4 or section 809(d)(9) and subparagraph (9) of this paragraph.

(b) Denial of double deduction. Nothing in section 809(d) shall permit the same item to be deducted more than once in determining gain or loss from operations. For example, if an item is allowed as a deduction for the taxable year by reason of its being a loss incurred within such taxable year (whether or not ascertained) under section 809(d)(1), such item, or any portion thereof, shall not also be allowed as a deduction for such taxable year under section 809(d)(2).

[T.D. 6535, 26 FR 527, Jan. 20, 1961, as amended by T.D. 6610, 27 FR 8718, Aug. 31, 1962; T.D. 6886, 31 FR 8687, June 23, 1966; T.D. 6992, 34 FR 827, Jan. 18, 1969]

§ 1.809–6 Modifications.

Under section 809(e), the deductions allowed under section 809(d)(12) and paragraph (a)(12) of § 1.809–5 (relating to other deductions) are subject to the following modifications—

(a) Interest. No deduction shall be allowed under section 163 for interest in respect of items described in section 810(c) since such interest is taken into account in the determination of required interest under section 809.

(b) Bad debts. No deduction shall be allowed for an addition to reserves for bad debts under section 166(c). However, a deduction for specific bad debts shall be allowed to the extent that such deduction is allowed under section 166 and the regulations thereunder. In the case of a loss incurred on the sale of mortgaged or pledged property, see § 1.166–6 of this chapter.

(c) Charitable, etc., contributions and gifts. (1) The deduction by a life insurance company in any taxable year for a charitable contribution (as defined in section 170(c)) shall be limited to 5 percent of the gain from operations (as determined under section 809(b)(1)), computed without regard to any deductions for:

(i) Charitable contributions under section 170;

(ii) Dividends to policyholders under section 811(b);

(iii) Certain nonparticipating contracts under section 809(d)(5);

(iv) Group life insurance contracts and group accident and health insurance contracts under section 809(d)(6);

(v) Tax-exempt interest, dividends, etc., under section 809(d)(8); and

(vi) Any operations loss carryback to the taxable year under section 812.

(2) In applying the first sentence of section 170(b)(2) as contained in section 170 or, in the case of taxable years beginning after December 31, 1969, section 170(d)(2)(B) as contained in section 170A, any excess of the charitable contributions made by a life insurance company in a taxable year over the amount deductible in such year under the limitation contained in subparagraph (1) of this paragraph, shall be reduced to the extent that such excess:

(i) Reduces life insurance company taxable income (computed without regard to section 802(b)(3)) for the purpose of determining the offsets referred to in section 812(b)(2); and

(ii) Increases an operations loss carryover under section 812 for a succeeding taxable year.

(3) The application of the rules provided in section 809(e)(3) and this paragraph may be illustrated by the following example:

Example. Assume that life insurance company P is organized on January 1, 1958, and has a loss from operations for that year in the amount of $100,000 which is an operations loss carryover to 1959. In 1959, company P has a gain from operations and tax base (computed without regard to section 802(b)(3)) of $100,000 before the allowance of a deduction for a $5,000 charitable contribution made in 1959 and before the application of the operations loss carryover from 1958. Under

section 170(b)(2), the operations loss carryover from 1958 is first applied to eliminate the $100,000 gain from operations and tax base in 1959 and the $5,000 charitable contribution carryover would (except for the limitation contained in this paragraph) become a charitable contribution carryover to 1960. However, for the purpose of computing the offsets referred to in section 812(b)(2), the $5,000 charitable contribution is applied to reduce the gain from operations and tax base for 1959 to $95,000 before the application of the operations carryover from 1958. Since only $95,000 of the $100,000 loss from operations in 1958 is an offset for 1959, the remaining $5,000 becomes an operations loss carryover to 1960. Accordingly, under the limitation contained in this paragraph, the charitable contributions carryover provided under the second sentence of section 170(b)(2) is eliminated.

(d) **Amortizable bond premium.** No deduction shall be allowed under section 171 for the amortization of bond premiums since a special deduction for such premiums is specifically taken into account under section 818(b).

(e) **Net operating loss deduction.** No deduction shall be allowed under section 172 since section 812 allows an "operations loss deduction".

(f) **Partially tax-exempt interest.** No deduction shall be allowed under section 242 for partially tax-exempt interest since section 809(d)(8) allows a deduction for such interest.

(g) **Dividends received.** No deduction shall be allowed under sections 243, 244, and 245 for dividends received since section 809(d)(8) allows a deduction for such dividends.

[T.D. 6535, 26 FR 529, Jan. 20, 1961, as amended by T.D. 7207, 37 FR 20797, Oct. 5, 1972]

§ 1.809–7 Limitation on certain deductions.

(a) **In general.** Section 809(f)(1) limits the deductions under section 809(d)(3), (5), and (6), relating to deductions for dividends to policyholders, certain nonparticipating contracts, and group life, accident, and health insurance contracts, respectively. This limitation provides that the amount of such deductions shall not exceed the sum of (1) the amount (if any) by which the gain from operations for the taxable year (determined without regard to such deductions) exceeds the taxpayer's taxable investment income for such year, plus (2) $250,000.

(b) **Application of limitation.** Section 809(f)(2) provides a priority system for applying the limitation contained in section 809(f)(1) and paragraph (a) of this section. Under this priority system, the limitation shall be applied in the following order—

(1) For taxable years beginning before January 1, 1962:

(i) First to the amount of the deduction under section 809(d)(6) (relating to group life, accident, and health insurance);

(ii) Then to the amount of the deduction under section 809(d)(5) (relating to certain nonparticipating contracts); and

(iii) Finally to the amount of the deduction under section 809(d)(3) (relating to dividends to policyholders).

(2) For taxable years beginning after December 31, 1961, the limitation shall be applied in the following order:

(i) First to the amount of the deduction under section 809(d)(3);

(ii) Then to the amount of the deduction under section 809(d)(6); and

(iii) Finally to the amount of the deduction under section 809(d)(5).

Thus, for taxable years beginning after December 31, 1961, the limitation and priority system would operate first to disallow a deduction under section 809(d)(5), then a deduction under section 809(d)(6), and finally a deduction under section 809(d)(3). For purposes of applying the 50 percent limitation contained in section 809(d)(6) with respect to a taxable year beginning after December 31, 1961, the amount of the deductions for taxable years beginning before January 1, 1962, shall be determined by applying the priority system contained in subparagraph (1) of this paragraph.

(c) **Illustration of principles.** The operation of the limitation and priority system provided by section 809(f) and this section may be illustrated by the following examples:

Example (1). Assume the following facts with respect to M, a life insurance company, for the taxable year 1958:

Gain from operations computed without regard to the deductions under sec. 809(d)(3), (5), and (6)	$100,000,000
Taxable investment income	83,000,000
Tentative deduction for group life, accident, and health insurance under sec. 809(d)(6)	4,000,000
Tentative deduction for certain nonparticipating contracts under sec. 809(d)(5)	6,000,000
Tentative deduction for dividends to policyholders under sec. 809(d)(3)	10,000,000

In order to determine the limitation on the deductions under section 809(d)(3), (5), and (6), M would make up the following schedule:

(1) Statutory amount provided under sec. 809(f)(1)		$250,000
(2) Gain from operations computed without regard to the deductions under sec. 809(d)(3), (5), and (6)	$100,000,000	
(3) Taxable investment income	83,000,000	

(4) Excess of item (2) over item (3)	$17,000,000
(5) Limitation on deductions under sec. 809(d)(3), (5), and (6) (item (1) plus item (4))	17,250,000

Since the total tentative deductions under section 809(d)(3), (5), and (6) ($20,000,000) exceeds the limitation on such deductions ($17,250,000), M would make up the following schedule to determine the application of the priority system:

(6) Maximum possible deduction under sec. 809(d)(3), (5), and (6) (item (5))	$17,250,000
(7) Deduction for group life, accident, and health insurance under sec. 809(d)(6) (not in excess of item (6))	4,000,000
(8) Maximum possible deduction under sec. 809(d)(5) (item (6) less item (7))	13,250,000
(9) Deduction for certain nonparticipating contracts under sec. 809(d)(5) (not in excess of item (8))	6,000,000
(10) Maximum possible deduction under sec. 809(d)(3) (item (8) less item (9))	7,250,000
(11) Deduction for dividends to policyholders under sec. 809(d)(3) (not in excess of item (10))	7,250,000

Thus, as a result of the application of the limitation and priority system for the taxable year 1958, M shall be allowed a deduction of $4,000,000 under section 809(d)(6), $6,000,000 under section 809(d)(5), and only $7,250,000 of the $10,000,000 tentative deduction under section 809(d)(3).

Example (2). The facts are the same as in example (1), except that the taxable year is 1962. Since the total tentative deductions under section 809(d)(3), (5), and (6) ($20,000,000) exceeds the limitation on such deductions ($17,250,000), M would make up the following schedule to determine the application of the priority system:

(1) Maximum possible deductions under sec. 809(d)(3), (5), and (6) (item (5) in example (1))	$17,250,000
(2) Deduction for dividends to policyholders under sec. 809(d)(3) (not in excess of item (1))	10,000,000
(3) Maximum possible deduction under sec. 809(d)(6) (item (1) less item (2))	7,250,000
(4) Deduction for certain accident, health, and group life insurance under sec. 809(d)(6) (not in excess of item (3))	4,000,000
(5) Maximum possible deduction under sec. 809(d)(5) (item (4) less item (5))	3,250,000
(6) Deduction for certain nonparticipating contracts under sec. 809(d)(5) (not in excess of item (5))	3,250,000

Thus, as a result of the application of the limitation and priority system for the taxable year 1962, M shall be allowed a deduction of $10,000,000 under section 809(d)(3), $4,000,000 under section 809(d)(6), and only $3,250,000 of the $6,000,000 tentative deduction under section 809(d)(5).

[T.D. 6535, 26 FR 530, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8688, June 23, 1966]

§ 1.809–8 Limitation on deductions for certain mutualization distributions.

(a) Deduction not to reduce taxable investment income. Section 809(g)(1) limits the deduction under section 809(d)(11) for certain mutualization distributions. This limitation provides that such deduction shall not exceed the amount (if any) by which the gain from operations for the taxable year, computed without regard to such deduction (but after the application of the limitation contained in section 809(f) and § 1.809–7), exceeds the taxpayer's taxable investment income for such year.

(b) Deduction not to reduce tax below that imposed by 1957 law. Section 809(g)(2) further limits the deduction under section 809(d)(11). Under section 809(g)(2), such deduction shall be allowed only to the extent that it (after the application of all other deductions) does not reduce the tax imposed by section 802(a)(1) for the taxable year below the amount of tax which would have been imposed for such taxable year if the law in effect for 1957 applied for such taxable year. If such deduction is claimed for 1958 (or 1959), the company shall attach to its return a schedule showing what its tax for 1958 (or 1959) would have been had such tax been computed under the law in effect for 1957.

(c) Application of section 815. Section 809(g)(3) provides that any portion of a distribution which is allowed as a deduction under section 809(d)(11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distributions made in 1959, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(e)(2)(B) (relating to adjustment in allocation ratio for certain distributions after December 31, 1958).

[T.D. 6535, 26 FR 530, Jan. 20, 1961]

§ 1.810–1 Taxable years affected.

Sections 1.810–2 through 1.810–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6535, 26 FR 531, Jan. 20, 1961]

§ 1.810–2 Rules for certain reserves.

(a) Adjustment for decrease or increase in certain reserve items—(1) Adjustment for decrease. Section 810(a) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year exceeds the sum of such items at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the amount of such excess shall be

taken into account as a net decrease referred to in section 809(c)(2) and paragraph (a)(2) of § 1.809–4 in determining gain or loss from operations.

(2) **Adjustment for increase.** Section 810(b) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items at the beginning of the taxable year, the amount of such excess shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations.

(b) **Items taken into account.** The items described in section 810(c) and referred to in section 810(a) and (b) and paragraph (a) of this section are:

(1) The life insurance reserves (as defined in section 801(b) and § 1.801–4);

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2) and § 1.801–5;

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this subparagraph) life, health, or accident contingencies;

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto); and

(5) Premiums received in advance, and liabilities for premium deposit funds.

(6) Special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

For purposes of this paragraph, the same item shall be counted only once and deficiency reserves (as defined in section 801(b)(4) and paragraph (e)(4) of § 1.801–4) shall not be taken into account.

(c) **Special rules.** For purposes of section 810(a) and (b) and paragraph (a) of this section, in determining whether there is a net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year, the following rules shall apply:

(1) **Computation of net increase or decrease in reserves.** The sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year shall be the aggregate of the sums of each of such items at the beginning of the taxable year. The sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year shall be the aggregate of the sums of each of such items at the end of the taxable year. However, in order to determine whether there is a net increase or decrease in such items for the taxable year, the aggregate of the sums of the items at the end of the taxable year must first be reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1).

(2) **Effect of change in basis in computing reserves.** Any increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810(a) or (b) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of § 1.810–3.

(3) **Effect of section 818(c) election.** If a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), the sum of such reserves at the beginning and end of all taxable years (including the first taxable year) for which the election applies shall be the sum of such reserves computed on such net level premium basis.

(4) **Cross references.** For taxable years beginning before January 1, 1970, see section 810(e) (as in effect for such years) and § 1.810–4 for special rules for determining the net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section in the case of certain voluntary employees' beneficiary associations. For similar special rules in the case of life insurance companies issuing variable annuity contracts, see section 801(g)(4) and the regulations thereunder.

(d) Illustration of principles. The provisions of section 810(a) and (b) and this section may be illustrated by the following examples:

Example (1). Assume the following facts with respect to R, a life insurance company:

Sum of items described in section 810(c)(1) through (6) at beginning of taxable year ...	$940
Sum of items described in section 810(c)(1) through (6) at end of taxable year.........	1,060
Required interest (as defined in section 809(a)(2))	70
Investment yield (as defined in section 804(c))	100
Amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)	70

In order to determine the adjustment for decrease or increase in the sum of the items described in section 810(c) for the taxable year, R must first reduce the sum of such items at the end of the taxable year ($1,060) by the amount of investment yield ($70) not included in gain or loss from operations for the taxable year by reason of section 809(a)(1). Since the adjusted sum of such items at the end of the taxable year, $990 ($1,060 minus $70), exceeds the sum of such items at the beginning of the taxable year, $940, the excess of $50 ($990 minus $940) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations.

Example (2). Assume the facts are the same as in example (1), except that the sum of the items described in section 810(c) at the beginning of the taxable year is $1000. Since the sum of the items described in section 810(c) at the beginning of taxable year, $1000, exceeds the sum of such items at the end of the taxable year after adjustment for the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), $990 ($1060 minus $70), the excess of $10 ($1000 minus $990) shall be taken into account as a net decrease under section 809(c)(2) and paragraph (a)(2) of § 1.809–4 in determining gain or loss from operations.

Example (3). Assume the following facts with respect to S, a life insurance company:

Sum of items described in section 810(c)(1) through (6) at beginning of taxable year ...	$1,970
Sum of items described in section 810(c)(1) through (6) at the end of taxable year	2,040
Required interest (as defined in section 809(a)(2))	60
Investment yield (as defined in section 804(c))	40
Amount of investment yield not included in gain or loss from operations by reason of section 809(a)(1)	40

Under the provisions of section 809(a)(1), since the required interest ($60) exceeds the investment yield ($40), the share of each and every item of investment yield set aside for policyholders and not included in gain or loss from operations for the taxable year shall be 100 percent. Thus, applying the provisions of section 810(a) and (b), the sum of the items described in section 810(c) at the end of the taxable year ($2,040) must first be reduced by the entire amount of the investment yield ($40) in order to determine the net increase or decrease in the sum of such items for the taxable year. Since the adjusted sum of such items at the end of the taxable year, $2,000 ($2,040 minus $40), is greater than the sum of such items at the beginning of the taxable year, $1,970, the excess of $30 ($2,000 minus $1,970) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations. No additional deduction is allowed under section 809(d) for the amount ($20) by which the required interest exceeds the investment yield for the taxable year.

Example (4). Assume the facts are the same as in example (1), except that as a result of a change in the basis used in computing an item described in section 810(c) during the taxable year, the sum of such items at the end of the taxable year is $1,200. Under the provisions of paragraph (c)(2) of this section, any increase or decrease in the sum of the section 810(c) items for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810(a) and (b). Thus, for purposes of section 810(a) and (b), the sum of the items described in section 810(c) at the end of the taxable year shall be $1,060 (the amount computed without regard to the change in basis) and S shall treat the $50 computed in the manner described in example (1) as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations for the taxable year. The amount of the increase in the section 810(c) items which is attributable to the change in basis during the taxable year, $140 ($1,200 minus $1,060), shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of § 1.810–3.

Example (5). The life insurance reserves of M, a life insurance company, computed with respect to contracts for which such reserves are determined on a recognized preliminary term basis amount to $100 on January 1, 1960, and $110 on December 31, 1960. For the taxable year 1960, M elects to revalue such reserves on a net level premium basis under section 818(c). Such reserves computed under section 818(c) amount to $115 on January 1, 1960, and $127 on December 31, 1960. Under the provisions of paragraph (c)(3) of this section, a company which makes the section 818(c) election must use the net level premium basis in computing the sum of its life insurance reserves at the beginning and end of all taxable years for which the election applies. Thus, for purposes of section 810(a) and (b), in determining whether there is a net increase or decrease in the sum of the section 810(c) items for the taxable year 1960, M shall include $115 as its reserves with respect to such contracts under section 810(c)(1) at the beginning of the taxable year and $127 as its reserves with respect to such contracts under section 810(c)(1) at the end of the taxable year.

[T.D. 6535, 26 FR 531, Jan. 20, 1961, as amended by T.D. 7163, 37 FR 4189, Feb. 29, 1972; T.D. 7172, 37 FR 5619, March 17, 1972]

§ 1.810–3 Adjustment for change in computing reserves.

(a) Reserve strengthening or weakening. Section 810(d)(1) provides that if the basis for determining any item referred to in section 810(c) and paragraph (b) of § 1.810–2 at the end of any taxable year differs from the basis for such determination at the end of the preceding taxable year, then so much of the difference between—

(1) The amount of the item at the end of the taxable year, computed on the new basis, and

(2) The amount of the item at the end of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account as follows:

(i) If the amount of the item at the end of the taxable year computed on the new basis exceeds the amount of the item at the end of the taxable year computed on the old basis, 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years as a net increase to which section 809(d)(2) and paragraph (a)(2) of § 1.809–5 applies; or

(ii) If the amount of the item at the end of the taxable year computed on the old basis exceeds the amount of the item at the end of the taxable year computed on the new basis, 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) and paragraph (a)(2) of § 1.809–4 applies.

(b) Illustration of principles. The provisions of section 810(d)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example (1). Assume that the amount of an item described in section 810(c) of L, a life insurance company, at the beginning of the taxable year 1959 is $100. Assume that at the end of the taxable year 1959, as a result of a change in the basis used in computing such item during the taxable year, the amount of the item (computed on the new basis) is $200 but computed on the old basis would have been $150. Since the amount of the item at the end of the taxable year computed on the new basis, $200, exceeds the amount of the item at the end of the taxable year computed on the old basis, $150, by $50, 1/10 of the amount of such excess, or $5, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1959. Any increase (or decrease) in the sum of the section 810(c) items computed on the old basis at the end of the taxable year 1959 ($150) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items computed on the old basis at the beginning of the taxable year 1959 ($100), shall be taken into account in the manner prescribed in section 810(a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1959.

Example (2). Assume the facts are the same as in example (1), and that the sum of the items described in section 810(c) (computed on the new basis) is $200 on January 1, 1960, and $260 on December 31, 1960. Under the provisions of section 810(d)(1), as a result of the reserve strengthening attributable to the change in basis which occurred in 1959, L would include $5 (computed in the manner described in example (1)) as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations for 1960. In addition to this amount, any increase (or decrease) in the sum of the items described in section 810(c) at the end of the taxable year 1960 ($260) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items at the beginning of the taxable year 1960 ($200), shall be taken into account in the manner prescribed in section 810(a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1960.

(c) Termination as life insurance company. Section 810(d)(2) provides, subject to the provisions of section 381(c)(22) and the regulations thereunder (relating to carryovers in certain corporate readjustments), that if for any taxable year a company which previously was a life insurance company no longer meets the requirements of section 801(a) and paragraph (b) of § 1.801–3 (relating to the definition of a life insurance company), the balance of any adjustments remaining to be made under section 810(d)(1) and paragraph (a) of this section shall be taken into account for the preceding taxable year.

(d) Illustration of principles. The provisions of section 810(d)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume the facts are the same as in example (1) of paragraph (b) of this section, except that for the taxable year 1962, L no longer meets the requirements of section 801(a) (relating to the definition of a life insurance company) and that the provisions of section 381(c)(22) are not applicable. Under the provisions of section 810(d)(2), the entire balance of the adjustment remaining to be made with respect to the change in basis which occurred in 1959, 8/10 of $50, or $40, shall be taken into account for the taxable year 1961, the last year L was a life insurance company. Thus, for the taxable year 1961, the total amount to be taken into account by L as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations shall be $45. Of this amount, $5 (1/10 of $50) represents the amount determined under the provisions of section 810(d)(1), and $40 represents the amount determined under the provisions of section 810(d)(2).

(e) Effect of preliminary term election. (1) Section 810(d)(3) provides that if a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), such election shall not be treated as a change in basis within the meaning of section 810(d)(1) and paragraph (a) of this section. Thus, any increase or decrease in reserves attributable to such election shall not be taken into account under section 810(d)(1) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810(a) and (b) and paragraph (a) of § 1.810–2. See paragraph (c)(3) of § 1.810–2.

(2) Section 810(d)(3) further provides that where an election under section 818(c) would apply to an item referred to in section 810(c) but for the fact that the basis used in computing such item has actually been changed, any increase or decrease in such item attributable to such actual change in basis shall be subject to the adjustment required under section 810(d)(1) and paragraph (a) of this section. In such a case, however, for

purposes of section 810(d)(1)(B) and paragraph (a)(2) of this section, the amount of such item at the end of the taxable year computed on the old basis shall be the amount of such item at the end of the taxable year computed as if the election under section 818(c) applied in respect of such item for the taxable year.

(f) Illustration of principles. The provisions of section 810(d)(3) and paragraph (e) of this section may be illustrated by the following examples:

Example (1). Assume that S, a life insurance company which computes its life insurance reserves on a 3-percent assumed rate and the Commissioner's reserve valuation method (one of the recognized preliminary term reserve methods), elects to revalue such reserves on a net level premium method under section 818(c) and that the significant facts are as follows:

	Jan. 1, 1958	Dec. 31, 1958
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	100	118
Reserves at 3-percent assumed rate, after restatement under section 818(c)	110	131

Under the provisions of section 810(d)(3), an election under section 818(c) is not treated as a change in basis for purposes of section 810(d)(1). Accordingly, the increase of $21 ($131 minus $110) attributable to such election shall not be subject to the adjustment provided by section 810(d)(1) but shall be taken into account in the manner prescribed in section 810(b). For purposes of determining the amount to be taken into account under section 810(b), the reserves with respect to the contracts subject to the section 818(c) election shall be $110 at the beginning of the taxable year 1958 and $131 at the end of the taxable year 1958. However, as a result of making the election under section 818(c), the difference ($10) between the reserves computed on the preliminary term basis on January 1, 1958 ($100) and the reserves restated on the net level premium basis on January 1, 1958 ($110) shall not be taken into account under section 809(d) for the year 1958, or for any subsequent taxable year.

Example (2). Assume the facts are the same as in example (1), except that during the taxable year 1959, S actually changed from the preliminary term basis to a net level premium basis which was identical with the net level premium basis used under the section 818(c) election and that the significant facts are as follows:

	Jan. 1, 1959	Dec. 31, 1959
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	118	127
Reserves at 3-percent assumed rate, after restatement under section 818(c)	131	142
Strengthened reserves at 3-percent assumed rate and net level premium method	......	142

Under the provisions of section 810(d)(3), if a company which has made an election under section 818(c) which has not been revoked actually changes the basis used by it in computing the reserves subject to such election, any increase or decrease in reserves attributable to such change in basis shall be taken into account in the manner prescribed in section 810(d)(1). Since S actually changed to the same basis which it used in computing its reserves under section 818(c), the reserves at the end of the taxable year computed on the new basis ($142) are the same as the reserves at the end of the taxable year computed on the old basis ($142), *i.e.*, the basis which would have applied under section 818(c) if the election applied for 1959. Accordingly, no adjustment under section 810(d)(1) is required.

Example (3). Assume the facts are the same as in example (1), except that during the taxable year 1960, S actually changed the basis used by it in computing its reserves on a certain block of contracts subject to the election under section 818(c) and that the significant facts with respect to this block of contracts are as follows:

	Jan. 1, 1960	Dec. 31, 1960
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	50	63
Reserves at 3-percent assumed rate, after restatement under section 818(c)	60	75
Strengthened reserves at 2-percent assumed rate and net level premium method	......	95

Under the provisions of section 810(d)(3), the amount of the reserves subject to the section 818(c) election at the end of the taxable year computed on the old basis shall be the amount of such reserves at the end of the taxable year determined under section 818(c) ($75). Since the reserves at the end of the taxable year computed on the new basis, $95, exceed the reserves at the end of the taxable year computed on the old basis, $75, by $20, 1/10 of the excess of $20, or $2, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1960. For purposes of determining whether there is a net increase or decrease in the sum of the items described in section 810(c) for the taxable year 1960 under section 810(a) or (b), the sum of the reserves with respect to such block of contracts shall be $60 at the beginning of the taxable year and $75 at the end of the taxable year (the amount of such reserves computed under section 818(c) at the beginning and end of the taxable year). The difference ($10) between the reserves computed on the preliminary term basis on January 1, 1960 ($50) and the reserves restated on the net level premium basis on January 1, 1960 ($60) shall not be taken into account under section 809(d) for the year 1960, or for any subsequent taxable year.

[T.D. 6535, 26 FR 532, Jan. 20, 1961]

§ 1.810–4 Certain decreases in reserves of voluntary employees' beneficiary associations.

(a) Decreases due to voluntary lapses of policies issued before January 1, 1958. (1) Section 810(e) provides that if for any taxable year a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes an election in the

manner provided in section 810(e)(3) and paragraph (b) of this section, only 11½ percent of any decrease in life insurance reserves (as defined in section 801(b) and § 1.801–4) attributable to the voluntary lapse on or after January 1, 1958, of any policy issued prior to that date shall be taken into account under section 810(a) or (b) and paragraph (a) of § 1.810–2 in determining the net increase or decrease in the sum of the items described in section 810(c) during the taxable year. In applying the preceding sentence, the decrease in the reserve for any policy shall be determined by reference to the amount of such reserve at the beginning of the taxable year, reduced by any amount allowable as a deduction under section 809(d)(1) and paragraph (a)(1) of § 1.809–5 in respect of such policy by reason of such lapse. The election under section 810(e) shall be adhered to in computing the company's gain or loss from operation for the taxable year for which the election is made and for all subsequent taxable years, unless consent to revoke such election is obtained from the Commissioner.

(2) The application of the election provided under section 810(e) and subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, M, a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes the election under section 810(e). Assume the following facts with respect to a policy issued in 1955 which voluntarily lapsed during the taxable year:

(1) Life insurance reserve on January 1, 1960	$600
(2) Amount allowable as a deduction under sec. 809(d)(1)	200
(3) Decrease in life insurance reserves for sec. 810(e) purposes (item (1) minus item (2))	400
(4) Amount taken into account under sec. 810(a) and (b) by reason of sec. 810(e) election (11½% × $400)	46

Under the provisions of section 810(e) and subparagraph (1) of this paragraph, M would include $46 as its life insurance reserve with respect to such policy under section 810(c)(1) at the beginning of the taxable year 1960 for purposes of determining the net increase or decrease in the sum of the items described in section 810(c) for the taxable year under section 810(a) or (b).

(b) Time and manner of making election. The election provided by section 810(e)(3) shall be made in a statement attached to the life insurance company's income tax return for the first taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which the company desires the election to apply falls before January 20, 1961, the election provided by section 810(e)(3) may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before April 21, 1961. The statement shall indicate that the company meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, and has made the election provided under section 810(e) and paragraph (a) of this section. The statement shall set forth the following information with respect to each policy described in paragraph (a) of this section which has voluntarily lapsed during such year:

(1) Type of policy.

(2) Date issued.

(3) Date lapsed.

(4) Reason for lapse.

(5) Policy reserve as of beginning of taxable year.

(6) Deduction allowable under section 809(d)(1) and paragraph (a)(1) of § 1.809–5 during taxable year by reason of lapse.

(7) Decrease in policy reserve for section 810(e) purposes (excess of (5) over (6)).

In addition, the statement shall set forth the total of the amounts referred to in subparagraph (7) of this paragraph with respect to all policies described in paragraph (a) of this section which have voluntarily lapsed during the taxable year.

(c) Scope of election. An election made under section 810(e)(3) and paragraph (a) of this section shall be effective for the taxable year for which made and for all succeeding taxable years, unless consent to revoke the election is obtained from the Commissioner. However, for taxable years beginning prior to January 20, 1961, a company may revoke the election provided by section 810(e)(3) without obtaining consent from the Commissioner by filing, before April 21, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(d) Disallowance of carryovers from pre-1958 losses from operations. For any taxable year for which the election provided under section 810(e)(3) and paragraph (b) of this section is

effective, the provisions of section 812(b)(1) and § 1.812–4 shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(e) Effective date; cross reference. The provisions of section 810(e) (as in effect for such years) and this section apply only with respect to taxable years beginning before January 1, 1970. For provisions relating to certain funded pension trusts applicable to taxable years beginning after December 31, 1969, see section 501(c)(18) and the regulations thereunder.

[T.D. 6535, 26 FR 533, Jan. 20, 1961, as amended by T.D. 7172, 37 FR 5619, March 17, 1972]

§ 1.811–1 Taxable years affected.

Section 1.811–2, except as otherwise provided therein, is applicable only to taxable years beginning after December 31, 1957, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6535, 26 FR 534, Jan. 20, 1961]

§ 1.811–2 Dividends to policyholders.

(a) Dividends to policyholders defined. Section 811(a) defines the term "dividends to policyholders", for purposes of Part I, Subchapter L, Chapter 1 of the Code, to mean dividends and similar distributions to policyholders in their capacity as such. The term includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management. In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which during the taxable year contains a right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders. Similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company. However, the term does not include interest paid (as defined in section 805(e) and paragraph (b) of § 1.805–8) or return premiums (as defined in section 809(c) and paragraph (a)(1)(ii) of § 1.809–4). Thus, so-called excess-interest dividends and amounts returned by one life insurance company to another in respect of reinsurance ceded shall not be treated as dividends to policyholders even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of the management.

(b) Amount of deduction—(1) In general. Section 811(b)(1) provides, subject to the limitation of section 809(f), that the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders paid during the taxable year—

(i) Increased by the excess of the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, or

(ii) Decreased by the excess of the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year.

For the rule as to when dividends are considered paid, see section 561 and the regulations thereunder. For the determination of the amounts held as reserves for dividends to policyholders, see paragraph (c) of this section. For special provisions relating to the treatment of dividends to policyholders paid with respect to policies reinsured under modified coinsurance contracts, see section 820(c)(5) and the regulations thereunder.

(2) Certain amounts to be treated as net decreases. Section 811(b)(2) provides that if the amount determined under subparagraph (1)(ii) of this paragraph exceeds the dividends to policyholders paid during the taxable year, the amount of such excess shall be a net decrease referred to in section 809(c)(2).

(c) Reserves for dividends to policyholders defined—(1) In general. The term "reserves for dividends to policyholders", as used in section 811(b)(1)(A) and (B) and paragraph (b)(1) of this section, means only those amounts—

(i) Actually held, or set aside as provided in subparagraph (2) of this paragraph and thus treated as actually held, by the company at the end of the taxable year, and

(ii) With respect to which, at the end of the taxable year or, if set aside, within the period prescribed in subparagraph (2) of this paragraph, the company is under an obligation, which is either fixed or determined according to a formula

which is fixed and not subject to change by the company, to pay such amounts as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following the taxable year.

(2) Amounts set aside. (i) In the case of a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), all amounts set aside before the 16th day of the 3rd month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(ii) In the case of a mutual savings bank subject to the tax imposed by section 594, all amounts set aside before the 16th day of the 4th month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(3) 1958 reserve for dividends to policyholders. For purposes of section 811(b) and paragraph (b) of this section, the amounts held at the end of 1957 as reserves for dividends to policyholders payable during 1958 shall be determined as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied for 1957. Any adjustment in the reserves for dividends to policyholders at the beginning of 1957 required as a result of an understatement or overstatement of such reserves by the company shall be made to the balance of such reserves as of the beginning of 1957. For example, if at the beginning of 1957 the reserves for dividends to policyholders are stated to be $100 and it is subsequently determined that such reserves should have been $90, the reserves at the beginning of 1957 shall be reduced by $10. Under no circumstances shall an adjustment required with regard to the beginning 1957 reserves be made to the reserves at the end of 1957.

(4) Information to be filed. Every company claiming a deduction for dividends to policyholders shall keep such permanent records as are necessary to establish the amount of dividends actually paid during the taxable year. Such company shall also keep a copy of the dividend resolution and any necessary supporting data relating to the amounts of dividends declared and to the amounts held or set aside as reserves for dividends to policyholders during the taxable year. The company shall file with its return a concise statement of the pertinent facts relating to its dividend policy for the year, the amount of dividends actually paid during the taxable year, and the amounts held or set aside as reserves for dividends to policyholders during the taxable year.

(d) Illustration of principles. The provisions of section 811(b) and this section may be illustrated by the following examples:

Example (1). On December 31, 1959, M, a life insurance company, held $200 as reserves for dividends to policyholders due and payable in 1960. On March 10, 1960, M set aside an additional $50 as reserves for dividends to policyholders due and payable in 1960. During the taxable year 1960, M paid $240 as dividends to its policyholders and at the end of the taxable year 1960, held $175 as reserves for dividends to policyholders due and payable in 1961. No additional amount was set aside before March 16, 1961, as reserves for dividends to policyholders due and payable in 1961. For the taxable year 1960, subject to the limitation of section 809(f), M's deduction for dividends to policyholders is $165, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1960		$240
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–59 (including amounts set aside as provided in paragraph (c)(2) of this section)	$250	
(b) Reserves for dividends to policyholders as of 12–31–60	175	
		75
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		$165

Example (2). On December 31, 1960, S, a life insurance company, held $100 as reserves for dividends to policyholders due and payable in 1961. During the taxable year 1961, S paid $125 as dividends to its policyholders and at the end of the taxable year 1961, held $110 as reserves for dividends to policyholders due and payable in 1962. No additional amount was set aside for dividends to policyholders as provided in paragraph (c)(2) of this section before March 16, 1961, or March 16, 1962. For the taxable year 1961, subject to the limitation of section 809(f), S's deduction for dividends to policyholders is $135, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Increased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–61	$110	
(b) Reserves for dividends to policyholders as of 12–31–60	100	
		10
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f)).		$135

Example (3). Assume the facts are the same as in example (2), except that on December 31, 1960, the amount held as reserves for dividends to policyholders due and payable in 1961 is $250. For the taxable year 1961, S's deduction for dividends to policyholders is zero, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12-31-60	$250	
(b) Reserves for dividends to policyholders as of 12-31-61	110	
		140
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f)).		$0

Under the provisions of section 811(b)(2) and paragraph (b)(2) of this section, since the decrease in the reserves for dividends to policyholders during the taxable year, $140 ($250 minus $110), exceeds the dividends to policyholders paid during the taxable year 1961, $125, S shall include $15 (the amount of such excess) as a net decrease under section 809(c)(2) and paragraph (a)(2) of § 1.809-4 in determining its gain or loss from operations for 1961.

[T.D. 6535, 26 FR 534, Jan. 20, 1961]

§ 1.812-1 Taxable years affected.

Sections 1.812-2 through 1.812-8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6535, 26 FR 532, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.812-2 Operations loss deduction.

(a) **Allowance of deduction.** Section 812 provides that a life insurance company shall be allowed a deduction in computing gain or loss from operations for any taxable year beginning after December 31, 1957, in an amount equal to the aggregate of the operations loss carryovers and operations loss carrybacks to such taxable year. This deduction is referred to as the operations loss deduction. The loss from operations (computed under section 809), is the basis for the computation of the operations loss carryovers and operations loss carrybacks and ultimately for the operations loss deduction itself. Section 809(e)(5) provides that the net operating loss deduction provided in section 172 shall not be allowed a life insurance company since the operations loss deduction provided in section 812 and this paragraph shall be allowed in lieu thereof.

(b) **Steps in computation of operations loss deduction.** The three steps to be taken in the ascertainment of the operations loss deduction for any taxable year beginning after December 31, 1957, are as follows:

(1) Compute the loss from operations for any preceding or succeeding taxable year from which a loss from operations may be carried over or carried back to such taxable year.

(2) Compute the operations loss carryovers to such taxable year from such preceding taxable years and the operations loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such operations loss carryovers and carrybacks in order to determine the operations loss deduction for such taxable year.

(c) **Statement with tax return.** Every life insurance company claiming an operations loss deduction for any taxable year shall file with its return for such year a concise statement setting forth the amount of the operations loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the operations loss deduction.

(d) **Ascertainment of deduction dependent upon operations loss carryback.** If a life insurance company is entitled in computing its operations loss deduction to a carryback which it is not able to ascertain at the time its return is due, it shall compute the operations loss deduction on its return without regard to such operations loss carryback. When the life insurance company ascertains the operations loss carryback, it may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the operations loss deduction for the taxable year with the inclusion of such carryback; or it may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) **Law applicable to computations.** The following rules shall apply to all taxable years beginning after December 31, 1957—

(1) In determining the amount of any operations loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The loss from operations for any taxable year shall be determined under the law applicable

to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the operations loss deduction.

(3) The amount of the operations loss deduction which shall be allowed for any taxable year shall be determined under the law applicable for that year.

(f) **Special rules.** For purposes of taxable years beginning after December 31, 1954, and before January 1, 1958—

(1) The amount of any:

(i) Loss from operations;

(ii) Operations loss carryback; and

(iii) Operations loss carryover

shall be computed as if Part I, Subchapter L, Chapter 1 of the Code (as in effect for 1958) and section 381(c)(22) applied to such taxable years.

(2) A loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph) for such taxable years shall in no way affect the tax liability of any life insurance company for such taxable years. However, such loss may, to the extent allowed as an operations loss carryover under section 812, affect the tax liability of a life insurance company for a taxable year beginning after December 31, 1957. For example, for the taxable year 1956, X, a life insurance company, has a loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph). Such loss shall in no way affect X's tax liability for the taxable years 1956 (the year of the loss), 1955 (a year to which such loss shall be carried back), or 1957 (a year to which such loss shall be carried forward). However, to the extent allowed under section 812, any amount of the loss for 1956 remaining after such carryback and carryforward shall be taken into account in determining X's tax liability for taxable years beginning after December 31, 1957.

[T.D. 6535, 26 FR 536, Jan. 20, 1961]

§ 1.812–3 Computation of loss from operations.

(a) **Modification of deductions.** A loss from operations is sustained by a life insurance company in any taxable year, if and to the extent that, for such year, there is an excess of the sum of the deductions provided by section 809(d) over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) as determined under section 809(b)(3), and (2) the sum of the items of gross amount taken into account under section 809(c). In determining the loss from operations for purposes of section 812—

(i) No deduction shall be allowed under section 812 for the operations loss deduction.

(ii) The 85 percent limitation on dividends received provided by section 246(b) as modified by section 809(d)(8)(B) shall not apply to the deductions otherwise allowed under—

(a) Section 243(a) in respect to dividends received by corporations,

(b) Section 244 in respect of dividends received on certain preferred stock of public utilities, and

(c) Section 245 in respect of dividends received from certain foreign corporations.

(b) **Illustration of principles.** The application of paragraph (a) of this section may be illustrated by the following example:

Example. For the taxable year 1960, X, a life insurance company, has items taken into account under section 809(c) amounting to $150,000, its share of the investment yield amounts to $250,000, and total deductions allowed by section 809(d) of $375,000, exclusive of any operations loss deduction and exclusive of any deduction for dividends received. In 1960, X received as its share of dividends entitled to the benefits of section 243(a) the amount of $100,000. These dividends are included in X's share of the investment yield. X has no other deductions to which section 812(c) applies. On the basis of these facts, X has a loss from operations for the taxable year 1960 of $60,000, computed as follows:

Deductions for 1960	$375,000
Plus: Deduction for dividends received computed without regard to the limitation provided by sec. 246(b), as modified by sec. 809(d)(8)(B) (85% of $100,000)	85,000
Total deductions as modified by sec. 812(c)	460,000
Less: Sum of sec. 809(c) items and X's share of investment yield (including $100,000 of dividends)	400,000
Loss from operations for 1960	(60,000)

[T.D. 6535, 26 FR 536, Jan. 20, 1961]

§ 1.812–4 Operations loss carrybacks and operations loss carryovers.

(a) **In general—(1) Years to which loss may be carried.** In order to compute the operations loss deduction of a life insurance company the company must first determine the part of any losses from operations for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. Except as otherwise provided by this paragraph, a loss from operations for

taxable years beginning after December 31, 1954, shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 5 taxable years succeeding the loss year. Except as limited by section 812(e)(2) and paragraph (b) of § 1.812-6, if the life insurance company is a new company (as defined in section 812(e)(1)) for the loss year, the loss from operations shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 8 taxable years succeeding the loss year. In determining the span of years for which a loss from operations may be carried, taxable years in which a company does not qualify as a life insurance company (as defined in section 801(a)), or is not treated as a new company, shall be taken into account.

(2) **Special transitional rules.** (i) A loss from operations for any taxable year beginning before January 1, 1958, shall not be carried back to any taxable year beginning before January 1, 1955. Furthermore, a loss from operations for any taxable year beginning after December 31, 1957, shall not be carried back to any taxable year beginning before January 1, 1958.

(ii) If for any taxable year a life insurance company has made an election under section 810(e) (relating to certain decreases in reserves for voluntary employees' beneficiary associations) which is effective for such taxable year, the provisions of section 812(b)(1) and subparagraph (1) of this paragraph shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(3) **Illustration of principles.** The provisions of section 812(b)(1) and of this paragraph may be illustrated by the following examples:

Example (1). P, a life insurance company, organized in 1940, has a loss from operations of $1,000 in 1958. This loss cannot be carried back, but shall be carried forward to each of the 5 taxable years following 1958.

Example (2). Q, a life insurance company, organized in 1940, has a loss from operations of $1,200 in 1959. This loss shall be carried back to the taxable year 1958 and then shall be carried forward to each of the 5 taxable years following 1959.

Example (3). R, a life insurance company, organized in 1940, has a loss from operations of $1,300 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then shall be carried forward to each of the 5 taxable years following 1956. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied to such taxable years.

Example (4). S, a life insurance company, organized in 1958 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,400 for the taxable year 1958. This loss cannot be carried back, but shall be carried forward to each of the 8 taxable years following 1958, provided, however, S is not a nonqualified corporation at any time during the loss year (1958) or any taxable year thereafter.

Example (5). T, a life insurance company, organized in 1954 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,500 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then carried forward to each of the 8 taxable years following 1956, provided, however, T is not a nonqualified corporation at any time during the loss year (1956) or any taxable year thereafter. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I of subchapter L (as in effect for 1958) applied to such taxable years.

(4) **Periods of less than 12 months.** A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 812 the first, second, etc., preceding or succeeding taxable year. For the determination of the loss from operations for periods of less than 12 months, see section 818(d) and the regulations thereunder.

(5) **Amount of loss to be carried.** The amount which is carried back or carried over to any taxable year is the loss from operations to the extent it was not absorbed in the computation of gain from operations for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the gain from operations for any such preceding taxable year, the various operations loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the gain from operations in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(6) **Corporate acquisitions.** For the computation of the operations loss carryovers in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

(b) **Portion of loss from operations which is a carryback or a carryover to the taxable year in issue—(1) Manner of computation.** (i) A loss from operations shall first be carried back to the earliest taxable year permissible under section 812(b) and paragraph (a) of this section for which such loss is allowable as a carryback or a carryover. The entire amount of the loss from operation shall be carried back to such earliest year.

(ii) Section 812(b)(2) provides that the portion of the loss from operations which shall be carried to each of the taxable years subsequent to the earliest taxable year shall be the excess (if any) of

the amount of the loss from operations over the sum of the offsets (as defined in section 812(d) and paragraph (a) of § 1.812–5) for all prior taxable years to which the loss from operations may be carried.

(2) Illustration of principles. The application of this paragraph may be illustrated by the following example:

Example. T, a life insurance company (which is not a new company as defined in section 812(e)(1)), has a loss from operations for 1960. The entire amount of the loss from operations for 1960 shall first be carried back to 1958. The amount of the carryback to 1959 is the excess (if any) of the 1960 loss over the offset for 1958. The amount of the carryover to 1961 is the excess (if any) of the 1960 loss over the sum of the offsets for 1958 and 1959. The amount of the 1960 loss remaining (if any) to be carried over to 1962, 1963, or 1964 shall be computed in a like manner.

[T.D. 6535, 26 FR 537, Jan. 20, 1961]

§ 1.812–5 Offset.

(a) Offset defined. Section 812(d) defines the term "offset" for purposes of section 812(b)(2) and paragraph (b)(1)(ii) of § 1.812–4. For any taxable year the offset is only that portion of the increase in the operations loss deduction for the taxable year which is necessary to reduce the life insurance company taxable income (computed without regard to section 802(b)(3)) for such year to zero. For purposes of the preceding sentence, the offset shall be determined with the modifications prescribed in paragraph (b) of this section. Such modifications shall be made independently of, and without reference to, the modifications required by paragraph (a) of § 1.812–3 for purposes of computing the loss from operations itself.

(b) Modifications—(1) Operations loss deduction—(i) In general. Section 812(d)(2) provides that for purposes of section 812(d)(1) (relating to the definition of offset), the operations loss deduction for any taxable year shall be computed by taking into account only such losses from operations otherwise allowable as carryovers or as carrybacks to such taxable year as were sustained in taxable years preceding the taxable year in which the life insurance company sustained the loss from operations from which the offset is to be deducted. Thus, for such purposes the loss from operations for the loss year or for any taxable year thereafter shall not be taken into account.

(ii) Illustration of principles. The provisions of this subparagraph may be illustrated by the following example:

Example. In computing the operations loss deduction for 1960, Y, a life insurance company, has a carryover from 1958 of $9,000, a carryover from 1959 of $6,000, a carryback from 1961 of $18,000, and a carryback from 1962 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the operations loss deduction for 1960, for purposes of determining the tax liability for 1960, is $43,000. However, in computing the offset for 1960 which is subtracted from the loss from operations for 1961 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the operations loss deduction for 1960 is $15,000, that is, the aggregate of the $9,000 carryover from 1958 and the $6,000 carryover from 1959. In computing the operations loss deduction for such purpose, the $18,000 carryback from 1961 and the $10,000 carryback from 1962 are disregarded. In computing the offset for 1960, however, which is subtracted from the loss from operations for 1962 for the purpose of determining the portion of such 1962 loss which may be carried over for subsequent taxable years, the operations loss deduction for 1960 is $33,000, that is, the aggregate of the $9,000 carryover from 1958, the $6,000 carryover from 1959, and the $18,000 carryback from 1961. In computing the operations loss deduction for such purpose, the $10,000 carryback from 1962 is disregarded.

(2) Recomputation of deductions limited by section 809(f)—(i) In general. If in any taxable year a life insurance company has deductions under section 809(d)(3), (5), and (6), as limited by section 809(f), and sustains a loss from operations in a succeeding taxable year which may be carried back as an operations loss deduction, such limitation and deductions shall be recomputed. This recomputation is required since the carryback must be taken into account for purposes of determining such limitation and deductions.

(ii) Illustration of principles. The provisions of this subparagraph may be illustrated by the following example:

(a) Facts. The books of P, a life insurance company, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1959......	$9,000,000	$10,000,000	....
1960..			($9,800,000)

The gain from operations thus shown is computed without regard to any operations loss deduction or deductions under section 809(d)(3), (5), and (6), as limited by section 809(f). Assume that for the taxable year 1959, P has (without regard to the limitation of section 809(f) or the operations loss deduction for 1959) a deduction under section 809(d)(3) of $2,500,000 for dividends to policyholders and no deductions under section 809(d)(5) or (6).

(b) Determination of section 809(f) limitation and deduction for dividends to policyholders without regard to the operations loss deduction for 1959. In order to determine gain or loss from operations for 1959, P must determine the deduction for dividends to policyholders for such year. Under the provisions of section 809(f), the amount of such deduction shall not exceed the sum of (1) the amount (if any) by which the gain from operations for such year (determined without regard to such deduction) exceeds P's taxable investment income for such year, plus (2) $250,000. Since the gain from operations as thus determined ($10,000,000) exceeds the taxable investment income ($9,000,000) by $1,000,000, the limitation on such deduc-

tion is $1,250,000 ($1,000,000 plus $250,000). Accordingly, only $1,250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year is $8,750,000 ($10,000,000 minus $1,250,000).

(c) Recomputation of section 809(f) limitation and deduction for dividends to policyholders after application of the operations loss deduction for 1959. Since P has sustained a loss from operations for 1960 which shall be carried back to 1959 as an operations loss deduction, it must recompute the section 809(f) limitation and deduction for dividends to policyholders. Taking into account the $9,800,000 operations loss deduction for 1959 reduces gain from operations for such year to $200,000 ($10,000,000 minus $9,800,000). Since the gain from operations as thus determined ($200,000) is less than the taxable investment income ($9,000,000), the limitation on the deduction for dividends to policyholders is $250,000. Thus, only $250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year as thus determined is $9,750,000 ($10,000,000 minus $250,000) since for purposes of this determination the operations loss deduction for 1959 is not taken into account (see section 812(c)(1)). Accordingly, the offset for 1959 is $9,750,000 (the increase in the operations loss deduction for 1959, computed without regard to the carryback for 1960, which reduces life insurance company taxable income for 1959 to zero); thus, the portion of the 1960 loss from operations which shall be carried forward to 1961 is $50,000 (the excess of the 1960 loss ($9,800,000) over the offset for 1959 ($9,750,000)).

(3) Minimum limitation. The life insurance company taxable income, as modified under this paragraph, shall in no case be considered less than zero.

[T.D. 6535, 26 FR 537, Jan. 20, 1961]

§ 1.812–6 New company defined.

Section 812(e) provides that for purposes of part I, subchapter L, chapter 1 of the Code, a life insurance company is a "new company" for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or any predecessor if section 381(c)(22) applies or would have applied if in effect) was authorized to do business as an insurance company.

[T.D. 6535, 26 FR 538, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 7326, 39 FR 35354, Oct. 1, 1974]

§ 1.812–7 Application of subtitle A and subtitle F.

Section 812(f) provides that except as modified by section 809(e) (relating to modifications of deduction items otherwise allowable under subtitle A of the Code) subtitles A and F of the Code shall apply to operations loss carrybacks and carryovers, and to the operations loss deduction, in the same manner and to the same extent that such subtitles apply in respect of net operation loss carrybacks, net operating loss carryovers, and the net operating loss deduction of corporations generally. For the computation of the operations loss carrybacks and carryovers, and of the operations loss deduction in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

[T.D. 6535, 26 FR 539, Jan. 20, 1961]

§ 1.812–8 Illustration of operations loss carrybacks and carryovers.

The application of § 1.812–4 may be illustrated by the following example:

(a) Facts. The books of M, a life insurance company, organized in 1940, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1958	$11,000	$15,000	....
1959	23,000	30,000	....
1960	....	....	($75,000)
1961	25,000	20,000	....
1962	....	....	(150,000)
1963	22,000	30,000	....
1964	40,000	35,000	....
1965	62,000	75,000	....
1966	25,000	17,000	....
1967	39,000	53,000	....

The gain from operations thus shown is computed without regard to any operations loss deduction. The assumption is also made that none of the other modifications prescribed in paragraph (b) of § 1.812–5 apply. There are no losses from operations for 1955, 1956, 1957, 1968, 1969, 1970.

(b) Loss sustained in 1960. The portions of the $75,000 loss from operations for 1960 which shall be used as carrybacks to 1958 and 1959 and as carryovers to 1961, 1962, 1963, 1964, and 1965 are computed as follows:

(1) Carryback to 1958. The carryback to this year is $75,000, that is, the amount of the loss from operations.

(2) Carryback to 1959. The carryback to this year is $60,000 (the excess of the loss for 1960 over the offset for 1958), computed as follows:

Loss from operations	$75,000
Less:	
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	15,000
Carryback	60,000

(3) Carryover to 1961. The carryover to this year is $30,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958 and 1959), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduc-		

tion of the carryback from 1960 or the carryback from 1962)	30,000	
Sum of offsets		45,000
Carryover		30,000

(4) **Carryover to 1962.** The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, and 1961), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	80,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Sum of offsets		65,000
Carryover		10,000

(5) **Carryover to 1963.** The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, 1961, and 1962), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Sum of offsets		65,000
Carryover		10,000

(6) **Carryover to 1964.** The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, and 1963), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	30,000	
Sum of offsets		95,000
Carryover		0

(7) **Carryover to 1965.** The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, 1963, and 1964), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction for the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryover from 1962)	30,000	
Offset for 1964 (the $35,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	35,000	

Sum of offsets		$130,000
Carryover		0

(c) **Loss sustained in 1962.** The portions of the $150,000 loss from operations for 1962 which shall be used as carrybacks to 1959, 1960, and 1961 and as carryovers to 1963, 1964, 1965, 1966, and 1967 are computed as follows:

(1) **Carryback to 1959.** The carryback to this year is $150,000, that is, the amount of the loss from operations.

(2) **Carryback to 1960.** The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the offset for 1959), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0
Carryback	150,000

(3) **Carryback to 1961.** The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959 and 1960), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Sum of offsets		0
Carryback		150,000

(4) **Carryover to 1963.** The carryover to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, and 1961), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Sum of offsets		0
Carryover		150,000

(5) **Carryover to 1964.** The carryover to this year is $130,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, and 1963), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Sum of offsets		20,000
Carryover		130,000

(6) **Carryover to 1965.** The carryover to this year is $95,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, and 1964), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960 the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the		

carryover from 1962 to 1964 not being taken into account)	$35,000	
Sum of offsets		$55,000
Carryover		95,000

(7) **Carryover to 1966.** The carryover to this year is $20,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, and 1965), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover for such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	
Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 to 1960, the carryover from 1962 to 1965 not being taken into account)	$75,000	
Sum of offsets		$130,000
Carryover		20,000

(8) **Carryover to 1967.** The carryover to this year is $3,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, 1965, and 1966), computed as follows:

Loss from operations		$150,000
Less:		
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0	
Offset for 1960 (a year in which a loss from operations was sustained)	0	
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0	
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000	
Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1965 not being taken into account)	75,000	
Offset for 1966 (the $17,000 gain from operations for such year computed without the deduction of the carryover from 1962)	17,000	
Sum of offsets		147,000
Carryover		3,000

(d) **Determination of operations loss deduction for each year.** The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the operations loss deduction in the following manner:

Taxable year	Carryover From 1960	Carryover From 1962	Carryback From 1960	Carryback From 1962	Operations loss deductions
1958	....	....	$75,000	....	$75,000
1959	....	....	60,000	$150,000	210,000
1961	$30,000	....	....	150,000	180,000
1963	10,000	$150,000	....	....	160,000
1964	....	130,000	....	....	130,000
1965	....	95,000	....	....	95,000
1966	....	20,000	....	....	20,000
1967	....	3,000	....	....	3,000

[T.D. 6535, 26 FR 539, Jan. 20, 1961]

Distributions to Shareholders

§ 1.815–1 Taxable years affected.

Sections 1.815–2 through 1.815–6, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), the Act of October 10, 1962 (76 Stat. 808), and the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6535, 26 FR 524, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.815–2 Distributions to shareholders.

(a) In general. Section 815 provides that every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain two special surplus accounts for Federal income tax purposes. These special accounts are the shareholders surplus account (as defined in section 815(b) and § 1.815–3) and the policyholders surplus account (as defined in section 815(c) and § 1.815–4). To the extent that a distribution to shareholders (as defined in paragraph (c) of this section) is treated as being made out of the shareholders surplus account, no tax is imposed on the company with respect to such distribution. However, to the extent that a distribution to shareholders is treated as being made out of the policyholders surplus account, the amount subtracted from the policyholders surplus account by reason of such distribution shall be taken into account in determining life insurance company taxable income under section 802(b).

(b) Priority system for distributions to shareholders. **(1)** For purposes of section 815 (other than subsection (e) thereof relating to certain mutualizations) and section 802(b)(3) (relating to the determination of life insurance company taxable income), any distribution made to shareholders after December 31, 1958, shall be treated in the following manner:

(i) Distributions shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815–3);

(ii) Once the shareholders surplus account has been reduced to zero, distributions shall then be treated as being made out of the policyholders surplus account (as defined in section 815(c) and § 1.815–4) until that account has been reduced to zero; and

(iii) Finally, any distributions in excess of the amounts in the shareholders surplus account and the policyholders surplus account shall be treated as being made out of other accounts (as defined in § 1.815–5).

(2) For purposes of subparagraph (1) of this paragraph, in order to determine whether a distribution (or any portion thereof) shall be treated as being made out of the shareholders surplus account, policyholders surplus account, or other accounts, the amount in such accounts at the end of any taxable year shall be the cumulative balance in such accounts at the end of the taxable year, computed without diminution by reason of a distribution (or any portion thereof) during the taxable year which is treated as being made out of such accounts. For example, on January 1, 1960, S, a stock life insurance company, had $1,000 in its shareholders surplus account and $3,000 in its policyholders surplus account. On November 1, 1960, S distributed $4,000 to its shareholders. Under the provisions of section 815(b)(2) and paragraph (b) of § 1.815–3, S added $5,000 to its shareholders surplus account for the taxable year 1960. Since the distributions to shareholders during the taxable year 1960, $4,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions treated as made out of such account during the taxable year, $6,000 ($1,000 plus $5,000), the entire distribution is treated as being made out of the shareholders surplus account.

(3) Except in the case of a distribution in cash and as otherwise provided herein, the amount to be charged to the special surplus accounts referred to in subparagraph (1) of this paragraph with respect to any distributions to shareholders (as defined in section 815(a) and paragraph (c) of this section) shall be the fair market value of the property distributed, determined as of the date of distribution. However, for the amount of the adjustment to earnings and profits reflecting such distributions, see section 312 and the regulations thereunder. For a special rule relating to the determination of the amount to be charged to such special surplus accounts in the case of a distribution by a foreign life insurance company carrying on a life insurance business within the United States, see section 819(c)(1) and the regulations thereunder.

(c) **Distributions to shareholders defined.** (1) Except as otherwise provided in section 815(f) and subparagraph (2) of this paragraph, the term "distribution", as used in section 815(a) and paragraph (b) of this section, means any distribution of property made by a life insurance company to its shareholders. For purposes of the preceding sentence, the term "property" means any property (including money, securities, and indebtedness to the company) other than stock, or rights to acquire stock, in the company making the distribution. Thus, for example, the term includes a distribution which is considered a dividend under section 316, but is not limited to the extent that such distribution must be made out of the accumulated or current earnings and profits of the company making the distribution. For example, except as otherwise provided in section 815(f) and subparagraph (2) of this paragraph, there is a distribution within the meaning of this paragraph in any case in which a corporation acquires the stock of a shareholder in exchange for property in a redemption treated as a distribution in exchange for stock under section 302(a) or treated as a distribution of property under section 302(d). For special rules relating to distributions to shareholders in acquisition of stock pursuant to a plan of mutualization, see section 815(e) and paragraph (e) of § 1.815–6.

(2) The term "distribution", as used in section 815(a) and paragraph (b) of this section, does not (except for purposes of section 815(a)(3) and (e)(2)(B)) include any distribution in redemption of stock issued prior to January 1, 1958, where such stock was at all times on and after the date of its issuance and on and before the date of its redemption limited as to the amount of dividends payable and was callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of its issue price plus the amount of contribution to surplus (if any) made by the original purchaser at the time of his purchase.

[T.D. 6535, 26 FR 542, Jan. 20, 1961, as amended by T.D. 7189, 37 FR 12793, June 29, 1972]

§ 1.815–3 Shareholders surplus account.

(a) **In general.** Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a shareholders surplus account. This account shall be established as of January 1, 1958, and the beginning or opening balance of the shareholders surplus account on that date shall be zero.

(b) **Additions to shareholders surplus account.** (1) The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1957, shall be the amount by which the sum of:

(i) The life insurance company taxable income (computed without regard to section 802(b)(3)),

(ii) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss, reduced (in the case of a taxable year beginning after December 31, 1961) by the amount referred to in subdivision (i) of this subparagraph,

(iii) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)), the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B)), and the amount of interest excluded from gross income under section 103, and

(iv) The small business deduction provided by section 809(d)(10). Exceeds the taxes imposed for the taxable year by section 802(a), computed without regard to section 802(b)(3).

(c) **Subtractions from shareholders surplus account—(1) In general.** There shall be subtracted from the cumulative balance in the shareholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, the amount which is treated as being distributed out of such account under section 815(a) and paragraph (b) of § 1.815–2.

(2) **Special rule; distributions in 1958.** There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of the distributions to shareholders made by the company during 1958. For example, assume S, a stock life insurance company, had additions to its shareholders surplus account (as determined under section 815(b)(2) and paragraph (b) of this section) for the taxable year 1958 of $10,000, and actually distributed as dividends to its shareholders $8,000 during the year 1958. The balance in S's shareholders surplus account as of January 1, 1959, shall be $2,000. If S had distributed $12,000 as dividends in 1958, the balance in its shareholders surplus account as of January 1, 1959, would be zero and the other accounts referred to in section 815(a)(3) and paragraph (b)(1)(iii) of § 1.815–2 would be reduced by $2,000.

(d) Illustration of principles. The application of section 815(b) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960.

Balance in shareholders surplus account as of 1–1–60	$5,000
Life insurance company taxable income computed without regard to sec. 802(b)(3)	4,000
Excess of net long-term capital gain over net short-term capital loss	1,700
Tax-exempt interest included in gross investment income under sec. 804(b)	100
Small business deduction (determined under sec. 809(d)(10))	200
Tax liability under sec. 802(a)(1) and (2) computed without regard to sec. 802(b)(3)	1,625
Amount distributed to shareholders	9,000

For purposes of determining the amount to be subtracted from its shareholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in shareholders surplus account as of 1–1–60		$5,000
(2) Additions to account:		
(a) Life insurance company taxable income computed without regard to sec. 802(b)(3)	$4,000	
(b) Excess of net long-term capital gain over net short-term capital loss	1,700	
(c) Tax-exempt interest included in gross investment income under sec. 804(b)	100	
(d) Small business deduction (determined under sec. 809(d)(10))	200	
Total	6,000	
Less:		
Tax liability under sec. 802(a)(1) and (2) computed without regard to sec. 802(b)(3)	1,625	
		4,375
(3) Cumulative balance in shareholders surplus account as of 12–31–60 (item (1) plus item (2))		9,375

Since the amount distributed to shareholders during the taxable year, $9,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year, $9,375, under the provisions of section 815(a), the entire distribution shall be treated as being made out of the shareholders surplus account. Thus, $9,000 shall be subtracted from the shareholders surplus account (leaving a balance of $375 in such account at the end of the taxable year) and S shall incur no additional tax liability by reason of the distribution to its shareholders during the taxable year 1960.

[T.D. 6535, 26 FR 542, Jan. 20, 1961, as amended by T.D. 7189, 37 FR 12793, June 29, 1972]

§ 1.815–4 Policyholders surplus account.

(a) In general. Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a policyholders surplus account. This account shall be established as of January 1, 1959, and the beginning or opening balance of the policyholders surplus account on that date shall be zero.

(b) Additions to policyholders surplus account. The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of—

(1) An amount equal to 50 percent of the amount by which the gain from operations for the taxable year exceeds the taxable investment income,

(2) The deduction allowed or allowable under section 809(d)(5) (as limited by section 809(f)) for certain nonparticipating contracts, and

(3) The deduction allowed or allowable under section 809(d)(6) (as limited by section 809(f)) for taxable years beginning before January 1, 1963, for group life and group accident and health insurance contracts, and for taxable years beginning after December 31, 1962, for accident and health insurance and group life insurance contracts.

(c) Subtractions from policyholders surplus account—(1) In general. There shall be subtracted from the cumulative balance in the policyholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, an amount equal to the sum of—

(i) The amount which (without regard to subdivision (ii) of this subparagraph) is treated under section 815(a) as distributed out of the policyholders surplus account for the taxable year, plus

(ii) The amount (determined without regard to section 802(a)(3)) by which the tax imposed for taxable years beginning before January 1, 1962, by section 802(a)(1), and for taxable years beginning after December 31, 1961, by section 802(a), is increased by reason of section 802(b)(3).

In addition, there shall be subtracted from the policyholders surplus account for the taxable year those amounts which, at the close of the taxable year, are subtracted or treated as subtracted from the policyholders surplus account under section 815(d)(1) and (4) and paragraphs (a) and (d) of § 1.815–6. For purposes of this paragraph, the subtractions from the policyholders surplus ac-

count shall be treated as made in the following order:

(a) First the amount determined under section 815(c)(3) by reason of distributions to shareholders during the taxable year which are treated as being made out of the policyholders surplus account;

(b) Next the amount elected to be subtracted from the policyholders surplus account for the taxable year under section 815(d)(1);

(c) Then the amount which is treated as a subtraction from the policyholders surplus account for the taxable year by reason of the limitation provided in section 815(d)(4); and

(d) Finally the amount taken into account upon termination as a life insurance company as provided in section 815(d)(2).

(2) Method of computing amount subtracted from policyholders surplus account—(i) Where life insurance company taxable income, computed without regard to section 802(b)(3), exceeds $25,000. If the life insurance company taxable income for any taxable year computed under section 802(b), computed without regard to section 802(b)(3), exceeds $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate for the taxable year.

(ii) Where life insurance company taxable income does not exceed $25,000. If the life insurance company taxable income for any taxable year, computed under section 802(b), does not exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the normal tax rate for the taxable year.

(iii) Where life insurance company taxable income, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000. If the life insurance company taxable income for any taxable year, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined in the following manner:

(a) First, determine the amount by which $25,000 exceeds the amount determined under section 802(b)(1) and (2);

(b) Then, multiply the amount determined under (a) by a ratio, the numerator of which is 100 percent minus the normal tax rate and the denominator of which is 100 percent;

(c) Next, determine the amount by which the amount treated as distributed out of the policyholders surplus account exceeds the amount determined under (b) and multiply such excess by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate; and

(d) Finally, add the amounts determined under (a) and (c).

(3) Illustration of principles. The application of section 815(c)(3) and subparagraph (2) of this paragraph may be illustrated by the following examples:

Example (1). The life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000 for the taxable year 1959. Assume that of the amount distributed by S to its shareholders during the taxable year, $9,600 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the sum of the normal tax rate (30%) and the surtax rate (22%) in effect for 1959 is 52 percent. S shall subtract $20,000 from its policyholders surplus account for the taxable year 1959, computed as follows:

$$\$9{,}600\times 100/(100\text{–}52)=\$9{,}600\times 100/48=\$20{,}000$$

Of this amount, $9,600 is due to the application of section 815(c)(3)(A) and $10,400 to the application of section 815(c)(3)(B).

Example (2). Assume that for the taxable year 1960, S, a stock life insurance company, has taxable investment income of $1,000 and a gain from operations of $2,000. Assume further that of the amount distributed by S to its shareholders during the taxable year, $3,500 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since S's life insurance company taxable income does not exceed $25,000 for the taxable year and the normal tax rate in effect for 1960 is 30 percent, S shall subtract $5,000 from its policyholders surplus account for the taxable year 1960, computed as follows:

$$\$3{,}500\times 100/(100\text{–}30)=\$3{,}500\times 100/70=\$5{,}000$$

Of this amount, $3,500 is due to the application of section 815(c)(3)(A), and $1,500 to the application of section 815(c)(3)(B).

Example (3). For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), is $10,000. Assume that of the amount distributed by S to its shareholders during the taxable year, $12,000 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the

life insurance company taxable income of S, computed with regard to section 802(b)(3), exceeds $25,000, in order to determine the amount to be subtracted from its policyholders surplus account, S would make up the following schedule:

(1) $25,000 minus life insurance company taxable income, computed without regard to sec. 802(b)(3) ($25,000 minus $10,000)	$15,000
(2) Item (1) multiplied by 100 percent minus the normal tax rate as in effect for 1960, over 100 percent ($15,000 × (100–30) ÷ 100)	10,500
(3) Amount by which the amount treated as distributed out of policyholders surplus account ($12,000) exceeds item (2) ($10,500), multiplied by 100 percent over 100 percent minus the sum of the normal tax rate and the surtax rate as in effect for 1960 ($1,500 × 100 ÷ (100–52))	3,125
(4) Item (1) plus item (3) ($15,000 plus $3,125)	18,125

For the taxable year 1960, S shall subtract $18,125 from its policyholders surplus account. Of this amount, $10,500 represents the distribution from the policyholders surplus account which is taxed at a 30 percent tax rate and $1,500 the distribution from the policyholders surplus account which is taxed at a 52 percent tax rate. Thus, of the amount subtracted from the policyholders surplus account for the taxable year 1960, $12,000 is due to the application of section 815(c)(3)(A), and $6,125 to the application of section 815(c)(3)(B).

(d) Illustration of principles. The application of section 815(c) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Taxable investment income	$25,000
Gain from operations	30,000
Tax base (sec. 802(b)(1) and (2))	27,500
Deduction for certain nonparticipating policies provided by sec. 809(d)(5) (as limited by sec. 809(f))	600
Deduction for group policies provided by sec. 809(d)(6) (as limited by sec. 809(f))	400
Amount distributed to shareholders	60,000
Cumulative balance in shareholders surplus account as of 12–31–60	36,000
Balance in policyholders surplus account as of 1–1–60	48,000

For purposes of determining the amount to be subtracted from its policyholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the policyholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in policyholders surplus account as of 1–1–60		$48,000
(2) Additions to account:		
(a) 50 percent of the amount by which the gain from operations ($30,000) exceeds the taxable investment income ($25,000) (½ × $5,000)	$2,500	
(b) The deduction for certain nonparticipating contracts provided by sec. 809(d)(5) (as limited by sec. 809(f))	$600	
(c) The deduction for group contracts provided by sec. 809(d)(6) (as limited by sec. 809(f))	400	
		$3,500
(3) Cumulative balance in policyholders account as of 12–31–60 (item (1) plus item (2))		51,500

Under the provisions of section 815(a), since the amount distributed to shareholders during the taxable year, $60,000, exceeds the cumulative balance in the shareholders surplus at the end of the taxable year, computed without diminution by reason of distributions during the taxable year, $36,000, the shareholders surplus account shall first be reduced to zero. The remaining $24,000 ($60,000 minus $36,000) of the distribution shall then be treated as made out of the policyholders surplus account. Thus, since the tax base under section 802(b)(1) and (2) is in excess of $25,000, the total amount to be subtracted from the policyholders surplus account at the end of the taxable year would be $50,000 ($24,000 × 100 ÷ (100–52)). Of this amount $26,000 ($50,000 minus $24,000) represents the tax on the portion of the distribution to shareholders which is treated as being out of the policyholders surplus account.

(e) Special rule for 1959 and 1960. For a special transitional rule applicable to any increase in tax liability under section 802(b)(3) for the taxable years 1959 and 1960 which is due solely to the operation of section 815(c)(3) and this section, see section 802(a)(3) and § 1.802–5.

[T.D. 6535, 26 FR 543, Jan. 20, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.815–5 Other accounts defined.

The term "other accounts", as used in section 815(a)(3) and paragraph (b) of § 1.815–2, means all amounts which are not specifically included in the shareholders surplus account under section 815(b) and paragraph (b) of § 1.815–3, or in the policyholders surplus account under section 815(c) and paragraph (b) of § 1.815–4. Thus, for example, other accounts includes amounts representing the increase in tax due to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the special transitional rule provided in section 802(a)(3) and § 1.802–5, earnings and profits accumulated prior to January 1, 1958, paid-in surplus, capital, etc. To the extent that a distribution (or any portion thereof) is treated as being made out of other accounts, no tax is imposed on the company with respect to such distribution.

[T.D. 6535, 26 FR 544, Jan. 20, 1961]

§ 1.815–6 Special rules.

(a) Election to transfer amounts from policyholders surplus account to shareholders surplus account—(1) In general. Section 815(d)(1) per-

mits a life insurance company to elect, after the close of any taxable year for which it is a life insurance company, to subtract any amount (or any portion thereof) in its policyholders surplus account as of the close of the taxable year. The effect of such election is to subject the company to tax on the amounts elected to be subtracted for the taxable year for which the election applies. The amount so subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the taxable year following the taxable year for which the election applies and no further tax shall be imposed upon the company if the amount elected to be transferred to the shareholders surplus account is subsequently distributed to shareholders.

(2) Manner and effect of election. (i) The election provided by section 815(d)(1) and this section shall be made in a statement attached to the life insurance company's income tax return for any taxable year for which the company desires the election to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. In addition, the statement shall indicate that the company has made the election provided under section 815(d)(1) for the taxable year and the amount elected to be subtracted from the policyholders surplus account.

(ii) An election made under section 815(d)(1)(B) and subdivision (i) of this subparagraph shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which it desires the election to apply. Once such an election has been made for any taxable year it may not be revoked.

(3) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000. Assume that S elects to subtract $20,000 from its policyholders surplus account under section 815(d)(1) for the taxable year. Since S is subject to a 52 percent tax rate, the tax on the amount elected to be subtracted from the policyholders surplus account (as of the close of the taxable year 1960) is $10,400 ($20,000 × 52 percent). Thus, the amount to be added to the shareholders surplus account as of January 1, 1961, is $9,600 (the amount subtracted from the policyholders surplus account by virtue of the section 815(d)(1) election, less the tax imposed upon such amount by reason of section 802(b)(3), or $20,000 minus $10,400).

(b) Termination as life insurance company—(1) Effect of termination. Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), section 815(d)(2)(A) provides that if for any taxable year the taxpayer is not an insurance company (as defined in paragraph (a) of § 1.801–3), or if for any two successive taxable years the taxpayer is not a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), the amount taken into account under section 802(b)(3) for the last preceding year for which the company was a life insurance company shall be increased (after the application of section 815(d)(2)(B)) by the entire balance in the policyholders surplus account at the close of such last preceding taxable year.

(2) Effect of certain distributions. If for any taxable year the taxpayer is an insurance company (as defined in paragraph (a) of § 1.801–3) but is not a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), section 815(d)(2)(B) provides that any distribution to shareholders during such taxable year shall be treated as having been made on the last day of the last preceding taxable year for which the company was a life insurance company.

(3) **Examples.** The application of section 815(d)(2) and this paragraph may be illustrated by the following examples:

Example (1). At the end of the taxable year 1959, the balance in the policyholders surplus account of S, a life insurance company within the meaning of section 801(a) and paragraph (b) of § 1.801–3, is $12,000. If S fails to qualify as an insurance company (as defined in paragraph (a) of § 1.801–3) for the taxable year 1960, and section 381(c)(22) does not apply, under the provisions of section 815(d)(2)(A), the entire balance of $12,000 in the policyholders surplus account at the end of 1959, the last year S was a life insurance company, shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

Example (2). Assume the facts are the same as in example (1), except that for the taxable years 1960 and 1961, S qualifies as an insurance company (as defined in paragraph (a) of § 1.801–3) but does not qualify as a life insurance company within the meaning of section 801(a) and paragraph (b) of § 1.801–3. Assume further that as a result of a distribution by S to its shareholders in 1960, $4,800 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Under the provisions of section 815(d)(2)(B), if section 381(c)(22) does not apply, any distribution to shareholders during the taxable years 1960 and 1961 shall be treated as having been made on December 31, 1959 (the last day of the last preceding taxable year for which S was a life insurance company). Thus, assuming S is subject to a 52 percent tax rate on additions to life insurance company taxable income, $10,000 ($4,800 plus $5,200, the tax on the portion of the distribution treated as made out of the policyholders surplus account) shall

be treated as being subtracted from the policyholders surplus account at the end of 1959 and shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959. Under the provisions of section 815(d)(2)(A), the entire balance of $2,000 ($12,000 minus $10,000) in the policyholders surplus account at the end of 1959 (after the application of section 815(d)(2)(B)), shall also be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

(c) Treatment of certain indebtedness. Section 815(d)(3) provides that if a taxpayer makes any payment in discharge of its indebtedness and such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959, the amount of such payment shall be treated as a distribution in cash to shareholders both for purposes of section 802(b)(3) and section 815. However, this paragraph shall only apply to the extent that the distribution of such indebtedness to shareholders was treated as being out of accounts other than the shareholders and policyholders surplus accounts at the time of distribution.

(d) Limitation on amount in policyholders surplus account—(1) In general. Section 815(d)(4) provides a limitation on the amount that any life insurance company may accumulate in its policyholders surplus account. If the policyholders surplus account at the end of any taxable year (computed without regard to this paragraph) exceeds whichever of the following is the greatest—

(i) 15 percent of life insurance reserves (as defined in section 801(b) and paragraph (a) of § 1.801–4) at the end of the taxable year.

(ii) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or

(iii) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1),

then such excess shall be treated as a subtraction from the policyholders surplus account as of the end of such taxable year. The amount so treated as subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account at the beginning of the succeeding taxable year.

(2) Example. The application of the limitation contained in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Balance in policyholders surplus account, computed without regard to sec. 815(d)(4), as of 12–31–60	$175
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–60	4,500
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–58	3,900
Premiums and other consideration taken into account for the taxable year under sec. 809(c)(1)	310

In order to determine the limitations on the amount that it may accumulate in its policyholders surplus account at the end of the taxable year under section 815(d)(4), S would make up the following schedule:

(1) 15 percent of life insurance reserves at the end of the taxable year (15% × $4,500)	$675
(2) 25 percent of amount by which life insurance reserves at the end of the taxable year ($4,500) exceed life insurance reserves as of 12–31–58 ($3,900) (25% × $600)	150
(3) 50 percent of premiums and other consideration taken into account under sec. 809(c)(1) for the taxable year (50% × $310)	155
(4) Limitation on policyholders surplus account (the greatest of items (1), (2), or (3))	675

Since the balance in the policyholders surplus account at the end of the taxable year 1960, $175, does not exceed the limitation provided by section 815(d)(4), $675, S is not required to make any further adjustment to its policyholders surplus account at the end of the taxable year.

(e) Special rule for certain mutualizations—(1) In general. Section 815(e) provides a rule for determining priorities which shall operate in place of section 815(a) and paragraph (b) of § 1.815–2 where a life insurance company makes any distribution to its shareholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization. Section 815(e)(1) provides that such a distribution shall first be treated as being made out of paid-in capital and paid-in surplus, and, to the extent thereof, no tax shall be imposed on the company with respect to such distribution. Thereafter, distributions made pursuant to such plan of mutualization shall be treated as made in two allocable parts. One part shall be treated as being made out of other accounts (as defined in § 1.815–5) and the company shall incur no tax with respect to such portion of the distribution. The other part shall be treated as a distribution to which section 815(a) and paragraph (b) of § 1.815–2 applies. Thus, such portion of the distribution shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815–3), to the extent thereof, and then out of the policyholders surplus account (as defined in section 815(c) and § 1.815–4), to the extent thereof. See paragraph (a) of § 1.815–2. For purposes of this paragraph, a distribution shall be considered as being made pursuant to a plan of mutualization only if the

requirements of applicable State law for the adoption of such plan (as, for example, approval by the requisite majority of the board of directors, shareholders, and policyholders) have been fulfilled.

(2) Allocation ratio. Section 815(e)(2)(A) provides an allocation ratio which when applied to the amount distributed under a plan of mutualization in excess of the balance in the paid-in capital and paid-in surplus accounts determines the portion of such excess to be treated as distributed out of the shareholders surplus account, policyholders surplus account, or other accounts. The numerator of this ratio is the excess of the assets of the company (as defined in section 805(b)(4) and paragraph (a)(4) of § 1.805–5) over the total liabilities (including reserves), both determined as of December 31, 1958, and adjusted in the manner provided in subparagraph (3) of this paragraph. The denominator of this ratio is the amount included in the numerator plus the amounts in the shareholders surplus account and policyholders surplus account, all determined as of the beginning of the year of the distribution.

(3) Adjustment for certain distributions. Section 815(e)(2)(B) provides that if between 1958 and the year of distribution the taxpayer has been treated as having made a distribution (under a plan of mutualization or otherwise) which is treated as a return of paid-in capital and paid-in surplus or as out of other accounts (as defined in § 1.815–5), the aggregate amount of any such prior distributions must be subtracted from the numerator and denominator in all cases where the allocation ratio provided by subparagraph (2) of this paragraph applies.

(f) Recomputation required as a result of a subsequent loss from operations under section 812—(1) In general. Any amounts added to or subtracted from the special surplus accounts referred to in section 815(a) and paragraph (b) of § 1.815–2 for any taxable year shall be adjusted to the extent necessary to properly reflect a subsequent loss from operations which under section 812 is carried back to the taxable year for which such additions or subtractions were made.

(2) Example. The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that for the taxable years 1959 through 1961, the books of S, a stock life insurance company subject to a 30 percent tax rate for all taxable years involved, reflect the following items:

	1959	1960	1961
Taxable investment income	$40.00	$40.00	$40.00
Gain from operations	60.00	60.00	60.00
Tax base (sec. 802(b)(1) and (2))	50.00	50.00	50.00
Tax (sec. 802(b)(1) and (2) base)	15.00	15.00	15.00
Shareholders surplus account—			
At beginning of year	0	35.00	37.00
Added at beginning of year by reason of election under sec. 815(d)(1)	0	7.00	0
Added for year (without regard to election under sec. 815(d)(1))	35.00	35.00	35.00
Subtracted (distributions)	0	40.00	40.00
Policyholders surplus account—			
At beginning of year	0	0	10.00
Added for year	10.00	10.00	10.00
Subtracted (distributions)	0	0	0
Subtracted (by reason of election under sec. 815(d)(1))	10.00	0	0
Tax base (sec. 802(b)(3))	10.00	0	0
Tax (sec. 802(b)(3) base)	3.00	0	0

Assume further that S has a loss from operations for the taxable year 1962 of $25. Under the provisions of section 812, the $25 loss from operations would be carried back to the taxable year 1959 and would reduce the 1959 tax base under section 802(b)(1) and (2) to $35 ($60 minus $25). After adjustments reflecting the 1962 loss from operations, the results for the taxable years 1959 through the beginning of 1962 would be as follows:

	1959	1960	1961	1962
Taxable investment income	$40.00	$40.00	$40.00	.....
Gain from operations	35.00	60.00	60.00	.....
Tax base (sec. 802(b)(1) and (2))	35.00	50.00	50.00	.....
Tax (sec. 802(b)(1) and (2) base)	10.50	15.00	15.00	.....
Shareholders surplus account—				
At beginning of year	0	24.50	19.50	$14.50
Added for year (without regard to election under sec. 815(d)(1))	24.50	35.00	35.00	.....
Added by reason of election under sec. 815(d)(1)	0	0	0	.....
Subtracted (distributions)	0	40.00	40.00	.....

	1959	1960	1961	1962
Policyholders surplus account—				
At beginning of year	$0	$0	$10.00	$20.00
Added for year	0	10.00	10.00	.....
Subtracted (distributions)	0	0	0	.....
Subtracted (by reason of election under sec. 815(d)(1))	0	0	0	.....
Tax base (sec. 802(b)(3))	0	0	0	.....
Tax (sec. 802(b)(3) base)	0	0	0	.....

As a result of the loss from operations for 1962, the election under section 815(d)(1) for the taxable year 1959 has become inapplicable in its entirety since the balance in the policyholders surplus account at the end of 1959, as recomputed, is zero. Thus, S would be entitled to a total refund of $7.50 for the taxable year 1959. Of this amount, $4.50 is due to the recomputation of the section 802(b)(1) and (2) tax base and $3 to the amount of tax paid by reason of the election under section 815(d)(1).

[T.D. 6535, 26 FR 545, Jan. 20, 1961]

Miscellaneous Provisions

§ 1.817–1 Taxable years affected.

Except as otherwise provided therein, §§ 1.817–2 through 1.817–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 3 of the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6558, 26 FR 2781, Apr. 4, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.817–2 Treatment of capital gains and losses.

(a) In general. For taxable years beginning after December 31, 1958, and before January 1, 1962, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) prior to its amendment by section 3 of the Act of October 23, 1962 (76 Stat. 1134), imposes a separate tax equal to 25 percent of such excess. For taxable years beginning after December 31, 1961, if the net long-term capital gain of any life insurance company exceeds its net short-term capital loss, section 802(a)(2) imposes an alternative tax in lieu of the tax imposed by section 802(a)(1), if and only if such alternative tax is less than the tax imposed by section 802(a)(1). Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses, such as Subchapter O (relating to gain or loss on disposition of property), Subchapter P (relating to capital gains and losses), etc., shall apply with respect to life insurance companies.

(b) Modification of section 1221 and 1231. **(1)** In the case of a life insurance company, section 817(a)(1) provides that for purposes of applying section 1231(a) (relating to property used in the trade or business and involuntary conversions), the term "property used in the trade or business" shall be treated as including only—

(i) Property used in carrying on an insurance business, of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and real property used in carrying on an insurance business, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and which is not—

(a) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year;

(b) Property held by the taxpayer primarily for sale to customers in the ordinary course of business; or

(c) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by a taxpayer described in section 1221(3). In the case of a letter, memorandum, or property similar to a letter or memorandum, this subdivision (c) applies only to sales and other dispositions occurring after July 25, 1969.

(ii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(2) In the case of a life insurance company, section 817(a)(2) provides that for purposes of applying section 1221(2) (relating to the exclusion of certain property from the term capital asset), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

(3) Section 1231(a), as modified by section 817(a)(1) and subparagraph (1) of this paragraph, shall apply to recognized gains and losses from the following:

(i) The sale, exchange, or involuntary conversion of the following property, if held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977)—

(a) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(b) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company; and

(c) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(ii) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(iii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) Section 1221(2), as modified by section 817(a)(2) and subparagraph (2) of this paragraph, shall include only the following property;

(i) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(ii) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company; and

(iii) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(5) If an asset described in subparagraph (3)(i)(a), (b), or (c) or subparagraph (4) of this paragraph, or any portion thereof, is also an "investment asset" (an asset from which gross investment income, as defined in section 804(b), is derived), such asset, or portion thereof, shall not be treated as an asset used in carrying on an insurance business. Accordingly, the gains or losses from the sale or exchange (or considered as from the sale or exchange) of depreciable assets attributable to any trade or business, other than the insurance trade or business, carried on by the life insurance company, such as operating a radio station, housing development, or a farm, or renting various pieces of real estate shall be treated as gains or losses from the sale or exchange of a capital asset unless such asset is involuntarily converted (within the meaning of paragraph (e) of § 1.123-1).

(c) **Illustration of principles.** The provisions of section 817(a) and this section may be illustrated by the following examples:

Example (1). L, a life insurance company, has recognized gains and losses for the taxable year 1959 from the sale or involuntary conversion of the following items:

	Gains	*Losses*
Stocks, held for more than 6 months	$100,000	....
Bonds, held for more than 6 months	....	$5,000
Housing development, held for more than 6 months	....	400,000
Branch office building owned and occupied by L, held for more than 6 months	....	115,000
Furniture and equipment used in the investment department, held for more than 6 months	30,000	....
Radio station, held for more than 6 months	200,000	....
Involuntary conversion of apartment building, held for more than 6 months	7,000	....

The recognized gains and losses from the sale of the stocks, bonds, housing development, and radio station shall be treated as gains and losses from the sale of capital assets since such items are capital assets within the meaning of section 1221 (as modified by section 817(a)(2)). Accordingly, the provisions of section 1231 shall not apply to the sale of such capital assets. However, the provisions of section 1231 (as modified by section 817(a)(1)) shall apply to the sale of the branch office building and the furniture and equipment, and the apartment building involuntarily converted. Since the aggregate of the recognized losses ($115,000) exceeds the aggregate of the recognized gains ($37,000), the gains and losses are treated as ordinary gains and losses.

Example (2). Y, a life insurance company, owns a twenty-story home office building, having an adjusted basis of $15,-000,000, ten floors of which it rents to various tenants, one floor of which is utilized by it in operating its investment department, and the remaining nine floors of which are occupied by it in carrying on its insurance business. If in 1960, Y sells the building for $10,000,000, Y must first apportion its basis between that portion of the building (one-half) used in carrying on an insurance business, and that portion of the building (one-half) classified as an "investment asset", before it can determine the character of the loss attributable to each portion of the building. For such purpose, the one floor utilized by Y in operating its investment department is treated

as used in carrying on an insurance business. Assuming that each portion of the building bears an equal (one-half) relation to the basis of the entire building, Y (without regard to section 817(b)) would have a $2,500,000 ordinary loss on that portion used in carrying on an insurance business (assuming that Y had no gains subject to section 1231), and a $2,500,000 capital loss on that portion of the building classified as an investment asset.

[T.D. 6558, 26 FR 2782, April 4, 1961, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 7369, 40 FR 29840, July 16, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.817–3 Gain on property held on December 31, 1958, and certain substituted property acquired after 1958.

(a) Limitation on gain recognized on property held on December 31, 1958. (1) Section 817(b)(1) limits the amount of gain that shall be recognized on the sale or other disposition of property other than insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property) if:

(i) The property was held (or treated as held within the meaning of paragraph (c)(1) of this section) by a life insurance company on December 31, 1958;

(ii) The taxpayer has been a life insurance company at all times on and after December 31, 1958, including the date of the sale or other disposition of the property; and

(iii) The fair market value of the property on December 31, 1958, exceeds the adjusted basis for determining gain as of such date.

The gain on the sale or other disposition of such property shall be limited to an amount (but not less than zero) equal to the amount by which the gain (determined without regard to section 817(b)(1)) exceeds the difference between fair market value of such property on December 31, 1958, and the adjusted basis for determining gain as of such date. Accordingly, the tax imposed under section 802(a) shall apply with respect to the amount of gain so limited. In addition, in the case of a stock life insurance company, the amount of such gain shall be taken into account under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to the shareholders surplus account (as defined in section 815(b) and § 1.815–3) for the taxable year. Furthermore, the amount of the gain (determined without regard to section 817(b)(1) and this paragraph) which is not taken into account under section 802(a) and under paragraph (f) of § 1.802–3 by reason of the application of section 817(b)(1) shall be included in other accounts (as defined in § 1.815–5) by such a company for the taxable year.

(2) Section 817(b)(1) and subparagraph (1) of this paragraph shall not apply for purposes of determining loss with respect to property held on December 31, 1958.

(b) Illustration of principles. The application of section 817(b)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example (1). On December 31, 1958, J, a stock life insurance company, owned stock of Z Corporation and on such date the stock had an adjusted basis for determining gain of $5,000 and a fair market value of $6,000. On August 1, 1959, the company sells such stock for $8,000. Assuming J qualifies as a life insurance company for the taxable year 1959, and applying the provisions of section 817(b)(1) and paragraph (a) of this section, the gain recognized (assuming no adjustment to basis for the period since December 31, 1958) on the sale shall be limited to $2,000 (the amount by which the gain realized, $3,000, exceeds the difference, $1,000, between the fair market value, $6,000, and the adjusted basis, $5,000, for determining gain on December 31, 1958). Thus, J shall take into account $2,000 under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to its shareholders surplus account for the taxable year and shall include $1,000 in other accounts for the taxable year.

Example (2). The facts are the same as in example (1), except that the selling price is $5,800. In such case, no gain shall be recognized even though there is a realized gain of $800 since such realized gain does not exceed the difference ($1,000) between the fair market value ($6,000) and the adjusted basis ($5,000) for determining gain on December 31, 1958. Furthermore, no loss shall be realized or recognized as a result of this transaction. Thus, J shall include $800 in other accounts for the taxable year and shall not take into account any amount under section 815(b)(2)(A)(ii).

Example (3). The facts are the same as in example (1), except that the adjusted basis for determining loss is $5,000 and the selling price is $4,500. In such case, since J has sustained a loss, section 817(b)(1) does not apply.

(c) Certain substituted property acquired after December 31, 1958. Section 817(b)(2) provides that if a life insurance company acquires property after December 31, 1958, in exchange for property actually held by the company on December 31, 1958, and the property acquired has a substituted basis within the meaning of section 1016(b) and § 1.1016–10, the following rules shall apply:

(1) For purposes of section 817(b)(1), such acquired property shall be deemed as having been held continuously by the taxpayer since the beginning of the holding period thereof as determined under section 1223;

(2) The fair market value and adjusted basis referred to in section 817(b)(1) shall be that of that property for which the holding period taken into account includes December 31, 1958;

(3) Section 817(b)(1) shall apply only if the property or properties, the holding periods of which are taken into account, were held only by life insurance companies after December 31, 1958, during the holding periods so taken into account;

(4) The difference between the fair market value and adjusted basis referred to in section 817(b)(1) shall be reduced (but not below zero) by the excess of (i) the gain that would have been recognized but for section 817(b) on all prior sales or other dispositions after December 31, 1958, of properties referred to in section 817(b)(2)(C) over (ii) the gain that was recognized on such sales or other dispositions; and

(5) The basis of such acquired property shall be determined as if the gain which would have been recognized but for section 817(b) were recognized gain.

For purposes of section 817(b)(2) and this paragraph, the term "property" does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property). Furthermore, the provisions of section 817(b)(1) and paragraph (a)(1) of this section shall not apply for purposes of determining loss with respect to property described in section 817(b)(2) and this paragraph.

(d) Illustration of principles. The application of section 817(b)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume that W, a life insurance company, owns property B on December 31, 1958, at which time its adjusted basis was $1,000 and its fair market value was $1,800. On January 31, 1960, in a transaction to which section 1031 (relating to exchange of property held for productive use or investment) applies, W receives property H having a fair market value of $1,700 plus $300 in cash in exchange for property B. The gain realized on the transaction, without regard to section 817(b) is $1,000 (assuming no adjustments to basis for the period since December 31, 1958). Under the provisions of section 817(b)(1) the gain is limited to $200. The entire $200 shall be recognized since such amount is less than the amount of gain ($300) which would be recognized under section 1031. Applying the provisions of section 817(b)(2) and paragraph (c) of this section, the basis of property H shall be determined as if the entire $300 of cash received is recognized gain. Thus, the basis of property H under section 1031 is $1,000 ($1,000) (the basis of property B) minus $300 (the amount of money received) plus $300 (the recognized gain of $200 plus $100 which would have been recognized but for section 817(b)). If W later sells property H for $2,200 cash, and assuming no further adjustments to its basis of $1,000, the gain realized is $1,200, but due to the application of section 817(b)(2) the amount of gain recognized is $500, computed as follows:

Selling price		$2,200
Less: Adjusted basis as of date of sale		1,000
Gain realized		1,200
Fair market value as of 12–31–58	$1,800	
Adjusted basis as of 12–31–58	1,000	
Excess of fair market value over adjusted basis	800	
Less: Excess of gain which would have been recognized on all prior dispositions but for sec. 817(b) over gain recognized on all prior dispositions ($300 minus $200)	100	$700
Gain recognized		$500

[T.D. 6558, 26 FR 2783, April 4, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.817–4 Special rules.

(a) Limitation on capital loss carryovers. Section 817(c) provides that a net capital loss (as defined in section 1222(10)) for any taxable year beginning before January 1, 1959, shall not be taken into account. For any taxable year beginning after December 31, 1958, the provisions of Part II, Subchapter P, Chapter 1 of the Code (relating to the treatment of capital losses) shall be applicable to life insurance companies for purposes of determining the tax imposed by section 802(a) and § 1.802–3 (relating to the imposition of tax in case of capital gains).

(b) Gain on transactions occurring prior to January 1, 1959. For purposes of Part I, Subchapter L, Chapter 1 of the Code, section 817(d) provides that—

(1) There shall be excluded from tax any gain from the sale or exchange of a capital asset, and any gain considered as gain from sale or exchange of a capital asset, which results from sales or other dispositions of property prior to January 1, 1959; and

(2) Any gain after December 31, 1958, resulting from the sale or other disposition of property prior to January 1, 1959, which, but for this subparagraph would be taken into account under section 1231, shall not be taken into account under section 1231.

For example, if a life insurance company makes an installment sale of a capital asset prior to January 1, 1959, and payments are received after such date, any capital gain attributable to such sale shall not be taken into account for purposes of section 802(a). Furthermore, any gain referred to in subparagraphs (1) and (2) and the preceding sentence shall not be taken into account in determining the excess of the net short-term capital gain over the net long-term capital loss (and for taxable years

beginning after December 31, 1961, the excess of the net long-term capital gain over the net short-term capital loss) for purposes of computing taxable investment income under section 804(a)(2) or gain or loss from operations under section 809(b).

(c) Certain reinsurance transactions in 1958. For purposes of Part I, section 817(e) provides that where a life insurance company reinsures (or sells) all of its insurance contracts of a particular type, such as an entire industrial department, in either a single transaction, or in a series of related transactions, all of which occurred during 1958, and the reinsuring (or purchasing) company or companies assume all liabilities under such contracts, such reinsurance (or sale) shall be treated as the sale of a capital asset. However, such transaction shall be subject to the provisions of section 806(a) and § 1.806–3 (relating to adjustments for certain changes in reserves and assets).

(d) Certain other reinsurance transactions. (1) For any taxable year beginning after December 31, 1958, the reinsurance of all or a part of the insurance contracts of a particular type by a life insurance company, in either a single transaction, or in a series of related transactions, occurring in any such taxable year, whereby the reinsuring company or companies assume all liabilities under such contracts, shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of section 806(a) and 809 and the regulations thereunder. However, if in connection with a transaction described in the preceding sentence the reinsured or reinsurer transfers an asset which is a capital asset within the meaning of section 1221 (as modified by section 817(a)(2)), such transfer shall be treated as the sale or exchange of a capital asset by the transferor.

(2)(i) The consideration paid by the reinsured to the reinsurer in connection with a transaction described in subparagraph (1) of this paragraph shall be treated as an item of deduction under section 809(d)(7). However any amount received by the reinsured from the reinsurer shall be applied against and reduce (but not below zero) the amount of such consideration, and to the extent that it exceeds such consideration, shall be treated as an item of gross amount under section 809(c)(3).

(ii) In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809–5) transaction, a reinsurer shall in any taxable year beginning after December 31, 1957—

(A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and

(B) Treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

(iii) For purposes of paragraph (d)(2)(ii) of this section where the reinsured transfers to the reinsurer in connection with the assumption reinsurance transaction a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer shall be treated as—

(A) Having received from the reinsured consideration in an amount equal to the net amount of the increase in the reinsurer's reserves resulting from the transaction, and

(B) Having paid the reinsured an amount for the purchase of the contracts equal to the excess of the amount of such increase in the reinsurer's reserves over the net amount received from the reinsured.

(iv) For purposes of this subparagraph, the term "reasonably estimated life" means the period during which the contract reinsured remains in force. Such period shall be based on the facts in each case (such as age, health, and sex of the insured, type of contract reinsured, etc.) and the assuming company's experience (such as mortality, lapse rate, etc.) with similar risks.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). On June 30, 1959, X, a life insurance company, reinsured a portion of its insurance contracts with Y, a life insurance company, under an agreement whereby Y agreed to assume and to become solely liable under the contracts reinsured. The reserves on the contracts reinsured by X were $100,000. Under the reinsurance agreement X agreed to pay Y $100,000 for assuming such contracts and Y agreed to pay X $17,000 for the right to receive future premium payments under this block of contracts. Rather than exchange payments of money, X agreed to pay Y a net amount of $83,000 in cash. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, that there are no other insurance transactions by X or Y during the taxable year, and assuming that X and Y compute the reserves on the contracts reinsured on the same basis, X has income of $100,000 under section 809(c)(2) as a result of the net decrease in its reserves. X has a net deduction of $83,000 ($100,000–$17,000) under section

809(d)(7). For the taxable year 1959, Y has income of $100,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of $100,000 under section 809(d)(2) for the net increase in reserves and $1,000 ($17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining $16,000 shall be amortized over the next 16 succeeding taxable years (16×$1,000=$16,000) under section 809(d)(12) at the rate of $1,000 for each such taxable year.

Example (2). The facts are the same as in example (1), except X agreed to pay Y a consideration of $100,000 in cash for assuming these contracts and Y paid X a bonus of $17,000 in cash and that this bonus meets the requirements of section 162. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, X has income of $100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of $83,000 under section 809(d)(7) for the amount of the consideration ($100,000) paid to Y for assuming these contracts, reduced by the bonus ($17,000) received from Y. For the taxable year 1959, Y has income of $100,000 under section 809(c)(1) as a result of the consideration received from X and deductions of $100,000 under section 809(d)(2) for the net increase in reserves and $1,000 (the bonus of $17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining amount of the bonus ($16,000) shall be amortized over the next 16 succeeding taxable years (16×$1,000=$16,000) under section 809(d)(12) at the rate of $1,000 for each such taxable year.

Example (3). The facts are the same as in Example (1), except that the reinsurance agreement does not specifically provide that X agreed to pay Y $100,000 for assuming the contracts reinsured and Y agreed to pay X $17,000 for the right to receive future premium payments under such contracts. Instead, X agreed to pay Y a net amount of $83,000 in cash for assuming such contracts. Nevertheless, Y is treated as having received from X consideration equal to $100,000, the amount of the increase in Y's reserves, and as having paid $17,000 ($100,000 less $83,000) for the purchase of such contracts. Therefore, for the taxable year 1959, Y has income of $100,000 under section 809(c)(1). Y also has a deduction of $100,000 under section 809(d)(2) for the net increase in its reserves and an amortization deduction under section 809(d)(12) of $1,000 ($17,000 divided by 17, the reasonably estimated life of the contracts reinsured). The remaining $16,000 shall be amortized by Y over the next 16 succeeding years at the rate of $1,000 for each such year. For 1959, X has income of $100,000 under section 809(c)(2) as a result of the net decrease in its reserves and a deduction of $83,000 under section 809(d)(7) for the net amount of consideration paid to Y for assuming the contracts reinsured.

Example (4). The facts are the same as in example (1), except that X agreed to pay Y a consideration of $130,000 in cash for assuming such contracts. Based upon these facts, X has income of $100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of $130,000 under section 809(d)(7) for the amount of the consideration paid to Y for assuming these contracts. Y has income of $130,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of $100,000 under section 809(d)(2) for the net increase in its reserves.

Example (5). On August 1, 1960, R, a life insurance company, reinsured all of its insurance policies with S, a life insurance company, under an agreement whereby S agreed to assume and become solely liable under the contracts reinsured. The reserves on the contracts reinsured by R were $3,000,000. Under the reinsurance agreement, R agreed to pay S a consideration of $3,000,000 in stocks and bonds for assuming such contracts. Assuming no other insurance transactions by R or S during the taxable year, that R and S compute the reserves on the contracts reinsured on the same basis, and that R has a recognized gain (after the application of the limitation of section 817(b)(1)) of $20,000 due to appreciation in value of the assets transferred, the results to each company are as follows:

Company R (reinsured)

Net decrease in reserves (sec. 809(c)(2))	$3,000,000
Capital gain (as limited by sec. 817(b)(1)) to be taxed separately under sec. 802(a)(2)	20,000
Consideration paid by R to S in respect of S's assuming liabilities under contracts issued by R (sec. 809(d)(7))	$3,000,000

INCOME

Company S (reinsurer)

Consideration received by S in respect of assuming liabilities under contracts issued by R (sec. 809(c)(1))	$3,000,000

DEDUCTIONS

Net increase in reserves (sec. 809(d)(2))	$3,000,000

[T.D. 6558, 26 FR 2783, April 4, 1961, as amended by T.D. 6625, 27 FR 12543, Dec. 19, 1962; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 41 FR 5100, Feb. 4, 1976]

§ 1.817–5T Diversification requirements for variable annuity, endowment, and life insurance contracts.

(a) In general. For purposes of subchapter L, section 72, and section 7702 (a), a variable contract (as defined in section 817(d)), other than a pension plan contract (as defined in section 818(a)), which is based on one or more segregated asset accounts shall not be treated as an annuity, endowment, or life insurance contract for any period for which the investments of any such account are not adequately diversified. In addition, a variable contract that is not treated as an annuity, endowment, or life insurance contract for any period by reason of the preceding sentence shall not be treated as an annuity, endowment, or life insurance contract for any subsequent period even if the investments are adequately diversified for such subsequent period. See sections 7702 (g) and (h) for the treatment of a variable contract which is not treated as an annuity, endowment, or life insurance contract for Federal income tax purposes but which is a life insurance or endowment contract under other applicable (e.g., State or foreign) law.

(b) Diversification of investments—(1) In general. (i) Except as otherwise provided in this paragraph and paragraph (c) of this section, the investments of a segregated asset account shall be considered adequately diversified for purposes of this section and section 817(h) only if—

(A) No more than 55% of the value of the total assets of the account is represented by any one investment;

(B) No more than 70% of the value of the total assets of the account is represented by any two investments;

(C) No more than 80% of the value of the total assets of the account is represented by any three investments; and

(D) No more than 90% of the value of the total assets of the account is represented by any four investments.

(ii) For purposes of this section—

(A) All securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment;

(B) All government securities are treated as securities of a single issuer; and

(C) The members of an affiliated group (within the meaning of section 1504(a), determined without regard to the exceptions in section 1504(b)) ordinarily are treated as a single issuer.

(2) Safe harbor. A segregated asset account will be considered adequately diversified for purposes of this section and section 817(h) if—

(i) The account meets the requirements of section 851(b)(4) and the regulations thereunder; and

(ii) No more than 55% of the value of the total assets of the account is attributable to cash, cash items (including receivables), Government securities, and securities of other regulated investment companies.

(3) Alternative diversification requirements for variable life insurance contracts. (i) A segregated asset account with respect to variable life insurance contracts will be considered adequately diversified for purposes of this section and section 817(h) if the requirements of paragraph (b)(1) or (b)(2) of this section are satisfied or if the assets of such account, other than Treasury securities, satisfy the percentage limitations prescribed in paragraph (b)(1) of this section increased by the product of (A) .5 and (B) the percentage of the value of the total assets of the account that is represented by Treasury securities. In determining whether the assets of an account, other than Treasury securities, satisfy the increased percentage limitations, such limitations are applied as if the Treasury securities were not included in the account (i.e., the increased percentage limitations are not applied to Treasury securities and the value of the total assets of the account is reduced by the value of the Treasury securities).

(ii) See paragraphs (f) and (g) of this section for circumstances in which a segregated asset account is treated as the owner of Treasury securities held indirectly through certain pass-through entities and corporations taxed under Subchapter M, chapter 1 of the Code.

(iii) The provisions of this paragraph (b)(3) may be illustrated by the following examples:

Example (1). On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,-000. The assets of the account are represented by Treasury securities having a total value of $90,000 and securities of Corporation A having a total value of $10,000. The 55% limit described in paragraph (b)(1)(i) of this section would be increased by 45% (0.5×90%) to 100%, and would then be applied to the assets of the account other than Treasury securities. Because no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporation A, the investments of the account will be considered adequately diversified.

Example (2). On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of $100,-000. The assets of the account are represented by Treasury securities having a total value of $60,000, securities of Corporation A having a total value of $30,000, and securities of Corporation B having a total value of $10,000. The 55% and 70% limits described in paragraph (b)(1)(i) of this section would be increased by 30% (0.5×60%) to 85% and 100%, respectively, and would then be applied to the assets of the account other than Treasury securities. Securities of Corporation A represent 75%, and securities of Corporation B represent 25%, of the value of the assets of the account other than Treasury securities. Because no more than 85% of the value of the assets other than Treasury securities is represented by securities of Corporation A or B and no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporations A and B, the investments of the account will be considered adequately diversified.

(c) Periods for which an account is adequately diversified—(1) In general. A segregated asset account that satisfies the requirements of paragraph (b) of this section on the last day of a quarter of a calendar year (i.e., March 31, June 30, September 30, and December 31) or within 30 days after such last day shall be considered adequately diversified for such quarter.

(2) Start-up period. (i) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is not a real property account on its first anniversary shall be considered adequately diversified until such first anniversary.

(ii) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is a real property account on its first anniversary shall

be considered adequately diversified until the earlier of its fifth anniversary or the anniversary on which the account ceases to be a real property account.

(iii) For purposes of paragraph (c)(2) (i) and (ii) of this section, the anniversary of a segregated asset account is the anniversary of the date on which any amount received under a life insurance or annuity contract is first allocated to the account.

(iv) If more than 30 percent of the amount allocated to a segregated asset account as of any date is attributable to premium and investment income that was received more than one year before such date, paragraph (c)(2)(i) of this section shall not apply to the segregated asset account for any period after such date. Similarly, if more than 30 percent of the amount allocated to a segregated asset account as of any date is attributable to premium and investment income that was received more than 5 years before such date, paragraph (c)(2)(ii) of this section shall not apply to the segregated asset account for any period after such date. For this purpose, premium income is treated as received on the date on which such income is first received with respect to the variable contract (or with respect to any predecessor variable contract exchanged for the variable contract in a transaction to which section 1035 applied) and investment income is treated as received on the date on which such income is first credited to a segregated asset account on which such variable contract (or predecessor contract) is based. Also for this purpose, an amount allocated to a segregated asset account shall be treated as attributable to the most recently received premium and investment income.

(3) **Liquidated period.** A segregated asset account that satisfies the requirements of paragraph (b) of this section on the date a plan of liquidation is adopted shall be considered adequately diversified for—

(i) The one-year period beginning on the date the plan of liquidation is adopted if the account is not a real property account on such date; or

(ii) The two-year period beginning on the date the plan of liquidation is adopted if the account is a real property account on such date.

(d) **Aggregation of multiple accounts or funds.** Two or more accounts or funds are treated as a single segregated asset account for purposes of section 817(h) and this section only if the investment return and market value of each such account or fund must be allocated to the same variable contracts and in the identical proportions as the investment return and market value of each other such account or fund. This rule may be illustrated by the following example:

Example. Variable contracts are based on an account that consists of five sub-accounts. The contract provides that policyholders of variable contracts based on the account may specify what portion of each premium is to be invested in a particular sub-account, subject to the restriction that no more than 55% of any premium may be invested in any one sub-account, no more than 70% may be invested in any two sub-accounts, no more than 80% may be invested in any three sub-accounts, and no more than 90% may be invested in any four sub-accounts. The return on a variable contract based on this account will be computed with regard to the allocation of premiums among the sub-accounts. Thus, the investment return and market value of a sub-account may be allocated to different variable contracts or in different proportions than the investment return and market value of the other sub-accounts. Accordingly, each sub-account is treated as a separate segregated asset account for purposes of section 817(h) and this section. If any of the five sub-accounts fails to be adequately diversified, any variable contract based in part on the sub-account will not be treated as a variable annuity or life insurance contract.

(e) **Market fluctuations.** A segregated asset account that satisfies the requirements of paragraph (b) of this section at the end of any calendar quarter (or within 30 days after the end of such calendar quarter) shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition.

(f) **Look-through rule for underlying investment company or trust—(1) In general.** If this paragraph applies, a beneficial interest in a regulated investment company, a real estate investment trust, or a trust that is treated under sections 671 through 679 as owned by the grantor or another person ("investment company or trust") shall not be treated as a single investment of a segregated asset account. Instead, a pro rata portion of each asset of the investment company or trust shall be treated, for purposes of this section, as an asset of the segregated asset account. In the case of a regulated investment company having one or more segregated portfolios of assets in respect of which a series of stock is preferred over all other series, each segregated portfolio of assets will be treated solely for purposes of this paragraph as a separate regulated investment company.

(2) **Applicability.** This paragraph shall apply if—

(i) All the beneficial interests in the investment company or trust (other than those described in

paragraph (f)(3) of this section) are held by one or more segregated asset accounts of one or more insurance companies; and

(ii) Public access to such investment company or trust is available exclusively (except as otherwise permitted in paragraph (f)(3) of this section) through the purchase of a variable contract.

(3) Interests not held by segregated asset accounts. The application of this paragraph shall not be prevented by reason of beneficial interests in the investment company or trust that are—

(i) Held by the general account of a life insurance company or a corporation related in a manner specified in section 267(b) to a life insurance company, but only if the return on such interests is computed in the same manner as for the related variable contracts, there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company or trust;

(ii) Held by the manager, or a corporation related in a manner specified in section 267(b) to the manager, of the investment company or trust, but only if the holding of the interests is in connection with the creation or management of the investment company or trust, the return on such interests is computed in the same manner as for the related variable contracts, and there is no intent to sell such interests to the public;

(iii) Held by the trustee of a qualified pension or retirement plan; or

(iv) Held by the public, or treated as owned by policyholders pursuant to Rev. Rul. 81-225, 1981-2 C.B. 12, but only if (A) the investment company or trust was closed to the public in accordance with Rev. Rul. 82-55, 1982-1 C.B. 12, (B) all the assets of the investment company or trust are attributable to premium payments made by policyholders prior to September 26, 1981, or (C) all the assets of the investment company or trust are attributable to premium payments made in connection with a qualified pension or retirement plan.

(g) Look-through rule for underlying partnership interest. If a segregated asset account holds a partnership interest, other than a partnership interest registered under a Federal or State law regulating the offering or sale of securities, the segregated asset account will be deemed to own its proportionate share of each of the assets of the partnership. For purposes of this section, the interest of a partner in a partnership's assets shall be determined in accordance with his capital interest in the partnership.

(h) Definitions. The terms defined below shall, for purposes of this section, have the meanings set forth in such definitions:

(1) Government security. The term "government security" shall mean any security issued or (to the extent of the guaranteed or insured amount) guaranteed or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing. For purposes of this paragraph (h)(1), an instrumentality of the United States shall mean any person that is treated for purposes of 15 U.S.C. 80a-2(16), as amended, as a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.

(2) Treasury security. The term "Treasury security" shall mean a security the direct obligor of which is the United States Treasury.

(3) Real property. The term "real property" shall mean any property that is treated as real property under § 1.856-3 (d) except that it shall not include interests in real property.

(4) Real property account. A segregated asset account is a real property account on an anniversary of the account (within the meaning of paragraph (c)(2)(iii) of this section) or on the date a plan of liquidation is adopted if not less than the applicable percentage of the total assets of the account is represented by real property or interests in real property on such anniversary or date. For this purpose, the applicable percentage is 40% for the period ending on the first anniversary of the date on which premium income is first received, 50% for the year ending on the second anniversary, 60% for the year ending on the third anniversary, 70% for the year ending on the fourth anniversary, and 80% thereafter.

(5) Commodity. The term "commodity" shall mean any type of personal property other than a security.

(6) Security. The term "security" shall include a cash item and any partnership interest registered under a Federal or State law regulating the offering or sale of securities. The term shall not include any other partnership interest, any interest in real property, or any interest in a commodity.

(7) Interest in real property. The term "interest in real property" shall include the ownership and

coownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term shall not, however, include mineral, oil, or gas royalty interests, such as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term "interest in real property" also shall include options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(8) Interest in a commodity. The term "interest in a commodity" shall include the ownership and coownership of any type of personal property other than a security, and any leaseholds thereof. Such term shall include mineral, oil, and gas royalty interests, including any fractional undivided interest therein. Such term also shall include any put, call, straddle, option, or privilege on any type of personal property other than a security.

(9) Value. The term "value" shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account.

(10) Terms used in section 851. To the extent not inconsistent with this paragraph (h) all terms used in this section shall have the same meaning as when used in section 851.

(i) Effective date—(1) In general. This section is effective for taxable years beginning after December 31, 1983.

(2) Exceptions. (i) If, at all times after December 31, 1983, an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81-225, 1981-2 C.B. 12, this section will not apply to such account until December 15, 1986.

(ii) This section will not apply to any variable contract to which Rev. Rul. 77-85, 1977-1 C.B. 12, or Rev. Rul. 81-225, 1981-2 C.B. 12, did not apply by reason of the limited retroactive effect of such rulings.

(iii) In determining whether a segregated asset account is adequately diversified for any calendar quarter ending before July 1, 1987, debt instruments that are issued, guaranteed or insured by the United States or an instrumentality of the United States shall not be treated as Government securities if such debt instruments are secured by a mortgage on real property (other than real property owned by the United States or an instrumentality of the United States) or represent an interest in a pool of debt instruments secured by such mortgages.

[T.D. 7989, 49 FR 43052, Oct. 26, 1984; T.D. 8101, 51 FR 32633, Sept. 15, 1986]

§ 1.818–1 Taxable years affected.

Sections 1.818–2 through 1.818–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2785, April 4, 1961, as amended by T.D. 7469, 42 FR 12181, March 3, 1977]

§ 1.818–2 Accounting provisions.

(a) Method of accounting. (1) Section 818(a)(1) provides the general rule that all computations entering into the determination of taxes imposed by part I, subchapter L, chapter 1 of the Code, shall be made under an accrual method of accounting. Thus, the over-all method of accounting for life insurance companies shall be the accrual method. Except as otherwise provided in part I, the term "accrual method" shall have the same meaning and application in section 818 as it does under section 446 (relating to general rule for methods of accounting) and the regulations thereunder. For general rules relating to the taxable year for inclusion of income and deduction of expenses under an accrual method of accounting, see sections 451 and 461 and the regulations thereunder.

(2) Section 818(a)(2) provides that, to the extent permitted under this section, a life insurance company's method of accounting may be a combination of the accrual method with any other method of accounting permitted by chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. Thus, section 818(a)(2) specifically prohibits the use by a life insurance company of the cash receipts and disbursements method either separately or in combination with a permissible method of accounting. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. For purposes of section 818(a)(2), a life insurance company may elect to compute its taxable income under an over-all method of accounting consisting of the accrual method combined with the special methods of accounting for particular items of income and expense provided under

other sections of chapter 1 of the Internal Revenue Code of 1954, other than the cash receipts and disbursements method. These methods of accounting for special items include the accounting treatment provided for depreciation (section 167), research and experimental expenditures (section 174), soil and water conservation expenditures (section 175), organizational expenditures (section 248), etc. In addition, a life insurance company may, where applicable, use the crop method of accounting (as provided in the regulations under sections 61 and 162), and the installment method of accounting for sales of realty and casual sales of personalty (as provided in section 453(b)). To the extent not inconsistent with the provisions of the Internal Revenue Code of 1954 or the regulations thereunder and the method of accounting adopted by the taxpayer pursuant to this section, all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(3)(i) An election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provisions of the Internal Revenue Code of 1954 or prior revenue laws for purposes of determining a company's tax liabilities for prior years, shall have the same force and effect in determining the items of gross investment income under section 804(b) and the items of deduction under section 804(c) of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) as if such Act had not been enacted.

(ii) For purposes of determining gain or loss from operations under section 809(b), in computing the life insurance company's share of investment yield under section 809(b)(1)(A) and (2)(A), an election with respect to any of the special methods of accounting referred to in subparagraph (2) of this paragraph which was made pursuant to any provision of the Internal Revenue Code of 1954 or prior revenue laws, shall not be affected in any way by the enactment of the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

(iii) For purposes of determining gain or loss from operations under section 809(b), in computing the items of gross amount under section 809(c) and the deduction items under section 809(d), an election to use any of the special methods of accounting referred to in subparagraph (2) of this paragraph must be made in accordance with the specific statutory provisions of the sections containing such elections and the regulations thereunder. However, where a particular election may be made only with the consent of the Commissioner (either because the time for making the election without the consent of the Commissioner has expired or because the particular section contained no provision for making an election without consent), and the time prescribed by the applicable regulations for submitting a request for permission to make such an election for the taxable year 1958 has expired, a life insurance company may make such an election for the year 1958 at the time of filing its return for that year (including extensions thereof). For example, a life insurance company may elect any of the methods of depreciation prescribed in section 167 (to the extent permitted under that section and the regulations thereunder) with respect to those assets, or any portion thereof, for which no depreciation was allowable under prior revenue laws, for example, furniture and fixtures used in the underwriting department. Similarly, a life insurance company shall be permitted to make an election under section 461(c) (relating to the accrual of real property taxes) with respect to real property for which no deduction was allowable under prior revenue laws. Any such election shall be made in the manner and form prescribed in the applicable regulations.

(iv) For purposes of subdivision (ii) of this subparagraph, the method used under section 1016(a)(3)(C) (relating to adjustments to basis) in determining the amount of exhaustion, wear and tear, obsolescence, and amortization actually sustained shall not preclude a taxpayer from electing any of the methods prescribed in section 167 in accordance with the provisions of that section and the regulations thereunder for determining the amount of such exhaustion, wear and tear, obsolescence, and amortization for the year 1958. For example, if the amount of depreciation actually sustained, under section 1016(a)(3)(C), on a life insurance company's home office building (other than that portion for which depreciation was allowable under prior revenue laws) is determined on the straight line method, the life insurance company may elect for the year 1958 to use any of the methods prescribed in section 167 for determining its depreciation allowance for 1958. However, such election shall be binding for 1958, and for all subsequent taxable years, unless consent to change such election, if required, is obtained from the Commissioner in accordance with the provisions of section 167 and the regulations thereunder.

(4)(i) For purposes of section 805(b)(3)(B)(i) (relating to the determination of the current earn-

ings rate for any taxable year beginning before January 1, 1958), the determination for any year of the investment yield and the assets shall be made as though the taxpayer had been on the accrual method prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in determining the investment yield and assets for the taxable year 1958. However, where the method used for determining the deduction under section 167 for the year 1958 differs from the method used in prior years, the amount of the deduction actually allowed or allowable for such prior years for purposes of section 1016(a)(2) (relating to adjustments to basis) shall be the amount to be taken into account in determining the current earnings rate under section 805(b)(3)(B)(i).

(ii) For purposes of section 812(b)(1)(C) (relating to operations loss carrybacks and carryovers for years prior to 1958), the determination for those years of the gain or loss from operations shall be made as though the taxpayer had been on the accrual method of accounting prescribed in subparagraph (1) of this paragraph for such year, or the accrual method in combination with the other methods of accounting prescribed in subparagraph (2) of this paragraph, if these other methods of accounting are used by the taxpayer in the determination of gain or loss from operations for the taxable year 1958. However, where any adjustment to basis is required under section 1016(a)(3)(C) on account of exhaustion, wear and tear, obsolescence, amortization, and depletion sustained, the amount actually sustained as determined under section 1016(a)(3)(C) for each of the years involved shall be the amount allowed in the determination of gain or loss from operations for purposes of section 812(b)(1)(C).

(b) Adjustments required if accrual method of accounting was not used in 1957. The items of gross amount taken into account under section 809(c) and the items of deductions allowed under section 809(d) for the taxable year 1958 shall be determined as though the taxpayer had been on the accrual method of accounting prescribed in paragraph (a) of this section for all prior years. Thus, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of gross amount which would have been properly taken into account for the year 1957 if the company had been on the accrual method described in section 818(a). Likewise, life insurance companies not on the accrual method for the year 1957 shall accrue, as of December 31, 1957, those items of deductions which would have been properly allowed for the year 1957 if the company had been on the accrual method described in section 818(a). For example, if certain premium amounts were received during the year 1958 but such amounts would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be required to take such premium amounts into account for the year 1958. If, for example, certain claims, benefits, and losses were paid during the year 1958 but such items would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be permitted to deduct such expense items for the year 1958. For a special transitional rule applicable with respect to changes in method of accounting required by section 818(a) and paragraph (a) of this section, see section 818(e) and § 1.818–6.

(c) Change of basis in computing reserves. (1) Section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), the amount of such item shall be the amount computed on the old basis as of the close of the taxable year and the amount computed on the new basis as of the beginning of the next taxable year. Similarly, section 810(d)(1) provides rules for determining the amount of the adjustment to be made for purposes of Subpart C, Part I, Subchapter L, Chapter 1 of the Code (relating to the determination of gain or loss from operations), if the basis for determining any item referred to in section 810(c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year. Under an accrual method of accounting, a change in the basis or method of computing the amount of liability of any item referred to in section 810(c) occurs in the taxable year in which all the events have occurred which determine the change in the basis or method of computing the amount of such liability and, in which, the amount thereof (whether increased or decreased) can be determined with reasonable accuracy.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). Assume that during the taxable year 1960, M, a life insurance company, determines that the amount of its life insurance reserves held with respect to a particular block of contracts is understated on the present basis being used in valuing such liability and that such liability can be more accurately reflected by changing from the present basis to a particular new basis. Assume that M uses such new basis in computing its reserves under such contracts at the end of the taxable year 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine the change in basis and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy. Such change shall be treated as having occurred during the taxable year 1960 whether M determines that its liability under such contracts was understated for the first time during 1960, or that its liability under such contracts has, in fact, been understated for a number of prior years.

Example (2). Assume the facts are the same as in example (1), except that during the taxable year 1960 the insurance department of State X issues a ruling, pursuant to authority conferred by statute, requiring M to use the particular new basis which more accurately reflects its liability with respect to such contracts and that as a result of such ruling, M uses the new basis in computing its reserves under such contracts for the taxable years 1958, 1959, and 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine that a change in basis should be made and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy.

[T.D. 6558, 26 FR 2785, April 4, 1961]

§ 1.818–3 Amortization of premium and accrual of discount.

(a) In general. Section 818(b) provides that the appropriate items of income, deductions, and adjustments under Part I, Subchapter L, Chapter 1 of the Code, shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. The adjustment for accrual of discount increases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the exclusion and reduction for wholly tax-exempt interest. See section 103.

(b) Acquisitions before January 1, 1958. (1) In the case of any such security acquired before January 1, 1958, the premium is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, its then fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(2) The adjustments for amortization of premium and accrual of discount will be determined—

(i) According to the method regularly employed by the company, if such method is reasonable, or

(ii) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(3) The method of amortization and accrual prescribed by this section is as follows:

(i) The premium (or discount) shall be determined in accordance with this section; and

(ii) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For purposes of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered a month.

(c) **Acquisitions after December 31, 1957.** (1) In the case of—

(i) Any bond, as defined in section 171(d), acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under section 171(b) and the regulations thereunder, as if the election set forth in section 171(c) had been made, and

(ii) Any bond, note, debenture, or other evidence of indebtedness not described in subdivision (i) of this subparagraph and acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under paragraph (b) of this section.

(2) In the case of any bond, note, debenture, or other evidence of indebtedness acquired after December 31, 1957, the amount of the discount and the accrual of discount attributable to the taxable year shall be determined under paragraph (b) of this section.

(d) **Convertible evidences of indebtedness.** Section 818(b)(2)(B) provides that in no case shall the amount of premium on a convertible evidence of indebtedness (including any bond, note, or debenture) include any amount attributable to the conversion features of the evidence of indebtedness. This provision is the same as the one contained in section 171(b), and the rules prescribed in paragraph (c) of § 1.171–2 shall be applicable for purposes of section 818(b)(2)(B). This provision is to be applied without regard to the date upon which the evidence of indebtedness was acquired. Thus, where a convertible evidence of indebtedness was acquired before January 1, 1958, and a portion or all of the premium attributable to the conversion features of the evidence of indebtedness has been amortized for taxable years beginning before January 1, 1958, no adjustment for such amortization will be required by reason of section 818(b)(2)(B). Such amortization will, however, require an adjustment to the basis of the evidence of indebtedness under section 1016(a)(17). For taxable years beginning after December 31, 1957, no further amortization of the premium attributable to the conversion features of such an evidence of indebtedness will be taken into account.

(e) **Adjustments to basis.** Section 1016(a)(17) (relating to adjustments to basis) provides that in the case of any evidence of indebtedness referred to in section 818(b) and this section, the basis shall be adjusted to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years. The basis of any evidence of indebtedness shall be reduced by the amount of the adjustment required under section 818(b) (or the corresponding provision of prior income tax laws) on account of amortizable premium and shall be increased by the amount of the adjustment required under section 818(b) on account of accruable discounts.

(f) **Denial of double inclusion.** Any amount which is includible in gross investment income by reason of section 818(b) and paragraph (a) of this section shall not be includible in gross income under section 1232(a) (relating to the taxation of bonds and other evidences of indebtedness). See section 1232(a)(2)(C) and the regulations thereunder.

[T.D. 6558, 26 FR 2786, April 4, 1961]

§ 1.818–4 Election with respect to life insurance reserves computed on preliminary term basis.

(a) **In general.** Section 818(c) permits a life insurance company issuing contracts with respect to which the life insurance reserves are computed on one of the recognized preliminary term bases to elect to revalue such reserves on a net level premium basis for the purpose of determining the amount which may be taken into account as life insurance reserves for purposes of part I, Subchapter L, Chapter 1 of the Code, other than section 801 (relating to the definition of a life insurance company). If such an election is made, the method to be used in making this revaluation of reserves shall be either the exact revaluation method (as described in section 818(c)(1) and paragraph (b)(1) of this section) or the approximate revalua-

tion method (as described in section 818(c)(2) and paragraph (b)(2) of this section).

(b) Revaluation of reserves computed on preliminary term basis. If a life insurance company makes an election under section 818(c) in the manner provided in paragraph (e) of this section, the amount to be taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases:

(1) Exact revaluation method. As if the reserves for all such contracts had been computed on a net level premium basis (using the same mortality or morbidity assumptions and interest rates for both the preliminary term basis and the net level premium basis).

(2) Approximate revaluation method. The amount computed without regard to section 818(c)—

(i) Increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

(ii) Increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

(c) Exception. If a life insurance company which makes an election under section 818(c)(2) and paragraph (b)(2) of this section has life insurance reserves with respect to both life insurance and noncancellable accident and health contracts for which such reserves are computed on a preliminary term basis, it shall use the approximate revaluation method for all its life insurance reserves other than that portion of such reserves held with respect to its noncancellable accident and health contracts, and shall use the exact revaluation method for all its life insurance reserves held with respect to such noncancellable accident and health contracts.

(d) Reserves subject to recomputation. (1) For the first taxable year for which the election under section 818(c) and paragraph (b) of this section applies, a company making such election must revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the end of such taxable year on the basis elected under section 818(c) and paragraph (b) of this section. However, for purposes of the preceding sentence, an election under section 818(c) shall not apply with respect to such reserves which would not be treated as being computed on the preliminary term basis at the end of such taxable year except for the provisions of section 810(a) or (b). See paragraph (c)(2) of § 1.810–2. For example, if S, a life insurance company which computes its life insurance reserves on a recognized preliminary term basis at the beginning of the taxable year 1958, strengthens a portion of such reserves during the taxable year by actually changing to a net level premium basis in computing such reserves, and then makes the election under section 818(c) and paragraph (b) of this section for 1958, such election shall not apply with respect to the strengthened contracts.

(2) For any taxable year other than the first taxable year for which the election under section 818(c) and paragraph (b) of this section applies, a company making such election must revalue all its life insurance reserves held with respect to contracts for which such reserves are computed on a preliminary term basis at the beginning or end of the taxable year on the basis elected under section 818(c) and paragraph (b) of this section. For example, if M, a life insurance company which made a valid outstanding election under section 818(c) in the manner provided in paragraph (e) of this section for the taxable year 1959, sells a block of contracts subject to such election on September 1, 1960, M would value such contracts on the basis elected under section 818(c) and paragraph (b) of this section on January 1, 1960, for purposes of determining the net decrease or increase in the sum of the items described in section 810(c) for the taxable year under section 810 (a) or (b).

(3) For the effect of an election under section 818(c) and paragraph (b) of this section in determining gain or loss from operations for the taxable year, see paragraph (c)(3) of § 1.810–2 and paragraph (e) of § 1.810–3.

(e) Time and manner of making election. The election provided by section 818(c) shall be made in a statement attached to the life insurance company's income tax return for the first taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which the company desires the election to apply falls before April 4, 1961, the election provided by section

818(c) may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before July 4, 1961. The statement shall indicate whether the exact or the approximate method of revaluation has been adopted. The statement shall also set forth sufficient information as to mortality and morbidity assumptions; interest rates; the valuation method used; the amount of the reserves and the amount and type of insurance in force under all contracts for which reserves are computed on a preliminary term basis; and such other pertinent data as will enable the Commissioner to determine the correctness of the application of the revaluation method adopted and the accuracy of the computations involved in revaluing the reserves. The election to use either the exact revaluation method or the approximate revaluation method shall, except for the purposes of section 801, be adhered to in making the computations under part I for the taxable year for which such election is made and for all subsequent taxable years.

(f) Scope of election. An election made under section 818(c) and paragraph (b) of this section to use either the exact or the approximate method of revaluing the company's life insurance reserves shall be binding for the taxable year for which made, and, except as provided in paragraph (g) of this section, shall be binding for all succeeding taxable years, unless consent to revoke the election is obtained from the Commissioner. However, for taxable years beginning prior to April 4, 1961, a company may revoke the election provided by section 818(c) without obtaining consent from the Commissioner by filing, before July 4, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(g) Special rule for 1958. If an election is made for a taxable year beginning in 1958 to use the approximate revaluation method described in section 818(c)(2) and paragraph (b)(2) of this section the company may, for its first taxable year beginning after 1958, elect to change to the exact revaluation method described in section 818(c)(1) and paragraph (b)(1) of this section without obtaining the consent of the Commissioner. In such case, the election to change shall be made in a statement attached to the company's income tax return for such taxable year and filed not later than the date prescribed by law (including extensions thereof) for filing the return for such year. The statement shall indicate that the company has elected to change from the approximate to the exact revaluation method for such taxable year and shall include such information and data referred to in paragraph (e) of this section as will enable the Commissioner to determine the correctness and accuracy of the computations involved.
[T.D. 6558, 26 FR 2787, April 4, 1961; 26 FR 3276, April 18, 1961]

§ 1.818–5 Short taxable years.

(a) In general. Section 818(d) provides that if any return of a corporation made under Part I, Subchapter L, Chapter 1 of the Code, is for a period of less than the entire calendar year, then section 443 (relating to returns for a period of less than 12 months) shall not apply. This section further provides certain rules to be used in determining the life insurance company taxable income for a period of less than the entire calendar year.

(b) Returns for periods of less than the entire calendar year. A return for a short period, that is, for a taxable year consisting of a period of less than the entire calendar year, shall be made only under the following circumstances:

(1) If a company which qualifies as a life insurance company is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a life insurance company organized on August 1, is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, if a company which qualifies as a life insurance company completely dissolves during the taxable year it is required to file a return for the short period from January 1 to the date it goes out of existence. All items entering into the computation of taxable investment income and gain or loss from operations for the short period shall be determined on a consistent basis and in the manner provided in paragraph (c) of this section.

(2) A return must be filed for a short period resulting from the termination by the district director of a taxpayer's taxable year for jeopardy. See section 6851 and the regulations thereunder.

A company which was an insurance company for the preceding taxable year (but not a life insurance company as defined in section 801(a) and paragraph (b) of § 1.801–3) and which for the current taxable year qualifies as a life insurance company shall not file a return for the short period from the time during the taxable year that it first qualifies as a life insurance company to the end of the

taxable year. Similarly, an insurance company which was a life insurance company for the preceding taxable year but which for the current taxable year does not qualify as a life insurance company shall not file a return for the short period from the beginning of the taxable year to the time during the taxable year that it no longer qualifies as a life insurance company.

(c) Computation of life insurance company taxable income for short period. (1) If a return is made for a short period, section 818(d)(1) provides that the taxable investment income and the gain or loss from operations shall be determined on an annual basis by a ratable daily projection of the appropriate figures for the short period. The appropriate figures for the short period shall be determined on an annual basis by multiplying such figures by a fraction, the numerator of which is the number of days in the calendar year in which the short period occurs and the denominator of which is the number of days in the short period.

(2)(i) In computing taxable investment income for a short period, the investment yield, the policy and other contract liability requirements, the policyholders' share of each and every item of investment yield, and the company's share of any item of investment yield shall be determined on an annual basis.

(ii) For purposes of determining the investment yield on an annual basis, each item of gross investment income under section 804(b) and each item of deduction under section 804(c) shall be annualized in the manner provided in subparagraph (1) of this paragraph. In any case in which a limitation is placed on the amount of a deduction provided under section 804(c), the limitation shall apply to the item of deduction computed on an annual basis.

(iii) The policy and other contract liability requirements shall be determined on an annual basis in the following manner:

(a) The interest paid (as defined in section 805(e) and § 1.805-8) for the short period shall be annualized in the manner prescribed in subparagraph (1) of this paragraph.

(b) The current earnings rate for the taxable year in which the short period occurs shall be determined by dividing the taxpayer's investment yield, as determined on an annual basis under subdivision (ii) of this subparagraph, by the means of the taxpayer's assets at the beginning and end of the short period. For purposes of section 805, any reference to the current earnings rate for the taxable year in which the short period occurs means the current earnings rate as determined under this subdivision.

(c) The adjusted life insurance reserves shall be determined as provided in section 805(c), and the pension plan reserves shall be determined as provided in section 805(d).

(iv) The policyholders' share of each and every item of investment yield (as defined in section 804(a)) shall be that percentage obtained by dividing the policy and other contract liability requirements, determined under subdivision (iii) of this subparagraph, by the investment yield, determined under subdivision (ii) of this subparagraph.

(v) The taxable investment income for the short period shall be an amount (not less than zero) equal to the life insurance company's share of each and every item of investment yield, as determined under subdivision (ii) of this subparagraph, reduced by the items described in section 804(a)(2)(A) and (B). In determining these reductions under section 804(a)(2)(A) the amount of the respective items shall be the amount that is determined on an annual basis under subdivision (ii) of this subparagraph. The small business deduction, under section 804(a)(2)(B) shall be an amount (not to exceed $25,000) equal to 10 percent of the investment yield, determined under subdivision (ii) of this subparagraph, for the short period.

(vi) Except as provided in this paragraph, the determination of taxable investment income under Subpart B, Part I, Subchapter L, Chapter 1 of the Code, shall be made in accordance with all the provisions of that subpart.

(3)(i) In computing gain or loss from operations for a short period, the share of each and every item of investment yield set aside for policyholders, the life insurance company's share of each and every item of investment yield, the items of gross amount, and the items of deduction shall, except as modified by this subparagraph, be determined on an annual basis in the manner provided in subparagraph (1) of this paragraph. In any case in which a limitation is placed on the amount of a deduction provided under section 809, the limitation shall apply to the item of deduction computed on an annualized basis.

(ii) For purposes of sections 809 and 810, the investment yield shall be determined in the manner provided in subparagraph (2)(ii) of this paragraph. The share of any item of investment yield set aside for policyholders shall be that percentage obtained by dividing the required interest as deter-

mined under section 809(a)(2), by the investment yield, as determined in this subparagraph, except that if the required interest exceeds the investment yield then the share of any item of investment yield set aside for policyholders shall be 100 percent.

(iii) The items of gross amount and the items of deduction, other than the operations loss deduction under section 809(d)(4), shall be determined on an annual basis. See subdivision (iv) of this subparagraph for the manner in which the net decrease or net increase in reserves under section 810 shall be annualized.

(iv) For purposes of determining either a net decrease in reserves under section 810(a) or a net increase in reserves under section 810(b), the sum of the items described in section 810(c) as of the end of the short period shall be reduced by the amount of the investment yield not included in gain or loss from operations for the short period by reason of section 809(a)(1). The amount of investment yield excluded under section 809(a)(1) has been determined upon an annualized basis while the sum of the items described in section 180(c) at the end of the short period has been determined on an actual basis. In order to place these on the same basis, the amount of investment yield not included in gain or loss from operations by reason of section 809(a)(1), determined under subdivision (ii) shall, for purposes of section 810(a) and section 810(b), be reduced to an amount which bears the same ratio to the full amount as the number of days in the short period bears to the number of days in the entire calendar year. The net decrease or the net increase of the items referred to in section 810(c) for the short period shall then be determined, as provided in section 810(a) and section 810(b), respectively, and the result annualized.

(4) The portion of the life insurance company taxable income described in section 802(b)(1) and (2) (relating to taxable investment income and gain or loss from operations) shall be determined on an annual basis by treating the amounts ascertained under subparagraph (2) of this paragraph as the taxable investment income, and the amount ascertained under subparagraph (3) of this paragraph as the gain or loss from operations, for the taxable year.

(5) The portion of the life insurance company taxable income described in section 802(b)(1) and (2) for the short period shall be the amount which bears the same ratio to the amount ascertained under section 818(d)(2) and subparagraph (4) of this paragraph as the number of days in the short period bears to the number of days in the entire year.

(d) **Special rules.** (1) For purposes of determining the average earnings rate (as defined in section 805(b)(3)) for subsequent taxable years, the current earnings rate for the taxable year in which the short period occurs shall be the rate determined under paragraph (c)(2) of this section.

(2) For purposes of determining an operations loss deduction under section 812, the loss from operations for the short period shall be the loss from operations determined under paragraph (c)(5) of this section.

[T.D. 6558, 26 FR 2788, April 4, 1961]

§ 1.818-6 Transitional rule for change in method of accounting.

(a) **In general.** Section 818(e) prescribes the rules to be followed in recomputing the taxes of a life insurance company for the taxable year 1957 in cases where the method of accounting required to be used in computing the company's taxes for 1958 under section 818(a) and paragraph (a) of § 1.818-2 is different from the method used in 1957.

(b) **Recomputation of 1957 taxes.** (1) For purposes of recomputing its taxes for 1957, a life insurance company must ascertain the net amount of those adjustments which are determined (as of the close of 1957) to be necessary solely by reason of the change to the method of accounting required by section 818(a) and paragraph (a) of § 1.818-2 in order to prevent amounts from being duplicated or omitted. Thus, for example, life insurance companies not on the accrual method of accounting for the year 1957 shall accrue, as of December 31, 1957, those items of gross investment income under section 803(b) and those items of deduction under section 803(c), as in effect for 1957, which would have been properly accruable for the year 1957 if the company had been on the accrual method of accounting.

(2) In the case of a change in the over-all method of accounting, the term "net amount of those adjustments" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in the various accounts on December 31, 1957. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined with reference only to the net dollar balances in that particular account.

(3)(i) The amount of the taxpayer's tax for 1957 shall be recomputed (under the law applicable to 1957, modified as provided in section 818(e)(4) and paragraph (e) of this section) by taking into account an amount equal to one-tenth of the net amount of the adjustments determined under subparagraph (1) of this paragraph. The increase or decrease in tax attributable to the adjustments for such year is the difference between the tax for such year computed with the allocation of one-tenth of the net amount of the adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year.

(ii) The amount of increase or decrease (as the case may be) referred to in section 818(e)(2) or (3) and paragraphs (c) or (d) of this section, shall be the amount of the increase or decrease in tax ascertained in the manner described in subdivision (i) of this subparagraph, multiplied by 10.

(c) Treatment of decrease. Section 818(e)(2) provides that for purposes of Subtitle F of the Code, if the recomputation under paragraph (b)(3)(ii) of this section results in a decrease, the amount of such decrease shall be treated as a decrease in the tax imposed for 1957; except that for purposes of computing the period of limitation on the making of refunds or the allowance of credits with respect to such overpayments, the amount of such decrease shall be treated as an overpayment of tax for 1959. No interest shall be paid, for any period before March 16, 1960, on any overpayment of the tax imposed for 1957 which is attributable to such decrease.

(d) Treatment of increase—(1) In general. Section 818(e)(3)(A) provides that for purposes of Subtitle F of the Code, other than section 6016 (relating to declarations of estimated income tax by corporations) and section 6655 (relating to failure by corporations to pay estimated income tax), if the recomputation under paragraph (b)(3)(ii) of this section results in an increase, the amount of such increase shall be treated as a tax imposed for 1959. Such tax shall be payable in 10 equal annual installments, beginning with March 15, 1960.

(2) Special rules. Section 818(e)(3)(B) provides that for purposes of section 818(e)(3)(A) and subparagraph (1) of this paragraph—

(i) No interest shall be paid on any installment described in section 818(e)(3)(A) and subparagraph (1) of this paragraph before the time prescribed therein for the payment of such installment.

(ii) Section 6152(c) (relating to proration of deficiencies to installments) and the regulations thereunder shall apply. However, section 6152(a) (relating to the election to make installment payments) and the regulations thereunder shall not apply.

(iii) In applying section 6502(a)(1) (relating to collection after assessment) and the regulations thereunder, the assessment of any installment described in section 818(e)(3)(A) and subparagraph (1) of this paragraph shall be treated as made at the time prescribed therein for the payment of such installment.

(iv) If for any taxable year the taxpayer is not a life insurance company, the amount of the increase in tax (as determined under paragraph (b)(3)(ii) of this section), to the extent not taken into account for prior taxable years, shall be payable on the date the return for such taxable year is due (determined without regard to any extensions of time for filing such return), unless such amount is required to be taken into account by the acquiring corporation under section 381(c)(22) and the regulations thereunder.

(e) Modifications of 1957 tax computation. Section 818(e)(4) provides that in recomputing the taxpayer's tax for 1957 for purposes of section 818(e)(1) and paragraph (b) of this section—

(1) Section 804(b), as in effect for 1957 (relating to the maximum reserve and other policy liability deduction), shall not apply with respect to any amount required to be taken into account by reason of section 818(e)(1) and paragraph (b) of this section; and

(2) The amount of the deduction allowed by section 805, as in effect for 1957 (relating to the special interest deduction), shall not be reduced by reason of any amount required to be taken into account under section 818(e)(1) and paragraph (b) of this section.

(f) Illustration of principles. The application of section 818(e) and this section may be illustrated by the following examples:

Example (1). For the taxable year 1957, the life insurance taxable income of M, a life insurance company, is $200,000 computed on the cash receipts and disbursements method of accounting. The net amount of the adjustments required under section 818(e)(1) by reason of the change to the accrual method of accounting for 1958, increases M's life insurance taxable income for 1957 by $50,000. The increase in tax attributable to the change in method of accounting required by section 818(a) is $26,000, computed as follows:

(1) Life insurance taxable income before adjustments	$200,000

(2) Adjustments required by sec. 818(e)(1) (1/10 × $50,000)	5,000
(3) Life insurance taxable income after adjustments (item (1) plus item (2))	205,000
(4) Tax liability after adjustments (52% × $205,000, minus $5,500)	101,100
(5) Tax liability before adjustments (52% × $200,000, minus $5,500)	98,500
(6) Excess of item (4) over item (5)	2,600
(7) Increase in tax for purposes of sec. 818(e)(3) (item (6) multiplied by 10)	26,000

Under the provisions of section 818(e)(3), one-tenth of the increase in tax for 1957 attributable to the change in method of accounting required by section 818(a), $2,600 ($\frac{1}{10}$×$26,000), was due and payable on March 15, 1960, and the balance, $23,400 ($\frac{9}{10}$×$26,000), is due and payable in equal installments on March 15th of the nine succeeding taxable years. However, if for the taxable year 1965, M is no longer a life insurance company, and section 381(c)(22) does not apply, the balance of the installments not paid in prior taxable years, $10,400 ($\frac{4}{10}$×$26,000), shall be due and payable on March 15, 1966.

Example (2). Assume the facts are the same as in example (1), except that the net amount of the adjustments required by section 818(e)(1) decreases M's life insurance taxable income for 1957 by $25,000. The decrease in tax attributable to the change in method of accounting required by section 818(a) is $13,000, computed as follows:

(1) Life insurance taxable income before adjustments	$200,000
(2) Adjustments required by sec. 818(e)(1) (1/10 × $25,000)	2,500
(3) Life insurance taxable income after adjustments (item (1) minus item (2))	197,500
(4) Tax liability after adjustments (52% × $197,500, minus $5,500)	97,200
(5) Tax liability before adjustments (52% × $200,000, minus $5,500)	98,500
(6) Excess of item (5) over item (4)	1,300
(7) Decrease in tax for purposes of sec. 818(e)(2) (item (6) multiplied by 10)	13,000

Under the provisions of section 818(e)(2), the entire $13,000 decrease in tax for 1957 attributable to the change in method of accounting required by section 818(a) shall be treated as an overpayment of tax for the taxable year 1959.

[T.D. 6558, 26 FR 2789, April 4, 1961]

§ 1.818–7 Denial of double deductions.

Section 818(f) provides that the same item may not be deducted more than once under Subpart B, Part I, Subchapter L, Chapter 1 of the Code (relating to the determination of taxable investment income), and more than once under subpart C, Part I, Subchapter L, Chapter 1 of the Code (relating to the determination of gain or loss from operations).

[T.D. 6558, 26 FR 2790, April 4, 1961]

§ 1.818–8 Special rules relating to consolidated returns and certain capital losses.

Section 818(g) provides that, in the case of a life insurance company filing or required to file a consolidated return under section 1501 for a taxable year, the computations of the policyholders' share of investment yield under Subparts B and C, Part I, Subchapter L, Chapter 1 of the Code (including all determinations and computations incident thereto) shall be made as if such company were not filing a consolidated return. Thus, for example, if X and Y are life insurance companies which are entitled to file a consolidated return for 1975 and X has paid dividends to Y during such taxable year, Y must include such dividends in the computation of gross investment income under section 804(b). For other rules relating to the filing of consolidated returns, see sections 1501 through 1504 and the regulations thereunder.

[T.D. 7469, 42 FR 12181, March 3, 1977]

§ 1.819–1 Taxable years affected.

Section 1.819–2 is applicable only to taxable years beginning after December 31, 1957, and all references to sections of Part I, Subchapter L, Chapter 1 of the Code, are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2791, April 4, 1961]

§ 1.819–2 Foreign life insurance companies.

(a) Carrying on United States insurance business. Section 819(a) provides that a foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable on its United States business under section 802 in the same manner as a domestic life insurance company. Thus, the life insurance company taxable income of such a foreign life insurance company shall not be determined in the manner provided by Part I, Subchapter N, Chapter 1 of the Code (relating to determination of sources of income), but shall be determined in the manner provided by Part I, Subchapter L, Chapter 1 of the Code (relating to life insurance companies). See section 842. Accordingly, in determining its life insurance company taxable income from its United States business, such a foreign life insurance company shall take into account the appropriate items of income irrespective of whether such items of income are from sources within or without the United States. A foreign life insurance company shall take into account the appropriate items of expenses, losses, and other deductions properly allocable to such items of income from its United

States business. To the extent not inconsistent with the provisions of this paragraph, section 818(a), and section 819(b), all computations entering into the determination of taxes imposed by part I shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

(b) Adjustment where surplus held in the United States is less than specified minimum—(1) In general. Section 819(b)(1) provides that if the minimum figure for the taxable year determined under section 819(b)(2) and subparagraph (2)(i) of this paragraph exceeds the surplus held in the United States as of the end of the taxable year (as defined in section 819(b)(2)(B) and subparagraph (2)(ii) of this paragraph) by a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, then—

(i) The amount of the policy and other contract liability requirements (determined under section 805 and § 1.805–4 without regard to this subparagraph), and

(ii) The amount of the required interest (determined under section 809(a)(2) and paragraph (d) of § 1.809–2 without regard to this subparagraph),

shall each be reduced by an amount determined by multiplying such excess by the current earnings rate (as defined in section 805(b)(2) and paragraph (a)(2) of § 1.805–5) of such company. Such current earnings rate shall be determined by reference to the assets held by the company in the United States.

(2) Definitions. For purposes of section 819(b)(1) and subparagraph (1) of this paragraph—

(i) The term "minimum figure", in the case of a taxable year beginning after December 31, 1957, but before January 1, 1959, means the amount obtained by multiplying the company's total insurance liabilities on United States business by 9 percent. In the case of any taxable year beginning after December 31, 1958, such term means the amount obtained by multiplying the company's total insurance liabilities on United States business by the percentage determined and proclaimed by the Secretary as being applicable for such year.

(ii) The term "surplus held in the United States" means the excess of the assets held in the United States (as of the end of the taxable year) over the total insurance liabilities on United States business (as of the end of the taxable year).

(iii) The term "total insurance liabilities" means the sum of the total reserves (as defined in section 801(c) and paragraph (a) of § 1.801–5) as of the end of the taxable year plus (to the extent not included in total reserves) the items referred to in section 810(c)(3), (4), and (5) of paragraph (b)(3), (4), and (5) of § 1.810–2 as of the end of the taxable year; and

(iv) The term "assets" shall have the same meaning as that contained in section 805(b)(4) and paragraph (a)(4) of § 1.805–5.

(3) Illustration of principles. The provisions of section 819(b) and this paragraph may be illustrated by the following example:

Example. For the taxable year 1958, P, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has total insurance liabilities on United States business (as of the end of the taxable year) of $940,000, assets held in the United States of $1,000,000 (as of the end of the taxable year), policy and other contract liability requirements in the amount of $30,000 required interest in the amount of $20,000, and a current earnings rate of 4 percent. In order to determine whether section 819(b) applies for the taxable year 1958, P must first compute its minimum figure, for if the minimum figure is less than the surplus held in the United States (as of the end of the taxable year), no section 819(b) adjustments need be made. Since the minimum figure, $84,600 ($940,000, the total insurance liabilities on United States business multiplied by 9 percent, the percentage applicable for 1958), exceeds the surplus held in the United States, $60,000 (the excess of the assets held in the United States, $1,000,000, over the total insurance liabilities on United States business, $940,000), by $24,600, section 819(b) applies for the taxable year 1958. Thus, the amount of the policy and other contract liability requirements, $30,000, and the amount of the required interest, $20,000, shall each be reduced by $984 ($24,600, the amount of such excess, multiplied by 4 percent, the current earnings rate).

(4) Segregated asset accounts. For taxable years beginning after December 31, 1967, pursuant to the provisions of section 801(g)—

(i) A foreign corporation carrying on a life insurance business which issues contracts based on segregated asset accounts shall separately compute in a manner consistent with this subparagraph the adjustment (if any) under section 819 to the amount of policy and other contract liability requirements and the amount of required interest properly attributable to each of such segregated asset accounts. The "minimum figure" used in section 819 in making the adjustment with respect to each of the segregated asset accounts shall be computed as provided in subdivision (ii) of this subparagraph in lieu of the manner provided in subparagraphs (1), (2), and (3) of this paragraph.

(ii) The minimum figure applicable to a segregated asset account referred to in subdivision (i) of

this subparagraph is the amount determined by multiplying the total insurance liabilities on U.S. business attributable to such a segregated asset account, by 1 percent.

(iii) The minimum figure as computed under subdivision (ii) of this subparagraph shall be compared only with the surplus held in the United States attributable to each segregated asset account referred to in subdivision (i) of this subparagraph. Such surplus is the excess of assets held in the United States properly attributable to such segregated asset account over the total insurance liabilities on U.S. business properly attributable to such account.

(iv) If the minimum figure applicable to accounts other than segregated asset accounts exceeds the surplus held in the United States attributable to such other accounts, for purposes of section 819 and this paragraph, the amount of such excess shall not exceed the company's overall excess, as defined in this subdivision. No adjustment under section 819 or this paragraph shall be made with respect to any account if there is no such overall excess. For purposes of this subdivision and of subdivision (v) of this subparagraph, the term "overall excess" means the amount, if any, by which the aggregate minimum figures applicable to segregated asset accounts plus the minimum figure applicable to accounts other than segregated asset accounts exceeds the surplus held in the United States with respect to the company's entire U.S. life insurance business, including segregated asset accounts as well as other accounts.

(v) In the case of a company which issues contracts based on one or more than one segregated asset account, if the minimum figure applicable to a segregated asset account exceeds the surplus held in the United States attributable to such account, then for purposes of section 819 and this paragraph, the amount of such excess shall not exceed the account limitation figure, as defined in this subdivision. Therefore, no adjustment under section 819 or under this subparagraph shall be made with respect to any segregated asset account if the aggregate of the account limitation figures is zero, but nothing in this subdivision shall preclude an adjustment under section 819 with respect to accounts other than segregated asset accounts. For purposes of this subdivision, the term "account limitation figure" is a segregated assets account's proportionate share of the aggregate of the account limitation figures. Such aggregate of the account limitation figures is equal to the lesser of either the company's overall excess as defined in subdivision (iv) of this subparagraph, or the amount, if any, by which the aggregate of the minimum figures applicable to segregated asset accounts exceeds the surplus held in the United States with respect to all such segregated asset accounts. For purposes of this subdivision, a segregated asset account's proportionate share of the aggregate of the account limitation figures is determined by multiplying the amount of such aggregate of account limitation figures by a percentage, the numerator of which is the amount by which the minimum figure applicable to such account exceeds the surplus held in the United States attributable to such account, and the denominator of which is the aggregate of the amounts by which the minimum figure applicable to each segregated asset account exceeds the surplus held in the United States attributable to such account.

(vi) Subdivisions (i), (ii), (iii), (iv), and (v) of this subparagraph may be illustrated by the following examples:

Example (1). (a) For the taxable year 1968, T, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has the following assets and total insurance liabilities with respect to such U.S. business:

	Regular account	Separate account A	Separate account B
Assets	$9,300,000	$1,810,000	$515,000
Total insurance liabilities	8,000,000	1,800,000	500,000

It is further assumed that the percentage determined and proclaimed by the Secretary under section 819(a)(2)(A) for the taxable year 1968 is 15 percent.

(b) In order to determine whether any adjustment under section 819 must be made, T must compute the minimum figure applicable to its Regular Account as well as each of its Separate Accounts. The minimum figure for the Regular Account is $1,200,000 (15 percent of $8,000,000). The minimum figure applicable to Separate Account A is $18,000 (1 percent of $1,800,000). The minimum figure applicable to Separate Account B is $5,000 (1 percent of $500,000). The aggregate of the minimum figures is $1,223,000 ($1,200,000+$18,000+$5,000). The surplus held in the United States with respect to the Regular Account is $1,300,000 ($9,300,000–$8,000,000), with respect to Separate Account A is $10,000 ($1,810,000–$1,800,000) and with respect to Separate Account B is $15,000 ($515,000–$500,000). The surplus held in the United States with respect to T's entire U.S. life insurance business is $1,325,000 ($1,300,000+$10,000+$15,000).

(c) Since the aggregate of the minimum figures ($1,223,000) does not exceed the surplus held in the United States attributable to T's entire U.S. life insurance business ($1,325,000), under subdivision (iv) of this subparagraph no adjustment under section 819 shall be made with respect to the Regular Account or either of the Separate Accounts.

Example (2). (a) The facts are the same as in example (1) except that the assets held in the United States with respect to the Regular Account is $8,300,000 instead of $9,300,000. Thus, the surplus held in the United States with respect to the Regular Account is $300,000 ($8,300,000–$8,000,000), and the

surplus held in the United States with respect to T's entire U.S. life insurance business is $325,000 ($300,000 + $10,000 + $15,000).

(b) Since the aggregate of the minimum figures with respect to the Separate Accounts, $23,000 ($18,000 + $5,000), does not exceed the surplus held in the United States with respect to both of such Separate Accounts, $25,000 ($10,000 + $15,000), under subdivision (v) of this subparagraph, no adjustment under section 819 must be made with respect to either of the Separate Accounts.

(c) The excess of the minimum figure for the Regular Account ($1,200,000) over the surplus held in the United States with respect to the Regular Account ($300,000) is equal to $900,000 ($1,200,000–$300,000). However, the company's overall excess as defined in subdivision (iv) of this subparagraph, is $898,000 ($1,223,000–$325,000). Under subdivision (iv) of this subparagraph the excess with respect to the Regular Account ($900,000) is limited to the amount of overall excess ($898,000). Thus, the amount of policy and other contract liability requirements with respect to T's Regular Account and the amount of required interest with respect to T's Regular Account (both computed without regard to section 819) shall each be reduced by an amount equal to the product of $898,000 and the current earnings rate computed only with respect to T's Regular Account.

(c) Distributions to shareholders—(1) In general. In the case of a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, section 819(c)(1) provides alternative methods for determining the amount of distributions to shareholders for purposes of section 815 (relating to distributions to shareholders) and section 802(b)(3) (relating to life insurance company taxable income). Such a foreign life insurance company may elect (in the manner provided by subparagraph (4) of this paragraph) for each taxable year whichever of the alternative methods provided by section 819(c)(1) and this subparagraph it desires, and the method elected for any one taxable year shall be effective only with respect to the taxable year for which the election is made. Such alternative methods are:

(i) The amount of the distributions to shareholders shall be the amount determined by multiplying the total amount of distributions to shareholders by the percentage which the minimum figure for the taxable year is of the excess of the assets of the company over the total insurance liabilities; or

(ii) The amount of the distributions for shareholders shall be the amount determined by multiplying the total amount of distributions for shareholders by the percentage which the total insurance liabilities on United States business for the taxable year is of the total insurance liabilities of the company.

(2) Definitions. For purposes of section 819(c)(1) and subparagraph (1) of this paragraph:

(i) The term "total amount of the distributions to shareholders" means all distributions (within the meaning of section 815 and § 1.815–2) by a foreign life insurance company to all of its shareholders whether or not in the United States;

(ii) The term "minimum figure for the taxable year" means the amount determined under section 819(b)(2)(A) and paragraph (b)(2) of this section;

(iii) The term "assets of the company" means all of the assets (as defined in section 805(b)(4) and paragraph (a)(4) of § 1.805–5) of the foreign life insurance company whether or not in the United States (as of the end of the taxable year); and

(iv) The term "total insurance liabilities of the company" means the total insurance liabilities (as defined in section 819(b)(2) and paragraph (b)(2) of this section) on all of its business whether or not in the United States (as of the end of the taxable year).

(3) Illustration of principles. The provisions of section 819(c)(1) and subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example (1). For the taxable year 1958, T, a foreign life insurance company carrying on a life insurance business within the United States and taxable under section 802, has a minimum figure of $40,000, total amount of distributions to all shareholders (within the meaning of section 815) of $5,000, assets (as of the end of the year) of $500,000, total insurance liabilities (as of the end of the year) of $450,000, and total insurance liabilities on United States business (as of the end of the year) of $180,000. Based upon these facts, if T elects the method provided in section 819(c)(1)(A) and subparagraph (1)(i) of this paragraph, the amount of T's distributions to shareholders for the taxable year 1958 is $4,000, that is, $5,000 (the total amount of distributions to shareholders) multiplied by 80 percent (the percentage which the minimum figure for the taxable year, $40,000, is of $50,000, the excess of the assets of the company ($500,000) over the total insurance liabilities ($450,000)).

Example (2). The facts are the same as in example (1), except that for the taxable year 1958, T elects the method provided in section 819(c)(1)(B) and subparagraph (1)(ii) of this paragraph. Based upon these facts, the amount of T's distributions to shareholders for the taxable year 1958 is $2,000, that is, $5,000 (the total amount of distributions to shareholders) multiplied by 40 percent (the percentage which the total insurance liabilities on United States business ($180,000) is of the total insurance liabilities of the company ($450,000)).

(4) Manner and effect of election. (i) The election provided by section 819(c)(1) shall be made in a statement attached to the foreign life insurance company's income tax return for any taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including

extensions thereof) for filing the return for such taxable year. The statement shall indicate the method elected, the name and address of the taxpayer, and shall be signed by the taxpayer (or his duly authorized representative).

(ii) An election made under section 819(c)(1) and this paragraph shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which it desires the election to apply. Once such election has been made for any taxable year it may not be revoked. However, for taxable years beginning prior to April 4, 1961, a company may revoke the election provided by section 819(c)(1) without obtaining consent from the Commissioner by filing, before July 4, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation and the selection of the other percentage must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(5) Application of section 815. Once the amount of distributions to shareholders is determined under the provisions of section 819(c)(1) and this paragraph, the rules of section 815 (relating to distributions to shareholders) shall apply to the shareholders surplus account and the policyholders surplus account of a foreign stock life insurance company in the same manner as they would apply to a domestic stock life insurance company.

(d) Distributions pursuant to certain mutualizations. Section 819(c)(2) provides that for purposes of applying section 815(e) and paragraph (e) of § 1.815–6 (relating to a special rule for certain mutualizations) in the case of a foreign life insurance company subject to tax under section 802—

(1) The paid-in capital and paid-in surplus referred to in section 815(e)(1)(A) of a foreign life insurance company is the portion of such capital and surplus determined by multiplying such amounts by the percentage selected for the taxable year under section 819(c)(1) and paragraph (c)(1) of this section; and

(2) The excess referred to in section 815(e)(2)(A)(i) (without the adjustment provided by section 815(e)(2)(B)), is whichever of the following is the greater:

(i) The minimum figure for 1958 determined under section 819(b)(2)(A); or

(ii) The surplus held in the United States (as defined in section 819(b)(2)(B)) determined as of December 31, 1958.

(e) No United States insurance business. Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under part I, subchapter L, chapter 1 of the Code, but shall be taxable as other foreign corporations. See section 881 and the regulations thereunder.

[T.D. 6558, 26 FR 2791, April 4, 1961; 26 FR 3276, April 18, 1961, as amended by T.D. 6970, 33 FR 12044, Aug. 24, 1968]

§ 1.820–1 Taxable years affected.

Sections 1.820–2 and 1.820–3 are applicable only to taxable years beginning after December 31, 1957, and all references to part I, subchapter L, chapter 1 of the Code, are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

[T.D. 6558, 26 FR 2793, April 4, 1961]

§ 1.820–2 Optional treatment of policies reinsured under modified coinsurance contracts.

(a) In general. Section 820(a) provides that an insurance or annuity policy that is reinsured under a modified coinsurance contract (as defined in section 820(b) and paragraph (d) of this section) shall, for purposes of part I, subchapter L, chapter 1 of the Code (other than for purposes of section 801), be treated as if such policy were reinsured under a conventional coinsurance contract, if the reinsured company and the reinsuring company (hereinafter referred to as the "reinsured" and the "reinsurer") each consent to such treatment. This optional treatment applies with respect to any insurance or annuity policy reinsured under a modified coinsurance contract only in the event that the reinsured and the reinsurer consent to such treatment for all such policies reinsured under such contract and also consent to the application of the rules prescribed in and under section 820(c) and § 1.820–3 (relating to special rules).

(b) Time and manner of giving consent. **(1)** The consent of the reinsured and reinsurer to the application of section 820(a)(1) and paragraph (a) of this section to all insurance or annuity policies reinsured under a modified coinsurance contract and to the application of the rules prescribed in and under section 820(c) and § 1.820–3 shall be given in a written statement attached to the life insurance company income tax returns of both the

reinsured and reinsurer for the first taxable year to which such consent is to apply. The return and statement shall be filed not later than the time prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which such consent is to apply falls before April 4, 1961, such consent may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before July 4, 1961. The statement shall be executed by both the reinsured and reinsurer and shall be signed on their behalf by a person authorized to sign returns under section 6062 and the regulations thereunder.

(2) In addition to the statement of consent, the following shall also be filed with the returns of the reinsured and reinsurer:

(i) A copy of the original modified coinsurance contract between the reinsured and reinsurer as in effect for the first taxable year for which consent to the application of section 820 is given;

(ii) A separate schedule for the items referred to in paragraphs (1) through (5) of section 820(c) and paragraph (a) of § 1.820–3 (to the extent not reflected in the permanent books of account of the taxpayer) which relate to all policies reinsured under such modified coinsurance contract showing, in detail, the extent to which such items are to be taken into account for the taxable year by the reinsured and reinsurer under the terms of such contract and the provisions of that section; and

(iii) Such other data as is necessary to enable the Commissioner to determine the correctness of the application of the rules prescribed in and under section 820 and to ascertain the accuracy of the computations involved.

The contract referred to in subdivision (i) of this subparagraph need only be submitted with the returns of the reinsured and reinsurer for the first taxable year for which consent to the application of section 820 is given. Furthermore, the reinsured and reinsurer shall maintain as part of their permanent books of account any subsequent amendments to such contract. The information and data referred to in subdivisions (ii) and (iii) of this subparagraph shall be submitted annually and shall be attached to the returns of the reinsured and reinsurer for each taxable year for which the consent to the application of section 820 remains in effect.

(c) Scope of consent. The consent referred to in section 820(a)(2) and paragraphs (a) and (b) of this section shall be binding upon the reinsured and reinsurer for the taxable year for which given, and for all succeeding taxable years, unless permission to rescind such consent is obtained from the Commissioner. However, for taxable years beginning prior to April 4, 1961, such consent may be rescinded without obtaining permission from the Commissioner by filing, before July 4, 1961, a statement that the reinsured and the reinsurer desire to rescind the consent under section 820. Such statement shall be executed by both the reinsured and the reinsurer and shall be signed on their behalf by a person authorized to sign returns under section 6062 and the regulations thereunder. An amended return of both the reinsured and reinsurer reflecting such rescission must accompany the statement for all taxable years for which returns have been filed with respect to such consent.

(d) Modified coinsurance contract defined. For purposes of section 820, the term "modified coinsurance contract" means an indemnity reinsurance contract in which—

(1) One life insurance company (the reinsurer) agrees to indemnify another life insurance company (the reinsured) against the risk, or part thereof, assumed by the reinsured company under the insurance or annuity policy reinsured under the contract of reinsurance,

(2) The reinsured company retains ownership of the assets in relation to the reserve on the policy reinsured,

(3) All or part of the gross investment income derived from such assets is paid by the reinsured company to the reinsuring company as a part of the consideration for the reinsurance of such policy, and

(4) The reinsurer company is obligated for expenses incurred, and for Federal income taxes imposed, in respect of such gross investment income.

[T.D. 6558, 26 FR 2793, April 4, 1961]

§ 1.820–3 Special rules.

(a) In general. For purposes of section 820(a)(1), section 820(c) provides special rules (to the extent not improper under the terms of the modified coinsurance contract under which such policy is reinsured) to be applied in respect of the amount of such policy reinsured. Both the reinsured and the reinsurer must consent to these

special rules, in the manner provided in paragraph (b) of § 1.820–2, in order to obtain the optional treatment provided by section 820(a)(1). Such special rules and the adjustments required thereunder are—

(1) Premiums (to the extent allocable to the participation of the reinsurer therein) received for the policy reinsured shall be treated as received by the reinsurer and not by the reinsured. Amounts returned by the reinsurer to the reinsured shall be treated as reductions in premium income of the reinsurer under section 809(c)(1) and as other amounts received by the reinsured under section 809(c)(1).

(2)(i) Gross investment income (to the extent allocable to the participation of the reinsurer therein) derived from the assets in relation to the reserve on the policy reinsured shall be treated as gross investment income of the reinsurer and not of the reinsured. The gross investment income so treated shall be considered as derived proportionately from each of the various sources of gross investment income of the reinsured. For this purpose, the percentage used in determining the reinsurer's share of each and every item of gross investment income (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be determined by dividing the amount of gross investment income allocable to the reinsurer under the modified coinsurance contract by the total gross investment income of the reinsured. The percentage thus obtained is then applied to each and every item of gross investment income of the reinsured. The percentage used in determining the reinsured's share of each and every item of gross investment income (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be the percentage obtained by subtracting the percentage obtained under the preceding sentence from 100 percent.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. For the taxable year 1958, R, a life insurance company, reinsures a block of its policies with S, a life insurance company, under a modified coinsurance contract. Assume that R and S have consented to the application of section 820 and that the amount of gross investment income allocable to S (under the terms of the modified coinsurance contract) is $100,000. Assume further that R has gross investment income of $500,000 for the taxable year 1958, including $5,000 of wholly tax-exempt interest, $300,000 of interest on notes, loans, etc., $35,000 of rental income, $60,000 of royalty income, and $100,000 of dividends received on stock of domestic corporations. Since the gross investment income of R to be treated as gross investment income of S is 20 percent of R's gross investment income ($100,000÷$500,000), R would make up the following schedule for purposes of determining the portion of each individual item of gross investment income to be taken into account by R and S:

	Col. 1 Gross investment income	Col. 2 (20% × Col. 1) S's share of gross investment income	Col. 3 (Col. 1–Col. 2) R's share of gross investment income
Interest wholly tax-exempt	$5,000	$1,000	$4,000
Interest on notes, loans, etc.	300,000	60,000	240,000
Rents	35,000	7,000	28,000
Royalties	60,000	12,000	48,000
Dividends on stock of domestic corporations	100,000	20,000	80,000
Total	500,000	100,000	400,000

(3)(i) Gains and losses from sales and exchanges of capital assets, and gains and losses considered as gains and losses from sales and exchanges of capital assets, of the reinsured company shall (to the extent of the participation therein by the reinsurer under the terms of the modified coinsurance contract) be treated as gains and losses from sales and exchanges of capital assets of the reinsurer and not of the reinsured. The character of the gains and losses so treated shall be the same for the reinsurer as it would be in the hands of the reinsured. The gains and losses so treated shall be considered as derived proportionately from each sale and exchange of a capital asset, and each gain and loss considered as a gain and loss from the sale and exchange of a capital asset, of the reinsured.

(ii) The provisions of this subparagraph may be illustrated by the following example:

Example. For the taxable year 1959, L, a life insurance company, reinsures a block of its policies with N, a life insurance company, under a modified coinsurance contract. Assume that L and N have consented to the application of section 820 and that under the terms of such contract 20 percent of the gains and losses from the sales and exchanges of capital assets (and any gains and losses considered to be from sales and exchanges of capital assets under applicable law) of L are allocable to N. Assume further that for the taxable year 1959, L has a long-term capital gain of $5,000 from the sale of stock X, a short-term capital gain of $8,000 from the sale of stock Y, and a long-term capital loss of $4,000 from the sale of stock Z. Since 20 percent of such gains and losses of L are allocable to N, L would make up the following schedule for purposes of determining the portion of each of such gains and losses to be taken into account by L and N:

	Col. 1 Capital gain or loss	Col. 2 (20% × Col. 1) N's share of capital gain or loss	Col. 3 (Col. 1–Col. 2) L's share of capital gain or loss
Long-term capital gain	$5,000	$1,000	$4,000

	Col. 1 Capital gain or loss	Col. 2 (20% × Col. 1) N's share of capital gain or loss	Col. 3 (Col. 1–Col. 2) L's share of capital gain or loss
Short-term capital gain	$8,000	$1,600	$6,400
Long-term capital loss	4,000	800	3,200

(4) The reserve on the policy reinsured (to the extent allocable to the participation of the reinsurer therein) shall be treated as a part of the reserves of the reinsurer and not of the reinsured. Such reserve shall not be limited to the items taken into account under section 810(c).

(5) The assets in relation to the reserve referred to in section 820(c)(3) and in subparagraph (4) of this paragraph shall be treated as owned by the reinsurer and not by the reinsured.

(6)(i) The expenses (to the extent reimbursable by the reinsurer) incurred with respect to the policy reinsured which relate to the determination of gain or loss from operations under section 809(b) shall be treated as incurred by the reinsurer and not by the reinsured. Furthermore, any provision limiting the amount which shall be allowed as a deduction shall be applied after such adjustment has been made.

(ii) The expenses (to the extent reimbursable by the reinsurer) incurred with respect to the policy reinsured and with respect to the assets referred to in section 820(c)(3) and subparagraph (5) of this paragraph which relate to the determination of investment yield under section 804(c) shall be treated as incurred by the reinsurer and not by the reinsured. Furthermore, any provision limiting the amount which shall be allowed as a deduction shall be applied after such adjustment has been made. The expenses so treated shall be considered as incurred proportionately from each of the various sources of expenses incurred by the reinsured. For this purpose, the percentage used in determining the reinsurer's share of each and every item of such expenses shall be determined by dividing the amount of such expenses allocable to the reinsurer under the modified coinsurance contract by the total amount of such expenses. The percentage thus obtained is then applied to each and every item of such expenses. The percentage used in determining the reinsured's share of each and every item of such expenses shall be the percentage obtained by subtracting the percentage obtained under the preceding sentence from 100 percent.

(iii) The provisions of subdivision (ii) of this subparagraph may be illustrated by the following example:

Example. Assume the facts are the same as in the example contained in subparagraph (2)(ii) of this paragraph, except that R incurred expenses ($8,000 of which are reimbursable by S) relating to the determination of investment yield of $40,000, including investment expenses of $30,000, depreciation of $8,000, and real estate expenses of $2,000. Based upon these facts, R would make up the following schedule for purposes of determining the portion of each individual item of expense to be taken into account by R and S:

	Col. 1 Total	Col. 2 (20% × Col. 1) S's share of expenses	Col. 3 (Col. 1–Col. 2) R's share expenses
Investment expenses	$30,000	$6,000	$24,000
Depreciation	8,000	1,600	6,400
Real estate expenses	2,000	400	1,600
Expenses relating to determination of investment yield	40,000	8,000	32,000

(7) Dividends to policyholders (as defined in section 811(a) and paragraph (a) of § 1.811–2) paid in respect of the policy reinsured shall be treated as paid by the reinsurer and not by the reinsured. For purposes of the preceding sentence, the amount of dividends to policyholders treated as paid by the reinsurer shall be the amount paid, in respect of the policy reinsured, by the reinsurer to the reinsured as reimbursement for dividends to policyholders paid by the reinsured. This subparagraph shall apply also in respect of an insurance or annuity policy reinsured under a conventional reinsurance contract.

(8) Any amounts paid in 1958 or any subsequent year by the reinsurer to the reinsured as reimbursement for Federal income taxes imposed for a taxable year beginning in 1957 or any preceding taxable year shall not be taken into account by the reinsured as an item of gross amount under section 809(c) or taken into account by the reinsurer as an item of deduction under section 809(d).

(b) Denial of double deduction. In applying the special rules provided by section 820(c) and paragraph (a) of this section, an item shall be taken into account as income only once under subpart B, part I, subchapter L, chapter 1 of the Code, and only once under subpart C, part I, subchapter L, chapter 1 of the Code, by both the reinsured and the reinsurer, and an item shall be allowed as a deduction only once under such subpart B and only once under such subpart C to both the reinsured and the reinsurer.

[T.D. 6558, 26 FR 2793, April 4, 1961]

Mutual Insurance Companies (Other Than Life and Certain Marine Insurance Companies and Other Than Fire or Flood Insurance Companies Which Operate on Basis of Perpetual Policies or Premium Deposits)

§ 1.821–1 Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 831.

(a) In general. (1) For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 801 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 821 (a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821(a)(2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822(d)(2) and § 1.822–3.

(3) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821(a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821(a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with gross amounts of income from interest, dividends, rents, and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821(a)(1) or section 821(a)(2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821(b).

(b) Rates of tax. (1) The normal tax under section 821(a)(1)(A) and 821(b)(1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821(a)(1)(B) and 821(b)(2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821(a)(2), except as hereinafter indicated, is 1 percent of the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) Under section 821(a)(1)(A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of

$3,000.[1] The rate applicable in computing the normal tax of such companies is 60 percent. Under section 821(a)(2) companies with gross amounts of income from interest dividends, rents, and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) Under section 821(b)(1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821(b)(2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821(c) provides for an adjustment of the amount computed under section 821(a)(1), section 821(a)(2), and section 821(b) where the gross amount received during the taxable year from interest, dividends, rents, and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) Application. The application of section 821(a) to (c) inclusive, may be illustrated by the following examples:

Example (1). The W Company, a mutual casualty insurance company, for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from interest, dividends, rents and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821(a)(1) for the calendar year 1954 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1954 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821(a)(1)(A) is the normal tax of $1,020. The tax under section 821(a)(2) is 2 percent of $75,000 ($150,000–$75,000), or $1,500. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821 is $1,500, namely, that imposed by section 821(a)(2).

Example (2). If in example (1) the income for purposes of the normal tax was not over $3,000, the income for purposes of the surtax was not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) was $90,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, was $70,000, the W Company would be required to file an income tax return but due to section 821(a) no income tax would be imposed.

Example (3). The X Company, a mutual casualty insurance company, for the calendar year 1954 has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821(a)(1) its normal tax for the calendar year 1954 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000–$25,000), or $660. The combined tax under section 821(a)(1) is $7,560 ($6,900 plus $660). The tax under section 821(a)(2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821(a) is $12,000, namely, that imposed by section 821(a)(2).

Example (4). The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1954, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received from interest, dividends, rents and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821(a)(1), without application of section 821(c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821(c), since the gross receipts are between $75,000 and $125,000. The tax under section 821(a)(1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821(a)(2), without reference to section 821(c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821(c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821(a)(1), as adjusted, exceeds $450, the tax under section 821(a)(2), as adjusted, the tax under section 821(a)(1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal taxing and surtax of $10,080.

Example (5). The Z Exchange, an interinsurer, for the calendar year 1954 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821(b)(1) for the calendar

[1] Pub.L. 87–834, Oct. 16, 1962, 76 Stat. 989 increased taxable income from $3,000 to $6,000 and increased gross amount from $75,000 but less than $125,000 to $150,000 but less than $250,000.

year 1954 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821(a)(2), and is not entitled to the adjustment provided in section 821(c), its total tax under section 821(a) is $3,300.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.821-2 Taxable years affected.

Section 1.821-1 is applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Section 1.821-3 is applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.821-4 and 1.821-5 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to sections of the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6610, 27 FR 8718, Aug. 31, 1962, as amended by T.D. 6681, 28 FR 11110, Oct. 17, 1963]

§ 1.821-3 Tax on mutual insurance companies other than life or marine or fire insurance companies subject to the tax imposed by section 831.

(a) In general. **(1)** For taxable years beginning after December 31, 1954, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 802 or 831 and not specifically exempt under the provisions of section 501(c)(15), are subject to the tax imposed by section 821 on their investment income or on their gross income, whichever tax is the greater, except interinsurers and reciprocal underwriters which are taxed only on their investment income. For the alternative tax, in lieu of the tax imposed by section 821(a) or (b), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 821 differs from the taxable income of other corporations. See section 821(a)(2) and section 822. Such companies are entitled, in computing mutual insurance company taxable income, to the deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code. The gross amount of income during the taxable year from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. See section 822(d)(2) and § 1.822-7. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the deduction for wholly tax-exempt interest. See section 103. In the case of any such evidence of indebtedness, adjustment shall be made to basis in the same manner as that made by life insurance companies under section 1016(a)(17) and the regulations thereunder.

(3) All provisions of the Internal Revenue Code and of the regulations in this part not inconsistent with the specific provisions of section 821 are applicable to the assessment and collection of the tax imposed by section 821(a) or (b) and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) Foreign mutual insurance companies not carrying on an insurance business within the United States are not taxable under section 821(a) or (b), but are taxable as other foreign corporations. See section 881.

(5) Mutual insurance companies subject to the tax imposed by section 821, except interinsurers or reciprocal underwriters, with mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $3,000 or with gross amounts of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums (minus dividends to policyholders and wholly tax-exempt interest) in excess of $75,000, are subject to a tax computed under section 821(a)(1) or section 821(a)(2) whichever is the greater. Interinsurers and reciprocal underwriters with mutual insurance company taxable income

(computed without regard to the deduction provided in section 242 for partially tax-exempt interest) of over $50,000 are subject to a tax computed under section 821(b).

(b) Rates of tax. (1) For taxable years beginning before July 1, 1963, the normal tax under section 821(a)(1)(A) and 821(b)(1), except as hereinafter indicated, is computed upon mutual insurance company taxable income for purposes of the normal tax at the rate of 30 percent.

(2) The surtax under section 821(a)(1)(B) and 821(b)(2), except as hereinafter indicated, is computed on that portion of the mutual insurance company taxable income for the purposes of the surtax in excess of $25,000 at the rate of 22 percent. The tax under section 821(a)(2), except as hereinafter indicated, is 1 percent of the gross amount of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest.

(3) For taxable years beginning before July 1, 1963, under section 821(a)(1)(A) companies with mutual insurance company taxable income for purposes of the normal tax of over $3,000 and not over $6,000 pay a normal tax, at a specified rate, on that portion of such income in excess of $3,000. The rate applicable in computing the normal tax of such companies is 60 percent. Under section 821(a)(2) companies with gross amounts of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and minus wholly tax-exempt interest, of over $75,000 and not over $150,000 pay a tax equal to 2 percent of that portion in excess of $75,000.

(4) For taxable years beginning before July 1, 1963, under section 821(b)(1) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the normal tax of over $50,000 and not over $100,000 pay a normal tax computed on that portion of such income in excess of $50,000 at the rate of 60 percent. Under section 821(b)(2) interinsurers and reciprocal underwriters with mutual insurance company taxable income for purposes of the surtax of over $50,000 and not over $100,000 pay a surtax, at the rate of 33 percent, on that portion of such income in excess of $50,000.

(5) Section 821(c) provides for an adjustment of the amount computed under section 821(a)(1), section 821(a)(2), and section 821(b) where the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is over $75,000 and less than $125,000. The adjustment reduces the tax otherwise computed under those sections to an amount which bears the same proportion to such tax as the excess over $75,000 bears to $50,000.

(c) Application. The application of section 821(a) to (c) inclusive, may be illustrated by the following examples:

Example (1). The W Company, a mutual casualty insurance company, for the calendar year 1958, has mutual insurance company taxable income for purposes of the surtax of $5,500 and, due to partially tax-exempt interest of $800, has income for purposes of the normal tax of $4,700. The gross amount of income of the W Company from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $150,000. Its normal tax under section 821(a)(1) for the calendar year 1958 is 60 percent of $1,700 ($4,700 minus $3,000) or $1,020, since its income subject to normal tax is not over $6,000. It is not liable for surtax for the calendar year 1958 as its mutual insurance company taxable income for purposes of the surtax does not exceed $25,000. It has no surtax and, therefore, its total tax under section 821(a)(1)(A) is the normal tax of $1,020. The tax under section 821(a)(2) is 2 percent of $75,000 ($150,000–$75,000), or $1,500. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821 is $1,500, namely, that imposed by section 821(a)(2).

Example (2). If in the above example the income for purposes of the normal tax were not over $3,000, the income for purposes of the surtax were not over $25,000, the gross amount received from interest, dividends, rents, and premiums (including deposits and assessments) were $90,000, and the gross amount of income from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest were $70,000, the W Company would be required to file an income tax return but due to section 821(a) no income tax would be imposed.

Example (3). The X Company, a mutual casualty insurance company, for the calendar year 1958, has mutual insurance company taxable income for surtax purposes of $28,000 and, due to partially tax-exempt interest of $5,000, has income for normal tax purposes of $23,000. The gross amount of income of the X Company received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $1,200,000. Under section 821(a)(1) its normal tax for the calendar year 1958 is 30 percent of $23,000, or $6,900, and the surtax is 22 percent of $3,000 ($28,000–$25,000), or $660. The combined tax under section 821(a)(1) is $7,560 ($6,900 plus $660). The tax under section 821(a)(2) is 1 percent of $1,200,000, or $12,000. Since the tax under section 821(a)(2) exceeds the tax under section 821(a)(1), the tax under section 821(a) is $12,000, namely, that imposed by section 821(a)(2).

Example (4). The Y Company, a mutual fire insurance company subject to the tax imposed by section 821 for the calendar year 1958, has mutual insurance company taxable income for purposes of the surtax of $35,000 and, due to

partially tax-exempt interest of $5,000, has income for purposes of the normal tax of $30,000. The gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is $120,000, and the gross amount of income from interest, dividends, rents, and net premiums, minus dividends to policyholders and wholly tax-exempt interest, is $100,000. Under section 821(a)(1), without application of section 821(c), the normal tax would be 30 percent of $30,000, or $9,000, since this is less than $16,200, 60 percent of $27,000 (excess of $30,000 over $3,000); and the surtax would be 22 percent of $10,000 (excess of $35,000 over $25,000), or $2,200. The combined tax of $11,200 ($9,000 plus $2,200) would then be reduced by applying section 821(c), since the gross receipts are between $75,000 and $125,000. The tax under section 821(a)(1), as thus adjusted, would be 90 percent of $11,200, or $10,080, since $45,000 (excess of $120,000 over $75,000) is 90 percent of $50,000. Under section 821(a)(2), without reference to section 821(c), the tax is 2 percent of $25,000 (excess of $100,000 over $75,000), or $500, since this is less than $1,000, 1 percent of $100,000. Applying section 821(c) reduces this to $450, or 90 percent of $500. Since $10,080, the tax under section 821(a)(1), as adjusted, exceeds $450, the tax under section 821(a)(2), as adjusted, the tax under section 821(a)(1), as adjusted, is applicable. The Y Company would accordingly pay a combined normal tax and surtax of $10,080.

Example (5). The Z Exchange, an interinsurer, for the calendar year 1958 has mutual insurance company taxable income for purposes of the surtax of $60,000 and, due to partially tax-exempt interest of $12,000, has income for purposes of the normal tax of $48,000. The gross amount received during the taxable year from the items described in section 822(b)(other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is $2,700,000. The Z Exchange is not liable for normal tax under section 821(b)(1) for the calendar year 1958 as its mutual insurance company taxable income for purposes of the normal tax does not exceed $50,000. Its surtax is 33 percent of $10,000 ($60,000 minus $50,000), or $3,300, since that amount is less than $7,700, 22 percent of $35,000 (excess of $60,000 over $25,000). Since the Z Exchange has no normal tax, is not subject to the tax imposed by section 821(a)(2), and is not entitled to the adjustment provided in section 821(c), its total tax under section 821(b) is $3,300.

[T.D. 6610, 27 FR 8718, Aug. 31, 1962]

§ 1.821-4 Tax on mutual insurance companies other than life insurance companies and other than fire, flood, or marine insurance companies, subject to tax imposed by section 831.

(a) In general—(1) Tax imposed. (i) For taxable years beginning after December 31, 1962, all mutual insurance companies, including foreign insurance companies carrying on an insurance business within the United States, not taxable under section 802 or 831, and not specifically exempt under the provisions of section 501(c)(15), are subject either to the tax imposed by section 821(a) on mutual insurance company taxable income or, in the case of certain small companies, to the tax imposed by section 821(c) on taxable investment income. The determination of whether a mutual insurance company is taxable under section 821(a) or (c) for the taxable year is dependent upon the gross amount received by the company during such taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments). If such gross amount received exceeds $150,000, but does not exceed $500,000 for the taxable year, the company is subject to the tax imposed by section 821(c) on taxable investment income, unless (a) the company elects under section 821(d) in the manner provided in paragraph (f) of this section to be subject to the tax imposed by section 821(a), or (b) there is a balance in its protection against loss account at the beginning of the taxable year. A company having a gross amount received in excess of $500,000 is subject to the tax imposed by section 821(a). For exemption from income tax of companies having a gross amount received not in excess of $150,000, see section 501(c)(15). For the alternative tax, in lieu of the tax imposed by section 821(a) or (c), where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder. For the definition of an insurance company, see paragraph (a) of § 1.801-3.

(ii) The term "premiums" as used in section 821 and this section has the same meaning as in section 501(c)(15) and § 1.501(c)(15)-1, and means the total amount of the premiums and other consideration provided in the insurance contract without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, discounts on premiums paid in advance, interest applied in reduction of premiums (whether or not required to be credited in reduction of premiums under the terms of the contract), or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction), but does not include amounts received from other insurance companies for losses paid under reinsurance contracts.

(2) Tax base. The taxable income of mutual insurance companies taxable under section 821 differs from the taxable income of other corporations. See sections 821(b) and 822. Mutual insurance companies have special items of income and special deductions not provided for other cor-

porations. See, for example, sections 821(b)(1)(C), 822(d), 823(b), 824(a), and 825(a). Thus, the computation of mutual insurance company taxable income for a company taxable under section 821(a), and the computation of taxable investment income for a company taxable under section 821(c), must be made in strict accordance with the provisions of part II of subchapter L of the Code.

(3) **Applicability of other provisions.** All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of part II of subchapter L of the Code are applicable to the assessment and collection of the tax imposed by section 821(a) or (c), and mutual insurance companies subject to the tax imposed by section 821 are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. The return shall be on Form 1120M.

(4) **Certain foreign companies.** Foreign mutual insurance companies (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831) not carrying on an insurance business within the United States are not taxable under section 821(a) or (c), but are taxable as other foreign corporations. See section 881.

(b) **Rates of tax imposed by section 821(a)—(1) Normal tax.** For taxable years beginning before January 1, 1964, the normal tax imposed under section 821(a) is the lesser of 30 percent of mutual insurance company taxable income, or 60 percent of the amount by which mutual insurance company taxable income exceeds $6,000. In the case of taxable years beginning after December 31, 1963, the normal tax is imposed at the rate of 22 percent of mutual insurance company taxable income, or 44 percent of the amount by which mutual insurance company taxable income exceeds $6,000, whichever is the lesser. For example, a company subject to tax under section 821(a) will file a return but will pay no normal tax if mutual insurance company taxable income does not exceed $6,000. When mutual insurance company taxable income exceeds $6,000 but does not exceed $12,000, the company will pay a normal tax equal to 44 percent (60 percent in the case of taxable years beginning before Jan. 1, 1964), of the amount by which mutual insurance company taxable income exceeds $6,000. When mutual insurance company taxable income exceeds $12,000, the company will pay normal tax at the rate of 22 percent (30 percent in the case of taxable years beginning before Jan. 1, 1964), of such income.

(2) **Surtax—(i) Taxable years beginning before January 1, 1964.** For taxable years beginning before January 1, 1964, companies taxable under section 821(a) are subject to a surtax equal to 22 percent of so much of their mutual insurance company taxable income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) as exceeds $25,000. In the case of an interinsurer or reciprocal underwriter electing to be subject to the limitation provided in section 826(b), the surtax applies to any increase in mutual insurance company taxable income attributable to such election, without regard to the $25,000 surtax exemption otherwise provided by this subparagraph, and without regard to whether the company is liable for any normal tax under subparagraph (1) of this paragraph. See section 826(f) and § 1.826–2.

(ii) **Taxable years beginning after December 31, 1963.** For taxable years beginning after December 31, 1963, companies taxable under section 821(a) are subject to a surtax at the rates and with the exemptions provided in section 11(c) on their mutual insurance company taxable income. In the case of an interinsurer or reciprocal underwriter electing to be subject to the limitation provided in section 826(b), the surtax applies to any increase in mutual insurance company taxable income attributable to such election, without regard to the surtax exemption otherwise provided by section 11(d), and without regard to whether the company is liable for any normal tax under section 821(a)(1) and subparagraph (1) of this paragraph. See section 826(f) and § 1.826–2.

(c) **Mutual insurance company taxable income defined.** The tax imposed by section 821(a) with respect to any taxable year is computed upon mutual insurance company taxable income for the taxable year. Section 821(b) provides that in the case of a mutual insurance company subject to the tax imposed by section 821(a), mutual insurance company taxable income means the amount by which—

(1) The sum of—

(i) The taxable investment income (as defined in section 822(a)(1) and paragraph (a)(1) of § 1.822–8).

(ii) The statutory underwriting income (as defined in section 823(a)(1) and paragraph (b)(1) of § 1.823–6), and

(iii) The amounts required by section 824(d) and paragraph (b)(3) of § 1.824–1 to be subtracted from the protection against loss account, exceeds

(2) The sum of—

(i) The investment loss (as defined in section 822(a)(2) and paragraph (a)(2) of § 1.822–8),

(ii) The statutory underwriting loss (as defined in section 823(a)(2) and paragraph (b)(2) of § 1.823–6), and

(iii) The unused loss deduction provided by section 825(a) and paragraph (a) of § 1.825–1.

If for any taxable year the amount determined under subparagraph (2) of this paragraph equals or exceeds the amount determined under subparagraph (1) of this paragraph, the mutual insurance company taxable income for such year shall be zero.

(d) **Examples.** The application of the tax imposed by section 821(a) may be illustrated by the following examples:

Example (1). (a) M, a mutual casualty insurance company, for the calendar year 1963 has gross receipts from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) in excess of $500,000, and therefore is subject to the tax imposed by section 821(a). M's taxable investment income, computed under section 822, is $30,000 and its statutory underwriting income, computed under section 823, is $15,000. M subtracts $3,000 from its protection against loss account in accordance with the computation made under section 824(d). M has no unused loss deduction. M received no partially tax exempt interest. If M is not subject to section 826, its mutual insurance company taxable income for the taxable year 1963 is $48,000, computed as follows:

(1) Taxable investment income	$30,000
(2) Statutory underwriting income	15,000
(3) Subtractions from protection against loss account	3,000
(4) Total income items	48,000
(5) Investment loss	0
(6) Statutory underwriting loss	0
(7) Unused loss deduction	0
(8) Total loss items	0
(9) Mutual insurance company taxable income (item (4) minus item (8))	$48,000

(b) Since M's mutual insurance company taxable income is in excess of $12,000, M will pay normal tax on its mutual insurance company taxable income at a rate of 30 percent. In addition, since M's mutual insurance company taxable income exceeds $25,000, M will pay surtax on such excess at a rate of 22 percent. M's total tax liability for the taxable year 1963 is $19,460, computed as follows:

(1) Mutual insurance company taxable income as computed in item (a)(9)	$48,000
(2) Normal tax; 30 percent of mutual insurance company taxable income	14,400
(3) Surtax exemption	25,000
(4) Mutual insurance company taxable income subject to the surtax (item (1) minus item (3))	23,000
(5) Surtax: 22 percent of mutual insurance company taxable income subject to the surtax	5,060
(6) Total tax (item (2) plus item (5))	19,460

Example (2). If in example (1), M's mutual insurance company taxable income for 1963 had been in excess of $6,000 but not in excess of $12,000, M would pay normal tax in an amount equal to 60 percent of the amount by which such income exceeded $6,000. Thus, if M had mutual insurance company taxable income of $11,000, M's total tax liability for the taxable year 1963 would be $3,000, computed as follows:

(1) Mutual insurance company taxable income	$11,000
(2) Mutual insurance company taxable income in excess of $6,000 ($11,000 minus $6,000)	5,000
(3) 30 percent of item (1)	3,800
(4) 60 percent of item (2)	3,000
(5) Normal tax (lesser of items (3) or (4))	3,000
(6) Surtax exemption	25,000

Since the surtax exemption exceeds the mutual insurance company taxable income for purposes of the surtax, there is no surtax liability. Since the normal tax under section 821(a) is the lesser of 30 percent of mutual insurance company taxable income or 60 percent of the amount by which such income exceeds $6,000, M's normal tax (and total income tax liability) is $3,000. If M's mutual insurance company taxable income was not in excess of $6,000, M would be required to file a return, but would not be liable for any normal tax, since, in such a case, 60 percent of M's mutual insurance company taxable income in excess of $6,000 would be zero.

Example (3). Assume the same income as in example (1) in the 1965 calendar year and that M is not a corporation to which section 1561 (with respect to certain controlled corporations) applies. Since M's mutual insurance company taxable income is in excess of $12,000, M will pay normal tax on its mutual insurance company taxable income at a rate of 22 percent. In addition, since M's mutual insurance company taxable income exceeds the surtax exemption provided in section 11(d) of $25,000, M will pay a surtax on such excess at the rate provided in section 11(c), 26 percent. M's total liability for the taxable year 1964 is $16,540, computed as follows:

(1) Mutual insurance company taxable income as computed in example (1)	$48,000
(2) Normal tax: 22 percent of mutual insurance company taxable income for normal tax purposes	10,560
(3) Surtax exemption provided by section 11(d)	25,000
(4) Mutual insurance company taxable income subject to the surtax (item (1) minus item (3))	23,000
(5) Surtax: at rates provided in section 11(c): 26 percent of mutual insurance company taxable income subject to the surtax	5,980
(6) Total tax (item (2) plus item (5))	16,540

(e) **Alternative tax for certain small mutual insurance companies—(1) In general.** (i) Section 821(c) provides an alternative tax for certain small mutual insurance companies. This alternative tax, which is in lieu of the tax imposed by section 821(a), is imposed on taxable investment income (as defined in section 822(a)(1) and paragraph (a)(1) of § 1.822–8) and consists of a normal tax and a surtax. The tax provided by section 821(c) is imposed on every mutual insurance company (other than a life insurance company and other than a fire, flood, or marine insurance company

subject to the tax imposed by section 831) which received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) a gross amount in excess of $150,000 but not in excess of $500,000, except a company which has properly elected under section 821(d) and paragraph (f) of this section to be subject to the tax imposed by section 821(a), or a company which has a balance in its protection against loss account at the beginning of the taxable year.

(ii) Any company which would be taxable under section 821(c) but for the presence of an amount in its protection against loss account at the beginning of the taxable year may elect to subtract the balance from such account. See section 824(d)(5) and § 1.824–3. If such an election is made in such a case, the company shall not be subject to the tax imposed by section 821(a), but shall be subject to the tax imposed by section 821(c).

(2) Rates of tax imposed by section 821(c)—(i) Normal tax. The normal tax for taxable years beginning before January 1, 1964, is the lesser of 30 percent of taxable investment income or 60 percent of the amount by which taxable investment income exceeds $3,000. For taxable years beginning after December 31, 1963, the normal tax is imposed at the rate of 22 percent of taxable investment income, or 44 percent of the amount by which taxable investment income exceeds $3,000, whichever is the lesser. Thus, a company subject to tax under section 821(c) will file a return but will pay no tax if for the taxable year its taxable investment income does not exceed $3,000; or will pay a normal tax equal to 44 percent (60 percent in the case of taxable years beginning before Jan. 1, 1964), of taxable investment income in excess of $3,000 when such income exceeds $3,000 but does not exceed $6,000. When taxable investment income exceeds $6,000, the normal tax is imposed at the rate of 22 percent (30 percent in the case of taxable years beginning before Jan. 1, 1964) of such income.

(ii) Surtax. For taxable years beginning before January 1, 1964, a surtax is imposed at the rate of 22 percent of taxable investment income (computed without regard to the deduction provided in section 242 for partially tax-exempt interest) in excess of $25,000. For taxable years beginning after December 31, 1963, a surtax is imposed at the rate provided in section 11(c) on taxable investment income in excess of the surtax exemption provided in section 11(d).

(f) Election to be taxed under section 821(a)—(1) In general. Section 821(d) provides that any mutual insurance company taxable under section 821(c) may elect, in the manner provided by subparagraph (3) of this paragraph, to be taxed under section 821(a).

(2) Scope of election. Except as otherwise provided herein, an election made under section 821(d) and this paragraph to be taxable under section 821(a) shall be binding for the taxable year for which made and for all succeeding taxable years unless the Commissioner consents to a revocation of such election. If for any taxable year the gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $150,000, a company's prior election made under section 821(d) to be taxable under section 821(a) will automatically terminate and any balance in the protection against loss account will be taken into account for the preceding taxable year. (See section 824(d)(4) and § 1.824–2 for automatic termination of protection against loss account if company is not subject to the tax imposed by section 821(a).) If for any taxable year thereafter the gross amount received exceeds $150,000 but does not exceed $500,000, the company shall be taxable under section 821(c) unless it makes a new election to be taxable under section 821(a). If a company subject to tax under section 821(c) for a taxable year elects under section 821(d) and this section to be taxed under section 821(a) and, in a subsequent taxable year, the gross receipts of such company exceed $500,000, the election made for such earlier taxable year shall be considered as continuing in effect. Thus, such a company will continue to be taxable under section 821(a) notwithstanding that its gross receipts subsequently fall below $500,000 (so long as they do not fall below $150,000) unless the Commissioner consents to a revocation of the prior election. Whether revocation is permissible in any case will depend on the facts and circumstances of the particular case, but in no case will revocation be granted in the absence of a showing that the election creates an undue burden or material hardship on the company due to a substantial change in the character of its operations.

(3) Time and manner of making election. The election provided by section 821(d) shall be made in a statement attached to the company's income tax return for the first taxable year for which the election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or its duly authorized

representative), and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year.

(g) **Examples.** The application of the tax imposed by section 821(c) may be illustrated by the following examples:

Example (1). M, a mutual casualty insurance company, for the calendar year 1963 has a gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) of $400,000. Since M's gross amount received exceeds $150,000, but does not exceed $500,000, M is subject to the tax imposed by section 821(c) on taxable investment income unless it elects to be subject to the tax imposed on mutual insurance company taxable income by section 821(a). M computes its taxable investment income under section 822 to be $35,000. In computing taxable investment income, M deducted $2,000 of partially tax-exempt interest under section 242. If M does not make an election to be taxed under section 821(a), its total tax liability for the taxable year 1963 is $13,140 computed as follows:

(1) Taxable investment income as computed under section 822	$35,000
(2) 30 percent of taxable investment income	10,500
(3) 60 percent of taxable investment income in excess of $3,000	19,200
(4) Normal tax (lesser of items (2) or (3))	10,500
(5) Partially tax-exempt interest deducted in computing taxable investment income	2,000
(6) Taxable investment income for purposes of the surtax (item (1) plus item (5))	37,000
(7) Surtax exemption	25,000
(8) Taxable investment income subject to surtax (item (6) minus item (7))	12,000
(9) Surtax (22 percent of item (8))	2,640
(10) Total tax liability (item (4) plus item (9))	13,140

Example (2). N, a mutual casualty insurance company, for the taxable year 1963 has a gross amount received from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) of $210,000. Since N's gross amount received exceeds $150,000 but does not exceed $500,000, N is subject to the tax imposed by section 821(c) on taxable investment income unless it elects to be subject to the tax imposed by section 821(a). Furthermore, since the gross amount received by N does not exceed $250,000, N is entitled to the special tax reduction provided by section 821(c)(2). N computes its taxable investment income under section 822 to be $24,000. In computing taxable investment income, N deducted $2,000 of partially tax-exempt interest under section 242. If N does not make an election to be taxed under section 821(a), its total tax liability for the taxable year 1963 is $4,452 computed as follows:

(1) Taxable investment income as computed under section 822	$24,000
(2) 30 percent of taxable investment income	7,200
(3) 60 percent of taxable investment income in excess of $3,000	12,600
(4) Normal tax (lesser of items (2) or (3))	7,200
(5) Partially tax-exempt interest deducted in computing taxable investment income	2,000
(6) Taxable investment income for purposes of the surtax (item (1) plus item (5))	26,000
(7) Surtax exemption	25,000
(8) Taxable investment income subject to surtax (item (6) minus item (7))	$1,000
(9) Surtax 22 percent of item (8)	220
(10) Tax liability computed without regard to special reduction (item (4) plus item (9))	7,420
(11) Amount by which gross receipts exceed $150,000 ($210,000 gross receipts minus $150,000)	60,000
(12) Percentage which item (1) bears to $100,000 ($60,000 over $100,000)	0.60
(13) Tax as adjusted (percentage determined in item (12) applied to item (10))	4,452

If N's taxable investment income for purposes of the surtax did not exceed $3,000, N would file a return but would pay no tax. Had N elected (under section 821(d)) to be subject to tax under section 821(a), N would not be entitled to the special reduction afforded by section 821(c)(2), since that provision applies only to companies taxable under section 821(c).

[T.D. 6681, 28 FR 11110, Oct. 17, 1963, as amended by T.D. 7100, 36 FR 5333, March 20, 1971; 36 FR 5846, March 30, 1971]

§ 1.821–5 Special transitional underwriting loss.

(a) **In general.** Section 821(f) provides a special reduction in the statutory underwriting income (as defined by section 823(a)(1) and paragraph (b)(1) of § 1.823–6) of any company taxable under section 821(a) which was taxable under section 821 for the five taxable years immediately preceding January 1, 1962, and which incurred an underwriting loss (as defined in section 821(f)(3) and paragraph (c) of this section) for each of such five taxable years.

(b) **Amount of reduction.** In the case of a company described in section 821(f)(1) and paragraph (a) of this section the statutory underwriting income for the taxable year (determined without regard to this paragraph) shall be reduced by an amount equal to the amount by which—

(1) The sum of the underwriting losses of such company for the five taxable years immediately preceding January 1, 1962, exceeds

(2) The total amount by which the company's statutory underwriting income was reduced by reason of section 821(f) and this section for prior taxable years.

(c) **Underwriting loss defined.** For purposes of computing the amount of the reduction available under section 821(f) and paragraph (a) of this section, the term underwriting loss means statutory underwriting loss (as defined by section 823(a)(2) and paragraph (b)(2) of § 1.823–6) computed without any deduction under section 824(a) and paragraph (a) of § 1.824–1 (relating to deduction to provide protection against losses) and without any deduction under section 832(c)(11) (relat-

ing to dividends and similar distributions paid or declared to policyholders). For rules relating to the definition of dividends and similar distributions paid or declared to policyholders, see paragraph (a) of § 1.832–5.

(d) Years of applicability. Section 821(f)(4) provides that the special reduction of statutory underwriting income allowed by section 821(f)(2) and paragraph (b) of this section shall apply to any taxable year beginning after December 31, 1962, and before January 1, 1968, for which the taxpayer is subject to the tax imposed by section 821(a).

[T.D. 6681, 28 FR 11112, Oct. 17, 1963]

§ 1.822–1 Taxable income and deductions.

(a) In general. For taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, the taxable income of a mutual insurance company subject to the tax imposed by section 821 is its gross investment income, namely, the gross amount of income during the taxable year from interest, dividends, rents, and gains from sales or exchanges of capital assets, less the deductions provided in section 822(c) for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses to the extent provided in subchapter P (sec. 1201 and following), chapter 1 of the Code, and the special deductions provided in part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172.

(b) Wholly tax-exempt interest. Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(c) Investment expenses. The deduction allowed by section 822(c)(2) for investment expenses is the same as that allowed life insurance companies by section 803(g)(2). See paragraph (c) of § 1.803–4.

(d) Taxes and expenses with respect to real estate. The deduction allowed by section 822(c)(3) for taxes and expenses with respect to real estate owned by the company is the same as that allowed life insurance companies by section 803(g)(3). See paragraph (d) of § 1.803–4.

(e) Depreciation. The deduction allowed by section 822(c)(4) for depreciation is the same as that allowed life insurance companies by section 803(g)(4). See paragraph (e) of § 1.803–4.

(f) Interest paid or accrued. The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(g) Capital losses. (1) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(2) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of interest, dividends, rents, and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(3) The application of section 822(c)(6) may be illustrated by the following examples:

Example (1). The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1954 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, rents of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example (2). If in example (1) the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of interest, dividends, rents, and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example (3). If in example (1) the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1954, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(h) Special deductions. Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.822–2 Real estate owned and occupied.

The limitation in section 822(d)(1) on the amount allowable as a deduction for taxes, expenses, and depreciation upon or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 is the same as that provided in the case of life insurance companies by section 803(h). See § 1.803–5.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.822–3 Amortization of premium and accrual of discount.

Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 803(i) and shall be determined in accordance with § 1.803–6, except that in determining the premium and discount of a mutual insurance company subject to the tax imposed by section 821 the basis provided in section 1012 shall be used in lieu of the acquisition value.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.822–4 Taxable years affected.

Sections 1.822–1 through 1.822–3 are applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.822–5 through 1.822–7 are applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of part II, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.822–8 through 1.822–12 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of parts II and III, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6610, 27 FR 8720, Aug. 31, 1962, as amended by T.D. 6681, 28 FR 11113, Oct. 17, 1963]

§ 1.822–5 Mutual insurance company taxable income.

(a) Mutual insurance company taxable income defined. Section 822(a) defines the term "mutual insurance company taxable income" for purposes

of part II, subchapter L, chapter 1 of the Code. Mutual insurance company taxable income means gross investment income (as defined in section 822(b) and paragraph (b) of this section), less the deductions provided in section 822(c) and paragraph (c) of this section for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses, special deductions, trade or business (other than in insurance business) expenses, and depletion. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of Subtitle A of the Code. For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172, and a deduction shall not be permitted with respect to the same item more than once.

(b) Gross investment income defined. For purposes of part II, subchapter L, chapter 1 of the Code, section 822(b) defines the term "gross investment income" of a mutual insurance company subject to the tax imposed by section 821 as the sum of the following:

(1) The gross amount of income during the taxable year from—

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61–7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822–7;

(ii) Dividends, as described in § 1.61–9;

(iii) Rents and royalties, as described in § 1.61–8;

(iv) The entering into of any lease, mortgage or other instrument or agreement from which the company may derive interest, rents, or royalties;

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph;

(vi) Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses), Chapter 1 of the Code.

(2) The gross income from any trade or business (other than an insurance business) carried on by a mutual insurance company subject to the tax imposed by section 821, or by a partnership of which the insurance company is a partner.

For example, gross investment income includes amounts received as commitment fees, or as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage. In computing the gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner, any item described in section 822(b)(1) and paragraph (b)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) and paragraph (b)(1) of this section.

(c) Deductions from gross investment income—(1) Wholly tax-exempt interest. Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(2) Investment expenses. (i) The deduction for investment expenses under section 822(c)(2) includes only those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a mutual insurance company subject to the tax imposed by section 821 subjects the entire deduction for investment expenses to the limitation provided in section 822(c)(2) and subdivision (iii) of this subpara-

graph. As used in section 822(c)(2), the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expense is allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 822(c)(2) and subdivision (iii) of this subparagraph. However, a company subject to the tax imposed by section 821 shall not deduct under section 822(c)(2) its real estate taxes, depreciation, or other expenses with respect to any portion of the real estate which it owns, irrespective of whether such items are properly allocable to its investment department. For the rules relating to the deductibility of these items, see section 822(c)(3) and (4) and subparagraphs (3) and (4) of this paragraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 822(c)(2) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any.

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 822(c)(2) shall not exceed the sum of—

(a) One-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year, plus.

(b) One-fourth of the amount by which mutual insurance company taxable income (computed without any deduction for investment expenses, tax-free interest, partially tax-exempt interest, or dividends received) exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

For purposes of section 822(c)(2) and this paragraph, the term "invested assets" means only those assets which are owned and used, and to the extent used, for the purpose of producing the income specified in section 822(b). See paragraph (b) of this section. The term does not include real estate owned and occupied, and to the extent owned and occupied, by the company.

(3) Real estate expenses and taxes. The deduction for real estate expenses and taxes under section 822(c)(3) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 822(c)(3) for amounts allowed as a deduction under section 164(e) (relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 822(c)(3) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See § 1.822–6 for limitation of such deduction.

(4) Depreciation. The deduction allowed by section 822(c)(4) for depreciation is, except as provided in section 822(d)(1) and § 1.822–6, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining mutual insurance company taxable income is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 822(b).

(5) Interest paid or accrued. The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(6) Capital losses. (i) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P, chapter 1 of the Code but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(ii) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received. If, by

reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(iii) The application of section 822(c)(6) may be illustrated by the following examples:

Example (1). The X Company, a mutual fire insurance company subject to the tax imposed by section 821, in the taxable year 1958 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, royalties of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000) is $75,000. As the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income.

Example (2). If in example (1) the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example (3). If in example (1) the X Company had mutual insurance company taxable income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, chapter 1 of the Code, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1958, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,000 are added to capital gains of $10,000, since they are less than taxable income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable income for purposes of the surtax plus $20,000 other capital losses under section 822(c)(6) plus the portion of capital losses

allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(7) **Special deductions.** Section 822(c)(7) allows a mutual insurance company the special deductions provided by part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received.

(8) **Trade or business deductions.** (i) Under section 822(c)(8), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the company is a partner are, subject to the limitations in subdivision (ii) of this subparagraph, allowable as deductions from gross investment income in computing mutual insurance company taxable income. Such deductions are allowable, however, only to the extent that they relate to income which is included in the company's gross investment income by reason of section 822(b)(2). Thus, a deduction shall not be allowed under section 822(c)(8) with respect to any item described in section 822(b)(1). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 822(c)(8)—

(a) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if the company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(b) The deduction for net operating losses provided in section 172 shall not be allowed.

(9) **Depletion.** The deduction allowed by section 822(c)(9) for depletion is the same as that allowed life insurance companies under section 804(c)(4). See paragraph (b)(5) of § 1.804–4.

[T.D. 6610, 27 FR 8720, Aug. 31, 1962, as amended by T.D. 6631, 28 FR 219, Jan. 9, 1963]

§ 1.822–6 Real estate owned and occupied.

Section 822(d)(1) provides that the amount allowable as a deduction for taxes, expenses, and

depreciation on or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.822-7 Amortization of premium and accrual of discount.

Section 822(d)(2) makes provision for the appropriate amortization of premium and the appropriate accrual of discount, attributable to the taxable year, on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821. Such amortization and accrual is the same as that provided for life insurance companies by section 818(b)(1), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 133), and shall be determined in accordance with paragraphs (a) and (b) of § 1.818-3, except in the case of a mutual insurance company subject to the tax imposed by section 821, paragraph (b) of § 1.818-3 shall apply without regard to the date of acquisition and the basis provided in section 1012 shall be used in lieu of the acquisition value.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.822-8 Determination of taxable investment income.

(a) In general—(1) Taxable investment income defined. Section 822(a)(1) defines the term "taxable investment income" for purposes of part II, subchapter L, chapter 1 of the Code as the gross investment income (as defined in section 822(b) and paragraph (b) of this section), less the deductions provided in section 822(c) and paragraph (c) of this section for wholly tax-exempt interest, investment expenses, real estate expenses, depreciation, interest paid or accrued, capital losses, special deductions, trade or business (other than an insurance business) expenses, and depletion. However, such expenses are deductible only to the extent that they relate to investment income and the deduction of such expenses is not disallowed by any other provision of subtitle A of the Code.

For example, investment expenses are not allowable unless they are ordinary and necessary expenses within the meaning of section 162. In addition to the limitations on deductions relating to real estate owned and occupied by a mutual insurance company subject to the tax imposed by section 821 provided in section 822(d)(1), the adjustment for amortization of premium and accrual of discount provided in section 822(d)(2), and the limitation on the deduction for investment expenses where general expenses are allocated to investment income provided in section 822(c)(2), mutual insurance companies subject to the tax imposed by section 821 (a) or (c) are subject to the limitation on deductions relating to wholly tax-exempt income provided in section 265. Such companies are not entitled to the net operating loss deduction provided in section 172. See, however, section 825 and paragraph (a) of § 1.825-1 for unused loss deduction allowed companies taxable under section 821(a). A deduction shall not be permitted with respect to the same item more than once.

(2) Investment loss defined. The term "investment loss" is defined by section 822(a)(2) as the amount by which the deductions allowable under section 822(c) and paragraph (c) of this section exceed the gross investment income (as defined in section 822(b) and paragraph (b) of this section).

(b) Gross investment income defined. For purposes of part II, subchapter L, chapter 1 of the Code, section 822(b) defines the term "gross investment income" of a mutual insurance company subject to the tax imposed by section 821 (a) or (c) as the sum of the following:

(1) The gross amount of income during the taxable year from—

(i) Interest (including tax-exempt interest and partially tax-exempt interest), as described in § 1.61-7. Interest shall be adjusted for amortization of premium and accrual of discount in accordance with the rules prescribed in section 822(d)(2) and § 1.822-10;

(ii) Dividends, as described in § 1.61-9;

(iii) Rents and royalties, as described in § 1.61-8;

(iv) The entering into of any lease, mortgage or other instrument or agreement from which the company may derive interest, rents, or royalties;

(v) The alteration or termination of any instrument or agreement described in subdivision (iv) of this subparagraph;

(vi) Gains from sales or exchanges of capital assets to the extent provided in subchapter P (section 1201 and following, relating to capital gains and losses) chapter 1 of the Code.

(2) The gross income from any trade or business (other than an insurance business) carried on by a mutual insurance company subject to the tax imposed by section 821 (a) or (c), or by a partnership of which the insurance company is a partner.

For example, gross investment income includes amounts received as commitment fees, or as a bonus for the entering into of a lease, or as a penalty for the early payment of a mortgage. In computing the gross income from any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the insurance company is a partner, any item described in section 822(b)(1) and paragraph (b)(1) of this section shall not be considered as gross income arising from the conduct of such trade or business, but shall be taken into account under section 822(b)(1) and paragraph (b)(1) of this section.

(c) Deductions from gross investment income—(1) Wholly tax-exempt interest. Interest which in the case of other taxpayers is excluded from gross income by section 103 but included in the gross investment income by section 822(b) is allowed as a deduction from gross investment income by section 822(c)(1).

(2) Investment expenses. (i) The deduction for investment expenses under section 822(c)(2) includes only those expenses of the taxable year which are fairly chargeable against gross investment income. For example, investment expenses include salaries and expenses paid exclusively for work in looking after investments, and amounts expended for printing, stationery, postage, and stenographic work incident to the collection of interest. An itemized schedule of such expenses shall be attached to the return.

(ii) Any assignment of general expenses to the investment department of a mutual insurance company subject to the tax imposed by section 821 (a) or (c) subjects the entire deduction for investment expenses to the limitation provided in section 822(c)(2) and subdivision (iii) of this subparagraph. As used in section 822(c)(2), the term "general expenses" means any expense paid or incurred for the benefit of more than one department of the company rather than for the benefit of a particular department thereof. For example, if an expense, such as a salary, is attributable to more than one department, including the investment department, such expense may be properly allocated among these departments. If such expense is allocated, the amount properly allocable to the investment department shall be deductible as general expenses assigned to or included in investment expenses and as such shall be subject to the limitation of section 822(c)(2) and subdivision (iii) of this subparagraph. However, a company subject to the tax imposed by section 821 (a) or (c) shall not deduct under section 822(c)(2) its real estate taxes, depreciation, or other expenses with respect to any portion of the real estate which it owns, irrespective of whether such items are properly allocable to its investment department. For the rules relating to the deductibility of these items, see section 822(c)(3) and (4) and subparagraphs (3) and (4) of this paragraph. If general expenses are in part assigned to or included in investment expenses, the maximum allowance (as determined under section 822(c)(2)) shall not be granted unless it is shown to the satisfaction of the district director that such allowance is justified by a reasonable assignment of actual expenses. The accounting procedure employed is not conclusive as to whether any assignment has in fact been made. Investment expenses do not include Federal income and excess profits taxes, if any.

(iii) If any general expenses are in part assigned to or included in investment expenses, the total deduction under section 822(c)(2) shall not exceed the sum of—

(a) One-fourth of 1 percent of the mean of the book value of the invested assets held at the beginning and end of the taxable year, plus

(b) One-fourth of the amount by which taxable investment income (computed without any deduction for investment expenses, tax-free interest, partially tax-exempt interest, or dividends received) exceeds 3¾ percent of the book value of the mean of the invested assets held at the beginning and end of the taxable year.

For purposes of section 822(c)(2) and this paragraph, the term "invested assets" means only those assets which are owned and used, and to the extent used, for the purpose of producing the income specified in section 822(b). See paragraph (b) of this section. The term does not include real estate

owned and occupied, and to the extent owned and occupied, by the company.

(3) **Real estate expenses and taxes.** The deduction for real estate expenses and taxes under section 822(c)(3) includes taxes (as defined in section 164) and other expenses for the taxable year exclusively on or with respect to real estate owned by the company. For example, no deduction shall be allowed under section 822(c)(3) for amounts allowed as a deduction under section 164(e)(relating to taxes of shareholders paid by a corporation). No deduction shall be allowed under section 822(c)(3) for any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. An itemized schedule of such taxes and expenses shall be attached to the return. See § 1.822–9 for limitation of such deduction.

(4) **Depreciation.** The deduction allowed by section 822(c)(4) for depreciation is, except as provided in section 822(d)(1) and § 1.822–9, identical to that allowed other corporations by section 167. Such amount allowed as a deduction from gross investment income in determining taxable investment income is limited to depreciation sustained on the property used, and to the extent used, for the purpose of producing the income specified in section 822(b).

(5) **Interest paid or accrued.** The deduction allowed by section 822(c)(5) for interest on indebtedness is the same as that allowed other corporations by section 163. See § 1.163–1.

(6) **Capital losses.** (i) The deduction for capital losses under section 822(c)(6) includes not only capital losses to the extent provided in subchapter P, chapter 1 of the Code but in addition thereto losses from capital assets sold or exchanged to provide funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Losses in the latter case may be deducted from ordinary income while the deduction for losses under subchapter P is limited to the gains. See section 1211.

(ii) Capital assets are considered as sold or exchanged to provide for the funds or payments specified in section 822(c)(6), to the extent that the gross receipts from the sale or exchange of such assets are not greater than the excess, if any, for the taxable year of the sum of dividends and similar distributions paid to policyholders, and losses and expenses paid over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received. If, by reason of a particular sale or exchange of a capital asset, gross receipts are greater than such excess, the gross receipts and the resulting loss should be apportioned and the excess included in capital losses subject to the provisions of subchapter P. Capital losses actually used to reduce net income in any taxable year may not again be used in a succeeding taxable year as an offset against capital gains in that year and for that purpose a special rule is set forth for the application of section 1212.

(iii) The application of section 822(c)(6) may be illustrated by the following examples:

Example (1). The X Company, a mutual fire insurance company subject to tax under section 821, in the taxable year 1963 sells capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. The gross receipts from the sale are $60,000, resulting in losses of $20,-000. It pays dividends to policyholders of $150,000. It sustains losses of $25,000, and pays expenses of $25,000. It receives interest of $50,000, dividends of $5,000, royalties of $4,000, and net premiums of $66,000. The excess of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,000) is $75,-000. Since the gross receipts from the sale of capital assets ($60,000) do not exceed such excess ($75,000), the losses of $20,000 are allowable as a deduction from gross investment income in computing taxable investment income under section 822.

Example (2). If in example (1) the gross receipts were $76,000 and the last capital asset sold, for the purpose therein specified, resulted in gross receipts of $2,000 and a loss of $500, the losses allowable as a deduction from gross investment income would be $19,750. The last sale made the gross receipts of $76,000 exceed by $1,000 the excess ($75,000) of the sum of dividends, losses, and expenses paid ($200,000) over the sum of the items described in section 822(b) (other than paragraph (1)(D) thereof) and net premiums received ($125,-000). The gross receipts and the resulting loss from the last sale are apportioned on the basis of the ratio of the excess of $1,000 to the gross receipts of $2,000, or 50 percent. Fifty percent of the loss of $500 is deducted from the total loss of $20,000. The remaining gross receipts of $1,000 and the proportionate loss of $250 should be reported as capital losses under subchapter P.

Example (3). If in example (1) the X Company had taxable investment income for purposes of the surtax of $9,750 and, under the provisions of subchapter P, chapter 1 of the Code, had capital losses of $18,000 and capital gains of $10,000, the net capital loss for the taxable year 1963, in applying section 1212 for the purposes of section 822(c)(6), would be $8,000. This is determined by subtracting from total losses of $38,000 ($18,000 capital losses under subchapter P plus $20,000 other capital losses under section 822(c)(6)) the sum of capital gains of $10,000 and losses from the sale or exchange of capital assets sold or exchanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders of $20,000. Such losses of $20,-000 are added to capital gains of $10,000, since they are less than taxable investment income for purposes of the surtax, computed without regard to gains or losses from sales or exchanges of capital assets, of $29,750 ($9,750 taxable investment income for purposes of the surtax plus $20,000 other

capital losses under section 822(c)(6) plus the portion of capital losses allowable under subchapter P of $10,000 minus capital gains under subchapter P of $10,000).

(7) Special deductions. Section 822(c)(7) allows a mutual insurance company the special deductions provided by Part VIII (section 241 and following), except section 248, subchapter B, chapter 1 of the Code, relating to partially tax-exempt interest and to dividends received. In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of this subparagraph, the reference in such section to "taxable income" shall be treated as a reference to "taxable investment income".

(8) Trade or business deductions. (i) Under section 822(c)(8), the deductions allowed by subtitle A of the Code (without regard to this part) which are attributable to any trade or business (other than an insurance business) carried on by the insurance company, or by a partnership of which the company is a partner are, subject to the limitations in subdivision (ii) of this subparagraph, allowable as deductions from gross investment income in computing taxable investment income. Such deductions are allowable, however, only to the extent that they relate to income which is included in the company's gross investment income by reason of section 822(b)(2). Thus, a deduction shall not be allowed under section 822(c)(8) with respect to any item described in section 822(b)(1). The allowable deductions may exceed the gross income from such business.

(ii) In computing the deductions under section 822(c)(8)—

(a) Any item, to the extent attributable to the carrying on of the insurance business, shall not be taken into account. For example, if the company operates a radio station primarily to advertise its own insurance services, a portion of the expenses of the radio station shall not be allowed as a deduction. The portion disallowed shall be an amount which bears the same ratio to the total expenses of the station as the value of advertising furnished to the insurance company bears to the total value of services rendered by the station.

(b) The deduction for net operating losses provided in section 172 shall not be allowed.

(9) Depletion. The deduction allowed by section 822(c)(9) for depletion is the same as that allowed life insurance companies under section 804(c)(4). See paragraph (b)(5) of § 1.804–4.

[T.D. 6681, 28 FR 11113, Oct. 17, 1963]

§ 1.822–9 Real estate owned and occupied.

Section 822(d)(1) provides that the amount allowable as a deduction for taxes, expenses, and depreciation on or with respect to any real estate owned and occupied in whole or in part by a mutual insurance company subject to the tax imposed by section 821 (a) or (c) shall be limited to an amount which bears the same ratio to such deduction (computed without regard to this limitation) as the rental value of the space not so occupied bears to the rental value of the entire property. For example, if the rental value of the space not occupied by the company is equal to one-half of the rental value of the entire property, the deduction for taxes, expenses, and depreciation is one-half of the taxes, expenses, and depreciation on account of the entire property. Where a deduction is claimed as provided in this section, the parts of the property occupied and the parts not occupied by the company, together with the respective rental values thereof, must be shown in a statement accompanying the return.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–10 Amortization of premium and accrual of discount.

(a) In general. In computing taxable investment income for the taxable year, the gross amount of income from interest, the deduction under section 822(c)(1) for wholly tax-exempt interest, and the deduction under section 242 for partially tax-exempt interest, are, under the provisions of section 822(d)(2), each to be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 821 (a) or (c). However, only the accrual of discount relating to issue discount will increase the deduction for wholly tax-exempt interest. See section 103. Such amortization and accrual is the same as that provided for life insurance companies by section 818(b)(1), as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 133), and shall be determined in accordance with paragraphs (a) and (b) of § 1.818–3, except as provided by paragraph (b) of this section.

(b) Modifications. (1) Paragraph (b) of § 1.818–3 shall apply to mutual casualty insurance companies subject to the tax imposed by section 821 (a) or (c) without regard to the date of acquisition of the particular securities to which the

amortization of premium or accrual of discount is attributable.

(2) In computing the amount of premium or discount for purposes of section 822(d)(2) with respect to securities held by a company taxable under section 821, the basis provided by section 1012 shall be used in lieu of the acquisition value provided by paragraph (b) of § 1.818–3. In the case of a company subject to the tax imposed by section 821(c), adjustments to basis to reflect the accrual of discount and the amortization of premium shall be made in the manner provided by paragraphs (a) and (b) of § 1.818–3. However, for purposes of determining statutory underwriting income or loss for the taxable year under section 823, a company subject to the tax imposed by section 821(a) is not required to accrue discount or to amortize premium in computing its income under section 832 as if it were subject to the tax imposed by section 831. Thus, the accrual of discount and amortization of premium required in the computation of taxable investment income by a company subject to the tax imposed by section 821(a) neither increases nor decreases the mutual insurance company taxable income of such a company and, except to the extent such a company actually accrues discount or amortizes premium for purposes of making the section 832 computation, no adjustment shall be made to the basis of obligations held by it to reflect accrual of discount or amortization of premium.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–11 Net premiums.

The term "net premiums", defined in section 822(f)(1), includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 822(f)(2). Net premiums are used in sections 822(c)(6) and 832(c)(5) in determining the limitation on certain capital losses and in the application of section 1212.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.822–12 Dividends to policyholders.

(a) Dividends to policyholders are used in determining the "underwriting loss" for purposes of the special transitional underwriting loss deduction provided by section 821(f), and the limitation on capital losses under section 822(c)(6); in computing statutory underwriting income or loss under section 823, and the subtractions from the protection against loss account under section 824(d). The term "dividends to policyholders" is defined in section 822(f)(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 822(f)(1). Savings credited to the individual accounts of the subscribers of a reciprocal underwriter or interinsurer under section 823(b)(2) are not dividends paid or declared within the meaning of this paragraph. However, distributions in respect of such credits shall be considered as dividends paid. See section 823(b)(2) and paragraph (c)(2) of § 1.823–6. The term "paid or declared" is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed by adding the amount of dividends and similar distributions declared but unpaid at the end of the taxable year to dividends and similar distributions paid during the taxable year and deducting dividends and similar distributions declared but unpaid at the beginning of the taxable year. If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

[T.D. 6681, 28 FR 11115, Oct. 17, 1963]

§ 1.823–1 Net premiums.

Net premiums are one of the items used, together with interest, dividends, and rents, less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term "net premiums" is defined in section 823(1)

and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.823–2 Dividends to policyholders.

(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term "dividends to policyholders" is defined in section 823(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such amounts are not to be treated as return premiums under section 823(1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term "paid or declared" is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows:

To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year.

If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.823–3 Taxable years affected.

Sections 1.823–1 and 1.823–2 are applicable only to taxable years beginning after December 31, 1953, but before January 1, 1955, and ending after August 16, 1954, and all references to sections of Part II, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments. Sections 1.823–4 and 1.823–5 are applicable only to taxable years beginning after December 31, 1954, but before January 1, 1963, and all references to sections of Part II, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Tax Act for 1955 (70 Stat. 36). Sections 1.823–6 through 1.823–8 are applicable only to taxable years beginning after December 31, 1962, and all references to sections of Parts II and III, Subchapter L, Chapter 1 of the Code are to the Internal Revenue Code of 1954 as amended by section 8 of the Revenue Act of 1962 (76 Stat. 989).

[T.D. 6610, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6681, 28 FR 11116, Oct. 17, 1963]

§ 1.823–4 Net premiums.

Net premiums are one of the items used, together with the gross amount of income during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof), less dividends to policyholders and wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term "net premiums" is defined in section 823(1) and includes deposits and assessments, but excludes amounts returned to policyholders which are treated as dividends under section 823(2).

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.823–5 Dividends to policyholders.

(a) Dividends to policyholders is one of the deductions used, together with wholly tax-exempt interest, in determining tax liability under section 821(a)(2). They are also used in section 822(c)(6) in determining the limitation on certain capital losses and in the application of section 1212. The term "dividends to policyholders" is defined in section 823(2) as dividends and similar distributions paid or declared to policyholders. It includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. Such

amounts are not to be treated as return premiums under section 823(1). Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. The term "paid or declared" is to be construed according to the method of accounting regularly employed in keeping the books of the insurance company, and such method shall be consistently followed with respect to all deductions (including dividends and similar distributions to policyholders) and all items of income.

(b) If the method of accounting so employed is the cash receipts and disbursements method, the deduction is limited to the dividends and similar distributions actually paid to policyholders in the taxable year. If, on the other hand, the method of accounting so employed is the accrual method, the deduction, or a reasonably accurate estimate thereof, for dividends and similar distributions declared to policyholders for any taxable year will, in general, be computed as follows: To dividends and similar distributions paid during the taxable year add the amount of dividends and similar distributions declared but unpaid at the end of the taxable year and deduct dividends and similar distributions declared but unpaid at the beginning of the taxable year. If an insurance company using the accrual method does not compute the deduction for dividends and similar distributions declared to policyholders in the manner stated, it must submit with its return a full and complete explanation of the manner in which the deduction is computed. For the rule as to when dividends are considered paid, see the regulations under section 561.

[T.D. 6610, 27 FR 8722, Aug. 31, 1962]

§ 1.823–6 Determination of statutory underwriting income or loss.

(a) In general. Section 823(a) and this section provide that for purposes of determining statutory underwriting income or loss for the taxable year, a mutual insurance company subject to the tax imposed by section 821(a) must first take into account the same gross income and deduction items (except as modified by section 823(b) and paragraph (c) of this section) as a taxpayer subject to tax under section 831 would take into account for purposes of determining its taxable income under section 832. These items are then reduced to the extent that they include amounts which are included in determining taxable investment income or loss under section 822(a) and § 1.822–8. In addition, in computing its statutory underwriting income or loss for the taxable year, a company taxable under section 821(a) is allowed to deduct the amount determined under section 824(a) (relating to deduction to provide protection against losses) and, if its gross amount received is less than $1,100,000, is allowed to deduct the amount determined under section 823(c) and paragraph (d) of this section (relating to special deduction for certain small companies), subject to the limitations provided therein.

(b) Definitions—(1) Statutory underwriting income defined. Section 823(a)(1) defines the term "statutory underwriting income" for purposes of Part II of Subchapter L of the Code. Subject to the modifications provided by section 823(b) and paragraph (c) of this section, statutory underwriting income is defined as the amount by which—

(i) The gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income (as determined under section 822(b)), exceeds

(ii) The sum of—

(a) The deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c) (relating to deductions allowed in computing taxable investment income), plus

(b) The deductions provided in section 823(c) (relating to special deduction for small company having gross amount of less than $1,100,000) and section 824(a)(relating to deduction to provide protection against losses).

For purposes of subdivision (ii)(a) of this subparagraph, the limitations on the amounts deductible under paragraphs (9) (relating to charitable, etc., contributions) and (12) (relating to partially tax-exempt interest and to dividends received) of section 832(c) shall be computed by reference to taxable income as defined by section 832(a), and as modified by section 823(b) and paragraph (c) of this section.

(2) Statutory underwriting loss defined. "Statutory underwriting loss" is defined in section 823(a)(2) as the amount by which the amount determined under section 823(a)(1)(B) and subparagraph (1)(ii) of this paragraph exceeds the amount determined under section 823(a)(1)(A) and subparagraph (1)(i) of this paragraph.

(c) Modifications—(1) Net operating losses. In applying section 832 for purposes of determining statutory underwriting income or loss under sec-

tion 823(a) and paragraph (b) of this section, the deduction for net operating losses provided by section 172 is not allowed. However, see section 825(a) and § 1.825–1 for unused loss deduction allowed companies taxable under section 821(a) in computing mutual insurance company taxable income under section 821(b).

(2) Interinsurers and reciprocal underwriters—(i) In general. Section 823(b)(2) provides that in computing the statutory underwriting income or loss of a mutual insurance company which is an interinsurer or reciprocal underwriter, there shall be allowed as a deduction the increase for the taxable year in savings credited to subscriber accounts, or there shall be included as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts. For purposes of this subparagraph, the term "savings credited to subscriber accounts" means such portion of the surplus for the taxable year as is credited to the individual accounts of subscribers before the 16th day of the third month following the close of the taxable year, but only if the company would be obligated to pay such amount promptly to such subscriber if he terminated his contract at the close of the company's taxable year, and only if the company mails notification to such subscriber of the amount credited to his individual account in the manner provided by subdivision (v) of this subparagraph.

(ii) Limitations. Amounts representing return premiums (as defined in paragraph (a)(1)(ii) of § 1.809–4) which the company would be obligated to pay to any subscriber terminating his contract at the close of the company's taxable year are not savings credited to subscriber accounts within the meaning of section 823(b)(2) and subdivision (i) of this subparagraph. The deduction for savings credited to individual subscriber accounts is allowed only in the case of reciprocal underwriters or interinsurers where the subscriber or policyholder has not only a legally enforceable right to receive the amount so credited if he withdraws from the exchange, but where the amounts credited, as a matter of actual practice, are paid to subscribers or policyholders who terminate their contracts. Thus, no deduction shall be allowed for savings credited to subscriber accounts if such savings are not in fact promptly returned to subscribers when they terminate their contracts.

(iii) Computation of increase or decrease in savings credited to subscriber accounts. For purposes of determining the increase or decrease for the taxable year in savings credited to subscriber accounts, every reciprocal underwriter or interinsurer claiming a deduction under section 823(b)(2) and this section shall establish and maintain an account for savings credited to subscriber accounts. The opening balance in such account for the first taxable year for which a deduction is claimed under section 823(b)(2) and this section shall be zero. In each taxable year there shall be added to such account the total amount of savings credited to subscriber accounts for the taxable year, and there shall be subtracted from such account the total amount of savings subtracted from subscriber accounts for the taxable year. However, in no case may the amount added to the account exceed the total amount of savings to subscribers for the taxable year, irrespective of the amount of savings credited to subscriber accounts for the taxable year. Credits made to subscriber accounts after the close of the taxable year and before the 16th day of the third month following the close of the taxable year will be taken into account as if such amounts had been credited on the last day of the taxable year to the extent such amounts would have become fixed and determinable legal obligations due subscribers if such subscribers had terminated their contracts on the last day of the company's taxable year unless, at the time the amounts are credited, the company specifically designates such amounts as being from surplus for the taxable year in which the amounts were actually credited. Such a designation, once made, shall be irrevocable. However, if a company credited savings to subscriber accounts after December 31, 1962, and before March 16, 1963, and failed to designate such credits as being from surplus for the taxable year 1963, such company may designate such credits as being from surplus for the taxable year 1963 for purposes of determining the total amount of credits to subscriber accounts for such year. In determining the total amount of savings subtracted from subscriber accounts for the taxable year, only amounts subtracted from savings credited for taxable years beginning with the first taxable year for which a deduction was claimed under section 823(b)(2) and this subparagraph will be taken into account. The method of accounting regularly employed by the taxpayer in keeping its books of account will be used for purposes of determining whether the amounts subtracted from the subscriber accounts are from savings for taxable years beginning before the first taxable year for which a deduction is claimed under section 823(b)(2) and this subparagraph, or from savings for taxable years beginning with such first taxable year. Where the method of accounting regularly employed by the taxpayer in keeping its books of account does not clearly

indicate whether an amount was subtracted from savings credited to subscriber accounts for taxable years beginning before the first taxable year for which a deduction is claimed under section 823(b)(2) and this subparagraph, or from savings credited for such first taxable year and subsequent taxable years, the amount subtracted will be deemed to have come from savings credited to subscriber accounts for all taxable years, on a pro rata basis. Where an amount is subtracted from a subscriber's account for record purposes, but such subtraction does not reflect the discharge of the company's legal obligation to pay the amount subtracted promptly to the subscriber if he terminates his contract, then such subtraction shall not be taken into account for purposes of section 823(b)(2) and this subparagraph. On the other hand, where the company ceases to be under a legal obligation to pay promptly to any subscriber the amount credited to his individual account, then such amount shall be considered as having been subtracted from such subscriber's account at the time such obligation ceased to exist. For purposes of section 823(b)(2) and this subparagraph, the increase (if any) for the taxable year in savings credited to subscriber accounts shall be the amount by which the balance in the account for savings credited to subscriber accounts as of the close of the taxable year exceeds the balance in such account as of the close of the preceding taxable year; and the decrease (if any) for the taxable year in savings credited to subscriber accounts shall be the amount by which the balance in the account for savings credited to subscriber accounts as of the close of the preceding taxable year exceeds the balance in such account as of the close of the taxable year.

(iv) **Legal obligation.** For purposes of this subparagraph, the existence of a legal obligation on the part of the company to pay to the subscriber the savings credited to him will be determined under the insurance contract pursuant to which the credits are made. Where it appears that the company is otherwise legally obligated to pay amounts credited to its subscribers, the requisite legal obligation will not be considered absent merely because a subscriber's credits remain subject to absorption by future losses incurred if left on deposit with the company.

(v) **Notification to subscribers.** Every reciprocal underwriter or interinsurer claiming a deduction under section 823(b)(2) and this subparagraph for amounts credited to the individual accounts of its subscribers must mail to each such subscriber written notification of the amount credited to the subscriber's account for the taxable year, the date on which such amount was credited, and the date on which the subscriber's right to such amount first would have become fixed if such subscriber had terminated his contract at the close of the company's taxable year. As an alternative to providing each subscriber with specific information relating to the amount of savings credited to his individual account, the notification required by this subdivision may be provided in the form of a table or formula mailed to the subscribers. However, a table or formula may not be used in lieu of the specific notification required by this subdivision unless such table or formula has been approved by the Commissioner. Generally, a table or formula will be approved if it enables the subscriber to simply and readily ascertain the amount of savings credited to his individual account for the taxable year, the date on which such amount was credited, and the date on which his right to such amount first would have become fixed if he had terminated his contract at the close of the company's taxable year. A reciprocal underwriter or interinsurer which desires to use such a table or formula should direct a written request for approval of such table or formula to the Commissioner of Internal Revenue, Attention: T:R, Washington, D.C., 20224. Such request must set forth a copy of the table or formula proposed to be used, together with sufficient information to permit the Commissioner to determine the basis upon which such table or formula was prepared and the manner in which the subscribers will use such table or formula in determining the amounts credited to their individual accounts. Once a table or formula has been approved, the use of such table or formula with respect to savings credited for subsequent taxable years will not require further approval unless the basis upon which such table or formula was prepared, or the manner in which such table or formula is to be applied, is substantially changed. The table or formula method of notification may be used with respect to all or less than all of the company's subscribers. For example, the company might provide the notification required by this subdivision to one class of subscribers in the form of a table or formula mailed to the individual subscribers, while providing another class of subscribers with specific statements of the amounts credited to their individual accounts. The notification required by this subdivision must be mailed before the 16th day of the third month following the close of the reciprocal's taxable year for which the account was credited. Where for any taxable year a reciprocal underwriter or interinsurer claims a deduction under section 823(b) and this subpara-

graph and fails to give notice as required by this subdivision, such deduction shall not be allowed unless the reciprocal establishes to the satisfaction of the district director that the failure to mail such notice within the prescribed period was due to reasonable cause.

(d) Special deduction for small company having gross amount of less than $1,100,000—(1) In general. In the case of a taxpayer subject to the tax imposed by section 821(a), section 823(c) provides that if the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) is less than $1,100,000, then, subject to the limitation provided in section 823(c)(2) and subparagraph (2) of this paragraph, there shall be allowed an additional deduction for purposes of determining statutory underwriting income or loss under section 823(a) for the taxable year. The amount of the additional deduction is $6,000; except that if the gross amount received for the taxable year exceeds $500,000, the additional deduction is limited to an amount equal to 1 percent of the amount by which $1,100,000 exceeds such gross amount.

(2) Limitation. The amount of the deduction provided by section 823(c)(1) may not exceed the statutory underwriting income for the taxable year, computed without regard to the deduction allowed under section 823(c)(1) and subparagraph (1) of this paragraph, and the deduction allowed under section 824(a) (relating to deduction for protection against losses).

(3) Example. The application of section 823(c) and this paragraph may be illustrated by the following example:

M, a mutual insurance company subject to the tax imposed by section 821(a), has the following items for the taxable year 1963:

Gross amount for purposes of section 823(c)(1)	$800,000
Gross investment income (including capital gains)	150,000
Capital gains	100,000
Gross income under section 832	900,000
Deductions under section 822(c)	22,000
Deductions under section 832 (as modified by section 823(b)(2))	746,000

Under the provisions of section 823(c), M's special small company deduction for the taxable year 1963 would be $3,000, computed as follows:

(1) Gross amount for purposes of section 823(c)(1)	$800,000
(2) Amount by which $1,100,000 exceeds item (1) ($1,100,000 minus $800,000)	300,000
(3) 1 percent of item (2) (not to exceed $6,000)	3,000
(4) Gross income under section 832, reduced by gross investment income ($900,000 minus $150,000)	$750,00
(5) Deductions under section 832 (as modified by section 823(b)), reduced by deductions under section 822(c) ($746,000 minus $22,000)	724,000
(6) Limitation on deduction under section 823(c)(1) (excess, if any, of item (4) over item (5))	26,000
(7) Deduction under section 823(c)(1) (item (3) or item (6), whichever is the lesser)	3,000

[T.D. 6681, 28 FR 11116, Oct. 17, 1963]

§ 1.823–7 Subscribers of reciprocal underwriters and interinsurers.

A subscriber or policyholder of a reciprocal underwriter or interinsurer entitled to the deduction allowed by section 823(b)(2) and paragraph (c)(2) of § 1.823–6 shall treat amounts representing savings credit to his individual account for the taxable year as a dividend paid or declared for purposes of computing his taxable income. If a reciprocal credits savings to subscriber accounts after the close of its taxable year, but before the 16th day of the third month following the close of the taxable year, and the reciprocal takes such credits into account as if they had been made on the last day of its taxable year, the subscribers of such reciprocal must take such savings into account as if they had in fact been credited on the last day of the company's taxable year. The subscriber shall take savings credited to his account into account without regard to whether the amounts credited are actually distributed to him in cash. To the extent the insurance premium constituted a deductible expense when paid or accrued, the subscriber's taxable income for the taxable year will be increased and any loss for the taxable year will be decreased, by the amount credited to his account. Amounts credited to a subscriber's account which are taken into income by him and which subsequently are used to absorb losses of the reciprocal shall be treated by the subscriber as an additional insurance expense for the taxable year in which the amounts are absorbed. Such amounts may be deducted in computing taxable income to the extent insurance constitutes an otherwise properly deductible expense for such taxable year.

[T.D. 6681, 28 FR 11118, Oct. 17, 1963]

§ 1.823–8 Special transitional underwriting loss; cross reference.

With respect to taxable years beginning after December 31, 1962, and before January 1, 1968, section 821(f) provides, for any company subject to the tax imposed by section 821(a), a special reduction in the statutory underwriting income if such

company was subject to tax under section 821 for the five taxable years immediately preceding January 1, 1962, and incurred an underwriting loss in each of such five taxable years. For rules relating to the determination of the amount of such reduction, see section 821(f) and § 1.821–5.

[T.D. 6681, 28 FR 11118, Oct. 17, 1963]

§ 1.824–1 Adjustments to provide protection against losses.

(a) Allowance of deduction—(1) In general. Except as otherwise provided in section 824(d), section 824(a) provides that in determining statutory underwriting income or loss (as defined in section 823(a)) for any taxable year, a mutual insurance company subject to the tax imposed by section 821(a) is allowed a deduction in an amount equal to the sum of—

(i) 1 percent of the losses incurred during the taxable year (as determined under section 832(b)(5) and § 1.832–4);

(ii) 25 percent of the underwriting gain for the taxable year (as defined in subparagraph (2)(i) of this paragraph); and

(iii) If the concentrated windstorm, etc., premium percentage (as defined in subparagraph (2)(ii) of this paragraph) for the taxable year exceeds 40 percent, an amount determined by applying so much of such percentage as exceeds 40 percent to the underwriting gain for the taxable year.

(2) Definitions—(i) Underwriting gain. For purposes of this section and section 824(a)(1), the term "underwriting gain" means statutory underwriting income, computed under section 823(a) without regard to the deduction provided by section 824(a)(1) and subparagraph (1) of this paragraph.

(ii) Concentrated windstorm, etc., premium percentage. For purposes of this section and section 824(a), the term "concentrated windstorm, etc., premium percentage" means, with respect to any taxable year, the percentage obtained by dividing—

(a) The amount of the premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4) and paragraph (a) of § 1.832–1), to the extent attributable to insuring against losses arising either in any one State or within 200 miles of any fixed point selected by the taxpayer from windstorm, hail, flood, earthquake, or similar hazards, by

(b) The amount of the premiums earned on insurance contracts during the taxable year.

The term "similar hazards" as used in section 824(a) and this section includes tornadoes, cyclones, hurricanes and similar natural phenomena, but does not include insurance against fires, explosions, or riots. Where a company issues contracts insuring against a combination of risks, some of which are included in the definition of what constitutes concentrated windstorm, etc., coverage risks, and some of which are not so included, the taxpayer shall make a reasonable allocation of the premiums earned for the taxable year for purposes of determining such company's concentrated windstorm, etc., premium percentage for the taxable year. Where such an allocation is made, the taxpayer shall submit with his income tax return sufficient information to enable the district director to determine the basis upon which the allocation was made and the reasonableness thereof.

(3) Concentrated risk companies; selection of geographical area—(i) Manner of making selection. Section 824(a)(2)(A) permits a mutual insurance company taxable under section 821(a) to make an annual selection of the geographical area to be used in determining its concentrated windstorm, etc., premium percentage for the taxable year. The geographical area selected shall be indicated in a statement attached to the taxpayer's return for the taxable year for which such selection is to apply. Such statement shall include the name and address of the taxpayer, and shall set forth the computation by which the concentrated windstorm, etc., premium percentage was determined. In addition, the taxpayer shall furnish such other information as the district director may require in determining the correctness of the taxpayer's computation.

(ii) Scope of selection. The selection of a geographical area under section 824(a)(2)(A) shall be effective only with respect to the taxable year for which such selection is made and the area selected may be changed within the period of limitation allowed. Thus, the taxpayer must indicate the State or other geographical area selected for each taxable year for which an amount is deducted under section 824(a)(1)(C) and this paragraph.

(b) Protection against loss account—(1) In general. Section 824(b) requires every insurance company subject to the tax imposed by section 821(a) for any taxable year to establish and maintain a protection against loss account. This account is to be established for taxable years begin-

ning after December 31, 1962. The opening balance in such account shall be zero.

(2) Additions to the protection against loss account. Section 824(c) provides that in the case of a company subject to the tax imposed by section 821(a), there shall be added to the protection against loss account for each taxable year an amount equal to the amount allowable as a deduction for the taxable year under section 824(a)(1) and paragraph (a)(1) of this section.

(3) Subtractions from the protection against loss account—(i) In general. Section 824(d)(1) provides that, after making the additions to the protection against loss account required by section 824(c) and subparagraph (2) of this paragraph, certain amounts shall be subtracted from such account for the taxable year. The amounts subtracted are taken into account under section 821(b)(1)(C) for purposes of determining mutual insurance company taxable income for the taxable year. The amounts to be subtracted are—

(a) First, an amount equal to the excess (if any) of the protection against loss deduction allowed under section 824(a) and paragraph (a) of this section for the taxable year over the underwriting gain (as defined in section 824(a)(1)) for the taxable year,

(b) Then, the amount (if any) by which the sum of the investment loss for such year and the statutory underwriting loss (reduced by the amount referred to in section 824(d)(1)(A) and (a) of this subdivision) for such year, exceeds the sum of the statutory underwriting income for the taxable year and the taxable investment income for such taxable year,

(c) Next (in the order in which the losses occurred), amounts equal to the unused loss carryovers to such year,

(d) Next, any amount remaining which was added to the account for the fifth preceding taxable year, minus one-half of the amount remaining in the account for such taxable year which was added by reason of section 824(a)(1)(B), and

(e) Finally, the amount by which the total amount in the account exceeds the greater of 10 percent of premiums earned on insurance contracts during the taxable year (as defined in section 832(b)(4) and § 1.832–4) less dividends to policyholders (as defined in section 832(c)(11) and § 1.832–5), or the total amount in the account at the close of the preceding taxable year.

(ii) Rules for determining ceiling on protection against loss account. Section 824(d)(2) provides that for purposes of determining the ceiling on the protection against loss account under section 824(d)(1)(E), the total amount in the protection against loss account is to be determined after the subtractions required under section 824(d) but without regard to paragraph (1)(E) thereof (relating to the ceiling on such account), and without regard to amounts remaining in the account which were added, with respect to all taxable years, under section 824(a)(1)(C)(relating to additional deduction to provide protection against losses for certain companies having concentrated windstorm, etc., risks). Thus, the limitation provided in section 824(d)(1)(E) does not apply to amounts added to the protection against loss account by concentrated risk companies to the extent such amounts are attributable to the additional deduction allowed such companies under section 824(a)(1)(C). In no case does the limitation of section 824(d)(1)(E) require a taxpayer to reduce the balance in its protection against loss account below the balance in such account at the close of the preceding taxable year.

(iii) Priorities. (a) Section 824(d)(3) provides a priority system for making the subtractions required under section 824(d)(1). Under section 824(d)(3)(A) the subtractions required to be made under section 824(d)(1)(A), (B), and (C), are to be made (1) first (on a first-in, first-out basis), from amounts in the account with respect to the five preceding taxable years and the taxable year, and (2) then, from amounts in the account with respect to earlier years.

(b) Section 824(d)(3)(B) provides that the amounts to be subtracted under section 824(d)(1)(E) are to be subtracted only from amounts in the protection against loss account with respect to the taxable year.

(c) Section 824(d)(3)(C) provides that if the amount to be subtracted from the total amounts in the protection against loss account with respect to any taxable year is less than such total, the amount required to be subtracted from such account under section 824(d)(1)(A), (B), (C), and (E) is to be subtracted from each of the amounts referred to in section 824(a)(1) in the account with respect to such year in the proportion which each bears to the total amount in the account with respect to such year.

(c) Examples. The application of this section may be illustrated by the following examples:

Example (1). The computation of mutual insurance company taxable income, statutory underwriting income, and the protection against loss account, for a 6-year period with successive underwriting gains may be illustrated by assuming the facts shown in the following table:

Year	Insurance losses incurred	Underwriting gain	Additions to protection against loss account	Taxable investment in income
1963	700	12	10 (7+3)	10
1964	800	16	12 (8+4)	11
1965	600	12	9 (6+3)	12
1966	600	20	11 (6+5)	13
1967	900	24	15 (9+6)	14
1968	1,000	20	15 (10+5)	15

For 1963, the statutory underwriting income would be 2 (underwriting gain of 12 minus the 1 percent of incurred losses (7) and the 25 percent of underwriting gain (3) credited to the protection against loss account) while mutual insurance company taxable income would be 12, the sum of the taxable investment income of 10 and the statutory underwriting income of 2. For 1964 the statutory underwriting income would be 4 and the mutual insurance company taxable income 15; for 1965, the corresponding amounts would be 3 and 15; for 1966, 9 and 22; and for 1967, 9 and 23.

For 1968 the statutory underwriting income would be 5 (underwriting gain of 20 minus the 1 percent of losses incurred (10) and the 25 percent of underwriting gain (5) credited to the protection against loss account); but there would be included in mutual insurance company taxable income an amount equal to the first item added to the protection against loss account in 1963 (7), and half of the second item (1.5), so that for 1968 the mutual insurance company taxable income would be 28.5, the sum of the taxable investment income (15), the statutory underwriting income (5), and the 8.5 subtracted from the protection against loss account in accordance with section 824(d)(1)(D).

At the end of 1968, therefore, the total amount in the protection against loss account would be 63.5; amounts totaling 62 added for 1964 and the 4 following years plus 1.5 remaining from amounts added in 1963. Under the priority system provided by section 824(d)(3), the amounts added for 1964 and the 4 following years would be the amounts first subject to losses for years following 1968. If after having been in the account for 5 years such amounts were not absorbed by losses, then section 824(d)(1)(D) would require the amount attributable to the 1 percent of losses incurred for the fifth preceding taxable year, and one-half of the amount attributable to the 25 percent of underwriting gain for the fifth preceding taxable year, to be included in income.

Example (2). If in example (1) there had been a statutory underwriting loss of 30 for 1966 computed without regard to the protection against loss deduction, and losses incurred had been 600, the addition to the protection against loss account would have been 6 (1 percent of incurred losses of 600, plus 25 percent of underwriting gain of zero), and the statutory underwriting loss would be 36. After increasing the protection against loss account by the addition of 6, 23 would be subtracted from the protection against loss account under section 824(d)(1). Of the amount subtracted, 6 would be attributable to section 824(d)(1)(A) (the excess of the protection against loss deduction (6) over the underwriting gain (9)), and 17 would be attributable to section 824(d)(1)(B) (the excess of the statutory underwriting loss reduced by the subtraction required by section 824(d)(1)(A) (36 minus 6, or 30) over the taxable investment income (13)). Under section 824(d)(3)(A), the subtractions required by section 824(d)(1)(A), (B), and (C), would be made first (on a first-in, first-out basis) from amounts in the account with respect to the five preceding taxable years and the taxable year. Thus, the subtractions would be made as follows: 10 from the 10 added for 1963; next, 12 from the 12 added for 1964; finally, 1 from the 9 added for 1965. Since the amount to be subtracted from amounts added in 1965 is less than the total added for such year, the subtraction must be made from each of the amounts in the account with respect to 1965 in the proportion which each amount bears to the total amount in the account for such year. Of the 9 added to the protection against loss account in 1965, 6 represented 1 percent of losses incurred, and 3 represented 25 percent of the underwriting gain for that year. Thus, ⅔ of the amount to be subtracted will be subtracted from the 6, and ⅓ will be subtracted from the 3. After the subtractions required by section 824(d), the balance remaining in the protection against loss account at the end of 1966 will be 14, comprised of 8 (5.33 plus 2.67) from 1965, plus the 6 added for 1966. Since the 10 added in 1963 and the 12 added in 1964 were eliminated from the protection against loss account, there would be nothing to be included in mutual insurance company taxable income for 1968 or 1969 by reason of section 824(d)(1)(D). The mutual insurance company taxable income for 1966 would be zero (23 subtracted from the protection against loss account plus taxable investment income of 13, minus statutory underwriting loss of 36).

Example (3). For the taxable year 1963, W, a mutual insurance company taxable under section 821(a), writes windstorm, hail, and flood insurance, exclusively, and only operates in the States of A, B, and C. For the taxable year 1963 W has underwriting gain (as defined by section 824(a)(1)) of 100, losses incurred of 1,000, and earned premiums of 1,500. For purposes of determining its concentrated risk premium percentage for 1963, W selects the area encompassed by a circle having a 200-mile radius (400-mile diameter) with its center in Central City, State of B. W determines that during 1963, it earned premiums attributable to insurance against losses arising within this area in the amount of 1,350. On the facts assumed, W's concentrated risk premium percentage for the taxable year 1963 is 90 percent (1,350 divided by 1,500), and W's protection against loss deduction is 85. Of this amount, 10 (1 percent of losses incurred, or 1 percent of 1,000) is attributable to section 824(a)(1)(A); 25 (25 percent of underwriting gain, or 25 percent of 100) is attributable to section 824(a)(1)(B); and 50—the amount determined by multiplying the underwriting gain by so much of the concentrated windstorm, etc., premium percentage as exceeds 40 percent, or 50 percent (90 percent minus 40 percent) times 100—is attributable to section 824(a)(1)(C). W's selection of the area to be used in determining its concentrated risk premium percentage is not binding. In future taxable years, W may select some other area, such as the State of A, B, or C, or the area within 200 miles of any fixed point. Furthermore, W may file an amended return for 1963 (within the period of limitations prescribed) in order to change its selection for that year.

Example (4). For the taxable year 1969, X, a mutual insurance company subject to the tax imposed by section 821(a), has taxable investment income of 25 and a statutory underwriting loss of 22 (including a protection against loss deduction of 7 which is entirely attributable to the application of section 824(a)(1)(A)). The following table shows the protection against loss account of X before and after the application of section 824(d) for the taxable year 1969:

PROTECTION AGAINST LOSS ACCOUNT

	1963	1964	1965	1966	1967	1968	1969
Balance remaining in account with respect to each taxable year (before application of sec. 824(d))	3	1	1	1	2	1	7
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	3	0	0	0	0	0	6

Under the provisions of section 824(d)(1)(A), for the taxable year 1969, X would subtract 7 from its protection against loss account (the amount by which the protection against loss deduction allowed under section 824(a) for the taxable year exceeds the underwriting gain for the taxable year, or 7 minus 0). Under the provisions of section 824(d)(3)(A), since the subtractions are to be made with respect to amounts in the account for the 5 preceding taxable years and the taxable year on a first-in, first-out basis, X would first apply the amount to be subtracted to the amount in the account with respect to 1964, 1965, 1966, 1967, and 1968, in that order. This would reduce the total amount in the account with respect to such taxable years by 6, and the balance in the account with respect to each of the taxable years 1964 through 1968 would be reduced to zero. The remaining amount required to be subtracted under section 824(d)(1)(A), 1 (7 minus 6), would then be subtracted from the amount added to the account for the taxable year, 7 (an amount equal to the protection against loss deduction for the taxable year 1969), leaving a balance of 6 (7 minus 1) in the account with respect to 1969. No proration of the subtraction from the amount in the account for 1969 is required under section 824(d)(3)(C) since the entire amount added to the account in 1969 was added by reason of section 824(a)(1)(A).

Example (5). Assume the facts are the same as in example (4), except that X has taxable investment income of 7 (instead of 25) for the taxable year 1969. After the application of section 824(d) for the taxable year 1969, the results would be as follows:

PROTECTION AGAINST LOSS ACCOUNT

	1963	1964	1965	1966	1967	1968	1969
Balance remaining in account with respect to each taxable year (after application of sec. 824(d))	1	0	0	0	0	0	0

Under the provisions of section 824(d)(1), for the taxable year 1969, X would subtract 15 from its protection against loss account. Of this amount, 7 would be attributable to the application of section 824(d)(1)(A) (*i.e.*, the amount by which the protection against loss deduction allowed under section 824(a) for the taxable year exceeds the underwriting gain for the taxable year, or 7 minus 0), and 8 would be attributable to the application of section 824(d)(1)(B) (*i.e.*, the amount by which the statutory underwriting loss for the taxable year, reduced by the amount determined under section 824(d)(1)(A), exceeds the taxable investment income for the taxable year, or the amount by which 15 (22 minus 7) exceeds 7). Under section 824(d)(3)(A)(i), this subtraction would be made (on a first-in, first-out basis) from amounts in the account with respect to 1964, 1965, 1966, 1967, 1968, and 1969, in that order. This would reduce the total amount in the account with respect to such taxable years by 13, and the balance in the account with respect to each of the taxable years 1964 through 1969 would be reduced to zero. Under the provisions of section 824(d)(3)(A)(ii), the remaining amount required to be subtracted under section 824(d)(1), 2 (15 minus 13), would then be subtracted from the amount in the account with respect to 1963 (*i.e.*, the amount representing one-half of the amount added by reason of section 824(a)(1)(B) which was not required to be subtracted from the protection against loss account under section 824(d)(1)(D) in 1968). Thus, the amount in the account with respect to 1963 would be reduced to 1 (3 minus 2).

Example (6). Assume that Y, a mutual insurance company subject to tax under section 821(a), has a protection against loss account which reflects the following items for the taxable years 1963 through 1968:

ADDITIONS TO PROTECTION AGAINST LOSS ACCOUNT

	1963	1964	1965	1966	1967	1968
1 percent of losses incurred	15	20	60	60	60	60
25 percent of underwriting gain	60	20	40	50	45	45
Additional deduction for concentrated risks	0	0	5	5	0	0
Total	75	40	105	115	105	105

Y, in computing mutual insurance company taxable income for 1968, is required to subtract from the account with respect to 1963 the entire amount of 1 percent of losses incurred added for 1963 (15) and one-half of the underwriting gain (30) added for such year. Upon taking into account these subtractions, the balance in the protection against loss account with respect to 1963 is 30 (the one-half remaining in the account after the application of section 824(d)(1)(D)).

Assume further, that for the taxable year 1969, Y has taxable investment income of 50, underwriting gain of 80 (premiums earned less dividends to policyholders of 5,080, less incurred losses of 4,000 and expenses of 1,000). Under section 824(a), the protection against loss deduction for 1969 is 60. After applying section 824(c), but before applying section 824(d) for 1969, the protection against loss account as of the close of 1969 (after subtracting in 1968 the 45 amount with respect to 1963) would be as follows:

PROTECTION AGAINST LOSS ACCOUNT

	1963	1964	1965	1966	1967	1968	1969
Additions:							
1 percent of loss incurred	0	20	60	60	60	60	40
25 percent of underwriting gain	30	20	40	50	45	45	20
Additional deduction for concentrated risks	0	0	5	5	0	0	0
Total with respect to taxable year	30	40	105	115	105	105	60
Total (as of end of each year before 1969 subtractions)....	30	70	175	290	395	500	560

After making the addition to the protection against loss account for 1969 and obtaining the results shown in the table above, Y is required to make the subtractions for 1969 from the account. These subtractions may be summarized as follows:

SUBTRACTIONS UNDER SECTION 824(d) FOR 1969

Taxable year with respect to which amount is subtracted	1963	1964	1965	1966	1967	1968	1969
Par. (1)(A) subtraction...........	0	0	0	0	0	0	0
Par. (1)(B) subtraction...........	0	0	0	0	0	0	0
Par. (1)(C) subtraction...........	0	0	0	0	0	0	0
Par. (1)(D) subtraction...........	0	[1]30	0	0	0	0	0
Par. 1(E) subtraction	0	0	0	0	0	0	12
Pars. (4) and (5) subtraction	0	0	0	0	0	0	0

[1] 20 represents the amount added for 1964 with reference to incurred losses; 10 represents one-half of the amount added for 1964 with reference to underwriting gain.

After determining the subtractions with respect to years before 1969, the next step is to determine whether any subtraction is required for the taxable year 1969 under section 824(d)(1)(E). Since the total balance in the account after the application of section 824(d) (other than paragraph (1)(E) thereof), 520 (560 minus 30, and excluding 10 added to the account by reason of the additional deduction for protection against losses for concentrated windstorm, etc., companies provided by section 824(a)(1)(C)), exceeds 10 percent of premiums earned on insurance contracts during the taxable year less dividends to policyholders, 508 (10 percent of 5,080), Y would be subject to the ceiling on the protection against loss account for the taxable year 1969 and would be required to subtract 12 (the excess of 520 over 508) from the account under section 824(d)(1)(E). Under the provisions of section 824(d)(3)(B) this subtraction would be made only from amounts in the account with respect to the taxable year 1969. Under the provisions of section 824(d)(3)(C), however, since the amount to be subtracted, 12, is less than the total amount added to the account for the taxable year, 60 (40 plus 20), the subtractions under section 824(d)(1)(E) would be applied ratably against each of the amounts added to the account for the taxable year. Thus, the amount remaining in the account with respect to section 824(a)(1)(A) for the taxable year 1969, would be 32 (40 minus $^{40}/_{60} \times 12$, or 40 minus 8), and the amount remaining in the account with respect to section 824(a)(1)(B) for the taxable year 1969, would be 16 (20 minus $^{20}/_{60} \times 12$, or 20 minus 4).

Based on these facts, Y's mutual insurance company taxable income for 1969 would be 112 (the sum of taxable investment income of 50, plus statutory underwriting income of 20 (underwriting gain minus protection against loss deduction, or 80 minus 60), plus subtractions from the protection against loss account under section 824(d) of 42).

[T.D. 6681, 28 FR 11119, Oct. 17, 1963]

§ 1.824–2 Termination of taxability under section 821.

Section 824(d)(4) provides that if the taxpayer is not subject to tax under section 821 for any taxable year, the entire amount in its protection

against loss account at the close of the preceding taxable year must be subtracted from such account in such preceding taxable year and included in the company's mutual insurance company taxable income (as defined in section 821(b)) for such preceding taxable year.

[T.D. 6681, 28 FR 11122, Oct. 17, 1963]

§ 1.824–3 Election to subtract amount from protection against loss account.

(a) In general. Section 824(d)(5) provides that a taxpayer subject to the tax imposed by section 821(a) for any taxable year may elect, in the manner provided in paragraph (b) of this section, to subtract from its protection against loss account the amount which would otherwise be in such account at the close of such taxable year. The amount so subtracted is to be included in mutual insurance company taxable income (as defined in section 821(d)) for the taxable year.

(b) Manner of making election. The election provided by section 824(d)(5) and this section shall be made (after the close of the taxable year) in a statement attached to the taxpayer's income tax return originally filed for the taxable year for which such election is to apply or to an amended return for such year. If the election is made in an amended return, such amended return and statement must be filed not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year following such taxable year. The statement shall include the name and address of the taxpayer, and shall be signed by the taxpayer (or his duly authorized representative). In addition, the statement shall indicate that the company has elected under section 824(d)(5) to reduce the balance of its protection against loss account to zero as of the close of the taxable year and shall set forth the amount which would have been in such account but for such election.

(c) Scope of election. An election made under section 824(d)(5) and this section shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which such election is to apply. If the election allowed by section 824(d)(5) and this section has been made for any taxable year, it cannot be revoked.

[T.D. 6681, 28 FR 11122, Oct. 17, 1963]

§ 1.825–1 Unused loss deduction; in general.

(a) Amount of deduction. Section 825(a) provides that the unused loss deduction of a mutual insurance company subject to the tax imposed by section 821(a) shall be an amount equal to the sum of the unused loss carryovers and carrybacks to the taxable year. The amount so determined is used in the computation of mutual insurance company taxable income for the taxable year. See section 821(b) and § 1.821–4.

(b) Unused loss defined. Section 825(b) defines the term "unused loss" as the amount (if any) by which—

(1) The sum of the statutory underwriting loss (as defined in section 823(a)(2)) and the investment loss (as defined in section 822(a)(2)) exceeds

(2) The sum of—

(i) The taxable investment income (as defined in section 822(a)(1)),

(ii) The statutory underwriting income (as defined in section 823(a)(1)), and

(iii) The amounts required to be subtracted from the protection against loss account under section 824(d).

(c) Steps in computation of unused loss deduction. The three steps to be taken in the ascertainment of the unused loss deduction for any taxable year are as follows:

(1) Compute the unused loss for any preceding or succeeding taxable year from which an unused loss may be carried over or carried back to the taxable year.

(2) Compute the unused loss carryovers to the taxable year from such preceding taxable years and the unused loss carrybacks to the taxable year from such succeeding taxable years.

(3) Add such unused loss carryovers and carrybacks in order to determine the unused loss deduction for the taxable year.

(d) Statement with tax return. Every mutual insurance company taxable under section 821(a) claiming an unused loss deduction for any taxable year shall file with its return for such year a concise statement setting forth the amount of the unused loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the unused loss deduction.

(e) Ascertainment of deduction dependent upon unused loss carryback. If a mutual insurance company taxable under section 821(a) is entitled in computing its unused loss deduction to a carry-

back which it is not able to ascertain at the time its return is due, it shall compute the unused loss deduction on its return without regard to such unused loss carryback. When the company ascertains the unused loss carryback, it may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the unused loss deduction for the taxable year with the inclusion of such carryback; or it may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(f) Law applicable to computations. The following rules shall apply to taxable years for which the taxpayer is subject to the tax imposed by section 821(a)—

(1) In determining the amount of any unused loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The unused loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the unused loss deduction.

(3) The amount of the unused loss deduction which shall be allowed for any taxable year shall be determined under the law applicable for that year.

[T.D. 6681, 28 FR 11122, Oct. 17, 1963]

§ 1.825–2 Unused loss carryovers and carrybacks.

(a) Years to which loss may be carried—(1) In general. In order to determine its unused loss deduction for any taxable year, a mutual insurance company taxable under section 821(a) must first determine the part of any unused losses for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. An unused loss is to be an unused loss carryback to each of the 3 taxable years preceding the loss year, and an unused loss carryover to each of the 5 taxable years following the loss year, subject to the limitations provided in section 825(g) and subparagraph (2) of this paragraph.

(2) Limitations. An unused loss may not be carried—

(i) To or from any taxable year beginning before January 1, 1963,

(ii) To or from any taxable year for which the taxpayer is not subject to the tax imposed by section 821(a), nor

(iii) To any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the taxpayer was not subject to the tax imposed by section 821(a).

(3) Periods of less than 12 months. A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 825 the first, second, etc., preceding or succeeding taxable year.

(b) Loss year defined. The term "loss year" as used in this section means any taxable year for which a company subject to the tax imposed by section 821(a) has an unused loss in excess of zero.

(c) Amount of carrybacks and carryovers. Section 825(e) provides that in the case of a loss year for a company taxable under section 821(a), the entire amount of the unused loss shall be carried to the earliest taxable year to which such loss may be carried under section 825(d) (subject to the limitations of section 825(g)). The amount of the unused loss carried to each of the other taxable years to which such loss may be carried under section 825(d) following such earliest taxable year shall be the excess (if any) of such loss over the sum of the offsets for each taxable year preceding the taxable year to which the unused loss is carried.

(d) Offset defined—(1) In general. Section 825(f) defines the term "offset" and provides that the taxable year to which an unused loss is carried shall be referred to as the "offset year". The definition of the term offset in the case of an unused loss carryback to an offset year, differs from the definition of such term in the case of an unused loss carryover to an offset year.

(2) Offset in case of carryback. In the case of an unused loss carryback from the loss year to the offset year, the offset is the mutual insurance company taxable income for the offset year, computed without regard to any unused loss carryback from the loss year or any taxable year thereafter.

(3) Offset in case of carryover. In the case of an unused loss carryover from the loss year to the offset year, the offset is equal to the sum of—

(i) The amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) (relating to amounts equal to the unused loss carryovers to the offset year), plus

(ii) The mutual insurance company taxable income for the taxable year, computed without regard to any unused loss carryback or carryover from the loss year or any taxable year thereafter. [T.D. 6681, 28 FR 11123, Oct. 17, 1963]

§ 1.825–3 Examples.

The application of section 825 may be illustrated by the following examples:

Example (1). For the taxable year 1967, F, a mutual insurance company subject to the tax imposed by section 821(a), has the following items:

Taxable investment income	1
Underwriting loss	59
Addition to protection against loss account	8
Statutory underwriting loss	67

The subtractions from the protection against loss account are as follows:

Amount subtracted from amounts in account with respect to taxable years 1963 through 1966	18
Amount subtracted from amounts in account with respect to taxable year 1967	8
Total subtractions from protection against loss account under section 824(d)	26

The application of section 825 in this case may be illustrated by the facts and results shown in the following table and explained below:

TAXABLE YEAR

	1963	1964	1965	1966	1967	1968
Protection against loss account:						
Addition to account during taxable year	6	2	3	7	8	7
Subtraction from account during taxable year	0	0	0	0	8	7
Protection against loss account (at end of year)	6	2	3	7	0	0
Protection against loss account (at end of taxable year 1968)	0	0	0	0	0	0
Unused loss	0	0	0	0	40	0
Unused loss carryback	0	40	35	25	0	0
Unused loss carryover	0	0	0	0	0	18
Unused loss deduction	0	40	35	25	0	18
Mutual insurance company taxable income (computed without regard to unused loss)	13	5	10	7	0	2
Mutual insurance company taxable income (computed with regard to unused loss)	13	0	0	0	0	0
Offset for year	0	5	10	7	0	9
Offset total	0	5	15	22	22	31

1967: Under the provisions of section 825(b), F's unused loss for 1967 is 40, the amount by which the sum of the statutory underwriting loss and the investment loss, 67 (67 plus 0), exceeds the sum of the taxable investment income, the statutory underwriting income, and the amounts required to be subtracted from the protection against loss account under section 824(d) for the taxable year, 27 (the sum of 1, 0, and 26, respectively).

1967 carryback to 1964: Under the provisions of section 825(e), the entire unused loss for 1967 of 40 is carried back to 1964, the earliest year to which the loss may be carried under section 825(d). Since there are no other amounts carried to 1964, the unused loss deduction for 1964 is 40. Thus, after taking the unused loss deduction into account, the mutual insurance company taxable income for 1964 is zero, and the offset for 1964 is 5 (the mutual insurance company taxable income for 1964 determined without regard to the unused loss carryback from 1967 or any year thereafter).

1967 carryback to 1965: The portion of the unused loss for 1967 which is carried back to 1965 is 35 (40 minus 5, the offset for 1964). After taking the unused loss deduction into account, the mutual insurance company taxable income for 1965 is zero. The offset for 1965 is 10, the mutual insurance company taxable income for 1965 determined without regard to any unused loss carryback from 1967 or any year thereafter.

1967 carryback to 1966: The portion of the unused loss for 1967 which is carried back to 1966 is 25. This amount is the excess of the unused loss for 1967 of 40 over the sum of the offset for 1964 (5) and the offset for 1965 (10). As a result of the unused loss deduction the mutual insurance company taxable income for 1966 is reduced to zero. The offset for 1966 is 7.

1967 carryover to 1968: Under the provisions of section 825(d), the portion of the unused loss for 1967 which is carried forward to 1968 is 18 (40 minus the sum of 5, 10, and 7, the offsets for 1964, 1965, and 1966, respectively). Under section 825(f)(2), this amount is first applied against any amounts in the protection against loss account at the end of 1968, and is then applied against the mutual insurance company taxable income for 1968 (computed without regard to any unused loss carryovers or carrybacks from 1967 or any taxable year thereafter). Thus, assuming that there are no other subtractions from its protection against loss account under section 824(d) for 1968, F's protection against loss account of 7 is reduced to zero by reason of the subtraction under section 824(d)(1)(C). The remaining portion of the unused loss for 1967 which is carried to 1968, 11 (18 minus 7, the amount of the unused loss carryover to 1968 which is subtracted from the protection against loss account under section 824(d)(1)(C)), is then applied against the mutual insurance company taxable income for 1968 computed without regard to any unused carryback or carryover

from the loss year (1967) or any taxable year thereafter. After the application of the unused loss deduction for 1968, the mutual insurance company taxable income for 1968 is zero. The offset for 1968 is 9, the sum of the amount required to be subtracted from the protection against loss account under section 824(d)(1)(C) for 1968 (7), plus the mutual insurance company taxable income for 1968, determined without regard to any unused loss carryover or carryback from 1967 or any year thereafter (2). The remaining 9 of the unused loss for 1967 (40 minus the sum of 5, 10, 7, and 9, the offsets for 1964, 1965, 1966, and 1968, respectively), is carried forward to 1969, and to the extent not used in that year or any year thereafter, may be carried forward to 1970, 1971, and 1972, in that order.

Example (2). If in example (1) F had an unused loss in 1966 of 22, then, with respect to F's 1967 unused loss of 40, the offset for 1964 would be zero; the offset for 1965 would be 6—the 1965 mutual insurance company taxable income of 10 less an unused loss carryback of 4 from 1966 (the 1966 unused loss of 22 minus the 1963 offset of 13 and the 1964 offset of 5); the offset for the loss year 1966 would be zero, and 34 (the 1967 unused loss of 40 minus the offset for 1965 of 6) would remain as an unused loss carryover to 1968, 1969, 1970, 1971, 1972, in that order. Thus, the unused loss carrybacks or carryovers to an offset year are applied against the mutual insurance company taxable income for such year in the order in which the losses occurred, with the earliest loss being offset first.

Example (3). For the taxable year 1963, M, a mutual insurance company subject to tax imposed by section 821(a), has an unused loss (as defined in section 825(b)) of $65,000. Under section 825(g), the loss may not be carried back to any taxable year beginning before 1963. However, the loss may be carried forward to each of the 5 taxable years following 1963 provided that for each of such succeeding taxable years M is subject to the tax imposed by section 821(a).

Example (4). Assume the facts are the same as in example (3), except that for the taxable year 1964, the gross amount received by M from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) exceeds $150,000 but does not exceed $500,000. If M does not make the election under section 821(d) (relating to election to be taxed under section 821(a)) for 1964, M's 1963 unused loss of $65,000 will not be allowed as an unused loss carryover or carryback since, by reason of section 825(g)(3), the unused loss may not be carried to any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 821(a), and by reason of section 825(g)(1), the unused loss may not be carried to any taxable year beginning before 1963.

[T.D. 6681, 28 FR 11123, Oct. 17, 1963]

§ 1.826–1 Election by reciprocal underwriters and interinsurers.

(a) In general. Except as otherwise provided in section 826(c), any mutual insurance company which is an interinsurer or reciprocal underwriter taxable under section 821(a) may elect under section 826(a) to limit its deductions for amounts paid or incurred to its attorney-in-fact to the deductions of its attorney-in-fact which are allocable to income received by the attorney-in-fact from the reciprocal during the taxable year. See § 1.826–4 for rules relating to allocation of expenses. In no case may such an election increase the amount deductible by the reciprocal for amounts paid or due its attorney-in-fact for the taxable year. The election allowed by section 826(a) and this section in effect increases the income of the reciprocal by the net income of the attorney-in-fact attributable to its business with the reciprocal. A reciprocal making the election is allowed a credit for the amount of tax paid by the attorney-in-fact for the taxable year which is attributable to income received by the attorney-in-fact from the reciprocal. See section 826(e) and § 1.826–5.

(b) Companies eligible to elect under section 826(a). Any mutual insurance company which is a reciprocal underwriter or interinsurer subject to the tax imposed by section 821(a) may elect (in the manner prescribed by paragraph (c) of this section) to be subject to the limitation provided by section 826(b) and paragraph (a) of this section provided the attorney-in-fact of the electing reciprocal—

(1) Is subject to the taxes imposed by section 11 (b) and (c) and the regulations thereunder;

(2) Consents (in the manner provided by paragraph (a) of § 1.826–3) to provide the information required under paragraph (b) of § 1.826–3 during the period in which the election made under section 826(a) and this section is in effect;

(3) Reports the income received from the reciprocal and the deductions allocable thereto under the same method of accounting used by the reciprocal in reporting its deductions for amounts paid or due its attorney-in-fact; and

(4) Files its income tax return on a calendar year basis.

(c) Manner of making election. The election provided by section 826(a) and this section shall be made in a statement attached to the taxpayer's income tax return for the first taxable year for which such election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or its duly authorized representative), and shall be filed not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the first taxable year for which such election is to apply. For information required of an electing reciprocal, see paragraph (e) of this section.

(d) Scope of election. The election allowed by section 826(a) is binding for the taxable year for which made and all succeeding taxable years unless the Commissioner consents to a revocation of

such election. Whether revocation will be permitted will depend upon the facts and circumstances of each particular case.

(e) Information required of an electing company. Every reciprocal underwriter or interinsurer making the election provided by section 826(a) and this section shall, in the manner provided by paragraph (f) of this section, furnish the following information for each taxable year during which such election is in effect:

(1) The name and address of the attorney-in-fact with respect to which the election allowed by section 826(a) and this section is in effect; the district in which such attorney-in-fact filed its return for the taxable year; and a copy of the consent required by section 826 and § 1.826–3 and the date and district in which such consent was filed;

(2) The deductible amount paid or due to such attorney-in-fact from the reciprocal computed without regard to the limitation provided by section 826(b);

(3) The total amount claimed as a deduction by the reciprocal for amounts paid to its attorney-in-fact after giving effect to the limitation provided by section 826(b);

(4) The amount of the increase (if any) in underwriting gain (as defined in section 824(a)) attributable to the election allowed by section 826(a);

(5) The amount of the increase (if any) in the deduction allowed by section 824(a) (relating to deduction to provide protection against losses) attributable to the election allowed by section 826(a);

(6) The amount of any increase or decrease in the statutory underwriting income or loss for the taxable year (as computed under section 823) attributable to the election allowed by section 826(a);

(7) The amount of any increase or decrease in the mutual insurance company taxable income or unused loss for the taxable year attributable to the election allowed by section 826(a);

(8) The amount of the increase (if any) in the tax liability of the reciprocal for the taxable year attributable to the election allowed by section 826(a) before taking into account the credit provided by section 826(e);

(9) The amount of tax attributable to income received by the attorney-in-fact from the reciprocal during the taxable year (as determined under § 1.826–5) claimed (under section 826(e) and paragraph (a) of this section) by the reciprocal as a credit for the taxable year; and

(10) The information which the attorney-in-fact is required to submit to the reciprocal under paragraphs (b) and (c) of § 1.826–3.

(f) Manner in which information is to be provided. The information required by paragraph (e) of this section shall be set forth in a statement attached to the taxpayer's income tax return for each taxable year for which such information is required. Such statement shall include the name and address of the taxpayer; and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year with respect to which such information is being provided.

[T.D. 6681, 28 FR 11124, Oct. 17, 1963]

§ 1.826–2 Special rules applicable to electing reciprocals.

(a) Protection against loss account. Section 826(d) provides that for purposes of determining the amount to be subtracted from the protection against loss account under section 824(d)(1)(D) and the regulations thereunder (relating to amounts added to the account for the fifth preceding taxable year) for any taxable year, any amount which was added to such account by reason of the election under section 826(a) and paragraph (a) of § 1.826–1 shall be treated as having been added by reason of section 824(a)(1)(A) and the regulations thereunder (relating to amounts equal to 1 percent of losses incurred during the taxable year). Thus, no amount added to the protection against loss account by reason of an election made under section 826(a) may remain in such account beyond the end of the fifth taxable year following the taxable year with respect to which such amount was added. See section 824(d)(1)(D) and paragraph (b)(3) of § 1.824–1. The amount added to the protection against loss account by reason of an election under section 826(a) is that amount which is equal to 25 percent (plus, in the case of a reciprocal which qualifies as a concentrated risk company under section 824(a), so much of the concentrated wind-storm, etc., premium percentage as exceeds 40 percent) of the amount by which—

(1) The underwriting gain (as defined by section 824(a)(1)) computed after taking into account the limitation provided by section 826(b) and § 1.826–1, exceeds

(2) The underwriting gain computed without regard to the limitation provided by section 826(b) and § 1.826–1.

(b) Denial of surtax exemption. Section 826(f) provides that the tax imposed upon any increase in the mutual insurance company taxable income of a reciprocal which is attributable to the limitation provided by section 826(b) shall be computed without regard to the surtax exemption provided by section 821(a)(2) and the regulations thereunder. Thus, a company making the election provided under section 826(a) will be subject to surtax, as well as normal tax, on the increase in its mutual insurance company taxable income for the taxable year which is attributable to such election. Similarly, any amount which was added to the protection against loss account by reason of an election under section 826(a) and § 1.826–1, and which is subtracted from such account in accordance with section 826(d) and paragraph (a) of this section, will be subject to surtax, as well as normal tax, to the extent such amount increases mutual insurance company taxable income in the year in which the subtraction is made. Furthermore, the company will be subject to surtax on such increases notwithstanding the fact that it may have no normal tax liability for the taxable year, because its mutual insurance company taxable income (after giving effect to the election provided by section 826(a)) does not exceed $6,000.

(c) Adjustment for refunds. Section 826(g) provides that if for any taxable year an attorney-in-fact is allowed a credit or refund for taxes paid with respect to which credit or refund to the reciprocal resulted under section 826(e), the taxes of such reciprocal for such taxable year shall be properly adjusted. The reciprocal shall make the adjustment required by section 826(g) by increasing its income tax liability for its taxable year in which the credit or refund is allowed to the attorney-in-fact by the amount of such credit or refund which is attributable to taxes paid by the attorney-in-fact on income received from the reciprocal, as determined under § 1.826–6, but only to the extent that the payment of such amount by the attorney-in-fact resulted in a credit or refund to the reciprocal. However, if the refund or credit to the attorney-in-fact is the result of an error in determining its items of income or deduction for the taxable year with respect to which the refund or credit is allowed, and such error affects the amount of deductions allocable to its reciprocal for such taxable year, then, if the reciprocal's period for filing an amended return has not otherwise expired, the preceding sentence shall not apply and the reciprocal shall make the adjustment required by section 826(g) by filing an amended return for such taxable year and all subsequent taxable years for which an adjustment is required. The reciprocal's amended return or returns shall give effect to the change in the deductions of the attorney-in-fact allocable to income received from the reciprocal and the tax paid by the attorney-in-fact attributable to such income. The amount of any adjustment required by section 826(g) and this section and the computation thereof shall be set forth in a statement attached to and filed with the taxpayer's income tax return for the taxable year for which the adjustment is made. Such statement shall include the name and address of the taxpayer, and a copy of the notification received by the attorney-in-fact indicating that it has been allowed the credit or refund requiring adjustment of the reciprocal's taxes.

[T.D. 6681, 28 FR 11125, Oct. 17, 1963, as amended by T.D. 7100, 36 FR 5334, March 20, 1971]

§ 1.826–3 Attorney-in-fact of electing reciprocals.

(a) Manner of making consent. Section 826(c)(2) provides that a reciprocal may not elect to be subject to the limitation provided by section 826(b) unless its attorney-in-fact consents to make certain information available. See paragraph (b) of this section. The attorney-in-fact of a reciprocal making the election provided by section 826(a) shall signify the consent required by section 826(c) in a statement attached to its income tax return for the first taxable year for which the reciprocal's election is to apply. Such statement shall include the name and address of the consenting taxpayer; the name and address of the reciprocal with respect to which such consent is to apply; shall be signed by the taxpayer (or its duly authorized representative); and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the first taxable year for which such consent is to apply. In addition, such statement shall specify that the taxpayer is subject to the taxes imposed by section 11 (b) and (c); the method of accounting used in reporting income received from its reciprocal and the deductions allocable thereto; and that its return is filed on the calendar year basis. Consent, once given, shall be irrevocable for the period during which the election provided for the reciprocal by section 826(a) is in effect. See paragraph (e) of § 1.826–1.

(b) Information required of consenting attorney-in-fact. Every attorney-in-fact making the consent provided by section 826(c)(2) and para-

graph (a) of this section shall, in the manner prescribed by paragraph (c) of this section, furnish the following information for each taxable year during which the consent provided by section 826(c)(2) and paragraph (a) of this section is in effect:

(1) The name and address of the reciprocal with respect to which the consent required by section 826(c)(2) and paragraph (a) of this section is to apply;

(2) Gross income in total and by sources, adjusted for returns and allowances;

(3) Deductions (itemized to the same extent as on taxpayer's income tax return and accompanying schedules) allocable to each source of gross income and in total (see § 1.826–4);

(4) Method of allocation used in subparagraph (3) of this paragraph;

(5) Taxable income (if any) in total and by sources, as in subparagraph (2) of this paragraph (income by sources from subparagraph (2) of this paragraph minus expenses allocable thereto under subparagraph (3) of this paragraph);

(6) Total income tax liability (if any) for the taxable year;

(7) Taxes paid attributable (under § 1.826–5) to income earned by the taxpayer in dealing with the reciprocal;

(8) Such other information as may be required by the district director.

(c) Manner in which information is to be provided. (1) The information required by paragraph (b) of this section shall be set forth in a statement attached to the taxpayer's income tax return for each taxable year for which the consent provided by section 826(c)(2) and paragraph (a) of this section is in effect. Such statement shall include the name and address of the taxpayer, and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for each taxable year for which such information is required.

(2) A copy of the statement containing the information required by paragraph (b) of this section shall be submitted to the board of advisors (or other comparable body) of the reciprocal on whose behalf the consent provided under section 826(c)(2) is given. The copy shall be executed in the same manner as the original and shall be delivered to such board not later than 10 days before the last date prescribed by law (including extensions thereof) for filing the reciprocal's income tax return for the taxable year for which the information is required unless the attorney-in-fact establishes to the satisfaction of the district director that the failure to furnish such copy or the failure to furnish such copy within the prescribed 10 day period was due to circumstances beyond its control. In addition, there shall be attached to and made a part of such copy, a copy of the income tax return of the attorney-in-fact (including accompanying schedules) for each taxable year for which such statement is required.

[T.D. 6681, 28 FR 11125, Oct. 17, 1963]

§ 1.826–4 Allocation of expenses.

An attorney-in-fact allocating expenses as required by section 826(b) and paragraph (b) of § 1.826–3 shall allocate each expense itemized in its income tax return (and accompanying schedules) for the taxable year to each source of gross income (as set forth pursuant to paragraph (b)(2) of § 1.826–3). However, no portion of the net operating loss deduction allowed by section 172 shall be allocated to income received or due from the reciprocal, and no expenses, other than those directly related thereto, shall be allocated to capital gains. Where the method of allocation used by the taxpayer does not reasonably reflect the expenses of the taxpayer allocable to income received or due from the reciprocal, the district director may require the taxpayer to use such other method of allocation as is reasonable under the circumstances.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§ 1.826–5 Attribution of tax.

(a) In general. Section 826(e) provides that a reciprocal making the election allowed by section 826(a) shall be credited with so much of the tax paid by the attorney-in-fact as is attributable to the income received by the attorney-in-fact from the reciprocal in such taxable year.

(b) Computation. For purposes of section 826(e) and paragraph (a) of this section, the amount of tax attributable to income received by the attorney-in-fact from the reciprocal in the taxable year shall be computed in the following manner:

(1) First, compute the taxable income (if any) from each source of gross income set forth in paragraph (b)(2) of § 1.826–3 by deducting from each such amount the expenses allocable thereto under § 1.826–4;

(2) Second, compute the normal tax on each amount of taxable income computed in subparagraph (1) of this paragraph at the rate provided by section 11(b) of the Code;

(3) Third, deduct from each amount determined in subparagraph (1) of this paragraph an amount which bears the same proportion to the surtax exemption provided by section 11(c) of the Code as each amount computed under subparagraph (1) of this paragraph bears to the total of the amounts computed under subparagraph (1) of this paragraph;

(4) Fourth, compute the surtax on each remainder computed in subparagraph (3) of this paragraph at the rate provided by section 11(c) of the Code;

(5) Fifth, add the normal tax computed under subparagraph (2) of this paragraph to the surtax computed under subparagraph (4) of this paragraph for each amount computed under subparagraph (1) of this paragraph;

(6) Sixth, deduct from each amount of tax computed under subparagraph (5) of this paragraph any tax credits (other than those arising from payments made with respect to the tax liability for the taxable year or other taxable years) allocable (in the same manner as provided for expenses under § 1.826–4) to such amount;

(7) Seventh, compute that amount which bears the same proportion to the tax actually paid with respect to the taxable year as each individual amount computed under subparagraph (6) of this paragraph bears to the total of the amounts computed under subparagraph (6) of this paragraph. The amount so determined with respect to each amount computed under subparagraph (6) of this paragraph is the tax paid which is attributable to the amount computed under subparagraph (1) of this paragraph.

To the extent the amounts determined under subparagraph (1) of this paragraph are attributable to amounts received from the reciprocal for the taxable year, the tax attributable to such amounts (as determined under subparagraph (7) of this paragraph) shall be the amount of tax attributable to income received by the attorney-in-fact from the reciprocal during the taxable year.

(c) **Taxes of attorney-in-fact unaffected.** Nothing in section 826 or the regulations thereunder shall increase or decrease the taxes imposed on the income of the attorney-in-fact.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§ 1.826–6 Credit or refund.

(a) **Notification required.** In any case where a taxpayer applies for a credit or refund of taxes paid by it in respect of a taxable year for which the taxpayer was the consenting attorney-in-fact of a reciprocal making the election provided by section 826(a), such taxpayer shall give notice to its reciprocal for such taxable year, first, upon applying for the credit or refund; and again, within 10 days from the date on which a final determination is made that such credit or refund has been allowed or denied.

(b) **Notice form.** The notices required by this section shall include the name and address of the taxpayer and shall be signed by the taxpayer or its duly authorized representative. In addition, there shall be attached to and made a part of each first notice a concise statement of the claim upon which the application for refund or credit is based; and there shall be attached to and made a part of each second notice:

(1) A copy of the notification (if any) received by the taxpayer indicating that the credit or refund has been allowed; and

(2) A statement setting forth the amount of such credit or refund attributable to taxes paid by the taxpayer on income received from the reciprocal, and the computation by which such amount was determined.

(c) **Manner of apportioning refund or credit.** The taxpayer shall determine the amount of the refund or credit attributable to taxes paid on income received from its reciprocal by reallocating its income and expense items for the taxable year, with respect to which the refund or credit is allowed, in the manner provided by §§ 1.826–3 and 1.826–4 so as to reflect the adjustments (if any) in such items which resulted in the credit or refund of tax for the taxable year. The taxpayer shall then recompute the tax attributable to income received from its reciprocal for such taxable year in the manner provided by § 1.826–5. The district director may require such additional information as may be necessary in the circumstances to verify the computations required by this paragraph.

[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

§ 1.826–7 Examples.

The application of section 826 may be illustrated by the following examples:

Example (1). For the taxable year 1963, R, a reciprocal underwriter subject to the taxes imposed by section 821(a), has

the following items (determined before applying any election under section 826):

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	$100	
All other deductions	500	
Total deductions under sec. 832	600	
Deductions under sec. 822(c)		40
Incurred losses		400
Protection against loss deduction		4
Underwriting gain		0
Mutual insurance company taxable income		0
Unused loss		22
Credit or refund for taxes paid		0

Assume that the deductions of attorney-in-fact A allocable to the income received by A from R are 60 and the tax paid by A allocable to the income received from R is 16. If R elects to be subject to the limitation provided in section 826(b), the results for 1963 would be as follows:

Gross income under sec. 832		$578
Gross investment income		50
Deductions under sec. 832 (as modified by sec. 823(b)):		
Deduction for amounts paid by R to attorney-in-fact A	$60	
All other deductions	500	
Total deduction under sec. 832	560	
Deductions under sec. 822(c)		40
Incurred losses		400
Underwriting gain		8
Protection against loss deduction		6
Mutual insurance company taxable income		12
Unused loss		0
Credit or refund for taxes paid		16

Under the provisions of section 826(b), R's deduction for amounts paid or incurred to the attorney-in-fact in the taxable year 1963 would be limited to the deductions of A allocable to the income received by A from R. Thus, R's deductions under section 832 (as modified by section 823(b)) for 1963 would be 60 (the deductions of A which are allocable to the income received by A from R). As a result of making the election under section 826(a) for the taxable year 1963, R's underwriting gain would be 8, and its statutory underwriting income would be 2 (the underwriting gain of 8 minus the protection against loss deduction of 6—of which 4 represents the amount determined under section 824(a)(1)(A)—and 2 represents the amount determined under section 824(a)(1)(B)—or 8 minus 6). R's mutual insurance company taxable income for 1963 would be 12, consisting of taxable investment income of 10 (gross investment income minus deductions under section 822(c), or 50 minus 40) plus statutory underwriting income of 2. Since all of R's mutual insurance company taxable income of 12 is attributable to the limitation under section 826(b), the entire amount is subject to the surtax under section 821(a)(2) without regard to the $25,000 surtax exemption. The credit of 16, representing that part of the tax paid by A which is allocable to the income received by A from R, may be applied by R against its taxes with respect to its mutual insurance company taxable income of 12 for 1963, and R would be entitled to a refund of any excess of the amount of such credit over its tax liability for 1963.

Under the provisions of section 826(d), no portion of the amount added to the protection against loss account in 1963 by reason of the election under section 826(a), 2 (25 percent of the amount by which the consolidated underwriting gain exceeds 25 percent of the underwriting gain determined without regard to the election under section 826(a), or the amount by which 25 percent of 8 exceeds 25 percent of 0), may remain in such account beyond the taxable year 1968.

Example (2). For the taxable year 1963, F is a corporate attorney-in-fact subject to the taxes imposed by section 11(b) and (c) of the Code. F files its return on the calendar year basis and reports income received from its reciprocal and the deductions allocable thereto under the same method of accounting used by its reciprocal in reporting its deductions for amounts paid to R. F properly consents to provide the information required by paragraph (b) of § 1.826–3. In addition to its attorney-in-fact business, F owns real estate for investment purposes, and operates a real estate management service. For the taxable year 1963, F has gross income from these various sources as follows:

Attorney-in-fact fees	$85,000
Real estate management fees	18,000
Rental income	25,000

F allocates its expenses for the taxable year on the basis of their direct relation to each source of income. During 1963, F acquired property for use in its attorney-in-fact operations which entitled F to an investment credit of $800 under section 38. For 1963, F determines that the tax paid by it which is attributable to its reciprocal is $21,863, computed as follows:

	Attor-ney-in fact fees	Real estate man-agement	Rental income	Total
Gross income	$85,000	$18,000	$25,000	$128,000
Allocable expenses	25,000	3,000	35,000	63,000
Taxable income (loss)	60,000	15,000	(10,000)	65,000
Normal tax (30 percent)	18,000	4,500	0	19,500
Surtax exemption	20,000	5,000	0	25,000
Income subject to surtax	40,000	10,000	0	40,000
Surtax (22 percent)	8,800	2,200	0	8,800
Total tax	26,800	6,700	0	28,300
Investment credit	800	0	0	800
1963 tax liability	26,000	6,700	0	27,500
1963 tax paid				27,500
Allocation of tax paid	21,863	5,637	0	27,500

Under paragraph (b)(1) of § 1.826–5, F computes its taxable income from its attorney-in-fact fees to be $60,000 ($85,000 minus $25,000), and its taxable income from its real estate management to be $15,000 ($18,000 minus $3,000). Since F's rental operations resulted in a $10,000 loss for the taxable year ($25,000 minus $35,000), F's taxable income from its rental operations is zero. Using the 30 percent rate provided by section 11(b), F computes its normal tax to be $18,000 on its attorney-in-fact fees and $4,500 on its real estate management operations. F's normal tax on total income is $19,500. The $3,000 difference between the normal tax on F's total income and the normal taxes on F's profitable operations results from the loss on F's rental operations. Under paragraph (b)(3) of § 1.826–5, F allocates its surtax exemption as follows: $20,000 ($60,000/$75,000 × $25,000) to its attorney-in-fact fees; and

$5,000 ($15,000/$75,000×$25,000) to its real estate management operations. F computes its surtax on its profitable operations at the 22 percent rate provided by section 11(c) as follows: $8,800 (22 percent of $40,000) on attorney-in-fact fees; and $2,200 (22 percent of $10,000) on real estate management income. F adds its normal tax and surtax on its profitable operations and determines its total tax to be $26,800 on its attorney-in-fact operations; $6,700 on its real estate management operations; and $28,300 on its total income. F must allocate its investment credit on the same basis as it used to allocate its expenses. Thus, F's entire investment credit must be allocated to its attorney-in-fact operations. Accordingly, F's 1963 tax liability is $26,000 on its attorney-in-fact fees; $6,700 on its real estate management operations; $0 on its rental operations; and $27,500 on its total income. Under paragraph (b)(7) of § 1.826–5, F allocates $21,863 ($26,000/$32,700×$27,500) of its 1963 tax paid to its attorney-in-fact fees; and $5,637 ($6,700/$32,700×$27,500) of its 1963 tax paid to its real estate management business. F's reciprocal will be allowed a credit or refund of $21,863 for taxes paid by F which are attributable to F's income received from its reciprocal.

Example (3). Assume the same facts as in example (2), and assume further that in 1966 F sustains a net operating loss on its overall operations of $5,000. In carrying the loss back to 1963 as a net operating loss deduction under section 172, F must allocate the deduction under the same method it used in allocating its 1963 deductions. Thus, if the loss was entirely attributable to F's rental operations for the taxable year 1966, F would reduce its taxable income attributable to those operations by the entire amount of the loss and would recompute the tax attributable to those operations under paragraph (b) of § 1.826–5. As recomputed in the table below, F's 1963 tax liability from attorney-in-fact fees would be $19,800 and F's total tax liability would be $24,900.

	Attorney-in-fact fees	Real estate management	Rental income	Total
Gross income	$85,000	$18,000	$25,000	$128,000
Allocable expenses	25,000	3,000	35,000	63,000
Net operating loss deduction	0	0	5,000	5,000
Taxable income (loss)	60,000	15,000	(15,000)	60,000
Normal tax (30 percent)	18,000	4,500	0	18,000
Surtax exemption	20,000	5,000	0	25,000
Income subject to surtax	40,000	10,000	0	35,000
Surtax (22 percent)	8,800	2,200	0	7,700
Total tax	26,800	6,700	0	25,700
Investment credit	800	0	0	800
1963 tax liability	26,000	6,700	0	24,900
1963 tax paid				24,900
Allocation of tax paid	19,800	5,100	0	24,900

As a result of its 1966 net operating loss, F would be entitled to a refund of $2,600 (1963 taxes paid of $27,500 minus recomputed 1963 taxes of $24,900). Under paragraph (a) of § 1.826–6, F would be required to notify its reciprocal of its claim for refund and of the amount of the refund or credit attributable to taxes paid on income received from the reciprocal. Since the 1963 tax paid by F attributable to its reciprocal (as recomputed) is less than the amount claimed in 1963 by F's reciprocal as a credit, F's reciprocal would be required, under section 826(g), to add the difference—$2,063 ($21,863 minus $19,800), to its tax liability for 1966. Thus, F's reciprocal would first compute its tax liability for 1966 without regard to section 826(g) and then would increase such liability by $2,063.
[T.D. 6681, 28 FR 11126, Oct. 17, 1963]

Other Insurance Companies

§ 1.831–1 Tax on insurance companies (other than life or mutual), mutual marine insurance companies, and mutual fire insurance companies issuing perpetual policies.

(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire insurance companies exclusively issuing either perpetual policies, or policies for which the sole premium charged is a single deposit which, except for such deduction of underwriting costs as may be provided, is refundable upon cancellation or expiration of the policy, are subject to the tax imposed by section 831. As used in this section and §§ 1.832–1 and 1.832–2, the term "insurance companies" means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of § 1.801–1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code.

(d) Foreign insurance companies not carrying on an insurance business within the United States

are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11(b) and the surtax shall be computed as provided in section 11(c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.831–2 Taxable years affected.

Section 1.831–1 is applicable only to taxable years beginning after December 31, 1953, but before January 1, 1963, and ending after August 16, 1954, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 and the regulations thereunder before amendments. Section 1.831–3 is applicable only to taxable years beginning after December 31, 1962, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 as amended. Section 1.831–4 is applicable only with respect to the companies described therein, and only with respect to taxable years beginning after December 31, 1961.

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.831–3 Tax on insurance companies (other than life or mutual), mutual marine insurance companies, mutual fire insurance companies issuing perpetual policies, and mutual fire or flood insurance companies operating on the basis of premium deposits; taxable years beginning after December 31, 1962.

(a) All insurance companies, other than life or mutual or foreign insurance companies not carrying on an insurance business within the United States, and all mutual marine insurance companies and mutual fire or flood insurance companies exclusively issuing perpetual policies or whose principal business is the issuance of policies for which the premium deposits are the same regardless of the length of the term for which the policies are written, are subject to the tax imposed by section 831 if the unabsorbed portion of such premium deposits not required for losses, expenses or reserves is returned or credited to the policyholder on cancellation or expiration of the policy. For purposes of section 831 and this section, in the case of a mutual flood insurance company, the premium deposits will be considered to be the same if the payment of a premium increases the total insurance under the policy in an amount equal to the amount of such premium and the omission of any annual premium does not result in the reduction or suspension of coverage under the policy. As used in this section and section 832 and the regulations thereunder, the term "insurance companies" means only those companies which qualify as insurance companies under the definition provided by paragraph (b) of § 1.801–1 and which are subject to the tax imposed by section 831.

(b) All provisions of the Code and of the regulations in this part not inconsistent with the specific provisions of section 831 are applicable to the assessment and collection of the tax imposed by section 831(a), and insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations.

(c) Since section 832 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the returns under section 831 shall be made on the basis of the calendar year and shall be on Form 1120. Insurance companies are entitled, in computing insurance company taxable income, to the deductions provided in part VIII (section 241 and following), subchapter B, chapter 1 of the Code.

(d) Foreign insurance companies not carrying on an insurance business within the United States are not taxable under section 831 but are taxable as other foreign corporations. See section 881.

(e) Insurance companies are subject to both normal tax and surtax. The normal tax shall be computed as provided in section 11(b) and the surtax shall be computed as provided in section 11(c). For the circumstances under which the $25,000 exemption from surtax for certain taxable years may be disallowed in whole or in part, see section 1551. For alternative tax where the net long-term capital gain for any taxable year exceeds the net short-term capital loss, see section 1201(a) and the regulations thereunder.

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.831–4 Election of multiple line companies to be taxed on total income.

(a) In general. Section 831(c) provides that any mutual insurance company engaged in writing marine, fire, and casualty insurance which, for any 5-year period beginning after December 31, 1941, and ending before January 1, 1962, was subject to the tax imposed by section 831 (or the tax imposed by corresponding provisions of prior law) may elect, in the manner provided by paragraph (b) of this section, to be subject to the tax imposed by section 831, whether or not marine insurance is its predominant source of premium income. A company making an election under section 831(c) and this section will be subject to the tax imposed by section 831 for taxable years beginning after December 31, 1961, rather than subject to the tax imposed by section 821.

(b) Time and manner of making election. The election provided by section 831(c) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year 1962. The statement shall indicate that the taxpayer has made the election provided by section 831(c) and this section; shall include the name and address of the taxpayer, and shall be signed by the taxpayer or his duly authorized representative. In addition, the statement shall list the 5 consecutive taxable years prior to 1962 for which the taxpayer was subject to tax under section 831 (or the corresponding provisions of prior law); the types of insurance written by the company; and the percentage of marine insurance to total insurance written. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for the taxable year 1962. However, if the last date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year 1962 falls before October 17, 1963, the election provided by section 831(c) and this section may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before January 16, 1964.

(c) Scope of election. An election made under section 831(c) and paragraph (b) of this section shall be binding for all taxable years beginning after December 31, 1961, unless consent to revoke the election is obtained from the Commissioner. However, if a taxpayer made the election provided by section 831(c) and this section for taxable years beginning prior to October 17, 1963, the taxpayer may revoke such election without obtaining consent from the Commissioner by filing, before January 16, 1964, a statement that the taxpayer desires to revoke such election. Such statement shall be signed by the taxpayer or its duly authorized representative. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(d) Limitation on certain net operating loss carryovers and carrybacks. In the case of a taxpayer making the election allowed under section 831(c) and this section, a net operating loss shall not be carried—

(1) To or from any taxable year for which the insurance company is not subject to the tax imposed by section 831(a) (or predecessor sections); or

(2) To any taxable year if, between the loss year and such taxable year, there is an intervening taxable year for which the insurance company was not subject to the tax imposed by section 831(a) (or predecessor sections).

[T.D. 6681, 28 FR 11128, Oct. 17, 1963]

§ 1.832–1 Gross income.

(a) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in § 1.831–1 the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets. The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared

to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year. In computing "premiums earned on insurance contracts during the taxable year" the amount of the unearned premiums shall include (1) life insurance reserves as defined in section 803(b) and § 1.803–1 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801, and (2) liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War Department Insurance Rating Plan," and which return premiums are therefore not earned premiums. In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

(c) That part of the deduction for "losses incurred" which represents an adjustment to losses paid for salvage and reinsurance recoverable shall, except as hereinafter provided, include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash), real or personal, tangible or intangible, except that which may not be included by reason of express statutory provisions (or rules and regulations of an insurance department) of any State or Territory or the District of Columbia in which the company transacts business. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash received during the taxable year with respect to items of salvage or reinsurance shall be taken into account in computing losses paid during such taxable year.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960]

§ 1.832–2 Deductions.

(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c)(10) and (12) include in addition certain deductions provided in sections 161, and 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, "gross income" shall mean gross income as defined in section 832(b)(1) and the allowable deductions shall be those allowed by section 832(c) with the exceptions and limitations set forth in section 172(d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), Chapter 1 of the Code, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(c)(6) and the regulations thereunder. Insurance companies, other than mutual fire insurance companies described in § 1.831–1, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 823(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.
[T.D. 6500, 25 FR 11814, Nov. 26, 1960, as amended by T.D. 6867, 30 FR 15094, Dec. 12, 1965]

§ 1.832–3 Taxable years affected.

Sections 1.832–1 and 1.832–2 are applicable only to taxable years beginning after December 31, 1953, and before January 1, 1963, and ending after August 16, 1954, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 and the regulations thereunder before amendments. Sections 1.832–4, 1.832–5, and 1.832–6 are applicable only to taxable years beginning after December 31, 1962, and all references therein to sections of the Code and regulations are to sections of the Internal Revenue Code of 1954 as amended.
[T.D. 6681, 28 FR 11129, Oct. 17, 1963]

§ 1.832–4T Gross income(temporary).

(a)(1) Gross income as defined in section 832(b)(1) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from the sale or other disposition of property, and all other items constituting gross income under section 61, except that in the case of a mutual fire insurance company described in section 831(a)(3)(A) the amount of single deposit premiums received, but not assessments, shall be excluded from gross income. Section 832(b)(1)(D) provides that in the case of a mutual fire or flood insurance company described in section 831(a)(3)(B), there shall be included in gross income an amount equal to 2 percent of the premiums earned during the taxable year on contracts described in section 831(a)(3)(B) after deduction of premium deposits returned or credited during such taxable year with respect to such contracts. Gross income does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, or gross increase due to adjustments in book value of capital assets.

(2) The underwriting and investment exhibit is presumed to reflect the true net income of the company, and insofar as it is not inconsistent with the provisions of the Code will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Code. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared to shareholders in their capacity as such, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been allowed as deductions for worthless debts or, having been previously so allowed, are recovered during the taxable year.

(3) In computing "premiums earned on insurance contracts during the taxable year" the amount of the unearned premiums shall include:

(i) Life insurance reserves as defined in section 803(b) and § 1.803–1 pertaining to the life, burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801;

(ii) Liability for return premiums under a rate credit or retrospective rating plan based on experience, such as the "War Department Insurance Rating Plan," and which return premiums are therefore not earned premiums; and

(iii) In the case of a mutual fire or flood insurance company described in section 831(a)(3)(B) (with respect to the contracts described therein), the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the company's taxable year if all of its policies were terminated at such time.

(4) In computing the amount of unabsorbed premium deposits which a mutual fire or flood insurance company described in section 831(a)(3)(B) would be obligated to return to its policyholders at the close of its taxable year, the company must use its own schedule of unabsorbed premium deposit returns then in effect. A copy of the applicable schedule must be filed with the company's income tax return for each taxable year for which a computation based upon such schedule is made. In addition, a taxpayer making such a computation must provide the following information for each taxable year for which the computation is made:

(i) The amount of gross premiums received during the taxable year, and the amount of premiums paid for reinsurance during the taxable year, on the policies described in section 831(a)(3)(B) and on other policies;

(ii) The amount of insurance written during the taxable year under the policies described in section 831(a)(3)(B) and under other policies, and the amount of such insurance written which was reinsured during the taxable year. The information required under this subdivision shall only be submitted upon the specific request of the district director for a statement setting forth such information, and, if required, such statement shall be filed in the manner provided by this subparagraph or in such other manner as is satisfactory to the district director;

(iii) The amount of premiums earned during the taxable year on the policies described in section 831(a)(3)(B) and on other policies and the computations by which such amounts were determined, including sufficient information to support the taxpayer's determination of the amount of unearned premiums on premium deposit plan and other policies at the beginning and end of the taxable year, and the amount of unabsorbed premium deposits at the beginning and end of the taxable year on policies described in section 831(a)(3)(B).

The information required by this subparagraph shall be set forth in a statement attached to the taxpayer's income tax return for the taxable year for which such information is being provided. Such statement shall include the name and address of the taxpayer, and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the income tax return for the taxable year.

(5) In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them. See paragraph (b) of this section for rules relating to the treatment of salvage and reinsurance in determining unpaid losses.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, represent a fair and reasonable estimate of the amount the company will be required to pay. Estimated recoveries on account of salvage and reinsurance attributable to unpaid losses must be taken into account in the computation of unpaid losses. The amounts of such expected recoveries should be estimated based upon the facts in each case and the company's experience with similar cases. Amounts included in, or added to, the estimates of unpaid losses which, in the opinion of the district director, are in excess of the actual liability determined as provided in the preceding sentences will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

(c) That part of the deduction for "losses incurred" which represents an adjustment to losses paid for salvage and reinsurance recoverable shall include all salvage in course of liquidation, and all reinsurance in process of collection not otherwise taken into account as a reduction of losses paid, outstanding at the end of the taxable year. Salvage in course of liquidation includes all property (other than cash or cash equivalents), real or personal, tangible or intangible. Such salvage in course of liquidation shall be taken into account to the extent of the value thereof at the end of the taxable year as determined from a fair and reasonable estimate based upon either the facts in each case or the company's experience with similar cases. Cash or cash equivalents received during the taxable year with respect to items of salvage or reinsurance shall reduce losses paid during such taxable year. For purposes of this section the term "salvage" includes subrogation claims.

(d)(1) The treatment of salvage and reinsurance is a method of accounting. Every insurance company to which this section applies that did not treat salvage and reinsurance as provided in this section for the last taxable year beginning before

January 1, 1988, must change its method of accounting with respect to salvage and reinsurance in the first taxable year beginning after December 31, 1987. The change in method of accounting will result in a section 481(a) adjustment. The fresh start provision of section 1023(e) of the Tax Reform Act of 1986 does not apply to the change in method of accounting required by this paragraph (d)(1).

(2) In the case of any insurance company required by paragraph (d)(1) of this section to change its method of accounting for any taxable year, such change shall be treated as initiated by the taxpayer and made with the consent of the Commissioner.

(3) Any insurance company required to change its method of accounting under paragraph (d)(1) of this section shall take the required adjustment into account as provided in applicable administrative procedures.

(e) This section is effective for taxable years beginning after December 31, 1987. In computing unpaid losses for taxable years beginning before January 1, 1988, an insurance company to which this section applies is not required to take into account estimated recoveries on account of salvage attributable to unpaid losses. In addition, in computing paid losses for such taxable years, an insurance company to which this section applies is not required to take into account salvage recoverable if during such taxable years the inclusion of such salvage was prohibited by the laws of a state in which the company transacted business.

[T.D. 6681, 28 FR 11129, Oct. 17, 1963; T.D. 8171, 53 FR 118, Jan. 5, 1988]

§ 1.832–5 Deductions.

(a) The deductions allowable are specified in section 832(c) and by reason of the provisions of section 832(c)(10) and (12) include in addition certain deductions provided in sections 161, and 241 and following. The deductions, however, are subject to the limitation provided in section 265, relating to expenses and interest in respect of tax-exempt income. The net operating loss deduction is computed under section 172 and the regulations thereunder. For the purposes of section 172, relating to net operating loss deduction, "gross income" shall mean gross income as defined in section 832(b)(1) and the allowable deductions shall be those allowed by section 832(c) with the exceptions and limitations set forth in section 172(d). In addition to the deduction for capital losses provided in subchapter P (section 1201 and following), chapter 1 of the Code, insurance companies are allowed a deduction for losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. A special rule is provided for the application of the capital loss carryover provisions of section 1212. The deduction is the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(c)(6) and the regulation thereunder. Insurance companies, other than mutual fire insurance companies described in section 831(a)(3)(A) and the regulations thereunder, are also allowed a deduction for dividends and similar distributions paid or declared to policyholders in their capacity as such. Similar distributions include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual insurance companies. The deduction is otherwise the same as that allowed mutual insurance companies subject to the tax imposed by section 821; see section 822(f)(2) and the regulations thereunder.

(b) Among the items which may not be deducted are income and profits taxes imposed by the United States, income and profits taxes imposed by any foreign country or possession of the United States (in cases where the company chooses to claim to any extent a credit for such taxes), taxes assessed against local benefits, decrease during the year due to adjustments in the book value of capital assets, decrease in liabilities during the year on account of reinsurance treaties, dividends paid to shareholders in their capacity as such, remittances to the home office of a foreign insurance company by the United States branch, and borrowed money repaid.

(c) In computing taxable income of insurance companies, losses sustained during the taxable year from the sale or other disposition of property are deductible subject to the limitation contained in section 1211. Insurance companies are entitled to the alternative taxes provided in section 1201.

[T.D. 6681, 28 FR 11130, Oct. 17, 1963, as amended by T.D. 6867, 30 FR 15094, Dec. 7, 1965]

§ 1.832–6 Policyholders of mutual fire or flood insurance companies operating on the basis of premium deposits.

For purposes of determining his taxable income for any taxable year, a taxpayer insured by a mutual fire or flood insurance company under a policy for which the premium deposit is the same regardless of the length of the term for which the

policy is written, and who is entitled to have returned or credited to his on the cancellation or expiration of such policy the unabsorbed portion of the premium deposit not required for losses, expenses, or establishment of reserves, may, if such amount is otherwise deductible under this chapter, deduct so much of his premium deposit as was absorbed by the company during the taxpayer's taxable year. The amount of the premium deposit absorbed during the taxpayer's taxable year shall be determined in accordance with the schedule of unabsorbed premium deposit returns in effect for the company during such taxable year. If the taxpayer is unable to determine the applicable rate of absorption in effect during his taxable year, he shall compute his deduction on the basis of the rate of absorption in effect at the end of the company's taxable year which next preceded the end of the taxpayer's taxable year. In such a case, an appropriate adjustment will be made upon the final determination of the rate of absorption applicable to the taxable year.

[T.D. 6681, 28 FR 11130, Oct. 17, 1963]

REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS

§ 1.851–1 Definition of regulated investment company.

(a) In general. The term "regulated investment company" is defined to mean any domestic corporation (other than a personal holding company as defined in section 542) which meets (1) the requirements of section 851(a) and paragraph (b) of this section, and (2) the limitations of section 851(b) and § 1.851–2. As to the definition of the term "corporation", see section 7701(a)(3).

(b) Requirement. To qualify as a regulated investment company, a corporation must be:

(1) Registered at all times during the taxable year, under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), either as a management company or a unit investment trust, or

(2) A common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–3(c)) from the definition of "investment company" and not included in the definition of "common trust fund" by section 584(a).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.851–2 Limitations.

(a) Election to be a regulated investment company. Under the provisions of section 851(b)(1), a corporation, even though it satisfies the other requirements of part I, subchapter M, chapter 1 of the Code, for the taxable year, will not be considered a regulated investment company for such year, within the meaning of such part I, unless it elects to be a regulated investment company for such taxable year, or has made such an election for a previous taxable year which began after December 31, 1941. The election shall be made by the taxpayer by computing taxable income as a regulated investment company in its return for the first taxable year for which the election is applicable. No other method of making such election is permitted. An election once made is irrevocable for such taxable year and all succeeding taxable years.

(b) Gross income requirement—(1) General rule. Section 851(b)(2) and (3) provides that (i) at least 90 percent of the corporation's gross income for the taxable year must be derived from dividends, interest, and gains from the sale or other disposition of stocks or securities, and (ii) less than 30 percent of its gross income must have been derived from the sale or other disposition of stock or securities held for less than three months. In determining the gross income requirements under section 851(b)(2) and (3), a loss from the sale or other disposition of stock or securities does not enter into the computation. A determination of the period for which stock or securities have been held shall be governed by the provisions of section 1223 insofar as applicable.

(2) Special rules. (i) For purposes of section 851(b)(2), there shall be treated as dividends amounts which are included in gross income for the taxable year under section 951(a)(1)(A)(i) to the extent that (a) a distribution out of a foreign corporation's earnings and profits of the taxable year is not included in gross income by reason of section 959(a)(1), and (b) the earnings and profits are attributable to the amounts which were so included in gross income under section 951(a)(1)(A)(i). For allocation of distributions to earnings and profits of foreign corporations, see § 1.959–3. The provisions of this subparagraph shall apply with respect to taxable years of controlled foreign corporations beginning after December 31, 1975, and to taxable years of United States shareholders (within the meaning of section 951(b) within which or with which such taxable years of such controlled foreign corporations end.

(ii) For purposes of subdivision (i) of this subparagraph, if by reason of section 959(a)(1) a distribution of a foreign corporation's earnings and profits for a taxable year described in section 959(c)(2) is not included in a shareholder's gross income, then such distribution shall be allocated proportionately between amounts attributable to amounts included under each clause of section 951(a)(1)(A). Thus, for example, M is a United States shareholder in X Corporation, a controlled foreign corporation. M and X each use the calendar year as the taxable year. For 1977, M is required by section 951(a)(1)(A) to include $3,000 in its gross income, $1,000 of which is included under clause (i) thereof. In 1977, M received a distribution described in section 959(c)(2) of $2,700 out of X's earnings and profits for 1977, which is, by reason of section 959(a)(1), excluded from M's gross income. The amount of the distribution attributable to the amount included under section 951(a)(1)(A)(i) is $900, *i.e.,* $2,700 multiplied by ($1,000/$3,000).

(c) **Diversification of investments.** (1) Subparagraph (A) of section 851(b)(4) requires that at the close of each quarter of the taxable year at least 50 percent of the value of the total assets of the taxpayer corporation be represented by one or more of the following:

(i) Cash and cash items, including receivables;

(ii) Government securities;

(iii) Securities of other regulated investment companies; or

(iv) Securities (other than those described in subdivisions (ii) and (iii) of this subparagraph) of any one or more issuers which meet the following limitations: (a) The entire amount of the securities of the issuer owned by the taxpayer corporation is not greater in value than 5 percent of the value of the total assets of the taxpayer corporation, and (b) the entire amount of the securities of such issuer owned by the taxpayer corporation does not represent more than 10 percent of the outstanding voting securities of such issuer. For the modification of the percentage limitations applicable in the case of certain venture capital investment companies, see section 851(e) and § 1.851–6.

Assuming that at least 50 percent of the value of the total assets of the corporation satisfies the requirements specified in this subparagraph, and that the limiting provisions of subparagraph (B) of section 851(b)(4) and subparagraph (2) of this paragraph are not violated, the corporation will satisfy the requirements of section 851(b)(4), notwithstanding that the remaining assets do not satisfy the diversification requirements of subparagraph (A) of section 851(b)(4). For example, a corporation may own all the stock of another corporation, provided it otherwise meets the requirements of subparagraphs (A) and (B) of section 851(b)(4).

(2) Subparagraph (B) of section 851(b)(4) prohibits the investment at the close of each quarter of the taxable year of more than 25 percent of the value of the total assets of the corporation (including the 50 percent or more mentioned in subparagraph (A) of section 851(b)(4)) in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, or of two or more issuers which the taxpayer company controls and which are engaged in the same or similar trades or businesses or related trades or businesses, including such issuers as are merely a part of a unit contributing to the completion and sale of a product or the rendering of a particular service. Two or more issuers are not considered as being in the same or similar trades or businesses merely because they are engaged in the broad field of manufacturing or of any other general classification of industry, but issuers shall be construed to be engaged in the same or similar trades or businesses if they are engaged in a distinct branch of business, trade, or manufacture in which they render the same kind of service or produce or deal in the same kind of product, and such service or products fulfill the same economic need. If two or more issuers produce more than one product or render more than one type of service, then the chief product or service of each shall be the basis for determining whether they are in the same trade or business. [T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4090, April 28, 1962; T.D. 7555, 43 FR 32753, July 28, 1978]

§ 1.851–3 Rules applicable to section 851(b)(4).

In determining the value of the taxpayer's investment in the securities of any one issuer, for the purposes of subparagraph (B) of section 851(b)(4), there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer. See example (4) in § 1.851–5. For purposes of §§ 1.851–2, 1.851–4, 1.851–5, and 1.851–6, the terms "controls", "controlled group", and "value" have the meaning assigned to them by section 851(c). All other terms used in such sections have the same meaning as when used in the Investment

Company Act of 1940 (15 U.S.C., ch. 2D) or that act as amended.
[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.851–4 Determination of status.

With respect to the effect which certain discrepancies between the value of its various investments and the requirements of section 851(b)(4) and paragraph (c) of § 1.851–2, or the effect that the elimination of such discrepancies will have on the status of a company as a regulated investment company for purposes of part I, subchapter M, chapter 1 of the Code, see section 851(d). A company claiming to be a regulated investment company shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 851 during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.
[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4090, April 28, 1962]

§ 1.851–5 Examples.

The provisions of section 851 may be illustrated by the following examples:

Example (1). Investment Company W at the close of its first quarter of the taxable year has its assets invested as follows:

	Percent
Cash	5
Government securities	10
Securities of regulated investment companies	20
Securities of Corporation A	10
Securities of Corporation B	15
Securities of Corporation C	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	20
Total	100

Investment Company W owns all of the voting stock of Corporations A and B, 15 percent of the voting stock of Corporation C, and less than 10 percent of the voting stock of the other corporations. None of the corporations is a member of a controlled group. Investment Company W meets the requirements under section 851(b)(4) at the end of its first quarter. It complies with subparagraph (A) of section 851(b)(4) since it has 55 percent of its assets invested as provided in such subparagraph. It complies with subparagraph (B) of section 851(b)(4) since it does not have more than 25 percent of its assets invested in the securities of any one issuer, or of two or more issuers which it controls.

Example (2). Investment Company V at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash	10
Government securities	35
Securities of Corporation A	7
Securities of Corporation B	12
Securities of Corporation C	15
Securities of Corporation D	21
Total	100

Investment Company V fails to meet the requirements of subparagraph (A) of section 851(b)(4) since its assets invested in Corporations A, B, C, and D exceed in each case 5 percent of the value of the total assets of the company at the close of the particular quarter.

Example (3). Investment Company X at the close of the particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	20
Securities of Corporation A	5
Securities of Corporation B	10
Securities of Corporation C	25
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	40
Total	100

Investment Company X owns more than 20 percent of the voting power of Corporations B and C and less than 10 percent of the voting power of all of the other corporations. Corporation B manufactures radios and Corporation C acts as its distributor and also distributes radios for other companies. Investment Company X fails to meet the requirements of subparagraph (B) of section 851(b)(4) since it has 35 percent of its assets invested in the securities of two issuers which it controls and which are engaged in related trades or businesses.

Example (4). Investment Company Y at the close of a particular quarter of the taxable year has its assets invested as follows:

	Percent
Cash and Government securities	15
Securities of Corporation K (a regulated investment company)	30
Securities of Corporation A	10
Securities of Corporation B	20
Securities of various corporations (not exceeding 5 percent of its assets in any one company)	25
Total	100

Corporation K has 20 percent of its assets invested in Corporation L and Corporation L has 40 percent of its assets invested in Corporation B. Corporation A also has 30 percent of its assets invested in Corporation B, and owns more than 20 percent of the voting power in Corporation B. Investment Company Y owns more than 20 percent of the voting power of Corporations A and K. Corporation K owns more than 20 percent of the voting power of Corporation L, and Corporation L owns more than 20 percent of the voting power of Corporation L. Investment Company Y is disqualified under subparagraph (B) of section 851(b)(4) since more than 25 percent of its assets are considered invested in Corporation B as shown by the following calculation:

	Percent
Percentage of assets invested directly in Corporation B	20.0
Percentage invested through the controlled group, Y–K–L–B (40 percent of 20 percent of 30 percent)	2.4

	Percent
Percentage invested in the controlled group, Y–A–B (30 percent of 10 percent)	3.0
Total percentage of assets of investment Company Y invested in Corporation B	25.4

Example (5). Investment Company Z, which keeps its books and makes its returns on the basis of the calendar year, at the close of the first quarter of 1955 meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation A. Later during the taxable year it makes distributions to its shareholders and because of such distributions it finds at the close of the taxable year that it has more than 25 percent of its remaining assets invested in Corporation A. Investment Company Z does not lose its status as a regulated investment company for the taxable year 1955 because of such distributions, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such distributions.

Example (6). Investment Company Q, which keeps its books and makes its returns on the basis of a calendar year, at the close of the first quarter of 1955, meets the requirements of section 851(b)(4) and has 20 percent of its assets invested in Corporation P. At the close of the taxable year 1955, it finds that it has more than 25 percent of its assets invested in Corporation P. This situation results entirely from fluctuations in the market values of the securities in Investment Company Q's portfolio and is not due in whole or in part to the acquisition of any security or other property. Corporation Q does not lose its status as a regulated investment company for the taxable year 1955 because of such fluctuations in the market values of the securities in its portfolio, nor will it lose its status as a regulated investment company for 1956 or any subsequent year solely as a result of such market value fluctuations.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.851–6 Investment companies furnishing capital to development corporations.

(a) Qualifying requirements. (1) In the case of a regulated investment company which furnishes capital to development corporations, section 851(e) provides an exception to the rule relating to the diversification of investments, made applicable to regulated investment companies by section 851(b)(4)(A). This exception (as provided in paragraph (b) of this section) is available only to registered management investment companies which the Securities and Exchange Commission determines, in accordance with regulations issued by it, and certifies to the Secretary or his delegate, not earlier than 60 days before the close of the taxable year of such investment company, to be principally engaged in the furnishing of capital to other corporations which are principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available.

(2) For the purpose of the aforementioned determination and certification, unless the Securities and Exchange Commission determines otherwise, a corporation shall be considered to be principally engaged in the development or exploitation of inventions, technological improvements, new processes, or products not previously generally available, for at least 10 years after the date of the first acquisition of any security in such corporation or any predecessor thereof by such investment company if at the date of such acquisition the corporation or its predecessor was principally so engaged, and an investment company shall be considered at any date to be furnishing capital to any company whose securities it holds if within 10 years before such date it had acquired any of such securities, or any securities surrendered in exchange therefor, from such other company or its predecessor.

(b) Exception to general rule. (1) The registered management investment company, which for the taxable year meets the requirements of paragraph (a) of this section, may (subject to the limitations of section 851(e)(2) and paragraph (c) of this section) in the computation of 50 percent of the value of its assets under section 851(b)(4)(A) and paragraph (c)(1) of § 1.851–2 for any quarter of such taxable year, include the value of any securities of an issuer (whether or not the investment company owns more than 10 percent of the outstanding voting securities of such issuer) if at the time of the latest acquisition of any securities of such issuer the basis of all such securities in the hands of the investment company does not exceed 5 percent of the value of the total assets of the investment company at that time. The exception provided by section 851(e)(1) and this subparagraph is not applicable to the securities of an issuer if the investment company has continuously held any security of such issuer or of any predecessor company (as defined in paragraph (d) of this section) for 10 or more years preceding such quarter of the taxable year. The rule of section 851(e)(1) with respect to the relationship of the basis of the securities of an issuer to the value of the total assets of the investment company is, in substance, a qualification of the 5-percent limitation in section 851(b)(4)(A)(ii) and paragraph (c)(1)(iv) of § 1.851–2. All other provisions and requirements of section 851 and §§ 1.851–1 through 1.851–6 are applicable in determining whether such registered management investment company qualifies as a regulated investment company.

(2) The application of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) The XYZ Corporation, a regulated investment company, qualified under section 851(e) as an investment company furnishing capital to development corporations. On

June 30, 1954, the XYZ Corporation purchased 1,000 shares of the stock of the A Corporation at a cost of $30,000. On June 30, 1954, the value of the total assets of the XYZ Corporation was $1,000,000. Its investment in the stock of the A Corporation ($30,000) comprised 3 percent of the value of its total assets, and it therefore met the requirements prescribed by section 851(b)(4)(A)(ii) as modified by section 851(e)(1).

(ii) On June 30, 1955, the value of the total assets of the XYZ Corporation was $1,500,000 and the 1,000 shares of stock of the A Corporation which the XYZ Corporation owned appreciated in value so that they were then worth $60,000. On that date, the XYZ Investment Company increased its investment in the stock of the A Corporation by the purchase of an additional 500 shares of that stock at a total cost of $30,000. The securities of the A Corporation owned by the XYZ Corporation had a value of $90,000 (6 percent of the value of the total assets of the XYZ Corporation) which exceeded the limit provided by section 851(b)(4)(A)(ii). However, the investment of the XYZ Corporation in the A Corporation on June 30, 1955, qualified under section 851(b)(4)(A) as modified by section 851(e)(1), since the basis of those securities to the investment company did not exceed 5 percent of the value of its total assets as of June 30, 1955, illustrated as follows:

Basis to the XYZ Corporation of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 500 shares of the A Corporation's stock acquired by the XYZ Corporation on June 30, 1955	30,000
Basis of all stock of A Corporation	60,000

Basis of stock of A Corporation ($60,000)/Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000) = 4 percent

Example (2). The same facts existed as in example (1), except that on June 30, 1955, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 1,000 shares of that stock (instead of 500 shares) at a total cost of $60,000. No part of the investment of the XYZ Corporation in the A Corporation qualified under the 5 percent limitation provided by section 851(b)(4)(A) as modified by section 851(e)(1), illustrated as follows:

Basis to the XYZ Corporation of the 1,000 shares of the A Corporation's stock acquired on June 30, 1954	$30,000
Basis of the 1,000 shares of the A Corporation's stock acquired on June 30, 1955	60,000
Total	90,000

Basis of stock of A Corporation ($90,000)/Value of XYZ Corporation's total assets at June 30, 1955, time of the latest acquisition ($1,500,000) = 6 percent

Example (3). The same facts existed as in example (2) and on June 30, 1956, the XYZ Corporation increased its investment in the stock of the A Corporation by the purchase of an additional 100 shares of that stock at a total cost of $6,000. On June 30, 1956, the value of the total assets of the XYZ Corporation was $2,000,000 and on that date the investment in the A Corporation qualified under section 851(b)(4)(A) as modified by section 851(e)(1) illustrated as follows:

Basis to the XYZ Corporation of investments in the A Corporation's stock:	
1,000 shares acquired June 30, 1954	$30,000
1,000 shares acquired June 30, 1955	60,000
100 shares acquired June 30, 1956	6,000
Total	96,000

Basis of stock of A Corporation ($96,000)/Value of XYZ Corporation's total assets at June 30, 1956, time of the latest acquisition ($2,000,000) = 4.8 percent

(c) Limitation. Section 851(e) and this section do not apply in the quarterly computation of 50 percent of the value of the assets of an investment company under subparagraph (A) of section 851(b)(4) and paragraph (c)(1) of § 1.851–2 for any taxable year if at the close of any quarter of such taxable year more than 25 percent of the value of its total assets (including the 50 percent or more mentioned in such subparagraph (A)) is represented by securities (other than Government securities or the securities of other regulated investment companies) of issuers as to each of which such investment company (1) holds more than 10 percent of the outstanding voting securities of such issuer, and (2) has continuously held any security of such issuer (or any security of a predecessor of such issuer) for 10 or more years preceding such quarter, unless the value of its total assets so represented is reduced to 25 percent or less within 30 days after the close of such quarter.

(d) Definition of predecessor company. As used in section 851(e) and this section, the term "predecessor company" means any corporation the basis of whose securities in the hands of the investment company was, under the provisions of section 358 or corresponding provisions of prior law, the same in whole or in part as the basis of any of the securities of the issuer and any corporation with respect to whose securities any of the securities of the issuer were received directly or indirectly by the investment company in a transaction or series of transactions involving nonrecognition of gain or loss in whole or in part. The other terms used in this section have the same meaning as when used in section 851(b)(4). See paragraph (c) of § 1.851–2 and § 1.851–3.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.851–7 Certain unit investment trusts.

(a) In general. For purposes of the Internal Revenue Code, a unit investment trust (as defined in paragraph (d) of this section) shall not be treated as a person (as defined in section 7701(a)(1)) except for years ending before January 1, 1969. A holder of an interest in such a trust will be treated as directly owning the assets of such trust for taxable years of such holder which end with or within any year of the trust to which section 851(f) and this section apply.

(b) Treatment of unit investment trust. A unit investment trust shall not be treated as an individual, a trust estate, partnership, association, compa-

ny, or corporation for purposes of the Internal Revenue Code. Accordingly, a unit investment trust is not a taxpayer subject to taxation under the Internal Revenue Code. No gain or loss will be recognized by the unit investment trust if such trust distributes a holder's proportionate share of the trust assets in exchange for his interest in the trust. Also, no gain or loss will be recognized by the unit investment trust if such trust sells the holder's proportionate share of the trust assets and distributes the proceeds from such share to the holder in exchange for his interest in the trust.

(c) Treatment of holder of interest in unit investment trust. (1) Each holder of an interest in a unit investment trust shall be treated (to the extent of such interest) as owning a proportionate share of the assets of the trust. Accordingly, if the trust distributes to the holder of an interest in such trust his proportionate share of the trust assets in exchange for his interest in the trust, no gain or loss shall be recognized by such holder (or by any other holder of an interest in such trust). For purposes of this paragraph, each purchase of an interest in the trust by the holder will be considered a separate interest in the trust. Items of income, gain, loss, deduction, or credit received by the trust or a custodian thereof shall be taxed to the holders of interests in the trust (and not to the trust) as though they had received their proportionate share of the items directly on the date such items were received by the trust or custodian.

(2) The basis of the assets of such trust which are treated under subparagraph (1) of this paragraph as being owned by the holder of an interest in such trust shall be the same as the basis of his interest in such trust. Accordingly, the amount of the gain or loss recognized by the holder upon the sale by the unit investment trust of the holder's pro rata share of the trust assets shall be determined with reference the basis, of his interest in the trust. Also, the basis of the assets received by the holder, if the trust distributes a holder's pro rata share of the trust assets in exchange for his interest in the trust, will be the same as the basis of his interest in the trust. If the unit investment trust sells less than all of the holder's pro rata share of the trust assets and the holder retains an interest in the trust, the amount of the gain or loss recognized by the holder upon the sale shall be determined with reference to the basis of his interest in the assets sold by the trust, and the basis of his interest in the trust shall be reduced accordingly. If the trust distributes a portion of the holder's pro rata share of the trust assets in exchange for a portion of his interest in the trust, the basis of the assets received by the holder shall be determined with reference to the basis of his interest in the assets distributed by the trust, and the basis of his interest in the trust shall be reduced accordingly. For purposes of this subparagraph the basis of the holder's interest in assets sold by the trust or distributed to him shall be an amount which bears the same relationship to the basis of his total interest in the trust that the fair market value of the assets so sold or distributed bears to the fair market value of such total interest in the trust, such fair market value to be determined on the date of such sale or distribution.

(3) The period for which the holder of an interest in such trust has held the assets of the trust which are treated under subparagraph (1) of this paragraph as being owned by him is the same as the period for which such holder has held his interest in such trust. Accordingly, the character of the gain, loss, deduction, or credit recognized by the holder upon the sale by the unit investment trust of the holder's proportionate share of the trust assets shall be determined with reference to the period for which he has held his interest in the trust. Also, the holding period of the assets received by the holder if the trust distributes the holder's proportionate share of the trust assets in exchange for his interest in the trust will include the period for which the holder has held his interest in the trust.

(4) The application of the provisions of this paragraph may be illustrated by the following example:

Example. B entered a periodic payment plan of a unit investment trust (as defined in paragraph (d) of this section) with X Bank as custodian and Z as plan sponsor. Under this plan, upon B's demand, X must either redeem B's interest at a price substantially equal to the fair market value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust, or at B's option distribute such shares of Y to B. B's plan provides for quarterly payments of $1,000. On October 1, 1969, B made his initial quarterly payment of $1,000 and X credited B's account with 110 shares of Y. On December 1, 1969, Y declared and paid a dividend of 25 cents per share, 5 cents of which was designated as a capital gain dividend pursuant to section 852(b)(3) and § 1.852–4. X credited B's account with $27.50 but did not distribute the money to B in 1969. On December 31, 1969, X charged B's account with $1 for custodial fees for calendar year 1969. On January 1, 1970, B paid X $1,000 and X credited B's account with 105 shares of Y. On April 1, 1970, B paid X $1,000 and X credited B's account with 100 shares of Y. B must include in his tax return for 1969 a dividend of $22 and a long-term capital gain of $5.50. In addition, B is entitled to deduct the annual custodial fee of $1 under section 212 of the Code.

(a) On April 4, 1970, at B's request, X sells the shares of Y credited to B's account (315 shares) for $10 per share and distributes the proceeds ($3,150) to B together with the remaining balance of $26.50 in B's account. The receipt of the $26.50

does not result in any tax consequences to B. B recognizes a long-term capital gain of $100 and a short-term capital gain of $50, computed as follows:

(1) B is treated as owning 110 shares of Y as of October 1, 1969. The basis of these shares is $1,000, and they were sold for $1,100 (110 shares at $10 per share). Therefore, B recognizes a gain from the sale or exchange of a capital asset held for more than 6 months in the amount of $100.

(2) B is treated as owning 105 shares of Y as of January 1, 1970, and 100 shares as of April 1, 1970. With respect to the shares acquired on April 1, 1970, there is no gain recognized as the shares were sold for $1,000, which is B's basis of the shares. The shares acquired on January 1, 1970, were sold for $1,050 (105 shares at $10 per share), and B's basis of these shares is $1,000. Therefore, B recognizes a gain of $50 from the sale or exchange of a capital asset held for not more than 6 months.

(b) On April 4, 1970, at B's request, X distributes to B the shares of Y credited to his account and $26.50 in cash. The receipt of the $26.50 does not result in any tax consequences to B. B does not recognize gain or loss on the distribution of the shares of Y to him. The bases and holding periods of B's interests in Y are as follows:

Number of shares	Date acquired	Basis
110	10-1-69	$9.09
105	1-1-70	9.52
100	4-1-70	10.00

(d) Definition. A unit investment trust to which this section refers is a business arrangement (other than a segregated asset account, whether or not it holds assets pursuant to a variable annuity contract, under the insurance laws or regulations of a State) which (except for taxable years ending before Jan. 1, 1969)—

(1) Is a unit investment trust (as defined in the Investment Company Act of 1940);

(2) Is registered under such Act;

(3) Issues periodic payment plan certificates (as defined in such Act) in one or more series;

(4) Possesses, as substantially all of its assets, as to all such series, securities issued by—

(i) A single management company (as defined in such Act), and securities acquired pursuant to subparagraph (5) of this paragraph, or

(ii) A single other corporation; and

(5) Has no power to invest in any other securities except securities issued by a single other management company, when permitted by such Act or the rules and regulations of the Securities and Exchange Commission.

(e) Investment in two single management companies. (1) A unit investment trust may possess securities issued by two or more separate single management companies (as defined in such Act) if—

(i) The trust issues a separate series of periodic payment plan certificates (as defined in such Act) with respect to the securities of each separate single management company which it possesses; and

(ii) None of the periodic payment plan certificates issued by the trust permits joint acquisition of an interest in each series nor the application of payments in whole or in part first to a series issued by one of the single management companies and then to any other series issued by any other single management company.

(2) If a unit investment trust possesses securities of two or more separate single management companies as described in subparagraph (1) of this paragraph and issues a separate series of periodic payment plan certificates with respect to the securities of each such management company, then the holder of an interest in a series shall be treated as the owner of the securities in the single management company represented by such interest.

(i) A holder of an interest in a series of periodic payment plan certificates of a trust who transfers or sells his interest in the series in exchange for an interest in another series of periodic payment plan certificates of the trust shall recognize the gain or loss realized from the transfer or sale as if the trust had sold the shares credited to his interests in the series at fair market value and distributed the proceeds of the sale to him.

(ii) The basis of the interests in the series so acquired by the holder shall be the fair market value of his interests in the series transferred or sold.

(iii) The period for which the holder has held his interest in the series so acquired shall be measured from the date of his acquisition of his interest in that series.

(f) Cross references. (1) For reporting requirements imposed on custodians of unit investment trusts described in this section, see §§ 1.852-4, 1.852-9, 1.853-3, 1.854-2, and 1.6042-2.

(2) For rules relating to redemptions of certain unit investment trusts not described in this section, see § 1.852-10.

[T.D. 7187, 37 FR 13254, July 6, 1972, as amended by T.D. 7187, 37 FR 20688, Oct. 3, 1972]

§ 1.852-1 Taxation of regulated investment companies.

(a) Requirements applicable thereto—(1) In general. Section 852(a) denies the application of

the provisions of part I, subchapter M, chapter 1 of the Code (other than section 852(c), relating to earnings and profits), to a regulated investment company for a taxable year beginning after February 28, 1958, unless—

(i) The deduction for dividends paid for such taxable year as defined in section 561 (computed without regard to capital gain dividends) is equal to at least 90 percent of its investment company taxable income for such taxable year (determined without regard to the provisions of section 852(b)(2)(D) and paragraph (d) of § 1.852–3); and

(ii) The company complies for such taxable year with the provisions of § 1.852–6 (relating to records required to be maintained by a regulated investment company).

See section 853(b)(1)(B) and paragraph (a) of § 1.853–2 for amounts to be added to the dividends paid deduction, and section 855 and § 1.855–1, relating to dividends paid after the close of the taxable year.

(2) Special rule for taxable years of regulated investment companies beginning before March 1, 1958. The provisions of part I of subchapter M (including section 852(c)) are not applicable to a regulated investment company for a taxable year beginning before March 1, 1958, unless such company meets the requirements of section 852(a) and subparagraph (1)(i) and (ii) of this paragraph.

(b) Failure to qualify. If a regulated investment company does not meet the requirements of section 852(a) and paragraph (a)(1)(i) and (ii) of this section for the taxable year, it will, even though it may otherwise be classified as a regulated investment company, be taxed in such year as an ordinary corporation and not as a regulated investment company. In such case, none of the provisions of part I of subchapter M (other than section 852(c) in the case of taxable years beginning after February 28, 1958) will be applicable to it. For the rules relating to the applicability of section 852(c), see § 1.852–5.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4091, April 28, 1962]

§ 1.852–2 Method of taxation of regulated investment companies.

(a) Imposition of normal tax and surtax. Section 852(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the investment company taxable income, as defined in section 852(b)(2) and § 1.852–3, for each taxable year of a regulated investment company. The tax is imposed as if the investment company taxable income were the taxable income referred to in section 11. In computing the normal tax under section 11, the regulated investment company's taxable income and the dividends paid deduction (computed without regard to the capital gains dividends) shall both be reduced by the deduction for partially tax-exempt interest provided by section 242.

(b) Taxation of capital gains—(1) In general. Section 852(b)(3)(A) imposes (i) in the case of a taxable year beginning before January 1, 1970, a tax of 25 percent, or (ii) in the case of a taxable year beginning after December 31, 1969, a tax determined as provided in section 1201(a) and paragraph (a)(3) of § 1.1201–1, on the excess, if any, of the net long-term capital gain of a regulated investment company (subject to tax under part I, subchapter M, chapter 1 of the Code) over the sum of its net short-term capital loss and its deduction for dividends paid (as defined in section 561) determined with reference to capital gain dividends only. For the definition of capital gain dividend paid by a regulated investment company, see section 852(b)(3)(C) and paragraph (c) of § 1.852–4. In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, such deduction for dividends paid shall first be made from the amount subject to tax in accordance with section 1201(a)(1)(B), to the extent thereof, and then from the amount subject to tax in accordance with section 1201(a)(1)(A). See § 1.852–10, relating to certain distributions in redemption of interests in unit investment trusts which, for purposes of the deduction for dividends paid with reference to capital gain dividends only, are not considered preferential dividends under section 562(c). See section 855 and § 1.855–1, relating to dividends paid after the close of the taxable year.

(2) Undistributed capital gains—(i) In general. A regulated investment company (subject to tax under part I of subchapter M) may, for taxable years beginning after December 31, 1956, designate under section 852(b)(3)(D) an amount of undistributed capital gains to each shareholder of the company. For the definition of the term "undistributed capital gains" and for the treatment of such amounts by a shareholder, see paragraph (b)(2) of § 1.852–4. For the rules relating to the method of making such designation, the returns to be filed, and the payment of the tax in such cases, see paragraph (a) of § 1.852–9.

(ii) **Effect on earnings and profits of a regulated investment company.** If a regulated investment company designates an amount as undistributed capital gains for a taxable year, the earnings and profits of such regulated investment company for such taxable year shall be reduced by the total amount of the undistributed capital gains so designated. In such case, its capital account shall be increased—

(a) In the case of a taxable year ending before January 1, 1970, by 75 percent of the total amount designated,

(b) In the case of a taxable year ending after December 31, 1969, and beginning before January 1, 1975, by the total amount designated decreased by the amount of tax imposed by section 852(b)(3)(A) with respect to such amount, or

(c) In the case of a taxable year beginning after December 31, 1974, by 70 percent of the total amount designated. The earnings and profits of a regulated investment company shall not be reduced by the amount of tax which is imposed by section 852(b)(3)(A) on an amount designated as undistributed capital gains and which is paid by the corporation but deemed paid by the shareholder.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4091, April 28, 1962; T.D. 6921, 32 FR 8754, June 20, 1967; T.D. 7337, 39 FR 44972, Dec. 30, 1974]

§ 1.852–3 Investment company taxable income.

Section 852(b)(2) requires certain adjustments to be made to convert taxable income of the investment company to investment company taxable income, as follows:

(a) The excess, if any, of the net long-term capital gain over the net short-term capital loss shall be excluded;

(b) The net operating loss deduction provided in section 172 shall not be allowed;

(c) The special deductions provided in part VIII (section 241 and following, except section 248), subchapter B, chapter 1 of the Code, shall not be allowed. Those not allowed are the deduction for partially tax-exempt interest provided by section 242, the deductions for dividends received provided by sections 243, 244, and 245, and the deduction for certain dividends paid provided by section 247. However, the deduction provided by section 248 (relating to organizational expenditures), otherwise allowable in computing taxable income, shall likewise be allowed in computing the investment company taxable income. See section 852(b)(1) and paragraph (a) of § 1.852–2 for treatment of the deduction for partially tax-exempt interest (provided by section 242) for purposes of computing the normal tax under section 11;

(d) The deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gains dividends (as defined in section 852(b)(3)(C) and paragraph (c) of § 1.852–4); and

(e) The taxable income shall be computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months shall not be placed on an annual basis even though such short taxable year results from a change of accounting period.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.852–4 Method of taxation of shareholders of regulated investment companies.

(a) **Ordinary income.** (1) Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a regulated investment company shall include such dividends in gross income for the taxable year in which they are received.

(2) See section 853(b)(2) and (c) and paragraph (b) of § 1.853–2 and § 1.853–3 for the treatment by shareholders of dividends received from a regulated investment company which has made an election under section 853(a) with respect to the foreign tax credit. See section 854 and §§ 1.854–1 through 1.854–3 for limitations applicable to dividends received from regulated investment companies for the purpose of the credit under section 34 (for dividends received on or before December 31, 1964), the exclusion from gross income under section 116, and the deduction under section 243. See section 855(b) and (d) and paragraphs (c) and (f) of § 1.855–1 for treatment by shareholders of dividends paid by a regulated investment company after the close of the taxable year in the case of an election under section 855(a).

(b) **Capital gains—(1) In general.** Under section 852(b)(3)(B), shareholders of a regulated investment company who receive capital gain dividends (as defined in paragraph (c) of this section), in respect of the capital gains of an investment company for a taxable year for which it is taxable under part I, subchapter M, chapter 1 of the Code,

as a regulated investment company, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend to which section 1201(d)(1) or (2) applies is the portion so designated by the regulated investment company pursuant to paragraph (c)(2) of this section.

(2) **Undistributed capital gains.** (i) A person who is a shareholder of a regulated investment company at the close of a taxable year of such company for which it is taxable under part I of subchapter M shall include in his gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) any amount of undistributed capital gains. The term "undistributed capital gains" means the amount designated as undistributed capital gains in accordance with paragraph (a) of § 1.852–9, but the amount so designated shall not exceed the shareholder's proportionate part of the amount subject to tax under section 852(b)(3)(A). Such amount shall be included in gross income for the taxable year of the shareholder in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount of such gains designated under paragraph (a) of § 1.852–9 as gain described in section 1201(d)(1) or (2) shall be included in the shareholder's gross income as gain described in section 1201(d)(1) or (2). For certain administrative provisions relating to undistributed capital gains, see § 1.852–9.

(ii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall be deemed to have paid for his taxable year for which such amount is so includible—

(a) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, a tax equal to 25 percent of such amount.

(b) In the case of a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, a tax equal to the tax designated under paragraph (a)(1) of § 1.852–9 by the regulated investment company as his proportionate share of the capital gains tax paid with respect to such amount, or

(c) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, a tax equal to 30 percent of such amount.

Such shareholder is entitled to a credit or refund of the tax so deemed paid in accordance with the rules provided in paragraph (c)(2) of § 1.852–9.

(iii) Any shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D)(i) and subdivision (i) of this subparagraph shall increase the adjusted basis of the shares of stock with respect to which such amount is so includible—

(a) In the case of an amount designated with respect to a taxable year of the company ending before January 1, 1970, by 75 percent of such amount.

(b) In the case of an amount designated with respect to a taxable year of the company ending after December 31, 1969, and beginning before January 1, 1975, by the amount designated under paragraph (a)(1)(iv) of § 1.852–9 by the regulated investment company, or

(c) In the case of an amount designated with respect to a taxable year of the company beginning after December 31, 1974, by 70 percent of such amount.

(iv) For purposes of determining whether the purchaser or seller of a share or regulated investment company stock is the shareholder at the close of such company's taxable year who is required to include an amount of undistributed capital gains in gross income, the amount of the undistributed capital gains shall be treated in the same manner as a cash dividend payable to shareholders of record at the close of the company's taxable year. Thus, if a cash dividend paid to shareholders of record as of the close of the regulated investment company's taxable year would be considered income to the purchaser, then the purchaser is also considered to be the shareholder of such company at the close of its taxable year for purposes of including an amount of undistributed capital gains in gross income. If, in such a case, notice on Form 2439 is, pursuant to paragraph (a)(1) of § 1.852–9, mailed by the regulated investment company to the seller, then the seller shall be considered the nominee of the purchaser and, as

such, shall be subject to the provisions in paragraph (b) of § 1.852-9. For rules for determining whether a dividend is income to the purchaser or seller of a share of stock, see paragraph (c) of § 1.61-9.

(3) **Partners and partnerships.** If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a partnership, such amount shall be included in the gross income of the partnership for the taxable year of the partnership in which falls the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated. The amount so includible by the partnership shall be taken into account by the partners as distributive shares of the partnership gains and losses from sales or exchanges of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) pursuant to section 702(a)(2) and paragraph (a)(2) of § 1.702-1. The tax with respect to the undistributed capital gains is deemed paid by the partnership (under section 852(b)(3)(D)(ii) and subparagraph (2)(ii) of this paragraph), and the credit or refund of such tax shall be taken into account by the partners in accordance with section 702(a)(8) and paragraph (a)(8)(ii) of § 1.702-1 and paragraph (c)(2) of § 1.852-9. In accordance with section 705(a), the partners shall increase the basis of their partnership interests under section 705(a)(1) by the distributive shares of such gains, and shall decrease the basis of their partnership interests by the distributive shares of the amount of the tax under section 705(a)(2)(B) (relating to certain nondeductible expenditures) and paragraph (a)(3) of § 1.705-1.

(4) **Nonresident alien individuals.** If the shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a nonresident alien individual, such shareholder shall be treated, for purposes of section 871 and the regulations thereunder, as having realized a long-term capital gain in such amount on the last day of the taxable year of the regulated investment company in respect of which the undistributed capital gains were designated.

(5) **Effect on earnings and profits of corporate shareholders of a regulated investment company.** If a shareholder required to include an amount of undistributed capital gains in gross income under section 852(b)(3)(D) and subparagraph (2) of this paragraph is a corporation, such corporation, in computing its earnings and profits for the taxable year for which such amount is so includible, shall treat such amount as if it had actually been received and the taxes paid shall include any amount of tax liability satisfied by a credit under section 852(b)(3)(D) and subparagraph (2) of this paragraph.

(c) **Definition of capital gain dividend—(1) General rule.** A capital gain dividend, as defined in section 852(b)(3)(C), is any dividend or part thereof which is designated by a regulated investment company as a capital gain dividend in a written notice mailed to its shareholders within the period specified in paragraph (c)(4) of this section. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855) is greater than the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate amount so designated. For example, a regulated investment company making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1955, that of a distribution of $500,000 made December 15, 1955, $200,000 constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the excess of the net long-term capital gain over the net short-term capital loss of the taxable year, and that such excess was $100,000 instead of $200,000. In such case each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(2) **Shareholder of record custodian of certain unit investment trusts.** In any case where a notice is mailed pursuant to subparagraph (1) of this paragraph by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970, to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851-7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the capital gain dividend shown on the notice received by the nominee

pursuant to subparagraph (1) of this paragraph. The notice shall include the name and address of the nominee identified as such. This subparagraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of subparagraph (1) of this paragraph with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and, not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this subparagraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this subparagraph within 30 days of such notice. If a notice under paragraph (c)(1) of this section is mailed within the 120-day period following the date of a determination pursuant to paragraph (c)(4)(ii) of this section, the 120-day period and the 130-day period following the date of the determination shall be substituted for the 45-day period and the 55-day period following the close of the regulated investment company's taxable year prescribed by this subparagraph (2).

(3) **Subsection (d) gain for certain taxable years.** In the case of capital gain dividends with respect to any taxable year of a regulated investment company ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 855), the company must include in its written notice under paragraph (c)(1) of this section a statement showing the shareholder's proportionate share of the capital gain dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d)(1) or (2), the regulated investment company shall consider that capital gain dividends for a taxable year are first made from its long-term capital gains for such year which are not described in section 1201(d)(1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d)(1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the company's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of each capital gain dividend (to which this paragraph applies) which is gain described in section 1201(d)(1) or (2). If, for his taxable year, a shareholder must include in his gross income a capital gain dividend to which this paragraph applies, he shall attach to his income tax return for such taxable year a statement showing, with respect to the total of such dividends for such taxable year received from each regulated investment company, the name and address of the regulated investment company from which such dividends are received, the amount of such dividends, the portion of such dividends which was designated as gain described in section 1201(d)(1), and the portion of such dividends which was designated as gain described in section 1201(d)(2).

(4) **Mailing of written notice to shareholders.** (i) Except as provided in paragraph (c)(4)(ii) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year of the regulated investment company.

(ii) If a determination (as defined in section 860(e)) after November 6, 1978, increases the excess for the taxable year of the net capital gain over the deduction for capital gains dividends paid, then a regulated investment company may designate all or part of any dividend as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determi-

nation. The aggregate amount designated during this period may not exceed this increase. A dividend may be designated if it is actually paid during the taxable year, is one paid after the close of the taxable year to which section 855 applies, or is a deficiency dividend (as defined in section 860(f)), including a deficiency dividend paid by an acquiring corporation to which section 381(c)(25) applies. The date of a determination is established under § 1.860–2(b)(1).

(d) Special treatment of loss on the sale or exchange of regulated investment company stock held less than 31 days—(1) In general. Under section 852(b)(4), if any person, with respect to a share of regulated investment company stock acquired by such person after December 31, 1957, and held for a period of less than 31 days, is required by section 852(b)(3)(B) or (D) to include in gross income as a gain from the sale or exchange of a capital asset held for more than six months—

(i) The amount of a capital gain dividend, or

(ii) An amount of undistributed capital gains,

then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share of stock as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). Such special treatment with respect to the sale of regulated investment company stock held for a period of less than 31 days is applicable to losses for taxable years ending after December 31, 1957.

(2) Determination of holding period. The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 852(b)(4) and this paragraph, a share of regulated investment company stock has been held for a period of less than 31 days. In applying those rules, however, "30 days" shall be substituted for the number of days specified in subparagraph (B) of section 246(c)(3).

(3) Example. The application of section 852(b)(4) and this paragraph may be illustrated by the following example:

Example. On December 15, 1958, A purchased a share of stock in the X regulated investment company for $20. The X regulated investment company declared a capital gain dividend of $2 per share to shareholders of record on December 31, 1958. A, therefore, received a capital gain dividend of $2 which, pursuant to section 852(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than 6 months. On January 5, 1959, A sold his share of stock in the X regulated investment company for $17.50, which sale resulted in a loss of $2.50. Under section 852(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than 6 months.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6531, 26 FR 413, Jan. 19, 1961; T.D. 6598, 27 FR 4091, April 28, 1962; T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7337, 39 FR 44972, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.852–5 Earnings and profits of a regulated investment company.

(a) Any regulated investment company, whether or not such company meets the requirements of section 852(a) and paragraph (a)(1)(i) and (ii) of § 1.852–1, shall apply paragraph (b) of this section in computing its earnings and profits for a taxable year beginning after February 28, 1958. However, for a taxable year of a regulated investment company beginning before March 1, 1958, paragraph (b) of this section shall apply only if the regulated investment company meets the requirements of section 852(a) and paragraph (a)(1)(i) and (ii) of § 1.852–1.

(b) In the determination of the earnings and profits of a regulated investment company, section 852(c) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a corporation would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a regulated investment company would be $500,000. If the regulated investment company had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the corporation would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and

would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.852–6 Records to be kept for purpose of determining whether a corporation claiming to be a regulated investment company is a personal holding company.

(a) Every regulated investment company shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from the shareholders. The actual owner of stock includes the person who is required to include in gross income in his return the dividends received on the stock. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) For the purpose of determining whether a domestic corporation claiming to be a regulated investment company is a personal holding company as defined in section 542, the permanent records of the company shall show the maximum number of shares of the corporation (including the number and face value of securities convertible into stock of the corporation) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the corporation's taxable year, as provided in section 544.

(c) Statements setting forth the information (required by paragraph (b) of this section) shall be demanded not later than 30 days after the close of the corporation's taxable year as follows:

(1) In the case of a corporation having 2,000 or more record owners of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a corporation having less than 2,000 and more than 200 record owners of its stock, on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a corporation having 200 or less record owners of its stock, on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

When making demand for the written statements required of each shareholder by this paragraph, the company shall inform each of the shareholders of his duty to submit as a part of his income tax return the statements which are required by § 1.852–7 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with a company's demand shall be maintained as a part of its record required by this section. A company which fails to keep such records to show the actual ownership of its outstanding stock as are required by this section shall be taxable as an ordinary corporation and not as a regulated investment company.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.852–7 Additional information required in returns of shareholders.

Any person who fails or refuses to comply with the demand of a regulated investment company for the written statements which § 1.852–6 requires the company to demand from its shareholders shall submit as a part of his income tax return a statement showing, to the best of his knowledge and belief—

(a) The number of shares actually owned by him at any and all times during the period for which the return is filed in any company claiming to be a regulated investment company;

(b) The dates of acquisition of any such stock during such period and the names and addresses of persons from whom it was acquired;

(c) The dates of disposition of any such stock during such period and the names and addresses of the transferees thereof;

(d) The names and addresses of the members of his family (as defined in section 544(a)(2)); the names and addresses of his partners, if any, in any partnership; and the maximum number of shares, if any, actually owned by each in any corporation claiming to be a regulated investment company, at any time during the last half of the taxable year of such company;

(e) The names and addresses of any corporation, partnership, association, or trust in which he had a beneficial interest to the extent of at least 10 percent at any time during the period for which such return is made, and the number of shares of any corporation claiming to be a regulated investment company actually owned by each;

(f) The maximum number of shares (including the number and face value of securities convertible into stock of the corporation) in any domestic corporation claiming to be a regulated investment company to be considered as constructively owned by such individual at any time during the last half of the corporation's taxable year, as provided in section 544 and the regulations thereunder; and

(g) The amount and date of receipt of each dividend received during such period from every corporation claiming to be a regulated investment company.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.852–8 Information returns.

Nothing in §§ 1.852–6 and 1.852–7 shall be construed to relieve regulated investment companies or their shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.852–9 Special procedural requirements applicable to designation under section 852(b)(3)(D).

(a) Regulated investment company—(1) Notice to shareholders. (i) A designation of undistributed capital gains under section 852(b)(3)(D) and paragraph (b)(2)(i) of § 1.852–2 shall be made by notice on Form 2439 mailed by the regulated investment company to each person who is a shareholder of record of the company at the close of the company's taxable year. The notice on Form 2439 shall show the name, address, and employer identification number of the regulated investment company; the taxable year of the company for which the designation is made; the name, address, and identifying number of the shareholder; the amount designated by the company for inclusion by the shareholder in computing his long-term capital gains; and the tax paid with respect thereto by the company which is deemed to have been paid by the shareholder.

(ii) In the case of a designation of undistributed capital gains with respect to a taxable year of the regulated investment company ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show the shareholder's proportionate share of such gains which is gain described in section 1201(d)(1), his proportionate share of such gains which is gain described in section 1201(d)(2), and the amount (determined pursuant to subdivision (iv) of this subparagraph) by which the shareholder's adjusted basis in his shares shall be increased.

(iii) In determining under subdivision (ii) of this subparagraph the portion of the undistributed capital gains which, in the hands of the shareholder, is gain described in section 1201(d)(1) or (2), the company shall consider that capital gain dividends for a taxable year are made first from its long-term capital gains for such year which are not described in section 1201(d)(1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d)(1) or (2). A shareholder's proportionate share of undistributed capital gains for a taxable year which is gain described in section 1201(d)(1) is the amount which bears the same ratio to the amount included in his income as designated undistributed capital gains for such year as (a) the aggregate amount of the company's gains for such year which are described in section 1201(d)(1) and designated as undistributed capital gains bears to (b) the aggregate amount of the company's gains for such year which are designated as undistributed capital gains. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every regulated investment company shall keep a record of the proportion of undistributed capital gains (to which this subdivision applies) which is gain described in section 1201(d)(1) or (2).

(iv) In the case of a designation of undistributed capital gains for any taxable year ending after December 31, 1969, and beginning before January 1, 1975, Form 2439 shall also show with respect to the undistributed capital gains of each shareholder the amount by which such shareholder's adjusted basis in his shares shall be increased under section 852(b)(3)(D)(iii). The amount by which each shareholder's adjusted basis in his shares shall be increased is the amount includible in his gross income with respect to such shares under section 852(b)(3)(D)(i) less the tax which the shareholder is deemed to have paid with respect to such shares. The tax which each shareholder is deemed to have paid with respect to such shares is the amount which bears the same ratio to the amount of the tax imposed by section 852(b)(3)(A) for such year with respect to the aggregate amount of the designated undistributed capital gains as the amount of such gains includible in the shareholder's gross income bears to the aggregate amount of such gains so designated.

(v) Form 2439 shall be prepared in triplicate, and copies B and C of the form shall be mailed to the shareholder on or before the 45th day (30th

day for a taxable year ending before February 26, 1964) following the close of the company's taxable year. Copy A of each Form 2439 must be associated with the duplicate copy of the undistributed capital gains tax return of the company (Form 2438), as provided in subparagraph (2)(ii) of this paragraph.

(2) Return of undistributed capital gains tax—(i) Form 2438. Every regulated investment company which designates undistributed capital gains for any taxable year beginning after December 31, 1956, in accordance with subparagraph (1) of this paragraph, shall file for such taxable year an undistributed capital gains tax return on Form 2438 including on such return the total of its undistributed capital gains so designated and the tax with respect thereto. The return on Form 2438 shall be prepared in duplicate and shall set forth fully and clearly the information required to be included therein. The original of Form 2438 shall be filed on or before the 30th day after the close of the company's taxable year with the internal revenue officer designated in instructions applicable to Form 2438. The duplicate copy of Form 2438 for the taxable year shall be attached to and filed with the income tax return of the company on Form 1120 for such taxable year.

(ii) Copies A of Form 2439. For each taxable year which ends on or before December 31, 1965, there shall be submitted with the company's return on Form 2438 all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. For each taxable year which ends after December 31, 1965, there shall be submitted with the duplicate copy of the company's return on Form 2438, which is attached to and filed with the income tax return of the company on Form 1120 for the taxable year, all copies A of Form 2439 furnished by the company to its shareholders in accordance with subparagraph (1) of this paragraph. The copies A of Form 2439 shall be accompanied by lists (preferably in the form of adding machine tapes) of the amounts of undistributed capital gains and of the tax paid with respect thereto shown on such forms. The totals of the listed amounts of undistributed capital gains and of tax paid with respect thereto must agree with the corresponding entries on Form 2438.

(3) Payment of tax. The tax required to be returned on Form 2438 shall be paid by the regulated investment company on or before the 30th day after the close of the company's taxable year to the internal revenue officer with whom the return on Form 2438 is filed.

(b) Shareholder of record not actual owner—(1) Notice to actual owner. In any case in which a notice on Form 2439 is mailed pursuant to paragraph (a)(1) of this section by a regulated investment company to a shareholder of record who is a nominee of the actual owner or owners of the shares of stock to which the notice relates, the nominee shall furnish to each such actual owner notice of the owner's proportionate share of the amounts of undistributed capital gains and tax with respect thereto, as shown on the Form 2439 received by the nominee from the regulated investment company. The nominee's notice to the actual owner shall be prepared in triplicate on Form 2439 and shall contain the information prescribed in paragraph (a)(1) of this section, except that the name and address of the nominee, identified as such, shall be entered on the form in addition to, and in the space provided for, the name and address of the regulated investment company, and the amounts of undistributed capital gains and tax with respect thereto entered on the form shall be the actual owner's proportionate share of the corresponding items shown on the nominee's notice from the regulated investment company. Copies B and C of the Form 2439 prepared by the nominee shall be mailed to the actual owner—

(i) For taxable years of regulated investment companies ending after February 25, 1964, on or before the 75th day (55th day in the case of a nominee who is acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7 for taxable years of regulated investment companies ending after December 8, 1970, and 135th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year, or

(ii) For taxable years of regulated investment companies ending before February 26, 1964, on or before the 60th day (120th day if the nominee is a resident of a foreign country) following the close of the regulated investment company's taxable year.

(2) Transmittal of Form 2439. The nominee shall enter the word "Nominee" in the upper right hand corner of copy B of the notice on Form 2439 received by him from the regulated investment company, and on or before the appropriate day specified in subdivision (i) or (ii) of subparagraph (1) of this paragraph shall transmit such copy B, together with all copies A of Form 2439 prepared by him pursuant to subparagraph (1) of this para-

graph, to the internal revenue officer with whom his income tax return is required to be filed.

(3) Custodian of certain unit investment trusts. The requirements of this paragraph shall not apply to a nominee who is acting as a custodian of the unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7 provided that the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by such nominee as custodian and on or before the 45th day following the close of the company's taxable year, files with the Internal Revenue Service office where the company's income tax return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

(c) Shareholders—(1) Return requirements. The copy B of the Form 2439 furnished to a shareholder by the regulated investment company or by a nominee, as provided in paragraph (a) or (b), respectively, of this section, shall be attached to the return of income made by the shareholder for his taxable year in which the amount of undistributed capital gains is includible in gross income, as provided in paragraph (b)(2) of § 1.852–4.

(2) Credit or refund—(i) In general. The amount of the tax paid by the regulated investment company with respect to the undistributed capital gains required under section 852(b)(3)(D) and paragraph (b)(2) of § 1.852–4 to be included by a shareholder in his computation of long-term capital gains for any taxable year is deemed paid by such shareholder under section 852(b)(3)(D)(ii) and such payment constitutes, for purposes of section 6513(a) (relating to time tax considered paid), an advance payment in like amount of the tax imposed under chapter 1 of the Code for such taxable year. In the case of an overpayment of tax within the meaning of section 6401, see section 6402 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) for rules applicable to the treatment of an overpayment of tax and section 6511 and the regulations in Part 301 of this chapter (Regulations on Procedure and Administration) with respect to the limitations applicable to the credit or refund of an overpayment of tax.

(ii) Form to be used. Claim for refund or credit of the tax deemed to have been paid by a shareholder with respect to an amount of undistributed capital gains shall be made on the shareholder's income tax return for the taxable year in which such amount of undistributed capital gains is includable in gross income. In the case of a shareholder which is a partnership, claim shall be made by the partners on their income tax returns for refund or credit of their distributive shares of the tax deemed to have been paid by the partnership. In the case of a shareholder which is exempt from tax under section 501(a) and to which section 511 does not apply for the taxable year, claim for refund of the tax deemed to have been paid by such shareholder on an amount of undistributed capital gains for such year shall be made on Form 843 and copy B of Form 2439 furnished to such shareholder shall be attached to its claim. For other rules applicable to the filing of claims for credit or refund of an overpayment of tax, see § 301.6402–2 of this chapter (Regulations on Procedure and Administration), relating to claims for credit or refund, and § 301.6402–3 of this chapter, relating to special rules applicable to income tax.

(3) Records. The shareholder is required to keep copy C of the Form 2439 furnished for the regulated investment company's taxable years ending after December 31, 1969, and beginning before January 1, 1975, as part of his records to show increases in the adjusted basis of his shares in such company.

(d) Penalties. For criminal penalties for willful failure to file a return, supply information, or pay tax, and for filing a false or fraudulent return, statement, or other document, see sections 7203, 7206, and 7207.

[T.D. 6500, 25 FR 11710, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8755, June 20, 1967; T.D. 7012, 34 FR 7688, May 15, 1969; T.D. 7187, 37 FR 13256, July 6, 1972; T.D. 7332, 39 FR 44217, Dec. 23, 1974; T.D. 7337, 39 FR 44973, Dec. 30, 1974]

§ 1.852–10 Distributions in redemption of interests in unit investment trusts.

(a) *In general.* In computing that part of the excess of its net long-term capital gain over net short-term capital loss on which it must pay a capital gains tax, a regulated investment company is allowed under section 852(b)(3)(A)(ii) a deduction for dividends paid (as defined in section 561) determined with reference to capital gains dividends only. Section 561(b) provides that in determining the deduction for dividends paid, the rules provided in section 562 are applicable. Section 562(c) (relating to preferential dividends) provides that the amount of any distribution shall not be considered as a dividend unless such distribution is pro-rata, with no preference to any share of stock as compared with other shares of the same class except to the extent that the former is entitled to such preference.

(b) *Redemption distributions made by unit investment trust*—(1) *In general.* Where a unit investment trust (as defined in paragraph (c) of this section) liquidates part of its portfolio represented by shares in a management company in order to make a distribution to a holder of an interest in the trust in redemption of part or all of such interest, and by so doing, the trust realizes net long-term capital gain, that portion of the distribution by the trust which is equal to the amount of the net long-term capital gain realized by the trust on the liquidation of the shares in the management company will not be considered a preferential dividend under section 562(c). For example, where the entire amount of net long-term capital gain realized by the trust on such a liquidation is distributed to the redeeming interest holder, the trust will be allowed the entire amount of net long-term capital gain so realized in determining the deduction under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only. This paragraph and section 852(d) shall apply only with respect to the capital gain net income (net capital gain for taxable years beginning before January 1, 1977) realized by the trust which is attributable to a redemption by a holder of an interest in such trust. Such dividend may be designated as a capital gain dividend by a written notice to the certificate holder. Such designation should clearly indicate to the holder that the holder's gain or loss on the redemption of the certificate may differ from such designated amount, depending upon the holder's basis for the redeemed certificate, and that the holder's own records are to be used in computing the holder's gain or loss on the redemption of the certificate.

(2) *Example.* The application of the provisions of this paragraph may be illustrated by the following example:

Example. B entered into a periodic payment plan contract with X as custodian and Z as plan sponsor under which he purchased a plan certificate of X. Under this contract, upon B's demand, X must redeem B's certificate at a price substantially equal to the value of the number of shares in Y, a management company, which are credited to B's account by X in connection with the unit investment trust. Except for a small amount of cash which X is holding to satisfy liabilities and to invest for other plan certificate holders, all of the assets held by X in connection with the trust consist of shares in Y. Pursuant to the terms of the periodic payment plan contract, 100 shares of Y are credited to B's account. Both X and Y have elected to be treated as regulated investment companies. On March 1, 1965, B notified X that he wished to have his entire interest in the unit investment trust redeemed. In order to redeem B's interest, X caused Y to redeem 100 shares of Y which X held. At the time of redemption, each share of Y had a value of $15. X then distributed the $1,500 to B. X's basis for each of the Y shares which was redeemed was $10. Therefore, X realized a long-term capital gain of $500 ($5 × 100 shares) which is attributable to the redemption by B of his interest in the trust. Under section 852(d), the $500 capital gain distributed to B will not be considered a preferential dividend. Therefore, X is allowed a deduction of $500 under section 852(b)(3)(A)(ii) for dividends paid determined with reference to capital gains dividends only, with the result that X will not pay a capital gains tax with respect to such amount.

(c) *Definition of unit investment trust.* A unit investment trust to which paragraph (a) of this section refers is a business arrangement which—

(1) Is registered under the Investment Company Act of 1940 as a unit investment trust;

(2) Issues periodic payment plan certificates (as defined in such Act);

(3) Possesses, as substantially all of its assets, securities issued by a management company (as defined in such Act);

(4) Qualifies as a regulated investment company under section 851; and

(5) Complies with the requirements provided for by section 852(a).

Paragraph (a) of this section does not apply to a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7.

[T.D. 6921, 32 FR 8755, June 20, 1967, as amended by T.D. 7187, 37 FR 13527, July 6, 1972; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.853–1 Foreign tax credit allowed to shareholders.

(a) *In general.* Under section 853, a regulated investment company, meeting the requirements set forth in section 853(a) and paragraph (b) of this

section, may make an election with respect to the income, war-profits, and excess profits taxes described in section 901(b)(1) which it pays to foreign countries or possessions of the United States during the taxable year, including such taxes as are deemed paid by it under the provisions of any income tax convention to which the United States is a party. If an election is made, the shareholders of the regulated investment company shall apply their proportionate share of such foreign taxes paid, or deemed to have been paid by it pursuant to any income tax convention, as either a credit (under section 901) or as a deduction (under section 164(a)) as provided by section 853(b)(2) and paragraph (b) of § 1.853–2. The election is not applicable with respect to taxes deemed to have been paid under section 902 (relating to the credit allowed to corporate stockholders of a foreign corporation for taxes paid by such foreign corporation).

(b) Requirements. To qualify for the election provided in section 853(a), a regulated investment company (1) must have more than 50 percent of the value of its total assets, at the close of the taxable year for which the election is made, invested in stocks and securities of foreign corporations, and (2) must also, for that year, comply with the requirements prescribed in section 852(a) and paragraph (a) of § 1.852–1. The term "value", for purposes of the first requirement, is defined in section 851(c)(4). For the definition of foreign corporation, see section 7701(a).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.853–2 Effect of election.

(a) Regulated investment company. A regulated investment company making a valid election with respect to a taxable year under the provisions of section 853(a) is, for such year, denied both the deduction for foreign taxes provided by section 164(a) and the credit for foreign taxes provided by section 901 with respect to all income, war-profits, and excess profits taxes (described in section 901(b)(1)) which it has paid to any foreign country or possession of the United States. See section 853(b)(1)(A). However, under section 853(b)(1)(B), the regulated investment company is permitted to add the amount of such foreign taxes paid to its dividends paid deduction for that taxable year. See paragraph (a) of § 1.852–1.

(b) Shareholder. Under section 853(b)(2), a shareholder of an investment company, which has made the election under section 853, is, in effect, placed in the same position as a person directly owning stock in foreign corporations, in that he must include in his gross income (in addition to taxable dividends actually received) his proportionate share of such foreign taxes paid and must treat such amount as foreign taxes paid by him for the purposes of the deduction under section 164(a) and the credit under section 901. For such purposes he must treat as gross income from a foreign country or possession of the United States (1) his proportionate share of the taxes paid by the regulated investment company to such foreign country or possession and (2) the portion of any dividend paid by the investment company which represents income derived from such sources.

(c) Dividends paid after the close of the taxable year. For additional rules applicable to certain distributions made after the close of the taxable year which may be designated as income received from sources within and taxes paid to foreign countries or possessions of the United States, see section 855(d) and paragraph (f) of § 1.855–1.

(d) Example. This section may be illustrated as follows:

(1) The X Corporation, a regulated investment company, has total assets, at the close of the taxable year, of $10 million invested as follows:

Domestic corporations		$4,000,000
Foreign corporations in:		
Country A	$3,500,000	
Country B	2,500,000	
		6,000,000
Total assets		10,000,000

(2) The dividend income of X Corporation is received from the following sources:

Domestic corporations		$300,000
Foreign corporations:		
Country A	$250,000	
Country B	250,000	
		500,000
Total dividend income		800,000
Operation and management expenses		80,000
Net dividend income		720,000
Taxes withheld by Country B on dividends of $250,000 at a rate of 10 percent	25,000	
Taxes withheld by Country B on dividends of $250,000 at a rate of 20 percent	50,000	
Total foreign taxes withheld		75,000
Income available for distribution		645,000

(3) X Corporation has 250,000 shares of common stock outstanding and distributes the entire $645,000 as a dividend of $2.58 per share of stock.

(4) The X Corporation meets the 50 percent requirement of section 851(b)(4) and the require-

ments of section 852(a). It notifies each shareholder by mail, within the time prescribed by section 853(c), that by reason of the election they are to treat as foreign taxes paid $0.30 per share of stock ($75,000 of foreign taxes paid, divided by the 250,000 shares of stock outstanding), of which $0.20 represents taxes paid to Country B and $0.10 taxes paid to Country A. The shareholders must report as income $2.88 per share ($2.58 of dividends actually received plus the $0.30 representing foreign taxes paid). Of the $2.88 per share, $1.80 per share ($450,000 (which represents such part of the net dividend income of $720,000 as the foreign dividend income of $500,000 bears to the total dividend income of $800,000) divided by 250,000 shares) is to be considered as received from foreign sources. Ninety cents is to be considered as received from Country A, and ninety cents from Country B.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.853–3 Notice to shareholders.

(a) **General rule.** If a regulated investment company makes an election under section 853(a), in the manner provided in § 1.853–4, the investment company is required, under section 853(c), to furnish its shareholders with a written notice mailed not later than 45 days (30 days for taxable years ending before Feb. 26, 1964) after the close of its taxable year. The notice must designate the shareholder's portion of foreign taxes paid to each such country or possession and the portion of the dividend which represents income derived from sources within each such country or possession. For purposes of section 853(b)(2) and paragraph (b) of § 1.853–2, the amount that a shareholder may treat as his proportionate share of foreign taxes paid and the amount to be included as gross income derived from any foreign country or possession of the United States shall not exceed the amounts so designated by the company in such written notice. If, however, the amount designated by the company in the notice exceeds the shareholder's proper proportionate share of foreign taxes or gross income from sources within any foreign country or possession, the shareholder is limited to the amount correctly ascertained.

(b) **Shareholder of record custodian of certain unit investment trusts.** In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (b) of § 1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts of foreign taxes paid to each such country or possession and the holder's proportionate share of the dividend which represents income derived from sources within each country or possession shown on the notice received by the nominee pursuant to paragraph (a) of this section. The notice shall include the name and address of the nominee identified as such. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return for the taxable year is to be filed, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; *provided however,* if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8756, June 20, 1967; T.D. 7187, 37 FR 13257, July 6, 1972]

§ 1.853–4 Manner of making election.

(a) **General rule.** A regulated investment company, to make a valid election under section 853, must—

(1) File with Form 1099 and Form 1096 a statement as part of its return which sets forth the following information:

(i) The total amount of income received from sources within foreign countries and possessions of the United States;

(ii) The total amount of income, war profits, or excess profits taxes (described in section 901(b)(1)) paid, or deemed to have been paid under the provisions of any treaty to which the United States is a party, to such foreign countries or possessions;

(iii) The date, form, and contents of the notice to its shareholders;

(iv) The proportionate share of such taxes paid during the taxable year and foreign income received during such year attributable to one share of stock of the regulated investment company; and

(2) File as part of its return for the taxable year a Form 1118 modified so that it becomes a statement in support of the election made by a regulated investment company for taxes paid to a foreign country or a possession of the United States.

(b) Irrevocability of the election. The election is applicable only with respect to taxable years subject to the Code, shall be made with respect to all such foreign taxes, and must be made not later than the time prescribed for filing the return (including extensions thereof). Such election, if made, shall be irrevocable with respect to the dividend (or portion thereof), and the foreign taxes paid with respect thereto, to which the election applies.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.854–1 Limitations applicable to dividends received from regulated investment company.

(a) In general. Section 854 provides special limitations applicable to dividends received from a regulated investment company for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporations, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34.

(b) Capital gain dividend. Under the provisions of section 854(a) a capital gain dividend as defined in section 852(b)(3) and paragraph (c) of § 1.852–4 shall not be considered a dividend for purposes of the exclusion under section 116, the deduction under section 243, and, in the case of taxable years ending before January 1, 1965, the credit under section 34.

(c) Rule for dividends other than capital gain dividends. (1) Section 854(b)(1) limits the amount that may be treated as a dividend (other than a capital gain dividend) by the shareholder of a regulated investment company, for the purposes of the credit, exclusion, and deduction specified in paragraph (b) of this section, where the investment company receives substantial amounts of income (such as interest, etc.) from sources other than dividends from domestic corporations, which dividends qualify for the exclusion under section 116.

(2) Where the "aggregate dividends received" (as defined in section 854(b)(3)(B) and paragraph (b) of § 1.854–3) during the taxable year by a regulated investment company (which meets the requirements of section 852(a) and paragraph (a) of § 1.852–1 for the taxable year during which it paid such dividend) are less than 75 percent of its gross income for such taxable year (as defined in section 854(b)(3)(A) and paragraph (a) of § 1.854–3), only that portion of the dividend paid by the regulated investment company which bears the same ratio to the amount of such dividend paid as the aggregate dividends received by the regulated investment company, during the taxable year, bears to its gross income for such taxable year (computed without regard to gains from the sale or other disposition of stocks or securities) may be treated as a dividend for purposes of such credit, exclusion, and deduction.

(3) Subparagraph (2) of this paragraph may be illustrated by the following example:

Example. The XYZ regulated investment company meets the requirements of section 852(a) for the taxable year and has received income from the following sources:

Capital gains (from the sale of stock or securities)	$100,000
Dividends (from domestic sources other than dividends described in section 116(b))	70,000
Dividend (from foreign corporations)	5,000
Interest	25,000
Total	200,000
Expenses	20,000
Taxable income	180,000

The regulated investment company decides to distribute the entire $180,000. It distributes a capital gain dividend of $100,000 and a dividend of ordinary income of $80,000. The aggregate dividends received by the regulated investment company from domestic corporations ($70,000) is less than 75 percent of its gross income ($100,000) computed without regard to capital gains from sales of securities. Therefore, an apportionment is required. Since $70,000 is 70 percent of $100,000, out of every $1 dividend of ordinary income paid by the regulated investment company only 70 cents would be available for the credit, exclusion, or deduction referred to in section 854(b)(1). The capital gains dividend and the dividend received from foreign corporations are excluded from the computation.

(d) Dividends received from a regulated investment company during taxable years of sharehold-

ers ending after July 31, 1954, and subject to the Internal Revenue Code of 1939. For the application of section 854 to taxable years of shareholders of a regulated investment company ending after July 31, 1954, and subject to the Internal Revenue Code of 1939, see § 1.34–5 and § 1.116–2.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8756, June 20, 1967]

§ 1.854–2 Notice to shareholders.

(a) **General rule.** Section 854(b)(2) provides that the amount that a shareholder may treat as a dividend for purposes of the exclusion under section 116 for dividends received by individuals, the deduction under section 243 for dividends received by corporation, and, in the case of dividends received by individuals before January 1, 1965, the credit under section 34, shall not exceed the amount so designated by the company in a written notice to its shareholders mailed not later than 45 days (30 days for a taxable year ending before Feb. 26, 1964) after the close of the company's taxable year. If, however, the amount so designated by the company in the notice exceeds the amount which may be treated by the shareholder as a dividend for such purposes, the shareholder is limited to the amount as correctly ascertained under section 854(b)(1) and paragraph (c) of § 1.854–1.

(b) **Shareholder of record custodian of certain unit investment trusts.** In any case where a notice is mailed pursuant to paragraph (a) of this section by a regulated investment company with respect to a taxable year of the regulated investment company ending after December 8, 1970 to a shareholder of record who is a nominee acting as a custodian of a unit investment trust described in section 851(f)(1) and paragraph (d) of § 1.851–7, the nominee shall furnish each holder of an interest in such trust with a written notice mailed on or before the 55th day following the close of the regulated investment company's taxable year. The notice shall designate the holder's proportionate share of the amounts that may be treated as a dividend for purposes of the exclusion under section 116 for dividends received by individuals and the deduction under section 243 for dividends received by corporations shown on the notice received by the nominee pursuant to paragraph (a) of this section. This notice shall include the name and address of the nominee identified as such. This paragraph shall not apply if the regulated investment company agrees with the nominee to satisfy the notice requirements of paragraph (a) of this section with respect to each holder of an interest in the unit investment trust whose shares are being held by the nominee as custodian and not later than 45 days following the close of the company's taxable year, files with the Internal Revenue Service office where such company's return is to be filed for the taxable year, a statement that the holders of the unit investment trust with whom the agreement was made have been directly notified by the regulated investment company. Such statement shall include the name, sponsor, and custodian of each unit investment trust whose holders have been directly notified. The nominee's requirements under this paragraph shall be deemed met if the regulated investment company transmits a copy of such statement to the nominee within such 45-day period; provided however, if the regulated investment company fails or is unable to satisfy the requirements of this paragraph with respect to the holders of interest in the unit investment trust, it shall so notify the Internal Revenue Service within 45 days following the close of its taxable year. The custodian shall, upon notice by the Internal Revenue Service that the regulated investment company has failed to comply with the agreement, satisfy the requirements of this paragraph within 30 days of such notice.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8757, June 20, 1967; T.D. 7187, 37 FR 13257, July 6, 1972]

§ 1.854–3 Definitions.

(a) For the purpose of computing the limitation prescribed by section 854(b)(1)(B) and paragraph (c) of § 1.854–1, the term "gross income" does not include gain from the sale or other disposition of stock or securities. However, capital gains arising from the sale or other disposition of capital assets, other than stock or securities, shall not be excluded from gross income for this purpose.

(b) The term "aggregate dividends received" includes only dividends received from domestic corporations other than dividends described in section 116(b) (relating to dividends not eligible for exclusion from gross income). Accordingly, dividends received from foreign corporations will not be included in the computation of "aggregate dividends received". In determining the amount of any dividend for purposes of this section, the rules provided in section 116(c) (relating to certain distributions) shall apply.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960]

§ 1.855–1 Dividends paid by regulated investment company after close of taxable year.

(a) **General rule.** In—

(1) Determining under section 852(a) and paragraph (a) of § 1.852–1 whether the deduction for dividends paid during the taxable year (without regard to capital gain dividends) by a regulated investment company equals or exceeds 90 percent of its investment company taxable income (determined without regard to the provisions of section 852(b)(2)(D)),

(2) Computing its investment company taxable income (under section 852(b)(2) and § 1.852–3), and

(3) Determining the amount of capital gain dividends (as defined in section 852(b)(3) and paragraph (c) of § 1.852–4) paid during the taxable year, any dividend (or portion thereof) declared by the investment company either before or after the close of the taxable year but in any event before the time prescribed by law for the filing of its return for the taxable year (including the period of any extension of time granted for filing such return) shall, to the extent the company so elects in such return, be treated as having been paid during such taxable year. This rule is applicable only if the entire amount of such dividend is actually distributed to the shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment made after such declaration.

(b) Election—(1) *Method of making election.* The election must be made in the return filed by the company for the taxable year. The election shall be made by the taxpayer (the regulated investment company) by treating the dividend (or portion thereof) to which such election applies as a dividend paid during the taxable year in computing its investment company taxable income, or if the dividend (or portion thereof) to which such election applies is to be designated by the company as a capital gain dividend, in computing the amount of capital gain dividends paid during such taxable year. The election provided in section 855(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of section 852(c) and § 1.852–5) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year (not including distributions with respect to which an election has been made for a prior year under section 855(a)). The dividend or portion thereof, with respect to which the regulated investment company has made a valid election under section 855(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(2) *Irrevocability of the election.* After the expiration of the time for filing the return for the taxable year for which an election is made under section 855(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) Receipt by shareholders. Under section 855(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includible in the gross income of the shareholders of the regulated investment company for the taxable year in which the dividend is received by them.

(d) Examples. The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example (1). The X Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000. During that year the company distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1955, the company declared a dividend of $37,000 payable to shareholders on March 20, 1955. Such dividend consisted of the first regular quarterly dividend for 1955 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1954 which was not distributed in 1954. On March 15, 1955, the X Company filed its federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1955, as having been paid during the taxable year 1954. Assuming that the X Company actually distributed the entire amount of the dividend of $37,000 on March 20, 1955, an amount equal to $12,000 thereof will be treated for the purposes of section 852(a) as having been paid during the taxable year 1954. Such amount ($12,000) will be considered by the X Company as a distribution out of the earnings and profits for the taxable year 1954, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them.

Example (2). The Y Company, a regulated investment company, had taxable income (and earnings or profits) for the calendar year 1954 of $100,000, and for 1955 taxable income (and earnings or profits) of $125,000. On January 1, 1954, the company had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1954 the company distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1955, the company declared a dividend of $65,000 payable to shareholders on March 31, 1955. On March 15, 1955, the Y Company filed its federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1955, as a dividend paid by it during the taxable year 1954. On March 31, 1955, the Y Company distributed the entire amount of the dividend of $65,000 declared on March 5, 1955. The election under section 855(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1954 ($100,000 earnings and profits less $85,000 distributed during 1954). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1955, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Company out of earnings and profits for the taxable year

1955. Assuming that the only other distribution by the Y Company during 1955 was a distribution of $75,000 paid as a dividend on October 31, 1955, the total amount of the distribution of $65,000 paid on March 31, 1955, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Company will treat the amount of $15,000 as a distribution of the earnings or profits of the company for the taxable year 1954, and the remaining $50,000 as a distribution of the earnings or profits for the year 1955. The distribution of $75,000 on October 31, 1955, is, of course, a taxable dividend out of the earnings and profits for the year 1955.

(e) **Notice to shareholders.** Section 855(c) provides that in the case of dividends, with respect to which a regulated investment company has made an election under section 855(a), any notice to shareholders required under subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. Thus, the notice requirements of section 852(b)(3)(C) and paragraph (c) of § 1.852–4 with respect to capital gain dividends, section 853(c) and § 1.853–3 with respect to allowance to shareholder of foreign tax credit, and section 854(b)(2) and § 1.854–2 with respect to the amount of a distribution which may be treated as a dividend, may be satisfied with respect to amounts to which section 855(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 45 days (30 days for a taxable year ending before February 26, 1964) after the close of the taxable year in which the distribution is made. If the notice under section 855(c) relates to an election with respect to any capital gain dividends, such capital gain dividends shall be aggregated by the investment company with the designated capital gain dividends actually paid during the taxable year to which the election applies (not including such dividends with respect to which an election has been made for a prior year under section 855) for the purpose of determining whether the aggregate of the designated capital gain dividends with respect to such taxable year of the company is greater than the excess of the net long-term capital gain over the net short-term capital loss of the company. See section 852(b)(3)(C) and paragraph (c) of § 1.852–4.

(f) **Foreign tax election.** Section 855(d) provides that in the case of an election made under section 853 (relating to foreign taxes), the shareholder of the investment company shall consider the foreign income received, and the foreign tax paid, as received and paid, respectively, in the shareholder's taxable year in which distribution is made.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6921, 32 FR 8757, June 20, 1967]

Real Estate Investment Trusts

§ 1.856–0 Revenue Act of 1978 amendments not included.

The regulations under part II of subchapter M of the Code do not reflect the amendments made by the Revenue Act of 1978, other than the changes made by section 362 of the Act, relating to deficiency dividends.

[T.D. 7767, 46 FR 11265, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.856–1 Definition of real estate investment trust.

(a) **In general.** The term "real estate investment trust" means a corporation, trust, or association which (1) meets the status conditions in section 856(a) and paragraph (b) of this section, and (2) satisfies the gross income and asset diversification requirements under the limitations of section 856(c) and § 1.856–2. (See, however, paragraph (f) of this section, relating to the requirement that, for taxable years beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association).

(b) **Qualifying conditions.** To qualify as a "real estate investment trust", an organization must be one—

(1) Which is managed by one or more trustees or directors,

(2) The beneficial ownership of which is evidenced by transferable shares or by transferable certificates of beneficial interest,

(3) Which would be taxable as a domestic corporation but for the provisions of part II, subchapter M, chapter 1 of the Code,

(4) Which, in the case of a taxable year beginning before October 5, 1976, does not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business,

(5) Which is neither (i) a financial institution to which section 585, 586, or 593 applies, nor (ii) an insurance company to which subchapter L applies,

(6) The beneficial ownership of which is held by 100 or more persons, and

(7) Which would not be a personal holding company (as defined in section 542) if all of its gross income constituted personal holding company income (as defined in section 543).

(c) Determination of status. The conditions described in subparagraphs (1) through (5) of paragraph (b) of this section must be met during the entire taxable year and the condition described in subparagraph (6) of paragraph (b) of this section must exist during at least 335 days of a taxable year of 12 months or during a proportionate part of a taxable year of less than 12 months. The days during which the latter condition must exist need not be consecutive. In determining the minimum number of days during which the condition described in paragraph (b)(6) of this section is required to exist in a taxable year of less than 12 months, fractional days shall be disregarded. For example, in a taxable year of 310 days, the actual number of days prescribed would be $284^{38}/_{73}$ days ($^{310}/_{365}$ of 335). The fractional day is disregarded so that the required condition in such taxable year need exist for only 284 days.

(d) Rules applicable to status requirements. For purposes of determining whether an organization meets the conditions and requirements in section 856(a), the following rules shall apply.

(1) Trustee. The term "trustee" means a person who holds legal title to the property of the real estate investment trust, and has such rights and powers as will meet the requirement of "centralization of management" under paragraph (c) of § 301.7701–2 of this chapter (Regulations on Procedure and Administration). Thus, the trustee must have continuing exclusive authority over the management of the trust, the conduct of its affairs, and (except as limited by section 856(d)(3) and § 1.856–4) the management and disposition of the trust property. For example, such authority will be considered to exist even though the trust instrument grants to the shareholders any or all of the following rights and powers: To elect or remove trustees; to terminate the trust; and to ratify amendments to the trust instrument proposed by the trustee. The existence of a mere fiduciary relationship does not, in itself, make one a trustee for purposes of section 856(a)(1). The trustee will be considered to hold legal title to the property of the trust, for purposes of this subparagraph, whether the title is held in the name of the trust itself, in the name of one or more of the trustees, or in the name of a nominee for the exclusive benefit of the trust.

(2) Beneficial ownership. Beneficial ownership shall be evidenced by transferable shares, or by transferable certificates of beneficial interest, and (subject to the provisions of paragraph (c) of this section) must be held by 100 or more persons, determined without reference to any rules of attribution. Provisions in the trust instrument or corporate charter or bylaws which permit the trustee or directors to redeem shares or to refuse to transfer shares in any case where the trustee or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a real estate investment trust will not render the shares "nontransferable." For purposes of the regulations under part II of subchapter M, the terms "stockholder," "stockholders," "shareholder," and "shareholders" include holders of beneficial interest in a real estate investment trust, the terms "stock," "shares," and "shares of stock" include certificates of beneficial interest and the term "shares" includes shares of stock.

(3) Unincorporated organization taxable as a domestic corporation. The determination of whether an unincorporated organization would be taxable as a domestic corporation, in the absence of the provisions of part II of subchapter M, shall be made in accordance with the provisions of section 7701(a)(3) and (4) and the regulations thereunder and for such purposes an otherwise qualified real estate investment trust is deemed to satisfy the "objective to carry on business" requirement of paragraph (a) of § 301.7701–2 of this chapter. (Regulations on Procedure and Administration).

(4) Property held for sale to customers. In the case of a taxable year beginning before October 5, 1976, a real estate investment trust may not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business. Whether property is held for sale to customers in the ordinary course of the trade or business of a real estate investment trust depends upon the facts and circumstances in each case.

(5) Personal holding company. A corporation, trust, or association, even though it may otherwise meet the requirements of part II of subchapter M, will not be a real estate investment trust if, by considering all of its gross income as personal

holding company income under section 543, it would be a personal holding company as defined in section 542. Thus, if at any time during the last half of the trust's taxable year more than 50 percent in value of its outstanding stock is owned (directly or indirectly under the provisions of section 544) by or for not more than 5 individuals, the stock ownership requirement in section 542(a)(2) will be met and the trust would be a personal holding company. See § 1.857–8, relating to record requirements for purposes of determining whether the trust is a personal holding company.

(e) **Other rules applicable.** To the extent that other provisions of chapter 1 of the Code are not inconsistent with those under part II of subchapter M there of and the regulations thereunder, such provisions will apply with respect to both the real estate investment trust and its shareholders in the same manner that they would apply to any other organization which would be taxable as a domestic corporation. For example:

(1) Taxable income of a real estate investment trust is computed in the same manner as that of a domestic corporation;

(2) Section 301, relating to distributions of property, applies to distributions by a real estate investment trust in the same manner as it would apply to a domestic corporation;

(3) Sections 302, 303, 304, and 331 are applicable in determining whether distributions by a real estate investment trust are to be treated as in exchange for stock;

(4) Section 305 applies to distributions by a real estate investment trust of its own stock;

(5) Section 311 applies to distributions by a real estate investment trust;

(6) Except as provided in section 857(d), earnings and profits of a real estate investment trust are computed in the same manner as in the case of a domestic corporation;

(7) Section 316, relating to the definition of a dividend, applies to distributions by a real estate investment trust; and

(8) Section 341, relating to collapsible corporations, applies to gain on the sale or exchange of, or a distribution which is in exchange for, stock in a real estate investment trust in the same manner that it would apply to a domestic corporation.

(f) **Unincorporated status required for certain taxable years.** In the case of a taxable year beginning before October 5, 1976, a real estate investment trust must be an unincorporated trust or unincorporated association. Accordingly, in applying the regulations under part II of subchapter M of the Code with respect to such a taxable year, the term "an unincorporated trust or unincorporated association" is to be substituted for the term "a corporation, trust, or association" each place it appears, and the references to "directors" and "corporate charter or bylaws" are to be disregarded.

[T.D. 6598, 27 FR 4082, April 28, 1962, as amended by T.D. 6928, 32 FR 13221, Sept. 19, 1967; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856–2 Limitations.

(a) **Effective date.** The provisions of part II, subchapter M, chapter 1 of the Code, and the regulations thereunder apply only to taxable years of a real estate investment trust beginning after December 31, 1960.

(b) **Election.** Under the provisions of section 856(c)(1), a trust, even though it satisfies the other requirements of part II of subchapter M for the taxable year, will not be considered a "real estate investment trust" for such year, within the meaning of such part II, unless it elects to be a real estate investment trust for such taxable year, or has made such an election for a previous taxable year which has not been terminated or revoked under section 856(g)(1) or (2). The election shall be made by the trust by computing taxable income as a real estate investment trust in its return for the first taxable year for which it desires the election to apply, even though it may have otherwise qualified as a real estate investment trust for a prior year. No other method of making such election is permitted. An election cannot be revoked with respect to a taxable year beginning before October 5, 1976. Thus, the failure of an organization to be a qualified real estate investment trust for a taxable year beginning before October 5, 1976, does not have the effect of revoking a prior election by the organization to be a real estate investment trust, even though the organization is not taxable under part II of subchapter M for such taxable year. See section 856(g) and § 1.856–8 for rules under which an election may be revoked with respect to taxable years beginning after October 4, 1976.

(c) **Gross income requirements.** Section 856(c)(2), (3), and (4), provides that a corporation, trust, or association is not a "real estate investment trust" for a taxable year unless it meets certain requirements with respect to the sources of

its gross income for the taxable year. In determining whether the gross income of a real estate investment trust satisfies the percentage requirements of section 856(c)(2), (3), and (4), the following rules shall apply:

(1) Gross income. For purposes of both the numerator and denominator in the computation of the specified percentages, the term "gross income" has the same meaning as that term has under section 61 and the regulations thereunder. Thus, in determining the gross income requirements under section 856(c)(2), (3), and (4), a loss from the sale or other disposition of stock, securities, real property, etc. does not enter into the computation.

(2) Lapse of options. Under section 856(c)(6)(C), the term "interests in real property" includes options to acquire land or improvements thereon, and options to acquire leaseholds of land and improvements thereon. However, where a corporation, trust, or association writes an option giving the holder the right to acquire land or improvements thereon, or writes an option giving the holder the right to acquire a leasehold of land or improvements thereon, any income that the corporation, trust, or association recognizes because the option expires unexercised is not considered to be gain from the sale or other disposition of real property (including interests in real property) for purposes of section 856(c)(2)(D) and (3)(C). The rule in the preceding sentence also applies for purposes of section 856(c)(4)(C) in determining gain from the sale or other disposition of real property for the 30-percent-of-gross-income limitation.

(3) Commitment fees. For purposes of section 856(c)(2)(G) and (3)(G), if consideration is received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property, or for an agreement to purchase or lease both real property and other property, an apportionment of the consideration is required. The apportionment of consideration received or accrued for an agreement to make a loan secured by a mortgage covering both real property and other property shall be made under the principles of § 1.856–5(c), relating to the apportionment of interest income.

(4) Holding period of property. For purposes of the 30-percent limitation of section 856(c)(4), the determination of the period for which property described in such section has been held is governed by the provisions of section 1223 and the regulations thereunder.

(5) Rents from real property and interest. See §§ 1.856–4 and 1.856–5 for rules relating to rents from real property and interest.

(d) Diversification of investment requirements —(1) 75-percent test. Section 856(c)(5)(A) requires that at the close of each quarter of the taxable year at least 75 percent of the value of the total assets of the trust be represented by one or more of the following:

(i) Real estate assets;

(ii) Government securities; and

(iii) Cash and cash items (including receivables).

For purposes of this subparagraph the term "receivables" means only those receivables which arise in the ordinary course of the trust's operation and does not include receivables purchased from another person. Subject to the limitations in section 856(c)(5)(B) and subparagraph (2) of this paragraph, the character of the remaining 25 percent (or less) of the value of the total assets is not restricted.

(2) Limitations on certain securities. Under section 856(c)(5)(B), not more than 25 percent of the value of the total assets of the trust may be represented by securities other than those described in section 856(c)(5)(A). The ownership of securities under the 25-percent limitation in section 856(c)(5)(B) is further limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the trust and to not more than 10 percent of the outstanding voting securities of such issuer. Thus, if the real estate investment trust meets the 75-percent asset diversification requirement in section 856(c)(5)(A), it will also meet the first test under section 856(c)(5)(B) since it will, of necessity, have not more than 25 percent of its total assets represented by securities other than those described in section 856(c)(5)(A). However, the trust must also meet two additional tests under section 856(c)(5)(B), i.e. it cannot own the securities of any one issuer in an amount (i) greater in value than 5 percent of the value of the trust's total assets, or (ii) representing more than 10 percent of the outstanding voting securities of such issuer.

(3) Determination of investment status. The term "total assets" means the gross assets of the trust determined in accordance with generally accepted accounting principles. In order to determine the effect, if any, which an acquisition of any security or other property may have with respect to the status of a trust as a real estate investment

trust, section 856(c)(5) requires a revaluation of the trust's assets at the end of the quarter in which such acquisition was made. A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of a security or other property since the mere change in market value of property held by the trust does not, of itself, affect the status of the trust as a real estate investment trust. A change in the nature of "cash items", for example, the prepayment of insurance or taxes, does not constitute the acquisition of "other property" for purposes of this subparagraph. A real estate investment trust shall keep sufficient records as to investments so as to be able to show that it has complied with the provisions of section 856(c)(5) during the taxable year. Such records shall be kept at all times available for inspection by any internal revenue officer or employee and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(4) Illustrations. The application of section 856(c)(5) and this paragraph may be illustrated by the following examples:

Example (1). Real Estate Investment Trust M, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of various corporations (not exceeding, with respect to any one issuer, 5 percent of the value of the total assets of the trust nor 10 percent of the outstanding voting securities of such issuer)	24
Total	100

Trust M meets the requirements of section 856(c)(5) for that quarter of its taxable year.

Example (2). Real Estate Investment Trust P, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	6
Government securities	7
Real estate assets	63
Securities of Corporation Z	20
Securities of Corporation X	4
Total	100

Trust P meets the requirement of section 856(c)(5)(A) since at least 75 percent of the value of the total assets is represented by cash, Government securities, and real estate assets. However, Trust P does not meet the diversification requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation Z exceeds 5 percent of the value of the trust's total assets.

Example (3). Real Estate Investment Trust G, at the close of the first quarter of its taxable year, has its assets invested as follows:

	Percent
Cash	4
Government securities	9
Real estate assets	70
Securities of Corporation S	5
Securities of Corporation L	4
Securities of Corporation U	4
Securities of Corporation M (which equals 25 percent of Corporation M's outstanding voting securities)	4
Total	100

Trust G meets the 75-percent requirement of section 856(c)(5)(A), but does not meet the requirements of section 856(c)(5)(B) because its investment in the voting securities of Corporation M exceeds 10 percent of Corporation M's outstanding voting securities.

Example (4). Real Estate Investment Trust R, at the close of the first quarter of its taxable year (i.e. calendar year), is a qualified real estate investment trust and has its assets invested as follows:

Cash	$5,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities of Corporation P	4,000
Securities of Corporation O	5,000
Securities of Corporation U	5,000
Securities of Corporation T	5,000
Total assets	100,000

During the second calendar quarter the stock in Corporation P increases in value to $50,000 while the value of the remaining assets has not changed. If Real Estate Investment Trust R has made no acquisition of stock or other property during such second quarter it will not lose its status as a real estate investment trust merely by reason of the appreciation in the value of P's stock. If, during the third quarter, Trust R acquires stock of Corporation S worth $2,000, such acquisition will necessitate a revaluation of all of the assets of Trust R as follows:

Cash	$3,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	50,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	2,000
Total assets	146,000

Because of the discrepancy between the value of its various investments and the 25-percent limitation in section 856(c)(5), resulting in part from the acquisition of the stock of Corporation S, Trust R, at the end of the third quarter, loses its status as a real estate investment trust. However, if Trust R, within 30 days after the close of such quarter, eliminates the discrepancy so that it meets the 25-percent limitation, the trust will be considered to have met the requirements of section 856(c)(5) at the close of the third quarter, even though the discrepancy between the value of its investment in Corporation P and the 5-percent limitation in section 856(c)(5) (resulting solely from

appreciation) may still exist. If instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P, then because of the discrepancy between the value of its investments and both the 5-percent and the 25-percent limitations in section 856(c)(5) resulting in part from this acquisition, trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter both of the discrepancies are eliminated.

Example (5). If, in the previous example, the stock of Corporation P appreciates only to $10,000 during the second quarter and, in the third quarter, Trust R acquires stock of Corporation S worth $1,000, the assets as of the end of the third quarter would be as follows:

Cash	$4,000
Government securities	4,000
Receivables	4,000
Real estate assets	68,000
Securities in Corporation P	10,000
Securities in Corporation O	5,000
Securities in Corporation U	5,000
Securities in Corporation T	5,000
Securities in Corporation S	1,000
Total assets	106,000

Because the discrepancy between the value of its investment in Corporation P and the 6-percent limitation in section 856(c)(5) results solely from appreciation, and because there is no discrepancy between the value of its various investments and the 25-percent limitation, Trust R, at the end of the third quarter, does not lose its status as a real estate investment trust. If, instead of acquiring stock of Corporation S, Trust R had acquired additional stock of Corporation P worth $1,000, then, because of the discrepancy between the value of its investment in Corporation P and the 5-percent limitation resulting in part from this acquisition, Trust R, at the end of the third quarter, would lose its status as a real estate investment trust, unless within 30 days after the close of such quarter this discrepancy is eliminated.

[T.D. 6598, 27 FR 4083, April 28, 1962, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7767, 46 FR 11265, Feb. 6, 1981]

§ 1.856–3 Definitions.

For purposes of the regulations under part II, subchapter M, chapter 1 of the Code, the following definitions shall apply.

(a) Value. The term "value" means, with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees of the real estate investment trust. In the case of securities of other qualified real estate investment trusts, fair value shall not exceed market value or asset value, whichever is higher.

(b) Real estate assets. The term "real estate assets" means real property, interests in mortgages on real property (including interests in mortgages on leaseholds of land or improvements thereon), and shares in other qualified real estate investment trusts. The term "mortgages on real property" includes deeds of trust on real property.

(c) **Interests in real property.** The term "interests in real property" includes fee ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term does not, however, include mineral, oil, or gas royalty interests, as, for example, a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term "interests in real property" also includes options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(d) Real property. The term "real property" means land or improvements thereon, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). In addition, the term "real property" includes interests in real property. Local law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

(e) **Securities.** The term "securities" does not include "interests in real property" or "real estate assets" as those terms are defined in section 856 and this section.

(f) **Qualified real estate investment trusts.** The term "qualified real estate investment trust" means a real estate investment trust within the meaning of part II of subchapter M which is taxable under such part as a real estate investment trust. For purposes of the 75-percent requirement in section 856(c)(5)(A), the trust whose stock has been included by another trust as "real estate assets" must be a "qualified real estate investment trust" for its full taxable year in which falls the close of each quarter of the trust's taxable year for which the computation is made. For example, Real

Estate Investment Trust Z for its taxable year ending December 31, 1963, holds as "real estate assets" stock in Real Estate Investment Trust Y, which is also on a calendar year. If Trust Y is not a qualified real estate investment trust for its full taxable year ending December 31, 1963, Trust Z may not include the stock of Trust Y as "real estate assets" in computing the 75-percent requirement as of the close of any quarter of its taxable year ending December 31, 1963.

(g) Partnership interest. In the case of a real estate investment trust which is a partner in a partnership, as defined in section 7701(a)(2) and the regulations thereunder, the trust will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of section 856, the interest of a partner in the partnership's assets shall be determined in accordance with his capital interest in the partnership. The character of the various assets in the hands of the partnership and items of gross income of the partnership shall retain the same character in the hands of the partners for all purposes of section 856. Thus, for example, if the trust owns a 30-percent capital interest in a partnership which owns a piece of rental property the trust will be treated as owning 30 percent of such property and as being entitled to 30 percent of the rent derived from the property by the partnership. Similarly, if the partnership holds any property primarily for sale to customers in the ordinary course of its trade or business, the trust will be treated as holding its proportionate share of such property primarily for such purpose. Also, for example, where a partnership sells real property or a trust sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, shall be deemed gross income from the sale or disposition of real property held for either the period that the partnership has held the real property of the period that the trust was a member of the partnership, whichever is the shorter.

(h) Net capital gain. The term "net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year.

[T.D. 6598, 27 FR 4084, April 28, 1962, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 7767, 46 FR 11266, Feb. 6, 1981]

§ 1.856–4 Rents from real property.

(a) In general. Subject to the exceptions of section 856(d) and paragraph (b) of this section, the term "rents from real property" means, generally, the gross amounts received for the use of, or the right to use, real property of the real estate investment trust.

(b) Amounts specifically included or excluded—(1) Charges for customary services. For taxable years beginning after October 4, 1976, the term "rents from real property", for purposes of paragraphs (2) and (3) of section 856(c), includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pool facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investment trust or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant. The service must be furnished through an independent contractor from whom the trust does not derive or receive any income. See paragraph (b)(5) of this section. For taxable years beginning before October 5, 1976, the rules in paragraph (b)(3) of 26 CFR 1.856–4 (revised as of April 1, 1977), relating to the furnishing of services, shall continue to apply.

(2) Amounts received with respect to certain personal property—(i) In general. In the case of taxable years beginning after October 4, 1976, rent attributable to personal property that is leased under, or in connection with, the lease of real property is treated under section 856(d)(1)(C) as

"rents from real property" (and thus qualified for purposes of the income source requirements) if the rent attributable to the personal property is not more than 15 percent of the total rent received or accrued under the lease for the taxable year. If, however, the rent attributable to personal property is greater than 15 percent of the total rent received or accrued under the lease for the taxable year, then the portion of the rent from the lease that is attributable to personal property will not qualify as "rents from real property".

(ii) Application. In general, the 15 percent test in section 856(d)(1)(C) is applied separately to each lease of real property. However, where the real estate investment trust rents all (or a portion of all) the units in a multiple unit project under substantially similar leases (such as the leasing of apartments in an apartment building or complex to individual tenants), the 15 percent test may be applied with respect to the aggregate rent received or accrued for the taxable year under the similar leases of the property, by using the average of the trust's aggregate adjusted bases of all of the personal property subject to such leases, and the average of the trust's aggregate adjusted bases of all real and personal property subject to such leases. A lease of a furnished apartment is not considered to be substantially similar to a lease of an unfurnished apartment (including an apartment where the trust provides only personal property, such as major appliances, that is commonly provided by a landlord in connection with the rental of unfurnished living quarters).

(iii) Taxable years beginning before October 5, 1976. In the case of taxable years beginning before October 5, 1976, any amount of rent that is attributable to personal property does not qualify as rent from real property.

(3) Disqualification of rent which depends on income or profits of any person. Except as provided in paragraph (b)(6)(ii) of this section, no amount received or accrued, directly or indirectly, with respect to any real property (or personal property leased under, or in connection with, real property) qualifies as "rents from real property" where the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. However, any amount so accrued or received shall not be excluded from the term "rents from real property" solely by reason of being based on a fixed percentage or percentages of receipts or sales (whether or not receipts or sales are adjusted for returned merchandise, or Federal, State, or local sales taxes). Thus, for example, "rents from real property" would include rents where the lease provides for differing percentages or receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease and a change in such percentage is not renegotiated during the term of the lease (including any renewal periods of the lease), in a manner which has the effect of basing the rent on income of profits. See paragraph (b)(6) of this section for rules relating to certain amounts received or accrued by a trust which are considered to be based on the income or profits of a sublessee of the prime tenant. The amount received or accrued as rent for the taxable year which is based on a fixed percentage or percentages of the lessee's receipts or sales reduced by escalation receipts (including those determined under a formula clause) will qualify as "rents from real property". Escalation receipts include amounts received by a prime tenant from subtenants by reason of an agreement that rent shall be increased to reflect all or a portion of an increase in real estate taxes, property insurance, operating costs of the prime tenant, or similar items customarily included in lease escalation clauses. Where in accordance with the terms of an agreement an amount received or accrued as rent for the taxable year includes both a fixed rental and a percentage of all or a portion of the lessee's income or profits, neither the fixed rental nor the additional amount will qualify as "rents from real property". However, where the amount received or accrued for the taxable year under such an agreement includes only the fixed rental, the determination of which does not depend in whole or in part on the income or profits derived by the lessee, such amount may qualify as "rents from real property". An amount received or accrued as rent for the taxable year which consists, in whole or in part, of one or more percentages of the lessee's receipts or sales in excess of determinable dollar amounts may qualify as "rents from real property", but only if two conditions exist. First, the determinable amounts must not depend in whole or in part on the income or profits of the lessee. Second, the percentages and, in the case of leases entered into after July 7, 1978, the determinable amounts, must be fixed at the time the lease is entered into and a change in percentages and determinable amounts is not renegotiated during the term of the lease (including any renewal periods of the lease) in a manner which has the effect of basing rent on income or profits. In any event, an amount will not qualify as "rents from real property" if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal busi-

ness practice but is in reality used as a means of basing the rent on income or profits. The provisions of this subparagraph may be illustrated by the following example:

Example. A real estate investment trust owns land underlying an office building. On January 1, 1975, the trust leases the land for 50 years to a prime tenant for an annual rental of \$100x plus 20 percent of the prime tenant's annual gross receipts from the office building in excess of a fixed base amount of \$5,000x and 10 percent of such gross receipts in excess of \$10,000x. For this purpose the lease defines gross receipts as all amounts received by the prime tenant from occupancy tenants pursuant to leases of space in the office building reduced by the amount by which real estate taxes, property insurance, and operating costs related to the office building for a particular year exceed the amount of such items for 1974. The exclusion from gross receipts of increases since 1974 in real estate taxes, property insurance, and other expenses relating to the office building reflects the fact that the prime tenant passes on to occupancy tenants by way of a customary lease escalation provision the risk that such expenses might increase during the term of an occupancy lease. The exclusion from gross receipts of these expense escalation items will not cause the rental received by the real estate investment trust from the prime tenant to fail to qualify as "rents from real property" for purposes of section 856(c).

(4) Disqualification of amounts received from persons owned in whole or in part by the trust. "Rents from real property" does not include any amount received or accrued, directly or indirectly, from any person in which the real estate investment trust owns, at any time during the taxable year, the specified percentage or number of shares of stock (or interest in the assets or net profits) of that person. Any amount received from such person will not qualify as "rents from real property" if such person is a corporation and the trust owns 10 percent or more of the total combined voting power of all classes of its stock entitled to vote or 10 percent or more of the total number of shares of all classes of its outstanding stock, or if such person is not a corporation and the trust owns a 10-percent-or-more interest in its assets or net profits. For example, a trust leases an office building to a tenant for which it receives rent of \$100,000 for the taxable year 1962. The lessee of the building subleases space to various subtenants for which it receives gross rent of \$500,000 for the year 1962. The trust owns 15 percent of the total assets of an unincorporated subtenant. The rent paid by this subtenant for the taxable year is \$50,000. Therefore, \$10,000 (50,000/500,000 × \$100,000) of the rent paid to the trust does not qualify as "rents from real property". Where the real estate investment trust receives, directly or indirectly, any amount of rent from any person in which it owns any proprietary interest, the trust shall submit, at the time it files its return for the taxable year (or before June 1, 1962, whichever is later), a schedule setting forth—

(i) The name and address of such person and the amount received as rent from such person; and

(ii) If such person is a corporation, the highest percentage of the total combined voting power of all classes of its stock entitled to vote, and the highest percentage of the total number of shares of all classes of its outstanding stock, owned by the trust at any time during the trust's taxable year; or

(iii) If such person is not a corporation, the highest percentage of the trust's interest in the assets or net profits of such person, owned by the trust at any time during its taxable year.

(5) Furnishing of services or management of property must be through an independent contractor—(i) In general. No amount received or accrued, directly or indirectly, with respect to any real property (or any personal property leased under, or in connection with, the real property) qualifies as "rents from real property" if the real estate investment trust furnishes or renders services to the tenants of the property or manages or operates the property, other than through an independent contractor from whom the trust itself does not derive or receive any income. The prohibition against the trust deriving or receiving any income from the independent contractor applies regardless of the source from which the income was derived by the independent contractor. Thus, for example, the trust may not receive any dividends from the independent contractor. The requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's-length relationship. The independent contractor must be adequately compensated for any services which are performed for the trust. Compensation to an independent contractor determined by reference to an unadjusted percentage of gross rents will generally be considered to be adequate where the percentage is reasonable taking into account the going rate of compensation for managing similar property in the same locality, the services rendered, and other relevant factors. The independent contractor must not be an employee of the trust (*i.e.*, the manner in which he carries out his duties as independent contractor must not be subject to the control of the trust). Although the cost of services which are customarily rendered or furnished in connection with the rental of real property may be borne by the trust, the services must be furnished or rendered through an independent contractor. Furthermore, the facilities through which the ser-

vices are furnished must be maintained and operated by an independent contractor. For example, if a heating plant is located in the building, it must be maintained and operated by an independent contractor. To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

(ii) Trustee or director functions. The trustees or directors of the real estate investment trust are not required to delegate or contract out their fiduciary duty to manage the trust itself, as distinguished from rendering or furnishing services to the tenants of its property or managing or operating the property. Thus, the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees or directors may also make capital expenditures with respect to the trust's property (as defined in section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under section 162), the cost of which may be borne by the trust.

(iii) Independent contractor defined. The term "independent contractor" means—

(a) A person who does not own, directly or indirectly, at any time during the trust's taxable year more than 35 percent of the shares in the real estate investment trust, or

(b) A person—

(1) If a corporation, not more than 35 percent of the total combined voting power of whose stock (or 35 percent of the total shares of all classes of whose stock), or

(2) If not a corporation, not more than 35 percent of the interest in whose assets or net profits

is owned, directly or indirectly, at any time during the trust's taxable year by one or more persons owning at any time during such taxable year 35 percent or more of the shares in the trust.

(iv) Information required. The real estate investment trust shall submit with its return for the taxable year (or before June 1, 1962, whichever is later) a statement setting forth the name and address of each independent contractor; and

(a) The highest percentage of the outstanding shares in the trust owned at any time during its taxable year by such independent contractor and by any person owning at any time during such taxable year any shares of stock or interest in the independent contractor.

(b) If the independent contractor is a corporation such statement shall set forth the highest percentage of the total combined voting power of its stock and the highest percentage of the total number of shares of all classes of its stock owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(c) If the independent contractor is not a corporation such statement shall set forth the highest percentage of any interest in its assets or net profits owned at any time during its taxable year by any person owning shares in the trust at any time during such taxable year.

(6) Amounts based on income or profits of subtenants. (i) Except as provided in paragraph (b)(6)(ii) of this section, if a trust leases real property to a tenant under terms other than solely on a fixed sum rental (for example, a percentage of the tenant's gross receipts), and the tenant subleases all or a part of such property under an agreement which provides for a rental based in whole or in part on the income or profits of the sublessee, the entire amount of the rent received by the trust from the prime tenant with respect to such property is disqualified as "rents from real property".

(ii) Exception. For taxable years beginning after October 4, 1976, section 856(d)(4) provides an exception to the general rule that amounts received or accrued, directly or indirectly, by a real estate investment trust do not qualify as rents from real property if the determination of the amount depends in whole or in part on the income or profits derived by any person from the property. This exception applies where the trust rents property to a tenant (the prime tenant) for a rental which is based, in whole or in part, on a fixed percentage or percentages of the receipts or sales of the prime tenant, and the rent which the trust receives or accrues from the prime tenant pursuant to the lease would not qualify as "rents from real property" solely because the prime tenant receives

or accrues from subtenants (including concessionaires) rents or other amounts based on the income or profits derived by a person from the property. Under the exception, only a proportionate part of the rent received or accrued by the trust does not qualify as "rents from real property". The proportionate part of the rent received or accrued by the trust which is non-qualified is the lesser of the following two amounts:

(A) The rent received or accrued by the trust from the prime tenant pursuant to the lease, that is based on a fixed percentage or percentages of receipts or sales, or

(B) The product determined by multiplying the total rent which the trust receives or accrues from the prime tenant pursuant to the lease by a fraction, the numerator of which is the rent or other amount received by the prime tenant that is based, in whole or in part, on the income or profits derived by any person from the property, and the denominator of which is the total rent or other amount received by the prime tenant from the property. For example, assume that a real estate investment trust owns land underlying a shopping center. The trust rents the land to the owner of the shopping center for an annual rent of $10x plus 2 percent of the gross receipts which the prime tenant receives from subtenants who lease space in the shopping center. Assume further that, for the year in question, the prime tenant derives total rent from the shopping center of $100x and, of that amount, $25x is received from subtenants whose rent is based, in whole or in part, on the income or profits derived from the property. Accordingly, the trust will receive a total rent of $12x, of which $2x is based on a percentage of the gross receipts of the prime tenant. The portion of the rent which is disqualified is the lesser of $2x (the rent received by the trust which is based on percentage of gross receipts), or $3x, ($12x multiplied by $25x/$100x). Accordingly, $10x of the rent received by the trust qualifies as "rents from real property" and $2x does not qualify.

(7) **Attribution rules.** Paragraphs (2) and (3) of section 856(d) relate to direct or indirect ownership of stock, assets, or net profits by the persons described therein. For purposes of determining such direct or indirect ownership, the rules prescribed by section 318(a) (for determining the ownership of stock) shall apply except that "10 percent" shall be substituted for "50 percent" in section 318(a)(2)(C) and (3)(C).

[T.D. 6598, 27 FR 4085, April 28, 1962, as amended by T.D. 6969, 33 FR 12000, Aug. 23, 1968; T.D. 7767, 46 FR 11266, Feb. 6, 1981]

§ 1.856–5 Interest.

(a) **In general.** In computing the percentage requirements in section 856(c)(2)(B) and (3)(B), the term "interest" includes only an amount which constitutes compensation for the use or forbearance of money. For example, a fee received or accrued by a lender which is in fact a charge for services performed for a borrower rather than a charge for the use of borrowed money is not includable as interest.

(b) **Where amount depends on income or profits of any person.** Except as provided in paragraph (d) of this section, any amount received or accrued, directly or indirectly, with respect to an obligation is not includable as interest for purposes of section 856(c)(2)(B) and (3)(B) if, under the principles set forth in paragraphs (b)(3) and (6)(i) of § 1.856–4, the determination of the amount depends in whole or in part on the income or profits of any person (whether or not derived from property secured by the obligation). Thus, for example, if in accordance with a loan agreement an amount is received or accrued by the trust with respect to an obligation which includes both a fixed amount of interest and a percentage of the borrower's income or profits, neither the fixed interest nor the amount based upon the percentage will qualify as interest for purposes of section 856(c)(2)(B) and (3)(B). This paragraph and paragraph (d) of this section apply only to amounts received or accrued in taxable years beginning after October 4, 1976, pursuant to loans made after May 27, 1976. For purposes of the preceding sentence, a loan is considered to be made before May 28, 1976, if it is made pursuant to a binding commitment entered into before May 28, 1976.

(c) **Apportionment of interest—(1) In general.** Where a mortgage covers both real property and other property, an apportionment of the interest income must be made for purposes of the 75-percent requirement of section 856(c)(3). For purposes of the 75-percent requirement, the apportionment shall be made as follows:

(i) If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income shall be apportioned to the real property.

(ii) If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a frac-

tion, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

(2) Loan value. For purposes of this paragraph, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to make the loan becomes binding on the trust. In the case of a loan purchased by the trust, the loan value of the real property is the fair market value of the property, determined as of the date on which the commitment by the trust to purchase the loan becomes binding on the trust. However, in the case of a construction loan or other loan made for purposes of improving or developing real property, the loan value of the real property is the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. The fair market value of the land and the reasonably estimated cost of improvements or developments shall be determined as of the date on which a commitment to make the loan becomes binding on the trust. If the trust does not make the construction loan but commits itself to provide long-term financing following completion of construction, the loan value of the real property is determined by using the principles for determining the loan value for a construction loan. Moreover, if the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the trust's commitment is binding, the real property loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

(3) Amount of loan. For purposes of this paragraph, the amount of the loan means the highest principal amount of the loan outstanding during the taxable year.

(d) Exception. Section 856(f)(2) provides an exception to the general rule that amounts received, directly or indirectly, with respect to an obligation do not qualify as "interest" where the determination of the amounts depends in whole or in part on the income or profits of any person. The exception applies where the trust receives or accrues, with respect to the obligation of its debtor, an amount that is based in whole or in part on a fixed percentage or percentages of receipts or sales of the debtor, and the amount would not qualify as interest solely because the debtor has receipts or sale proceeds that are based on the income or profits of any person. Under this exception only a proportionate part of the amount received or accrued by the trust fails to qualify as interest for purposes of the percentage-of-income requirements of section 856(c)(2) and (3). The proportionate part of the amount received or accrued by the trust that is non-qualified is the lesser of the following two amounts:

(1) The amount received or accrued by the trust from the debtor with respect to the obligation that is based on a fixed percentage or percentages of receipts or sales, or

(2) The product determined by multiplying by a fraction the total amount received or accrued by the trust from the debtor with respect to the obligation. The numerator of the fraction is the amount of receipts or sales of the debtor that is based, in whole or in part, on the income or profits of any person and the denominator is the total amount of the receipts or sales of the debtor. For purposes of the preceding sentence, the only receipts or sales to be taken into account are those taken into account in determining the payment to the trust pursuant to the loan agreement.

[T.D. 7767, 46 FR 11268, Feb. 6, 1981]

§ 1.856–6 Foreclosure property.

(a) In general. Under section 856(e) a real estate investment trust may make an irrevocable election to treat as "foreclosure property" certain real property (including interests in real property), and any personal property incident to the real property, acquired by the trust after December 31, 1973. This section prescribes rules relating to the election, including rules relating to property eligible for the election. This section also prescribes rules relating to extensions of the general two-year period (hereinafter the "grace period") during which property retains its status as foreclosure property, as well as rules relating to early termination of the grace period under section 856(e)(4). The election to treat property as foreclosure property does not alter the character of the income derived therefrom (other than for purposes of section 856(c)(2)(F) and (3)(F)). For example, if foreclosure property is sold, the determination of whether it is property described in section 1221(1) will not be affected by the fact that it is foreclosure property.

(b) **Property eligible for the election—(1) Rules relating to acquisitions.** In general, the trust must acquire the property after December 31, 1973, as the result of having bid in the property at foreclosure, or having otherwise reduced the property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of the property (where the trust was the lessor) or on an indebtedness owed to the trust which the property secured. Foreclosure property which secured an indebtedness owed to the trust is acquired for purposes of section 856(e) on the date of which the trust acquires ownership of the property for Federal income tax purposes. Foreclosure property which a trust owned and leased to another is acquired for purposes of section 856(e) on the date on which the trust acquires possession of the property from its lessee. A trust will not be considered to have acquired ownership of property for purposes of section 856(e) where it takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss with respect to the property except as a creditor of the mortgagor. A trust may be considered to have acquired ownership of property for purposes of section 856(e) even though legal title to the property is held by another person. For example, where, upon foreclosure of a mortgage held by the trust, legal title to the property is acquired in the name of a nominee for the exclusive benefit of the trust and the trust is the equitable owner of the property, the trust will be considered to have acquired ownership of the property for purposes of section 856(e). Generally, the fact that under local law the mortgagor has a right of redemption after foreclosure is not relevant in determining whether the trust has acquired ownership of the property for purposes of section 856(e). Property is not ineligible for the election solely because the property, in addition to securing an indebtedness owed to the trust, also secures debts owed to other creditors. Property eligible for the election includes a building or other improvement which has been constructed on land owned by the trust and which is acquired by the trust upon default of a lease of the land.

(2) **Personal property.** Personal property (including personal property not subject to a mortgage or lease of the real property) will be considered incident to a particular item of real property if the personal property is used in a trade or business conducted on the property or the use of the personal property is otherwise an ordinary and necessary corollary of the use to which the real property is put. In the case of a hotel, such items as furniture, appliances, linens, china, food, etc. would be examples of incidental personal property. Personal property incident to the real property is eligible for the election even though it is acquired after the real property is acquired or is placed in the building or other improvement in the course of the completion of construction.

(3) **Property with respect to which default is anticipated.** Property is not eligible for the election to be treated as foreclosure property if the loan or lease with respect to which the default occurs (or is imminent) was made or entered into (or the lease or indebtedness was acquired) by the trust with an intent to evict or foreclose, or when the trust knew or had reason to know that default would occur ("improper knowledge"). For purposes of the preceding sentence, a trust will not be considered to have improper knowledge with respect to a particular lease or loan, if the lease or loan was made pursuant to a binding commitment entered into by the trust at a time when it did not have improper knowledge. Moreover, if the trust, in an attempt to avoid default or foreclosure, advances additional amounts to the borrower in excess of amounts contemplated in the original loan commitment or modifies the lease or loan, such advance or modification will be considered not to have been made with an intent to evict or foreclose, or with improper knowledge, unless the original loan or lease was entered into with that intent or knowledge.

(c) **Election—(1) In general.** (i) An election to treat property as foreclosure property applies to all of the eligible real property acquired in the same taxable year by the trust upon the default (or as a result of the imminence of default) on a particular lease (where the trust is the lessor) or on a particular indebtedness owed to the trust. For example, if a loan made by a trust is secured by two separate tracts of land located in different cities, and in the same taxable year the trust acquires both tracts on foreclosure upon the default (or imminence of default) of the loan, the trust must include both tracts in the election. For a further example, the trust may choose to make a separate election for only one of the tracts if they are acquired in different taxable years or were not security for the same loan. If real property subject to the same election is acquired at different times in the same taxable year, the grace period for a particular property begins when that property is acquired.

(ii) If the trust acquires separate pieces of real property that secure the same indebtedness (or are under the same lease) in different taxable years because the trust delays acquiring one of them

until a later taxable year, and the primary purpose for the delay is to include only one of them in an election, then if the trust makes an election for one piece it must also make an election for the other piece. A trust will not be considered to have delayed the acquisition of property for this purpose if there is a legitimate business reason for the delay (such as an attempt to avoid foreclosure by further negotiations with the debtor or lessee).

(iii) All of the eligible personal property incident to the real property must also be included in the election.

(2) Time for making election. The election to treat property as foreclosure property must be made on or before the due date (including extensions of time) for filing the trust's income tax return for the taxable year in which the trust acquires the property with respect to which the election is being made, or April 3, 1975, whichever is later.

(3) Manner of making the election. An election made after February 6, 1981, shall be made by a statement attached to the income tax return for the taxable year in which the trust acquired the property with respect to which the election is being made. The statement shall indicate that the election is made under section 856(e) and shall identify the property to which the election applies. The statement shall also set forth—

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired by the trust, and

(iii) A brief description of how the real property was acquired, including the name of the person or persons from whom the real property was acquired and a description of the lease or indebtedness with respect to which default occurred or was imminent.

An election made on or before February 6, 1981 shall be filed in the manner prescribed in 26 CFR 10.1(f) (revised as of April 1, 1977) (temporary regulations relating to the election to treat property as foreclosure property) as in effect when the election is made.

(4) Status of taxpayer. In general, a taxpayer may make an election with respect to an acquisition of property only if the taxpayer is a qualified real estate investment trust for the taxable year in which the acquisition occurs. If, however, the taxpayer establishes, to the satisfaction of the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for a taxable year was due to reasonable cause and not due to willful neglect, the taxpayer may make the election with respect to property acquired in such taxable year. The principles of §§ 1.856–7(c) and 1.856–8(d) (including the principles relating to expert advice will apply in determining whether, for purposes of this subparagraph, the failure of the taxpayer to be a qualified real estate investment trust for the taxable year in which the property is acquired was due to reasonable cause and not due to willful neglect. If a taxpayer makes a valid election to treat property as foreclosure property, the property will not lose its status as foreclosure property solely because the taxpayer is not a qualified real estate investment trust for a subsequent taxable year (including a taxable year which encompasses an extension of the grace period). However, the rules relating to the termination of foreclosure property status in section 856(e)(4) (but not the tax on income from foreclosure property imposed by section 857(b)(4)) apply to the year in which the property is acquired and all subsequent years, even though the taxpayer is not a qualified real estate investment trust for such year.

(d) Termination of 2-year grace period; subsequent leases—(1) In general. Under section 856(e)(4)(A), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which the trust either—

(i) Enters into a lease with respect to any of the property which, by its terms, will give rise to income of the trust which is not described in section 856(c)(3) (other than section 856(c)(3)(F)), or

(ii) Receives or accrues, directly or indirectly, any amount which is not described in section 856(c)(3) (other than section 856(c)(3)(F)) pursuant to a lease with respect to any of the real property entered into by the trust on or after the day the trust acquired the property.

For example, assume the trust acquires, in a particular taxable year, a shopping center upon the default of an indebtedness owed to the trust. Also assume that the trust subsequently enters into a lease with respect to one of several stores in the shopping center that requires the lessee to pay rent to the trust which is not income described in

section 856(c)(3) (other than section 856(c)(3)(F)). In such case, the entire shopping center will cease to be foreclosure property on the day the trust enters into the lease.

(2) **Extensions or renewals of leases.** Generally, the extension or renewal of a lease of foreclosure property will be treated as the entering into of a new lease only if the trust has a right to renegotiate the terms of the lease. If, however, by operation of law or by contract, the acquisition of the foreclosure property by the trust terminates a preexisting lease of the property, or gives the trust a right to terminate the lease, then for purposes of section 856(e)(4)(A), a trust, in such circumstances, will not be considered to have entered into a lease with respect to the property solely because the terms of the preexisting lease are continued in effect after foreclosure without substantial modification. The letting of rooms in a hotel or motel does not constitute the entering into a lease for purposes of section 856(e)(4)(A).

(3) **Rent attributable to personal property.** Solely for the purposes of section 856(e)(4)(A), if a trust enters into a lease with respect to real property on or after the day upon which the trust acquires such real property by foreclosure, and a portion of the rent from such lease is attributable to personal property which is foreclosure property incident to such real property, such rent attributable to the incidental personal property will not be considered to terminate the status of such real property (or such incidental personal property) as foreclosure property.

(e) **Termination of 2-year grace period; completion of construction—(1) In general.** Under section 856(e)(4)(B), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring on or after the day on which the trust acquired the property) on which any construction takes place on the property, other than completion of a building (or completion of any other improvement) where more than 10 percent of the construction of the building (or other improvement) was completed before default became imminent. If more than one default occurred with respect to an indebtedness or lease in respect of which there is an acquisition, the more-than-10-percent test (including the rule prescribed in this paragraph relating to the test) will not be applied at the time a particular default became imminent if it is clear that the acquisition did not occur as the result of such default. For example, if the debtor fails to make four consecutive payments of principal and interest on the due dates, and the trust takes action to acquire the property securing the debt only after the fourth default becomes imminent, the 10-percent test is applied at the time the fourth default became imminent (even though the trust would not have foreclosed on the property had not all four defaults occurred).

(2) **Determination of percentage of completion.** The determination of whether the construction of a building or other improvement was more than 10 percent complete when default became imminent shall be made by comparing the total direct costs of construction incurred with respect to the building or other improvement as of the date default became imminent with the estimated total direct costs of construction as of such date. If the building or other improvement qualifies as more than 10 percent complete under this method, the building or other improvement shall be considered to be more than 10 percent complete. For purposes of this subparagraph, direct costs of construction include the cost of labor and materials which are directly connected with the construction of the building or improvement.

Thus, for example, direct costs of construction incurred as of the date default became imminent would include amounts paid, or for which liability has been incurred, for labor which has been performed as of such date that is directly connected with the construction of the building or other improvement and for building materials and supplies used or consumed in connection with the construction as of such date. For purposes of applying the 10-percent test the trust may also take into account the cost of building materials and supplies which have been delivered to the construction site as of the date default became imminent and which are to be used or consumed in connection with the construction. On the other hand, architect's fees, administrative costs of the developer or builder, lawyers' fees, and expenses incurred in connection with obtaining zoning approval or building permits are not considered to be direct costs of construction. Any construction by the trust as mortgagee-in-possession is considered to have taken place after default resulting in acquisition of the property became imminent. Generally, the trust's estimate of the total direct costs of completing construction as of the date the default became imminent will be accepted, provided that the estimate is reasonable, in good faith, and is based on all of the data reasonably available to the trust when the trust undertakes completion of construction of the building or other improvement.

Appropriate documentation which shows that construction was more than 10 percent complete when default became imminent must be available at the principal place of business of the trust for inspection in connection with an examination of the income tax return. Construction includes the renovation of a building, such as the remodeling of apartments, or the renovation of an apartment building to convert rental units to a condominium. The renovation must be more than 10 percent complete (determined by comparing the total direct cost of the physical renovation which has been incurred when default became imminent with the estimated total direct cost of renovation as of such date) when default became imminent in order for the property not to lose its status as foreclosure property if the trust undertakes the renovation.

(3) Modification of a building or improvement. Generally, the terms "building" and "improvement" in section 856(e)(4)(B) mean the building or improvement (including any integral part thereof) as planned by the mortgagor or lessee (or other person in possession of the property, if appropriate) as of the date default became imminent. The trust, however, may estimate the total direct costs of construction and complete the construction of the building or other improvement by modifying the building or other improvement as planned as of the date default became imminent so as to reduce the estimated direct cost of construction of the building or improvement. If the trust does so modify the planned construction of the building or improvement, the 10-percent test is to be applied by comparing the direct costs of construction incurred as of the date default became imminent that are attributable to the building or improvement as modified, with the estimated total direct costs (as of such date) of construction of the building or other improvement as modified. The trust, in order to meet the 10-percent test, may not, however, modify the planned building or improvement by reducing the estimated direct cost of construction to such an extent that the building or improvement is not functional.

Also, the trust may make subsequent modifications which increase the direct cost of construction of the building or improvement if such modifications—

(i) Are required by a Federal, State, or local agency, or

(ii) Are alterations that are either required by a prospective lessee or purchaser as a condition of leasing or buying the property or are necessary for the property to be used for the purpose planned at the time default became imminent.

Subdivision (ii) of the preceding sentence applies, however, only if the building or improvement, as modified, was more than 10 percent complete when default became imminent. A building completed by the trust will not cease to be foreclosure property solely because the building is used in a manner other than that planned by the defaulting mortgagor or lessee. Thus, for example, assume a trust acquired on foreclosure a planned apartment building which was 20 percent complete when default became imminent and that the trust completes the building without modifications which increase the direct cost of construction. The property will not cease to be foreclosure property by reason of section 856(e)(4)(B) solely because the trust sells the dwelling units in the building as condominium units, rather than holding them for rent as planned by the defaulting mortgagor. (See, however, section 856(e)(4)(C) and paragraph (f)(2) of this section for rules relating to the requirement that where foreclosure property is used in a trade or business (including a trade or business of selling the foreclosure property), the trade or business must be conducted through an independent contractor after 90 days after the property is acquired.)

(4) Application on building-by-building basis. Generally the more than 10 percent test is to be applied on a building-by-building basis. Thus, for example, if a trust has foreclosed on land held by a developer building a housing subdivision, the trust may complete construction of the houses which were more than 10 percent complete when default became imminent. The trust, however, may not complete construction of houses which were only 10 percent (or less) complete, nor may the trust begin construction of other houses planned for the subdivision on which construction has not begun. The trust, however, may construct an additional building or improvement (whether or not the construction thereof has begun) which is an integral part of another building or other improvement that was more than 10 percent complete when default became imminent if the additional building or improvement and the other building or improvement, taken together as a unit, meet the more than 10 percent test. For purposes of this paragraph, an additional building or other improvement will be considered to be an integral part of another building or improvement if—

(i) It is ancillary to the other building or improvement and its principal intended use is to furnish services or facilities which either supplement the use of such other building or improvement or are necessary for such other building or

improvement to be utilized in the manner or for the purpose for which it is intended, or

(ii) The buildings or improvements are intended to comprise constituent parts of an interdependent group of buildings or other improvements.

However, a building or other improvement will not be considered to be an integral part of another building or improvement unless the buildings or improvements were planned as part of the same overall construction plan or project before default became imminent. An additional building or other improvement (such as, for example, an outdoor swimming pool or a parking garage) may be considered to be an integral part of another building or improvement, even though the additional building or improvement was also intended to be used to provide facilities or services for use in connection with several other buildings or improvements which will not be completed. If the trust chooses not to undertake the construction of an additional building or other improvement which qualifies as an integral part of another building or improvement, so much of the costs of construction (including both the direct costs of construction incurred before the default became imminent and the estimated costs of completion) as are attributable to that "integral part" shall not be taken into account in determining whether any other building or improvement was more than 10 percent complete when default became imminent. For example, assume the trust acquires on foreclosure a property on which the defaulting mortgagor has begun construction of a motel. The motel, as planned by the mortgagor, was to consist of a two-story building containing 30 units, and two detached one-story wings, each of which was to contain 20 units. At the time default became imminent, the defaulting mortgagor had completed more than 10 percent of the construction of the two-story structure but the two wings, an access road, a parking lot, and an outdoor swimming pool planned for the motel were each less than 10 percent complete. The trust may construct the two wings of the motel, the access road, the parking lot, and the swimming pool: *Provided*, That the motel and the other improvements which the trust undertakes to construct, taken together as a unit, were more than 10 percent complete when default became imminent. If, however, the trust chooses not to undertake construction of the swimming pool, the cost of construction attributable to the swimming pool, whether incurred before default became imminent or estimated as the cost of completion, shall not be taken into account in determining whether the trust can complete construction of the other buildings and improvements. For another example, assume that the trust acquires a planned shopping center on foreclosure. At the time default became imminent several large buildings intended to house shops and stores in the shopping center were more than 10 percent complete. Less than 10 percent of the construction, however, had been completed on a separate structure intended to house a bank. The bank was planned as a component of the shopping center in order to provide, in conjunction with the other shops and stores, a specific range and variety of goods and services with which to attract customers to the shopping center. The trust may complete construction of the bank: *Provided*, That the bank and the other buildings and improvements which the trust undertakes to complete, taken together as a unit, were more than 10 percent complete when default became imminent. If the trust chooses not to construct the bank, no actual or estimated construction costs attributable to the bank are to be taken into account in applying the 10-percent test with respect to the other buildings and improvements in the shopping center. For a third example, assume that a defaulting mortgagor had planned to construct two identical apartment buildings, A and B, on the same tract of land, that neither building is to provide substantial facilities or services to be used in connection with the other, and that only building A was more than 10 percent complete when default became imminent. The trust, in this case, may not complete building B. On the other hand, if the facts are the same except that pursuant to the plans of the defaulting mortgagor, one of the buildings is to contain the furnace and central air conditioning machinery for both buildings A and B, the trust may complete both buildings A and B: *Provided*, That, taken together as a unit, the two buildings meet the more-than-10-percent test.

(5) **Repair and maintenance.** Under this paragraph (e), "construction" does not include—

(i) The repair or maintenance of a building or other improvement (such as the replacement of warn or obsolete furniture and appliances) to offset normal wear and tear or obsolescence, and the restoration of property required because of damage from fire, storm, vandalism or other casualty.

(ii) The preparation of leased space for a new tenant which does not substantially extend the useful life of the building or other improvement or significantly increase its value, even though, in the case of commercial space, this preparation includes adapting the property to the conduct of a different business, or

(iii) The performing of repair or maintenance described in paragraph (e)(5)(i) of this section after property is acquired that was deferred by the defaulting party and that does not constitute renovation under paragraph (e)(2) of this section.

(6) Independent contractor required. If any construction takes place on the foreclosure property more than 90 days after the day on which such property was acquired by the trust, such construction must be performed by an independent contractor (as defined in section 856(d)(3) and § 1.856–4(b)(5)(iii)) from whom the trust does not derive or receive any income. Otherwise, the property will cease to be foreclosure property.

(7) Failure to complete construction. Property will not cease to be foreclosure property solely because a trust which undertakes the completion of construction of a building or other improvement on the property that was more than 10 percent complete when default became imminent does not complete the construction. Thus, for example, if a trust continues construction of a building that was 20 percent complete when default became imminent, and the trust constructs an additional 40 percent of the building and then sells the property, the property will not lose its status as foreclosure property solely because the trust fails to complete construction of the building.

(f) Termination of 2-year grace period; use of foreclosure property in a trade or business—(1) In general. Under section 856(e)(4)(C), all real property (and any incidental personal property) for which a particular election has been made (see paragraph (c)(1) of this section) shall cease to be foreclosure property on the first day (occurring more than 90 days after the day on which the trust acquired the property) on which the property is used in a trade or business conducted by the trust, other than a trade or business conducted by the trust through an independent contractor from whom the trust itself does not derive or receive any income. (See section 856(d)(3) for the definition of independent contractor.)

(2) Property held primarily for sale to customers. For the purposes of section 856(e)(4)(C), foreclosure property held by the trust primarily for sale to customers in the ordinary course of a trade or business is considered to be property used in a trade or business conducted by the trust. Thus, if a trust holds foreclosure property (whether real property or personal property incident to real property) for sale to customers in the ordinary course of a trade or business more than 90 days after the day on which the trust acquired the real property, the trade or business of selling the property must be conducted by the trust through an independent contractor from whom the trust does not derive or receive any income. Otherwise, after such 90th day the property will cease to be foreclosure property.

(3) Change in use. Foreclosure property will not cease to be foreclosure property solely because the use of the property in a trade or business by the trust differs from the use to which the property was put by the person from whom it was acquired. Thus, for example, if a trust acquires a rental apartment building on foreclosure, the property will not cease to be foreclosure property solely because the trust converts the building to a condominium apartment building and, through an independent contractor from whom the trust derives no income, engages in the trade or business of selling the individual condominium units.

(g) Extension of 2-year grace period—(1) In general. A real estate investment trust may apply to the district director of the internal revenue district in which is located the principal place of business (or principal office or agency) of the trust for an extension of the 2-year grace period. If the trust establishes to the satisfaction of the district director that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in foreclosure property, or for an orderly renegotiation of a lease or leases of the property, the district director may extend the 2-year grace period. See section 856(e)(3) (as in effect with respect to the particular extension) for rules relating to the maximum length of an extension, and the number of extensions which may be granted. An extension of the grace period may be granted by the district director either before or after the date on which the grace period, but for the extension, would expire. The extension shall be effective as of the date on which the grace period, but for the extension, would expire.

(2) Showing required. Generally, in order to establish the necessity of an extension, the trust must demonstrate that it has made good faith efforts to renegotiate leases with respect to, or dispose of, the foreclosure property. In certain cases, however, the trust may establish the necessity of an extension even though it has not made such efforts. For example, if the trust demonstrates that, for valid business reasons, construction of the foreclosure property could not be completed before the expiration of the grace period, the necessity of the extension could be established even though the trust had made no effort to sell the property. For another example, if the trust

demonstrates that due to a depressed real estate market, it could not sell the foreclosure property before the expiration of the grace period except at a distress price, the necessity of an extension could be established even though the trust had made no effort to sell the property. The fact that property was acquired as foreclosure property prior to January 3, 1975 (the date of enactment of section 856(e)), generally will be considered as a factor (but not a controlling factor) which tends to establish that an extension of the grace period is necessary.

(3) **Time for requesting an extension of the grace period.** A request for an extension of the grace period must be filed with the appropriate district director more than 60 days before the day on which the grace period would otherwise expire. In the case of a grace period which would otherwise expire before August 6, 1976, a request for an extension will be considered to be timely filed if filed on or before June 7, 1976.

(4) **Information required.** The request for an extension of the grace period shall identify the property with respect to which the request is being made and shall also include the following information:

(i) The name, address, and taxpayer identification number of the trust,

(ii) The date the property was acquired as foreclosure property by the trust,

(iii) The taxable year of the trust in which the property was acquired,

(iv) If the trust has been previously granted an extension of the grace period with respect to the property, a statement to that effect (which shall include the date on which the grace period, as extended, expires) and a copy of the information which accompanied the request for the previous extension,

(v) A statement of the reasons why the grace period should be extended,

(vi) A description of any efforts made by the trust after the acquisition of the property to dispose of the property or to renegotiate any lease with respect to the property, and

(vii) A description of any other factors which tend to establish that an extension of the grace period is necessary for the orderly liquidation of the trust's interest in the property, or for an orderly renegotiation of a lease or leases of the property.

The trust shall also furnish any additional information requested by the district director after the request for extension is filed.

(5) **Automatic extension.** If a real estate investment trust files a request for an extension with the district director more than 60 days before the expiration of the grace period, the grace period shall be considered to be extended until the end of the 30th day after the date on which the district director notifies the trust by certified mail sent to its last known address that the period of extension requested by the trust is not granted. In no event, however, shall the rule in the preceding sentence extend the grace period beyond the expiration of (i) the period of extension requested by the trust, or (ii) the 1-year period following the date that the grace period (but for the automatic extension) would expire. The date of the postmark on the sender's receipt is considered to be the date of the certified mail for purposes of this subparagraph. This subparagraph does not apply, however, if the date of the notification by certified mail described in the first sentence is more than 30 days before the date that the grace period (determined without regard to this subparagraph) expires. Moreover, this subparagraph shall not operate to allow any period of extension that is prohibited by the last sentence of section 856(e)(3) (as in effect with respect to the particular extension).

(6) **Extension of time for filing.** If a real estate investment trust fails to file the request for an extension of the grace period within the time provided in paragraph (g)(3) of this section, then the district director shall grant a reasonable extension of time for filing such request, provided (i) it is established to the satisfaction of the district director that there was reasonable cause for failure to file the request within the prescribed time and (ii) a request for such extension is filed within such time as the district director considers reasonable under the circumstances.

(7) **Status of taxpayer.** The reference to "real estate investment trust" or "trust" in this paragraph (g) shall be considered to include a taxpayer that is not a qualified real estate investment trust, if the taxpayer establishes to the satisfaction of the district director that its failure to be a qualified real estate investment trust for the taxable year was due to reasonable cause and not due to willful neglect. The principles of § 1.856–7(c) and § 1.856–8(d) (including the principles relating to expert advice) shall apply for determining reason-

able cause (and absence of willful neglect) for this purpose.

[T.D. 7767, 46 FR 11269, Feb. 6, 1981; 46 FR 15263, March 5, 1981]

§ 1.856–7 Certain corporations, etc., that are considered to meet the gross income requirements.

(a) In general. A corporation, trust, or association which fails to meet the requirements of paragraph (2) or (3) of section 856(c), or of both such paragraphs, for any taxable year nevertheless is considered to have satisfied these requirements if the corporation, trust, or association meets the requirements of subparagraphs (A), (B), and (C) of section 856(c)(7) (relating to a schedule attached to the return, the absence of fraud, and reasonable cause).

(b) Contents of the schedule. The schedule required by subparagraph (A) of section 856(c)(7) must contain a breakdown, or listing, of the total amount of gross income falling under each of the separate subparagraphs of section 856(c)(2) and (3). Thus, for example, the real estate investment trust, for purposes of listing its income from the sources described in section 856(c)(2), would list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, etc. The listing is not required to be on a lease-by-lease, loan-by-loan, or project-by-project basis, but the real estate investment trust must maintain adequate records on such a basis with which to substantiate each total amount listed in the schedule.

(c) Reasonable cause—(1) In general. The failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) will be considered due to reasonable cause and not due to willful neglect if the real estate investment trust exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the trust. However, even if the trust exercised ordinary business care and prudence in entering into a transaction, if the trust later determines that the transaction results in the receipt or accrual of nonqualified income and that the amounts of such nonqualified income, in the context of the trust's overall portfolio, reasonably can be expected to cause a source-of-income requirement to be failed, the trust must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, dispose of property acquired or leased in the transaction, or alter other elements of its portfolio. In any case, failure to meet an income source requirement will be considered due to willful neglect and not due to reasonable cause if the failure is willful and the trust could have avoided such failure by taking actions not inconsistent with ordinary business care and prudence. For example, if the trust enters into a lease knowing that it will produce nonqualified income which reasonably can be expected to cause a source-of-income requirement to be failed, the failure is due to willful neglect even if the trust has a legitimate business purpose for entering into the lease.

(2) Expert advice—(i) In general. The reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes "reasonable cause" if income from that transaction causes the trust to fail to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs). The absence of such a reasoned, written opinion with respect to a transaction does not, by itself, give rise to any inference that the failure to meet a percentage of income requirement was without reasonable cause. An opinion as to the character of income from a transaction includes an opinion pertaining to the use of a standard form of transaction or standard operating procedure in a case where such standard form or procedure is in fact used or followed.

(ii) If the opinion indicates that a portion of the income from a transaction will be nonqualified income, the trust must still exercise ordinary business care and prudence with respect to the nonqualified income and determine that the amount of that income, in the context of its overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed. Reliance on an opinion is not reasonable if the trust has reason to believe that the opinion is incorrect (for example, because the trust withholds facts from the person rendering the opinion).

(iii) Reasoned written opinion. For purposes of this subparagraph (2), a written opinion means an opinion, in writing, rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction. A written opinion is considered "reasoned" even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion is based on a full disclosure of the factual situation by the real estate investment trust and is addressed to the facts and law

which the person rendering the opinion believes to be applicable. However, an opinion is not considered "reasoned" if it does nothing more than recite the facts and express a conclusion.

(d) **Application of section 856(c)(7) to taxable years beginning before October 5, 1976.** Pursuant to section 1608(b) of the Tax Reform Act of 1976, paragraph (7) of section 856(c) and this section apply to a taxable year of a real estate investment trust which begins before October 5, 1976, only if as the result of a determination occurring after October 4, 1976, the trust does not meet the requirements of paragraph (2) or (3) of section 856(c), or both paragraphs, as in effect for the taxable year. The requirement that the schedule described in subparagraph (A) of section 856(c)(7) be attached to the income tax return of a real estate investment trust in order for section 856(c)(7) to apply is not applicable to taxable years beginning before October 5, 1976. For purposes of section 1608(b) of the Tax Reform Act of 1976 and this paragraph, the rules relating to determinations prescribed in section 860(e) and § 1.860–2(b)(1) (other than the second, third, and last sentences of § 1.860–2(b)(1)(ii)) shall apply. However, a determination consisting of an agreement between the taxpayer and the district director (or other official to whom authority to sign the agreement is delegated) shall set forth the amount of gross income for the taxable year to which the determination applies, the amount of the 90 percent and 75 percent source-of-income requirements for the taxable year to which the determination applies, and the amount by which the real estate investment trust failed to meet either or both of the requirements. The agreement shall also set forth the amount of tax for which the trust is liable pursuant to section 857(b)(5). The agreement shall also contain a finding as to whether the failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) was due to reasonable cause and not due to willful neglect.

[T.D. 7767, 46 FR 11274, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.856–8 Revocation or termination of election.

(a) **Revocation of an election to be a real estate investment trust.** A corporation, trust, or association that has made an election under section 856(c)(1) to be a real estate investment trust may revoke the election for any taxable year after the first taxable year for which the election is effective. The revocation must be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement must be filed on or before the 90th day after the first day of the first taxable year for which the revocation is to be effective. The statement must be signed by an official authorized to sign the income tax return of the taxpayer and must—

(1) Contain the name, address, and taxpayer identification number of the taxpayer,

(2) Specify the taxable year for which the election was made, and

(3) Include a statement that the taxpayer, pursuant to section 856(g)(2), revokes its election under section 856(c)(1) to be a real estate investment trust.

The revocation may be made only with respect to a taxable year beginning after October 4, 1976, and is effective for the taxable year in which made and for all succeeding taxable years. A revocation with respect to a taxable year beginning after October 4, 1976, that is filed before February 6, 1981, in the time and manner prescribed in § 7.856(g)–1 of this chapter (as in effect when the revocation was filed) is considered to meet the requirements of this paragraph.

(b) **Termination of election to be a real estate investment trust.** An election of a corporation, trust, or association under section 856(c)(1) to be a real estate investment trust shall terminate if the corporation, trust, or association is not a qualified real estate investment trust for any taxable year (including the taxable year with respect to which the election is made) beginning after October 4, 1976. (This election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent.) The term "taxable year" includes a taxable year of less than 12 months for which a return is made under section 443. The termination of the election is effective for the first taxable year beginning after October 4, 1976, for which the corporation, trust, or association is not a qualified real estate investment trust and for all succeeding taxable years.

(c) **Restrictions on election after termination or revocation—(1) General rule.** Except as provided in paragraph (d) of this section, if a corporation, trust, or association has made an election under section 856(c)(1) to be a real estate investment trust and the election has been terminated or revoked under section 856(g)(1) or (2), the corporation, trust, or association (and any successor corporation, trust, or association) is not eligible to

make a new election under section 856(c)(1) for any taxable year prior to the fifth taxable year which begins after the first taxable year for which the termination or revocation is effective.

(2) Successor corporation. The term "successor corporation, trust, or association", as used in section 856(g)(3), means a corporation, trust, or association which meets both a continuity of ownership requirement and a continuity of assets requirement with respect to the corporation, trust, or association whose election has been terminated under section 856(g)(1) or revoked under section 856(g)(2). A corporation, trust, or association meets the continuity of ownership requirement only if at any time during the taxable year the persons who own, directly or indirectly, 50 percent or more in value of its outstanding shares owned, at any time during the first taxable year for which the termination or revocation was effective, 50 percent or more in value of the outstanding shares of the corporation, trust, or association whose election has been terminated or revoked. A corporation, trust, or association meets the continuity of assets requirement only if either (i) a substantial portion of its assets were assets of the corporation, trust, or association whose election has been revoked or terminated, or (ii) it acquires a substantial portion of the assets of the corporation, trust, or association whose election has been terminated or revoked.

(3) Effective date. Section 856(g)(3) does not apply to the termination of an election that was made by a taxpayer pursuant to section 856(c)(1) on or before October 4, 1976, unless the taxpayer is a qualified real estate investment trust for a taxable year ending after October 4, 1976, for which the pre-October 5, 1976, election is in effect. For example, assume that Trust X, a calendar year taxpayer, files a timely election under section 856(c)(1) with respect to its taxable year 1974, and is a qualified real estate investment trust for calendar years 1974 and 1975. Assume further that Trust X is not a qualified real estate investment trust for 1976 and 1977 because it willfully fails to meet the asset diversification requirements of section 856(c)(5) for both years. The failure (whether or not willful) to meet these requirements in 1977 terminates the election to be a real estate investment trust made with respect to 1974. (See paragraph (b) of this section.) The termination is effective for 1977 and all succeeding taxable years. However, under section 1608(d)(3) of the Tax Reform Act of 1976, Trust X is not prohibited by section 856(g)(3) from making a new election under section 856(c)(1) with respect to 1978.

(d) Exceptions. Section 856(g)(4) provides an exception to the general rule of section 856(g)(3) that the termination of an election to be a real estate investment trust disqualifies the corporation, trust, or association from making a new election for the 4 taxable years following the first taxable year for which the termination is effective. This exception applies where the corporation, trust, or association meets the requirements of section 856(g)(4)(A), (B) and (C) (relating to the timely filing of a return, the absence of fraud, and reasonable cause, respectively) for the taxable year with respect to which the termination of election occurs. In order to meet the requirements of section 856(g)(4)(C), the corporation, trust, or association must establish, to the satisfaction of the district director for the internal revenue district in which the corporation, trust, or association maintains its principal place of business or principal office or agency, that its failure to be a qualified real estate investment trust for the taxable year in question was due to reasonable cause and not due to willful neglect. The principles of § 1.856–7(c) (including the principles relating to expert advice will apply in determining whether, for purposes of section 856(g)(4), the failure of a corporation, trust, or association to be a qualified real estate investment trust for a taxable year was due to reasonable cause and not due to willful neglect. Thus, for example, the corporation, trust, or association must exercise ordinary business care and prudence in attempting to meet the status conditions of section 856(a) and the distribution and recordkeeping requirements of section 857(a), as well as the gross income requirements of section 856(c). The provisions of section 856(g)(4) do not apply to a taxable year in which the corporation, trust, or association makes a valid revocation, under section 856(g)(2), of an election to be a real estate investment trust.

[T.D. 7767, 46 FR 11275, Feb. 6, 1981; 46 FR 15263, March 5, 1981]

§ 1.856–9 Election with respect to property held for sale in a taxable year beginning before October 5, 1976.

(a) In general. Section 856(a)(4), as in effect with respect to taxable years beginning before October 5, 1976, provided that a real estate investment trust could not hold any property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business. Section 1603 of the Tax Reform Act of 1976 (the Act) repealed the prohibition on holding property primarily for sale to customers, effective for taxable years beginning after October 4, 1976,

and imposed the tax on net income from prohibited transactions under section 857(b)(6). Section 1608(d)(2) of the Act provides that if as a result of a determination occurring after October 4, 1976, a real estate investment trust does not meet the requirement of section 856(a)(4) (as in effect before amendment by the Act) for any taxable year beginning before October 5, 1976, the trust may elect to have the provisions of section 1603 (other than paragraphs (1), (2), (3), and (4) of section 1603 (c)) of the Act apply with respect to the taxable year. For purposes of section 1608(d)(2) of the Tax Reform Act of 1976 and this section, the definition of "determination" in section 860(e) shall apply.

(b) Election. The election provided by section 1608(d)(2) of the Act shall be made by filing a statement with the district director for the internal revenue district in which the taxpayer maintains its principal place of business or principal office or agency. The statement shall be signed by the taxpayer and shall include the following information:

(1) The name, address, and taxpayer identification number of the taxpayer;

(2) The taxable year (or years) to which the election applies;

(3) A statement that the taxpayer, pursuant to section 1608(d)(2) of the Tax Reform Act of 1976, elects to have the provisions of section 1603 (other than paragraphs (1), (2), (3), and (4) of section 1603(c)) of the Act apply to such taxable year (or years); and

(4) A description of the determination and the date upon which the determination became final.

A copy of the closing agreement, the Tax Court decision, the judgment, decree, or other order, or the agreement with the district director (or other official) which constitutes the determination shall be attached to the statement.

(c) Time for filing the election. The election must be filed within 60 days after the date of the determination. The date of a determination described in section 860(e)(1) or (2) shall be determined in accordance with section 860(e) and § 1.860–2(b)(1)(i). The date of a determination which is an agreement with the district director (or other official) under section 860(e)(3) shall be determined in accordance with paragraph (e) of this section.

(d) Revocation—(1) In general. An election made by a taxpayer pursuant to section 1608(d)(2) of the Tax Reform Act of 1976 after February 6, 1981 is irrevocable.

(2) Elections made under temporary regulations. A taxpayer who has made an election under section 1608(d)(2) of the Act on or before February 6, 1981 in accordance with § 7.0(c)(1) of this chapter may apply to the Commissioner for consent to revoke the election. The application for consent must be filed with the Commissioner after February 6, 1981 and before May 8, 1981.

(e) Determination. For purposes of section 1608(d)(2) of the Tax Reform Act of 1976, a determination under section 860(e)(3) may be made by an agreement signed by the district director or such other official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall identify the taxable year (or years) to which it applies and shall state that the taxpayer, during such taxable year (or years), held property (other than foreclosure property) primarily for sale to customers in the ordinary course of its trade or business, within the meaning of section 856(c)(4), as in effect before amendment by the Act. The agreement further shall set forth, for each taxable year to which it applies, the amount, if any, of the net income (or net loss) from prohibited transactions, and the amount, if any, of the tax imposed by paragraph (6) of section 857(b). An agreement under this subparagraph shall be sent to the taxpayer at its last known address by either registered or certified mail. If registered mail is used, the date of registration shall be treated as the date of determination. If certified mail is used, the date of the postmark on the sender's receipt shall be treated as the date of determination. However, if the statement described in paragraph (b) of this section is filed by the taxpayer before the registration or postmark date but on or after the date the agreement is signed by the district director (or the other official to whom authority to sign the agreement is delegated), the date of determination shall be the date of signing.

(f) Rules relating to refunds, credits, assessment, and collection. In a case where an election to have section 1603 of the Act apply results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X. See section 1608(d)(2) of the Act for special rules relating to the period of limitations on filing the claim and to assessment and collection of any deficiency established by the determination.

[T.D. 7767, 46 FR 11276, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2106, Jan. 18, 1984]

§ 1.857-1 Taxation of real estate investment trusts.

(a) Requirements applicable thereto. Section 857(a) denies the application of the provisions of part II, subchapter M, chapter 1 of the Code (other than sections 856(g), relating to the revocation or termination of an election, and 857(d), relating to earnings and profits) to a real estate investment trust for a taxable year unless—

(1) The deduction for dividends paid for the taxable year as defined in section 561 (computed without regard to capital gain dividends) equals or exceeds the amount specified in section 857(a)(1), as in effect for the taxable year; and

(2) The trust complies for such taxable year with the provisions of § 1.857-8 (relating to records required to be maintained by a real estate investment trust).

See section 858 and § 1.858-1, relating to dividends paid after the close of the taxable year.

(b) Failure to qualify. If a real estate investment trust does not meet the requirements of section 857(a) and paragraph (a) of this section for the taxable year, it will, even though it may otherwise be classified as a real estate investment trust, be taxed in such year as an ordinary corporation and not as a real estate investment trust. In such case, none of the provisions of part II of subchapter M (other than sections 856(g) and 857(d)) will be applicable to it. For the rules relating to the applicability of sections 856(g) and 857(d), see § 1.857-7.

[T.D. 6598, 27 FR 4087, April 28, 1962, as amended T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857-2 Real estate investment trust taxable income and net capital gain.

(a) Real estate investment trust taxable income. Section 857(b)(1) imposes a normal tax and surtax, computed at the rates and in the manner prescribed in section 11, on the "real estate investment trust taxable income", as defined in section 857(b)(2). Section 857(b)(2) requires certain adjustments to be made to convert taxable income of the real estate investment trust to "real estate investment trust taxable income". The adjustments are as follows:

(1) Net capital gain. In the case of taxable years ending before October 5, 1976, the net capital gain, if any, is excluded.

(2) Special deductions disallowed. The special deductions provided in part VIII, subchapter B, chapter 1 of the Code (except the deduction under section 248) are not allowed.

(3) Deduction for dividends paid—(i) General rule. The deduction for dividends paid (as defined in section 561) is allowed. In the case of taxable years ending before October 5, 1976, the deduction for dividends paid is computed without regard to capital gains dividends.

(ii) Deduction for dividends paid if there is net income from foreclosure property. If for any taxable year the trust has net income from foreclosure property (as defined in section 857(b)(4)(B) and § 1.857-3), the deduction for dividends paid is an amount equal to the amount which bears the same proportion to the total dividends paid or considered as paid during the taxable year that otherwise meet the requirements for the deduction for dividends paid (as defined in section 561) as the real estate investment trust taxable income (determined without regard to the deduction for dividends paid) bears to the sum of—

(A) The real estate investment trust taxable income (determined without regard to the deduction for dividends paid), and

(B) The amount by which the net income from foreclosure property exceeds the tax imposed on such income by section 857(b)(4)(A).

For purposes of the preceding sentence, the term "total dividends paid or considered as paid during the taxable year" includes deficiency dividends paid with respect to the taxable year that are not otherwise excluded under this subdivision or section 857(b)(3)(A). The term, however, does not include either deficiency dividends paid during the taxable year with respect to a preceding taxable years ending before October 5, 1976, capital gains dividends.

(iii) Deduction for dividends paid for purposes of the alternative tax. The rules in section 857(b)(3)(A) apply in determining the amount of the deduction for dividends paid that is taken into account in computing the alternative tax. Thus, for example, if a real estate investment trust has net income from foreclosure property for a taxable year ending after October 4, 1976, then for purposes of determining the partial tax described in section 857(b)(3)(A)(i), the amount of the deduction for dividends paid is computed pursuant to paragraph (a)(3)(ii) of this section, except that capital gains dividends are excluded from the dividends paid or considered as paid during the taxable year, and the net capital gain is excluded in computing real estate investment trust taxable income.

(4) **Section 443(b) disregarded.** The taxable income is computed without regard to section 443(b). Thus, the taxable income for a period of less than 12 months is not placed on an annual basis even though the short taxable year results from a change of accounting period.

(5) **Net operating loss deduction.** In the case of a taxable year ending before October 5, 1976, the net operating loss deduction provided in section 172 is not allowed.

(6) **Net income from foreclosure property.** An amount equal to the net income from foreclosure property (as defined in section 857(b)(4)(B) and paragraph (a) of § 1.857–3), if any, is excluded.

(7) **Tax imposed by section 857(b)(5).** An amount equal to the tax (if any) imposed on the trust by section 857(b)(5) for the taxable year is excluded.

(8) **Net income or loss from prohibited transactions.** An amount equal to the amount of any net income derived from prohibited transactions (as defined in section 857(b)(6)(B)(i) is excluded. On the other hand, an amount equal to the amount of any net loss derived from prohibited transactions (as defined in section 857(b)(6)(B)(ii)) is included. Because the amount of the net loss derived from prohibited transactions is taken into account in computing taxable income before the adjustments required by section 857(b)(2) and this section are made, the effect of including an amount equal to the amount of the loss is to disallow a deduction for the loss.

(b) **Net capital gain in taxable years ending before October 5, 1976.** The rules relating to the taxation of capital gains in 26 CFR 1.857–2(b) (revised as of April 1, 1977) apply to taxable years ending before October 5, 1976.

[T.D. 6598, 27 FR 4087, Apr. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857–3 Net income from foreclosure property.

(a) **In general.** For purposes of section 857(b)(4)(B), net income from foreclosure property means the aggregate of—

(1) All gains and losses from sales or other dispositions of foreclosure property described in section 1221(1), and

(2) The difference (hereinafter called "net gain or loss from operations") between (i) the gross income derived from foreclosure property (as defined in section 856(e)) to the extent such gross income is not described in subparagraph (A), (B), (C), (D), (E), or (G) of section 856(c)(3), and (ii) the deductions allowed by chapter 1 of the Code which are directly connected with the production of such gross income.

Thus, the sum of the gains and losses from sales or other dispositions of foreclosure property described in section 1221(1) is aggregated with the net gain or loss from operations in arriving at net income from foreclosure property. For example, if for a taxable year a real estate investment trust has gain of $100 from the sale of an item of foreclosure property described in section 1221(1), a loss of $50 from the sale of an item of foreclosure property described in section 1221(1), gross income of $25 from the rental of foreclosure property that is not gross income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3), and deductions of $35 allowed by chapter 1 of the Code which are directly connected with the production of the rental income, the net income from foreclosure property for the taxable years is $40 (($100–$50) + ($25–$35)).

(b) **Directly connected deductions.** A deduction which is otherwise allowed by chapter 1 of the Code is "directly connected" with the production of gross income from the foreclosure property if it has a proximate and primary relationship to the earning of the income. Thus, in the case of gross income from real property that is foreclosure property, "directly connected" deductions would include depreciation on the property, interest paid or accrued on the indebtedness of the trust (whether or not secured by the property) to the extent attributable to the carrying of the property, real estate taxes, and fees paid to an independent contractor hired to manage the property. On the other hand, general overhead and administrative expenses of the trust are not "directly connected" deductions. Thus, salaries of officers and other administrative employees of the trust are not "directly connected" deductions. The net operating loss deduction provided by section 172 is not allowed in computing net income from foreclosure property.

(c) **Net loss from foreclosure property.** The tax imposed by section 857(b)(4) applies only if there is net income from foreclosure property. If there is a net loss from foreclosure property (that is, if the aggregate computed under paragraph (a) of this section results in a negative amount) the loss is taken into account in computing real estate investment trust taxable income under section 857(b)(2).

(d) Gross income not subject to tax on foreclosure property. If the gross income derived from foreclosure property consists of two classes, a deduction directly connected with the production of both classes (including interest attributable to the carrying of the property) must be apportioned between them. The two classes are:

(1) Gross income which is taken into account in computing net income from foreclosure property and

(2) Other income (such as income described in subparagraph (A), (B), (C), (D), or (G) of section 856(c)(3)).

The apportionment may be made on any reasonable basis.

(e) Allocation and apportionment of interest. For purposes of determining the amount of interest attributable to the carrying of foreclosure property under paragraph (b) of this section, the following rules apply:

(1) Deductible interest. Interest is taken into account under this paragraph (e) only if it is otherwise deductible under chapter 1 of the Code.

(2) Interest specifically allocated to property. Interest that is specifically allocated to an item of property is attributable only to the carrying of that property. Interest is specifically allocated to an item of property if (i) the indebtedness on which the interest is paid or accrued is secured only by that property, (ii) such indebtedness was specifically incurred for the purpose of purchasing, constructing, maintaining, or improving that property, and (iii) the proceeds of the borrowing were applied for that purpose.

(3) Other interest. Interest which is not specifically allocated to property is apportioned between foreclosure property and other property under the principles of § 1.861–8(e)(2)(v).

(4) Effective date. The rules in this paragraph (e) are mandatory for all taxable years ending after February 6, 1981.

[T.D. 7767, 46 FR 11277, Feb. 6, 1981]

§ 1.857–4 Tax imposed by reason of the failure to meet certain source-of-income requirements.

Section 857(b)(5) imposes a tax on a real estate investment trust that is considered, by reason of section 856(c)(7), as meeting the source-of-income requirements of paragraph (2) or (3) of section 856(c) (or both such paragraphs). The amount of the tax is determined in the manner prescribed in section 857(b)(5).

[T.D. 7767, 46 FR 11278, Feb. 2, 1981]

§ 1.857–5 Net income and loss from prohibited transactions.

(a) In general. Section 857(b)(6) imposes, for each taxable year, a tax equal to 100 percent of the net income derived from prohibited transactions. A prohibited transaction is a sale or other disposition of property described in section 1221(1) that is not foreclosure property. The 100-percent tax is imposed to preclude a real estate investment trust from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development tract. In order to prevent a trust from receiving any tax benefit from such activities, a net loss from prohibited transactions effectively is disallowed in computing real estate investment trust taxable income. See § 1.857–2(a)(8). Such loss, however, does reduce the amount which a trust is required to distribute as dividends. For purposes of applying the provisions of the Code, other than those provisions of part II of subchapter M which relate to prohibited transactions, no inference is to be drawn from the fact that a type of transaction does not constitute a prohibited transaction.

(b) Special rules. In determining whether a particular transaction constitutes a prohibited transaction, the activities of a real estate investment trust with respect to foreclosure property and its sales of such property are disregarded. Also, if a real estate investment trust enters into a purchase and leaseback of real property with an option in the seller-lessee to repurchase the property at the end of the lease period, and the seller exercises the option pursuant to its terms, income from the sale generally will not be considered to be income from a prohibited transaction solely because the purchase and leaseback was entered into with an option in the seller to repurchase and because the option was exercised pursuant to its terms. Other facts and circumstances, however, may require a conclusion that the property is held primarily for sale to customers in the ordinary course of a trade or business. Gain from the sale or other disposition of property described in section 1221(1) (other than foreclosure property) that is included in gross income for a taxable year of a qualified real estate investment trust constitutes income from a prohibited transaction, even though the sale or other disposition from which the gain is derived occurred in a prior taxable year. For example, if a corporation that is a qualified real

estate investment trust for the current taxable year elected to report the income from the sale of an item of section 1221(1) property (other than foreclosure property) on the installment method of reporting income, the gain from the sale that is taken into income by the real estate investment trust for the current taxable year is income from a prohibited transaction. This result follows even though the sale occurred in a prior taxable year for which the corporation did not qualify as a real estate investment trust. On the other hand, if the gain is taken into income in a taxable year for which the taxpayer is not a qualified real estate investment trust, the 100-percent tax does not apply.

(c) **Net income or loss from prohibited transactions.** Net income or net loss from prohibited transactions is determined by aggregating all gains from the sale or other disposition of property (other than foreclosure property) described in section 1221(1) with all losses from the sale or other disposition of such property. Thus, for example, if a real estate investment trust sells two items of property described in section 1221(1) (other than foreclosure property) and recognizes a gain of $100 on the sale of one item and a loss of $40 on the sale of the second item, the net income from prohibited transactions will be $60.

[T.D. 7767, 46 FR 11278, Feb. 6, 1981]

§ 1.857–6 Method of taxation of shareholders of real estate investment trusts.

(a) **Ordinary income.** Except as otherwise provided in paragraph (b) of this section (relating to capital gains), a shareholder receiving dividends from a real estate investment trust shall include such dividends in gross income for the taxable year in which they are received. See section 858(b) and paragraph (c) of § 1.858–1 for treatment by shareholders of dividends paid by a real estate investment trust after the close of its taxable year in the case of an election under section 858(a).

(b) **Capital gains.** Under section 857(b)(3)(B), shareholders of a real estate investment trust who receive capital gain dividends (as defined in paragraph (e) of this section), in respect of the capital gains of a corporation, trust, or association for a taxable year for which it is taxable under part II of subchapter M as a real estate investment trust, shall treat such capital gain dividends as gains from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) and realized in the taxable year of the shareholder in which the dividend was received. In the case of dividends with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975, the portion of a shareholder's capital gain dividend which in his hands is gain to which section 1201(d)(1) or (2) applies is the portion so designated by the real estate investment trust pursuant to paragraph (e)(2) of this section.

(c) **Special treatment of loss on the sale or exchange of real estate investment trust stock held less than 31 days—(1) In general.** Under section 857(b)(7), if any person with respect to a share of real estate investment trust stock held for a period of less than 31 days, is required by section 857(b)(3)(B) to include in gross income as a gain from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) the amount of a capital gains dividend, then such person shall, to the extent of such amount, treat any loss on the sale or exchange of such share as a loss from the sale or exchange of a capital asset held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977).

(2) **Determination of holding period.** The rules contained in section 246(c)(3) (relating to the determination of holding periods for purposes of the deduction for dividends received) shall be applied in determining whether, for purposes of section 857(b)(7)(B) and this paragraph, a share of real estate investment trust stock has been held for a period of less than 31 days. In applying those rules, however, "30 days" shall be substituted for the number of days specified in subparagraph (B) of such section.

(3) **Illustration.** The application of section 857(b)(7) and this paragraph may be illustrated by the following example:

Example. On December 15, 1961, A purchased a share of stock in the S Real Estate Investment Trust for $20. The S trust declared a capital gains dividend of $2 per share to shareholders of record on December 31, 1961. A, therefore, received a capital gain dividend of $2 which, pursuant to section 857(b)(3)(B), he must treat as a gain from the sale or exchange of a capital asset held for more than six months. On January 5, 1962, A sold his share of stock in the S trust for $17.50, which sale resulted in a loss of $2.50. Under section 857(b)(4) and this paragraph, A must treat $2 of such loss (an amount equal to the capital gain dividend received with respect to such share of stock) as a loss from the sale or exchange of a capital asset held for more than six months.

(d) **Dividend received credit, exclusion, and deduction not allowed.** Any dividend received from

a real estate investment trust which, for the taxable year to which the dividend relates, is a qualified real estate investment trust, shall not be eligible for the dividend received credit (for dividends received on or before December 31, 1964) under section 34(a), the dividend received exclusion under section 116, or the dividend received deduction under section 243.

(e) Definition of capital gain dividend. (1)(i) A capital gain dividend, as defined in section 857(b)(3)(C), is any dividend or part thereof which is designated by a real estate investment trust as a capital gain dividend in a written notice mailed to its shareholders within the period specified in section 857(b)(3)(C) and paragraph (f) of this section. If the aggregate amount so designated with respect to the taxable year (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858) is greater than the net capital gain of the taxable year, the portion of each distribution which shall be a capital gain dividend shall be only that proportion of the amount so designated which such excess of the net long-term capital gain over the net short-term capital loss bears to the aggregate of the amount so designated. For example, a real estate investment trust making its return on the calendar year basis advised its shareholders by written notice mailed December 30, 1961, that $200,000 of a distribution of $500,000 made December 15, 1961, constituted a capital gain dividend, amounting to $2 per share. It was later discovered that an error had been made in determining the net capital gain of the taxable year and the net capital gain was $100,000 instead of $200,000. In such case, each shareholder would have received a capital gain dividend of $1 per share instead of $2 per share.

(ii) For purposes of section 857(b)(3)(C) and this paragraph, the net capital gain for a taxable year ending after October 4, 1976, is deemed not to exceed the real estate investment trust taxable income determined by taking into account the net operating loss deduction for the taxable year but not the deduction for dividends paid. See example (2) in § 1.172–5(a)(4).

(2) In the case of capital gain dividends designated with respect to any taxable year of a real estate investment trust ending after December 31, 1969, and beginning before January 1, 1975 (including capital gain dividends paid after the close of the taxable year pursuant to an election under section 858), the real estate investment trust must include in its written notice designating the capital gain dividend a statement showing the shareholder's proportionate share of such dividend which is gain described in section 1201(d)(1) and his proportionate share of such dividend which is gain described in section 1201(d)(2). In determining the portion of the capital gain dividend which, in the hands of a shareholder, is gain described in section 1201(d)(1) or (2), the real estate investment trust shall consider that capital gain dividends for a taxable year are first made from its long-term capital gains which are not described in section 1201(d)(1) or (2), to the extent thereof, and then from its long-term capital gains for such year which are described in section 1201(d)(1) or (2). A shareholder's proportionate share of gains which are described in section 1201(d)(1) is the amount which bears the same ratio to the amount paid to him as a capital gain dividend in respect of such year as (i) the aggregate amount of the trust's gains which are described in section 1201(d)(1) and paid to all shareholders bears to (ii) the aggregate amount of the capital gain dividend paid to all shareholders in respect of such year. A shareholder's proportionate share of gains which are described in section 1201(d)(2) shall be determined in a similar manner. Every real estate investment trust shall keep a record of the proportion of each capital gain divided (to which this subparagraph applies) which is gain described in section 1201(d)(1) or (2).

(f) Mailing of written notice to shareholders—(1) General rule. Except as provided in paragraph (f)(2) of this section, the written notice designating a dividend or part thereof as a capital gain dividend must be mailed to the shareholders not later than 30 days after the close of the taxable year of the real estate investment trust.

(2) Net capital gain resulting from a determination. If, as a result of a determination (as defined in section 860(e)), occurring after October 4, 1976, there is an increase in the amount by which the net capital gain exceeds the deduction for dividends paid (determined with reference to capital gains dividends only) for the taxable year, then a real estate investment trust may designate a dividend (or part thereof) as a capital gain dividend in a written notice mailed to its shareholders at any time during the 120-day period immediately following the date of the determination. The designation may be made with respect to a dividend (or part thereof) paid during the taxable year to which the determination applies (including a dividend considered as paid during the taxable year pursuant to section 858). A deficiency dividend (as defined in section 860(f)), or a part thereof, that is paid with respect to the taxable year also may be designated as a capital gain dividend by the real

estate investment trust (or by the acquiring corporation to which section 381(c)(25) applies) before the expiration of the 120-day period immediately following the determination. However, the aggregate amount of the dividends (or parts thereof) that may be designated as capital gain dividends after the date of the determination shall not exceed the amount of the increase in the excess of the net capital gain over the deduction for dividends paid (determined with reference to capital gains dividends only) that results from the determination. The date of a determination shall be established in accordance with § 1.860-2(b)(1).

[T.D. 6598, 27 FR 4088, April 28, 1962 as amended by T.D. 6777, 29 FR 17809, Dec. 16, 1964; T.D. 7337, 39 FR 44974, Dec. 30, 1974; T.D. 7728, 45 FR 72650, Nov. 3, 1980. Redesignated and amended by T.D. 7767, 46 FR 11277, 11279 and 11283, Feb. 6, 1981; T.D. 7936, 49 FR 2107, Jan. 18, 1984; T.D. 8107, 51 FR 43347, Dec. 2, 1986]

§ 1.857-7 Earnings and profits of a real estate investment trust.

(a) Any real estate investment trust whether or not such trust meets the requirements of section 857(a) and paragraph (a) of § 1.857-1 for any taxable year beginning after December 31, 1960 shall apply paragraph (b) of this section in computing its earnings and profits for such taxable year.

(b) In the determination of the earnings and profits of a real estate investment trust, section 857(d) provides that such earnings and profits for any taxable year (but not the accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year. Thus, if a trust would have had earnings and profits of $500,000 for the taxable year except for the fact that it had a net capital loss of $100,000, which amount was not deductible in determining its taxable income, its earnings and profits for that year if it is a real estate investment trust would be $500,000. If the real estate investment trust had no accumulated earnings and profits at the beginning of the taxable year, in determining its accumulated earnings and profits as of the beginning of the following taxable year, the earnings and profits for the taxable year to be considered in such computation would amount to $400,000 assuming that there had been no distribution from such earnings and profits. If distributions had been made in the taxable year in the amount of the earnings and profits then available for distribution, $500,000, the trust would have as of the beginning of the following taxable year neither accumulated earnings and profits nor a deficit in accumulated earnings and profits, and would begin such year with its paid-in capital reduced by $100,000, an amount equal to the excess of the $500,000 distributed over the $400,000 accumulated earnings and profits which would otherwise have been carried into the following taxable year. For purposes of section 857(d) and this section, if an amount equal to any net loss derived from prohibited transactions is included in real estate investment trust taxable income pursuant to section 857(b)(2)(F), that amount shall be considered to be an amount which is not allowable as a deduction in computing taxable income for the taxable year. The earnings and profits for the taxable year (but not the accumulated earnings and profits) shall not be considered to be less than (i) in the case of a taxable year ending before October 5, 1976, the amount (if any) of the net capital gain for the taxable year, or (ii) in the case of a taxable year ending after December 31, 1973, the amount (if any), of the excess of the net income from foreclosure property for the taxable year over the tax imposed thereon by section 857(b)(4)(A).

[T.D. 6598, 27 FR 4088, April 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857-8 Records to be kept by a real estate investment trust.

(a) **In general.** Under section 857(a)(2) a real estate investment trust is required to keep such records as will disclose the actual ownership of its outstanding stock. Thus, every real estate investment trust shall maintain in the internal revenue district in which it is required to file its income tax return permanent records showing the information relative to the actual owners of its stock contained in the written statements required by this section to be demanded from its shareholders. Such records shall be kept at all times available for inspection by any internal revenue officer or employee, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) **Actual owner of stock.** The actual owner of stock of a real estate investment trust is the person who is required to include in gross income in his return the dividends received on the stock. Generally, such person is the shareholder of record of the real estate investment trust. However, where the shareholder of record is not the actual owner of the stock, the stockholding record of the real estate investment trust may not disclose the actual ownership of such stock. Accordingly, the real

estate investment trust shall demand written statements from shareholders of record disclosing the actual owners of stock as required in paragraph (d) of this section.

(c) Stock ownership for personal holding company determination. For the purpose of determining under section 856(a)(6) whether a trust, claiming to be a real estate investment trust, is a personal holding company, the permanent records of the trust shall show the maximum number of shares of the trust (including the number and face value of securities convertible into stock of the trust) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the trust's taxable year, as provided in section 544.

(d) Statements to be demanded from shareholders. The information required by paragraphs (b) and (c) of this section shall be set forth in written statements which shall be demanded from shareholders of record as follows:

(1) In the case of a trust having 2,000 or more shareholders of record of its stock on any dividend record date, from each record holder of 5 percent or more of its stock; or

(2) In the case of a trust having less than 2,000 and more than 200 shareholders of record of its stock on any dividend record date, from each record holder of 1 percent or more of its stock; or

(3) In the case of a trust having 200 or less shareholders of record of its stock on any dividend record date, from each record holder of one-half of 1 percent or more of its stock.

(e) Demands for statements. The written statements from shareholders of record shall be demanded by the real estate investment trust in accordance with paragraph (d) of this section within 30 days after the close of the real estate investment trust's taxable year (or before June 1, 1962, whichever is later). When making demand for such written statements, the trust shall inform each such shareholder of his duty to submit at the time he files his income tax return (or before July 1, 1962, whichever is later) the statements which are required by § 1.857–9 if he fails or refuses to comply with such demand. A list of the persons failing or refusing to comply in whole or in part with the trust's demand for statements under this section shall be maintained as a part of the trust's records required by this section. A trust which fails to keep such records to show, to the extent required by this section, the actual ownership of its outstanding stock shall be taxable as an ordinary corporation and not as a real estate investment trust.

[T.D. 5598, 27 FR 4088, April 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857–9 Information required in returns of shareholders.

(a) In general. Any person who fails or refuses to submit to a real estate investment trust the written statements required under § 1.857–8 to be demanded by such trust from its shareholders of record shall submit at the time he files his income tax return for his taxable year which ends with, or includes, the last day of the trust's taxable year (or before July 1, 1962, whichever is later) a statement setting forth the information required by this section.

(b) Information required—(1) Shareholder of record not actual owner. In the case of any person holding shares of stock in any trust claiming to be a real estate investment trust who is not the actual owner of such stock, the name and address of each actual owner, the number of shares owned by each actual owner at any time during such person's taxable year, and the amount of dividends belonging to each actual owner.

(2) Actual owner of shares. In the case of an actual owner of shares of stock in any trust claiming to be a real estate investment trust—

(i) The name and address of each such trust, the number of shares actually owned by him at any and all times during his taxable year, and the amount of dividends from each such trust received during his taxable year;

(ii) If shares of any such trust were acquired or disposed of during such person's taxable year, the name and address of the trust, the number of shares acquired or disposed of, the dates of acquisition or disposition, and the names and addresses of the persons from whom such shares were acquired or to whom they were transferred;

(iii) If any shares of stock (including securities convertible into stock) of any such trust are also owned by any member of such person's family (as defined in section 544(a)(2)), or by any of his partners, the name and address of the trust, the names and addresses of such members of his family and his partners, and the number of shares owned by each such member of his family or partner at any and all times during such person's taxable year; and

(iv) The names and addresses of any corporation, partnership, association, or trust, in which such person had a beneficial interest of 10 percent or more at any time during his taxable year.
[T.D. 6598, 27 FR 4089, April 28, 1962, as amended by T.D. 6628, 27 FR 12794, Dec. 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.857-10 Information returns.

Nothing in §§ 1.857-8 and 1.857-9 shall be construed to relieve a real estate investment trust or its shareholders from the duty of filing information returns required by regulations prescribed under the provisions of subchapter A, chapter 61 of the Code.
[T.D. 6598, 27 FR 4089, April 28, 1962. Redesignated and amended by T.D. 7767, 46 FR 11277 and 11279, Feb. 6, 1981]

§ 1.858-1 Dividends paid by real estate investment trust after close of taxable year.

(a) General rule. Under section 858, a real estate investment trust may elect to treat certain dividends that are distributed within a specified period after the close of a taxable year as having been paid during the taxable year. The dividend is taken into account in determining the deduction for dividends paid for the taxable year in which it is treated as paid. The dividend may be an ordinary dividend or, subject to the requirements of sections 857(b)(3)(C) and 858(c), a capital gain dividend. The trust may make the dividend declaration required by section 858(a)(1) either before or after the close of the taxable year as long as the declaration is made before the time prescribed by law for filing its return for the taxable year (including the period of any extension of time granted for filing the return).

(b) Election—(1) Method of making election. The election must be made and the return filed by the trust for the taxable year. The election shall be made by treating the dividend (or portion thereof) to which the election applies as a dividend paid during the taxable year of the trust in computing its real estate investment trust taxable income and, if applicable, the alternative tax imposed by section 857(b)(3)(A). (In the case of an election with respect to a taxable year ending before October 5, 1976, if the dividend (or portion thereof) to which the election is to apply is a capital gain dividend, the trust shall treat the dividend as paid during such taxable year in computing the amount of capital gains dividends paid during the taxable year.) In the case of an election with respect to a taxable year beginning after October 4, 1976, the trust must also specify in its return (or in a statement attached to its return) the exact dollar amount that is to be treated as having been paid during the taxable year.

(2) Limitation based on earnings and profits. The election provided in section 858(a) may be made only to the extent that the earnings and profits of the taxable year (computed with the application of sections 857(d) and 1.857-7) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year. For purposes of the preceding sentence, deficiency dividends and distributions with respect to which an election has been made for a prior year under section 858(a) are disregarded in determining the total amount of distributions out of earnings and profits actually made during the taxable year. The dividend or portion thereof, with respect to which the real estate investment trust has made a valid election under section 858(a), shall be considered as paid out of the earnings and profits of the taxable year for which such election is made, and not out of the earnings and profits of the taxable year in which the distribution is actually made.

(3) Additional limitation based on amount specified. The amount treated under section 858(a) as having been paid in a taxable year beginning after October 4, 1976, cannot exceed the lesser of (i) the dollar amount specified by the trust in its return (or a statement attached thereto)in making the election or (ii) the amount allowable under the limitation prescribed in paragraph (b)(2) of this section.

(4) Irrevocability of the election. After the expiration of the time for filing the return for the taxable year for which an election is made under section 858(a), such election shall be irrevocable with respect to the dividend or portion thereof to which it applies.

(c) Receipt by shareholders. Under section 858(b), the dividend or portion thereof, with respect to which a valid election has been made, will be includable in the gross income of the shareholders of the real estate investment trust for the taxable year in which the dividend is received by them.

(d) Illustrations. The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following examples:

Example (1). The X Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar

year 1961 of $100,000. During that year the trust distributed to shareholders taxable dividends aggregating $88,000. On March 10, 1962, the trust declared a dividend of $37,000 payable to shareholders on March 20, 1962. Such dividend consisted of the first regular quarterly dividend for 1962 of $25,000 plus an additional $12,000 representing that part of the taxable income for 1961 which was not distributed in 1961. On March 15, 1962, the X Trust filed its Federal income tax return and elected therein to treat $12,000 of the total dividend of $37,000 to be paid to shareholders on March 20, 1962, as having been paid during the taxable year 1961. Assuming that the X Trust actually distributed the entire amount of the dividend of $37,000 on March 20, 1962, an amount equal to $12,000 thereof will be treated for the purposes of section 857(a) as having been paid during the taxable year 1961. Upon distribution of such dividend the trust becomes a qualified real estate investment trust for the taxable year 1961. Such amount ($12,000) will be considered by the X Trust as a distribution out of the earnings and profits for the taxable year 1961, and will be treated by the shareholders as a taxable dividend for the taxable year in which such distribution is received by them. However, assuming that the X Trust is not a qualified real estate investment trust for the calendar year 1962, nevertheless, the $12,000 portion of the dividend (paid on March 20, 1962) which the trust elected to relate to the calendar year 1961, will not qualify as a dividend for purposes of section 34, 116, or 243.

Example (2). The Y Trust, a real estate investment trust, had taxable income (and earnings and profits) for the calendar year 1964 of $100,000, and for 1965 taxable income (and earnings and profits) of $125,000. On January 1, 1964, the trust had a deficit in its earnings and profits accumulated since February 28, 1913, of $115,000. During the year 1964 the trust distributed to shareholders taxable dividends aggregating $85,000. On March 5, 1965, the trust declared a dividend of $65,000 payable to shareholders on March 31, 1965. On March 15, 1965, the Y Trust filed its Federal income tax return in which it included $40,000 of the total dividend of $65,000 payable to shareholders on March 31, 1965, as a dividend paid by it during the taxable year 1964. On March 31, 1965, the Y Trust distributed the entire amount of the dividend of $65,000 declared on March 5, 1965. The election under section 858(a) is valid only to the extent of $15,000, the amount of the undistributed earnings and profits for 1964 ($100,000 earnings and profits less $85,000 distributed during 1964). The remainder ($50,000) of the $65,000 dividend paid on March 31, 1965, could not be the subject of an election, and such amount will be regarded as a distribution by the Y Trust out of earnings and profits for the taxable year 1965. Assuming that the only other distribution by the Y Trust during 1965 was a distribution of $75,000 paid as a dividend on October 31, 1965, the total amount of the distribution of $65,000 paid on March 31, 1965, is to be treated by the shareholders as taxable dividends for the taxable year in which such dividend is received. The Y Trust will treat the amount of $15,000 as a distribution of the earnings or profits of the trust for the taxable year 1964, and the remaining $50,000 as a distribution of the earnings or profits for the year 1965. The distribution of $75,000 on October 31, 1966, is, of course, a taxable dividend out of the earnings and profits for the year 1965.

Example (3). Assume the facts are the same as in example (2), except that the taxable years involved are calendar years 1977 and 1978, and Y Trust specified in its Federal income tax return for 1977 that the dollar amount of $40,000 of the $65,000 distribution payable to shareholders on March 31, 1978, is to be treated as having been paid in 1977. The result will be the same as in example (2), since the amount of the undistributed earnings and profits for 1977 is less than the $40,000 amount specified by Y Trust in making its election. Accordingly, the election is valid only to the extent of $15,000. Y Trust will treat the amount of $15,000 as a distribution, in 1977, of earnings and profits of the trust for the taxable year 1977 and the remaining $50,000 as a distribution, in 1978, of the earnings and profits for 1978.

(e) **Notice to shareholders.** Section 858(c) provides that, in the case of dividends with respect to which a real estate investment trust has made an election under section 858(a), any notice to shareholders required under part II, subchapter M, chapter 1 of the Code, with respect to such amounts, shall be made not later than 30 days after the close of the taxable year in which the distribution is made. Thus, the notice requirement of section 857(b)(3)(C) and paragraph (f) of § 1.857–6 with respect to capital gains dividends may be satisfied with respect to amounts to which section 858(a) and this section apply if the notice relating to such amounts is mailed to the shareholders not later than 30 days after the close of the taxable year in which the distribution is made. If the notice under section 858(c) relates to an election with respect to any capital gains dividends, such capital gains dividends shall be aggregated by the real estate investment trust with the designated capital gains dividends actually paid during the taxable year to which the election applies (not including deficiency dividends or dividends with respect to which an election has been made for a prior taxable year under section 858) to determine whether the aggregate of the designated capital gains dividends with respect to such taxable year exceeds the net capital gain of the trust. See section 857(b)(3)(C) and paragraph (f) of § 1.857–6.

[T.D. 6598, 27 FR 4089, April 28, 1962, as amended by T.D. 7767, 46 FR 11279, Feb. 6, 1981]

§ 1.860–1 Deficiency dividends.

Section 860 allows a qualified investment entity to be relieved from the payment of a deficiency in (or to be allowed a credit or refund of) certain taxes. "Qualified investment entity" is defined in section 860(b). The taxes referred to are those imposed by sections 852(b)(1) and (3), 857(b)(1) or (3), the minimum tax on tax preferences imposed by section 56 and, if the entity fails the distribution requirements of section 852(a)(1)(A) or 857(a)(1) (as applicable), the corporate income tax imposed by section 11(a) or 1201(a). The method provided by section 860 is to allow an additional deduction for a dividend distribution (that meets the requirements of section 860 and § 1.860–2) in computing the deduction for dividends paid for the taxable year for which the deficiency is determined. A deficiency divided may be an ordinary

dividend or, subject to the limitations of sections 852(b)(3)(C), 857(b)(3)(C), and 860(f)(2)(B), may be a capital gain dividend.

[T.D. 7767, 46 FR 11280, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2107, Jan. 18, 1984]

§ 1.860–2 Requirements for deficiency dividends.

(a) In general—(1) Determination, etc. A qualified investment entity is allowed a deduction for a deficiency divided only if there is a determination (as defined in section 860(e) and paragraph (b)(1) of this section) that results in an adjustment (as defined in section 860(d)(1) or (2)) for the taxable year for which the deficiency dividend is paid. An adjustment does not include an increase in the excess of (i) the taxpayer's interest income excludable from gross income under section 103(a) over (ii) its deductions disallowed under sections 265 and 171(a)(2).

(2) Payment date and claim. The deficiency dividend must be paid on, or within 90 days after, the date of the determination and before the filing of a claim under section 860(g) and paragraph (b)(2) of this section. This claim must be filed within 120 days after the date of the determination.

(3) Nature and amount of distribution. (i) The deficiency dividend must be a distribution of property (including money) that would have been properly taken into account in computing the dividends paid deduction under section 561 for the taxable year for which tax liability resulting from the determination exists if the property had been distributed during that year. Thus, if the distribution would have been a dividend under section 316(a) if it had been made during the taxable year for which the determination applies, and the distribution may qualify under sections 316(b)(3), 562(a), and 860(f)(1), even though the distributing corporation, trust, or association has no current or accumulated earnings and profits for the taxable year in which the distribution is actually made. The amount of the distribution is determined under section 301 as of the date of the distribution.

The amount of the deduction is subject to the applicable limitations under sections 562 and 860(f)(2). Thus, if the entity distributes to an individual shareholder property (other than money) which on the date of the distribution has a fair market value in excess of its adjusted basis in the hands of the entity, the amount of the deficiency dividend in the individual's hands for purposes of section 316(b)(3) is determined by using the property's fair market value on that date. Nevertheless, the amount of the deficiency dividend the entity may deduct is limited, under § 1.562–1(a), to the adjusted basis of the property and the amount taxable to the individual as a dividend is determined by reference to the current and accumulated earnings and profits for the year to which the determination applies.

(ii) The qualified investment entity does not have to distribute the full amount of the adjustment in order to pay a deficiency dividend. For example, assume that in 1983 a determination with respect to a calendar year regulated investment company results in an increase of $100 in investment company taxable income (computed without the dividends paid deduction) for 1981 and no other change. The regulated investment company may choose to pay a deficiency dividend of $100 or of any lesser amount and be allowed a dividends paid deduction for 1981 for the amount of that deficiency dividend.

(4) Status of distributor. The corporation, trust, or association that pays the deficiency dividend does not have to be a qualified investment entity at the time of payment.

(5) Certain definitions to apply. For purposes of sections 860(d) (defining adjustment) and (f)(2) (limitations) the definitions of the terms "investment company taxable income," "real estate investment trust taxable income," and "capital gains dividends" in sections 852(b)(2), 857(b)(2), 852(b)(3)(C), and 857(b)(3)(C) apply, as appropriate to the particular entity.

(b) Determination and claim for deduction—(1) Determination. For purposes of applying section 860(e), the following rules apply:

(i) The date of determination by a decision of the United States Tax Court, the date upon which a judgment of a court becomes final, and the date of determination by a closing agreement shall be determined under the rules in § 1.547–2(b)(1)(ii), (iii), and (iv).

(ii) A determination under section 860(e)(3) may be made by an agreement signed by the district director or another official to whom authority to sign the agreement is delegated, and by or on behalf of the taxpayer. The agreement shall set forth the amount, if any, of each adjustment described in subparagraphs (A), (B), and (C) of section 860(d)(1) or (2) (as appropriate) for the taxable year and the amount of the liability for any tax imposed by section 11(a), 56(a), 852(b)(1), 852(b)(3)(A), 857(b)(1), 857(b)(3)(A), or 1201(a) for the taxable year. The agreement shall also set

forth the amount of the limitation (determined under section 860(f)(2)) on the amount of deficiency dividends that can qualify as capital gain dividends and ordinary dividends, respectively, for the taxable year. An agreement under this subdivision (ii) which is signed by the district director (or other delegate) shall be sent to the taxpayer at its last known address by either registered or certified mail. If registered mail is used, the date of registration is the date of determination. If certified mail is used, the date of the postmark on the sender's receipt is the date of determination. However, if a dividend is paid by the taxpayer before the registration or postmark date, but on or after the date the agreement is signed by the district director (or other delegate), the date of determination is the date of signing.

(2) **Claim for deduction.** A claim for deduction for a deficiency dividend shall be made, with the requisite declaration, on Form 976 and shall contain the following information and have the following attachments:

(i) The name, address, and taxpayer identification number of the corporation, trust, or association;

(ii) The amount of the deficiency and the taxable year or years involved;

(iii) The amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof;

(iv) A statement as to how the deficiency was established (i.e., by an agreement under section 860(e)(3), by a closing agreement under section 7121, or by a decision of the Tax Court or court judgment);

(v) Any date or other information with respect to the determination that is required by Form 976;

(vi) The amount and date of payment of the dividend with respect to which the claim for the deduction for deficiency dividends is filed;

(vii) The amount claimed as a deduction for deficiency dividends;

(viii) If the amount claimed as a deduction for deficiency dividends includes any amount designated (or to be designated) as capital gain dividends, the amount of capital gain dividends for which a deficiency dividend deduction is claimed;

(ix) Any other information required by the claim form;

(x) A certified copy of the resolution of the trustees, directors, or other authority authorizing the payment of the dividend with respect to which the claim is filed; and

(xi) A copy of any court decision, judgment, agreement, or other document required by Form 976.

(3) **Filing claim.** The claim, together with the accompanying documents, shall be filed with the district director, or director of the internal revenue service center, with whom the income tax return for the taxable year for which the determination applies was filed. In the event that the determination is an agreement with the district director (or other delegate) described in section 860(e)(3) and paragraph (b)(1)(ii) of this section, the claim may be filed with the district director with whom (or pursuant to whose delegation) the agreement was made.

[T.D. 7767, 46 FR 11280, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2107, Jan. 18, 1984; 49 FR 3177, Jan. 26, 1984]

§ 1.860–3 Interest and additions to tax.

(a) *In general.* If a qualified investment entity is allowed a deduction for deficiency dividends with respect to a taxable year, under section 860(c)(1) the tax imposed on the entity by chapter 1 of the Code (computed by taking into account the deduction) for that year is deemed to be increased by the amount of the deduction. This deemed increase in tax, however, applies solely for purposes of determining the liability of the entity for interest under subchapter A of chapter 67 of the Code and for additions to tax and additional amounts under chapter 68 of the Code. For purposes of applying subchapter A of chapter 67 and chapter 68, the last date prescribed for payment of the deemed increase in tax is considered to be the last date prescribed for the payment of tax (determined in the manner provided in section 6601(b)) for the taxable year for which the deduction for deficiency dividends is allowed. The deemed increase in tax is considered to be paid as of the date that the claim for the deficiency dividend deduction described in section 860(g) is filed.

(b) **Overpayments of tax.** If a qualified investment entity is entitled to a credit or refund of an overpayment of the tax imposed by chapter 1 of the Code for the taxable year for which the deficiency dividend deduction is allowed, then, for purposes of computing interest, additions to tax, and additional amounts, the payment (or payments) that result in the overpayment and that precede the filing of the claim described in section 860(g) will be applied against and reduce the

increase in tax that is deemed to occur under section 860(c)(1).

(c) **Examples.** This section is illustrated by the following examples:

Example (1). Corporation X is a real estate investment trust that files its income tax return on a calendar year basis. X receives an extension of time until June 15, 1978, to file its 1977 income tax return and files the return on May 15, 1978. X does not elect to pay any tax due in installments. For 1977, X reports real estate investment trust taxable income (computed without the dividends paid deduction) of $100, a dividends paid deduction of $100, and no tax liability. Following an examination of X's 1977 return, the district director and X enter into an agreement which is a determination under section 860(e)(3). The determination is dated November 1, 1979, and increases X's real estate investment trust taxable income (computed without the dividends paid deduction) by $20 to $120. Thus, taking into account the $100 of dividends paid in 1977, X has undistributed real estate investment trust taxable income of $20 as a result of the determination. X pays a dividend of $20 on November 10, 1979, files a claim for a deficiency dividend deduction of this $20 pursuant to section 860(g) on November 15, 1979, and is allowed a deficiency dividend deduction of $20 for 1977. After taking into account this deduction, X has no real estate investment trust taxable income and meets the distribution requirements of section 857(a)(1). However, for purposes of section 6601 (relating to interest on underpayment of tax), the tax imposed by chapter 1 of the Code on X for 1977 is deemed increased by this $20, and the last date prescribed for payment of the tax is March 15, 1978 (the due date of the 1977 return determined without any extension of time). The tax of $20 is deemed paid on November 15, 1979, the date the claim for the deficiency dividend deduction is filed. Thus, X is liable for interest on $20, at the rate established under section 6621, for the period from March 15, 1978, to November 15, 1979. Also, for purposes of determining whether X is liable for any addition to tax or additional amount imposed by chapter 68 of the Code (including the penalty prescribed by section 6697), the amount of tax imposed on X by chapter 1 of the Code is deemed to be increased by $20 (the amount of the deficiency dividend deduction allowed), the last date prescribed for payment of such tax is March 15, 1978, and the tax of $20 is deemed to be paid on November 15, 1979. X, however, is not subject to interest and penalties for the amount of any tax for which it would have been liable under section 11(a), 56(a), 1201(a), or 857(b) had it not been allowed the $20 deduction for deficiency dividends.

Example (2). Assume the facts are the same as in example (1) except that the district director, upon examining X's income tax return, asserts an income tax deficiency of $4, based on an asserted increase of $10 in real estate investment trust taxable income, and no agreement is entered into between the parties. X pays the $4 on June 1, 1979, and files suit for refund in the United States District Court. The District Court, in a decision which becomes final on November 1, 1980, holds that X did fail to report $10 of real estate investment trust taxable income and is not entitled to any refund. (No other item of income or deduction is in issue.) X pays a dividend of $10 on November 10, 1980, files a claim for a deficiency dividend deduction of this $10 on November 15, 1980, and is allowed a deficiency dividend deduction of $10 for 1977. Assume further that $4 is refunded to X on December 31, 1980, as the result of the $10 deficiency dividend deduction being allowed. Also assume that any assessable penalties, additional amounts, and additions to tax (including the penalty imposed by section 6697) for which X is liable are paid within 10 days of notice and demand, so that no interest is imposed on such penalties, etc. X's liability for interest for the period March 15, 1978, to June 1, 1979, is determined with respect to $10 (the amount of the deficiency dividend deduction allowed). X's liability for interest for the period June 1, 1979, to November 15, 1980, is determined with respect to $6, i.e., $10 minus the $4 payment. X is entitled to interest on the $4 overpayment for the period described in section 6611(b)(2), beginning on November 15, 1980.

[T.D. 7767, 46 FR 11281, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2108, Jan. 18, 1984]

§ 1.860–4 Claim for credit or refund.

If the allowance of a deduction for a deficiency dividend results in an overpayment of tax, the taxpayer, in order to secure credit or refund of the overpayment, must file a claim on Form 1120X in addition to the claim for the deficiency dividend deduction required under section 860(g). The credit or refund will be allowed as if on the date of the determination (as defined in section 860(e)) two years remained before the expiration of the period of limitations on the filing of claim for refund for the taxable year to which the overpayment relates.

[T.D. 7767, 46 FR 11282, Feb. 6, 1981, as amended by T.D. 7936, 49 FR 2109, Jan. 18, 1984]

§ 1.860–5 Effective date.

(a) **In general.** Section 860 and §§ 1.860–1 through 1.860–4 apply with respect to determinations after November 6, 1978.

(b) **Prior determination of real estate investments trusts.** Section 859 (as in effect before the enactment of the Revenue Act of 1978) applies to determinations with respect to real estate investment trusts occurring after October 4, 1976, and before November 7, 1978. In the case of such a determination, the rules in §§ 1.860–1 through 1.860–4 apply, a reference in this chapter 1 to section 860 (or to a particular provision of section 860) shall be considered to be a reference to section 859 (or to the corresponding substantive provision of section 859), as in effect before enactment of the Revenue Act of 1978, and "qualified investment entity" in §§ 1.381(c)25–1(a) and 1.860–1 through 1.860–3 means a real estate investment trust.

[T.D. 7936, 49 FR 2109, Jan. 18, 1984]

§ 1.860D–1T Election to be treated as a real estate mortgage investment conduit (temporary).

(a) **In general.** An entity, or a segregated pool of assets within an entity, shall elect to be treated as a REMIC by complying with the requirements of paragraph (b) of this section and computing tax-

able income as a REMIC on its return (as prescribed in §1.860F-4T(b)) for the first taxable year of its existence. Once made, this election is irrevocable for that taxable year and all succeeding taxable years.

(b) Required information. When electing to be treated as a REMIC, the entity, or segregated pool of assets within an entity, shall provide either on its return or in a separate statement attached to its return—

(1) The REMIC's employer identification number, which shall not be the same as the identification number of any other entity,

(2) Information concerning the terms and conditions of the regular interests and the designated residual interest of the REMIC, or a copy of the offering circular or prospectus containing such information,

(3) A description of the prepayment and reinvestment assumptions that are made pursuant to section 1272(a)(6) and the regulations thereunder, including a statement supporting the selection of the prepayment assumption,

(4) The form of the electing entity under State law or, if an election is being made with respect to a segregated pool of assets within an entity, the form of that latter entity under State law, and

(5) Such other information as the Commissioner may by form or revenue procedure require.

(c) Determination of status. An entity, or segregated pool of assets within an entity, that elects to be a REMIC shall keep sufficient records as to investments and other assets to be able to show that it has complied with the provisions of sections 860A through 860G and the regulations thereunder during each taxable year.

[T.D. 8186, 53 FR 7510, March 9, 1988]

§ 1.860F–4T REMIC reporting requirements and other administrative rules (temporary).

(a) In general. For purposes of Subtitle F of the Code, a REMIC shall be treated as a partnership and any holder of a residual interest in the REMIC shall be treated as a partner. A REMIC shall not be subject, however, to the rules of Subchapter C of Chapter 63 of Subtitle F, relating to the treatment of partnership items, for a taxable year, if there is at no time during the taxable year more than one holder of a REMIC residual interest.

(b) REMIC tax return—(1) Return of income. To satisfy the requirement under section 6031 to make a return of income for each taxable year, a REMIC shall file the return required by paragraph (b)(2) of this section. The due date and any extensions for filing the REMIC's annual return shall be determined as if the REMIC were a partnership.

(2) Income tax return. Because a REMIC, unlike a partnership, may be liable for taxes imposed under Subtitle A of the Code (for example, the tax imposed under section 860F(a) on net income from prohibited transactions), the REMIC shall make a return, as required by section 6011(a), for each taxable year on Form 1066, U.S. Real Estate Mortgage Investment Conduit Income Tax Return. The return shall include—

(i) The amount of principal outstanding on each class of regular interests as of the close of the taxable year,

(ii) The amount of the daily accruals determined under section 860E(c),

(iii) The REMIC's employer identification number, and

(iv) Such other information as the Commissioner may by form or revenue procedure require.

(c) Signing of REMIC return. For purposes of section 6063, a REMIC's income tax return for any taxable year may be signed by any one of the holders of a residual interest during that taxable year or, as provided in section 6903, by a fiduciary as defined in section 7701(a)(6) who is acting for the REMIC and who has furnished adequate notice in the manner prescribed in § 301.6903-1(b).

(d) Designation of tax matters person. A REMIC may designate a tax matters person in the same manner in which a partnership may designate a tax matters partner under § 301.6231(a)(7)-1T. For purposes of applying that section, all holders of a residual interest in the REMIC are treated as general partners.

(e) Notice to holders of residual interests—(1) Information required—(i) In general. At the close of each calendar quarter, a REMIC shall provide to each person who held a residual interest in the REMIC during that quarter notice on Schedule Q (Form 1066) of all the information required by the form and the information required by paragraphs (e) (1) (i) (A) Through (F) of this section.

(A) The REMIC shall provide to a residual interest holder that person's share of the taxable income or net loss of the REMIC for the calendar quarter.

(B) The REMIC shall provide to a residual interest holder the amount of the excess inclusion (as defined in section 860E and the regulations thereunder), if any, with respect to that person's residual interest for the calendar quarter.

(C) If the holder of a residual interest is also a pass-through interest holder (as defined in § 1.67-3T (a) (2)), the REMIC shall provide to that holder the allocable investment expenses (as defined in § 1.67-3T (a) (3)) for the calendar quarter.

(D) For calendar quarters after 1987, if the percentage of the REMIC's assets, computed on the basis of the average fair market value of the assets held during the calendar quarter (as described in paragraph (e) (1) (ii) (A) of this section), represented by each of the following categories:

(1) Qualifying real property loans under section 593,

(2) Assets of a domestic building and loan association (as described in section 7701 (a) (19)), and

(3) Real estate assets as defined in paragraph (e) (1) (ii) (C) of this section,

is at least 95 percent, the REMIC shall provide a statement for each category for which the REMIC met this test, specifying that at least 95 percent of the REMIC's assets were represented by that category. If the REMIC fails to meet the 95 percent test for any category, the percentage of the REMIC's assets represented by that category shall be provided.

(E) For calendar quarters after 1987, if less than 95 percent of the assets of the REMIC are real estate assets (as defined in paragraph (e) (1) (ii) (C) of this section), the REMIC shall also provide to any real estate investment trust (REIT) that holds a residual interest the following information:

(1) The percentage of the REMIC's assets described in section 856 (c) (5) (A), excluding from real estate assets any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, computed on the bases of the average fair market value of the assets of the REMIC during the calendar quarter (as described in paragraph (e) (1) (ii) (A) of this section), and

(2) The percentage of the REMIC's gross income (as defined in paragraph (e) (1) (ii) (B) of this section) described in section 856 (c) (3) (A) through (F), computed as of the close of the calendar quarter. For purposes of this paragraph, the term "foreclosure property" contained in section 856 (c) (3) (F) shall have the meaning specified in section 860G (a) (8).

In determining whether a REIT satisfies the limitations of section 856 (c) (2), all gross income shall be deemed to be derived from a source specified in section 856 (c) (2).

(F) For calendar quarters in 1987, the percentages of assets required in paragraph (e) (1) (i) (D) and (E) of this section may be computed on the basis of the fair market value of the assets of the REMIC as of the close of the calendar quarter, instead of on the basis of the average during the calendar quarter.

(ii) **Special provisions.** For purposes of this paragraph (e) (1) (ii) and paragraph (e) (1) (i) (D), (E), and (F) of this section:

(A) The average fair market value of the assets during each calendar quarter is determined by making the appropriate computation as of the close of each month, week, or day, and by using the quarterly average of the monthly, weekly or daily percentages. The monthly, weekly, or daily computation period shall be applied uniformly during the calendar quarter to all categories of assets and gross income, and may not be changed in succeeding calendar quarters without the consent of the Commissioner.

(B) Gross income shall mean gross income excluding gross income from prohibited transactions defined in section 860F (a) (2).

(C) Real estate assets shall mean real estate assets and defined in section 856 (c) (6) (B) excluding any property (not otherwise a real estate asset) attributable to the temporary investment of new capital.

(2) **Quarterly notice required—(i) In general.** Schedule Q shall be mailed (or otherwise delivered) to each holder of a residual interest during a calendar quarter no later than the last day of the month following the close of the calendar quarter.

(ii) **Special rule for 1987.** Notice to any holder of a REMIC residual interest of the information required in paragraph (e) (1) of this section for any of the four calendar quarters of 1987 shall be mailed (or otherwise delivered) to each holder no later than March 28, 1988.

(3) **Nominee reporting—(i) In general.** If a REMIC is required under paragraphs (e) (1) and (2) of this section to provide notice to an interest holder who is a nominee of another person with

respect to an interest in the REMIC, the nominee shall furnish such notice to the actual owner or owners.

(ii) Time for furnishing statement. Under paragraph (e) (3) (i) of this section, the nominee shall furnish the required notice to the actual owner or owners of a REMIC interest no later than 30 days after receiving such information.

(4) Reports to the Internal Revenue Service. A copy of Schedule Q for each person who was a residual interest holder at any time during a REMIC's taxable year and for each quarter in which that person was a residual interest holder shall be attached to the REMIC's income tax return for that taxable year. Quarterly notice to the Internal Revenue Service is not required.

[T.D. 8186, 53 FR 7510, March 9, 1988]

INDEX
FEDERAL TAX REGULATIONS UNDER I.R.C. 1986

SEE VOLUME 4

END OF VOLUME